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Alert Memo

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SEC Proposes Revisions to Remove Credit Ratings from Certain Securities Act and Exchange Act Rules and Forms

The Securities and Exchange Commission (the "SEC") has proposed revisions to certain of its rules and forms, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

In 2008, the SEC first proposed sweeping amendments to remove references to credit ratings from its rules and forms. That proposal was prompted by perceptions that over-reliance on credit ratings by market participants had contributed to the financial crisis (and especially the turmoil in the subprime mortgage market) and concern that the use of ratings in SEC rules and forms appeared to give them an official imprimatur.

The comments on the 2008 proposal generally urged the SEC to retain many of the references to credit ratings in its rules and forms as useful and appropriate. In September 2009, the SEC adopted a small number of its proposed rule amendments and sought further comments on the more controversial of its 2008 proposals, including those affecting Regulation M, the broker-dealer net capital rule, and eligibility for short-form securities registration and shelf offerings. Once more, the comments generally opposed the proposed changes, and the SEC did not take further action.

Dodd-Frank became law in July of 2010. Section 939A of Dodd-Frank requires each Federal agency to review its regulations and "remove any reference to or requirement of reliance on credit ratings" and substitute alternative standards of credit-worthiness. In their statements at the meeting, the SEC Commissioners made clear that in light of the Dodd-Frank mandate, they no longer feel they have the discretion to leave credit rating references in their rules, and so will once again be proposing non-ratings-based criteria to substitute for the credit ratings currently referred to in their rules and forms. The proposals described in this memorandum are the first in a series of proposals that will focus on different sets of SEC rules. The current proposals concern revisions to a handful of rules and forms under the Securities Act of 1933 (the "Securities Act") and to Schedule 14A under the Securities Exchange Act of 1934 (the "Exchange Act") and are substantially similar to the SEC's 2008 proposals with respect to these provisions.

Although the SEC is re-proposing the same changes they had previously proposed, they recognize that these revisions would exclude certain investment-grade issuers from favorable treatment that they are currently entitled to under the existing rules and forms, and

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the SEC specifically requests suggestions for alternative or additional criteria that would permit such issuers to continue to be eligible for such treatment. The comment period for the proposed changes closes on March 28, 2011.

Rules Proposed to be Changed

The credit rating references that this proposal seeks to modify are found in the following SEC rules and forms:

- Securities Act Forms S-3 and F-3, which contain various requirements that must be met for an issuer of securities to qualify to register its securities on those forms.
  - The principal benefits of registering securities on these forms is the ability to incorporate by reference into the registration statement information that the issuer has filed with the SEC under the Exchange Act ("short-form registration") and the ability to offer securities on a delayed or continuous basis after the registration statement is declared effective ("shelf registration").
  - Currently, Forms S-3 and F-3 can be used by otherwise qualified issuers to make primary offerings of non-convertible securities that are rated investment grade by at least one nationally recognized statistical rating organization ("NRSRO").[1]
- Securities Act Forms S-4 and F-4, which are used primarily to register securities issued in merger transactions. As currently in effect, these forms permit issuers to incorporate information by reference if they meet the registrant requirements of Form S-3 or F-3 and are registering non-convertible investment grade debt or preferred equity securities.
- Exchange Act Schedule 14A, which is the form used for proxy statements, similarly permits incorporation by reference if the proxy statement is being used to solicit action in respect of non-convertible investment grade debt or preferred equity securities.
- Securities Act Rule 134, which provides a "safe harbor" for certain communications that are made in connection with an offering of securities. Rule 134 provides that communications that include only enumerated types of information will not be deemed a "prospectus" or "free writing prospectus" under the Securities Act. One of the currently permitted items is credit ratings assigned or expected to be assigned by an NRSRO to the applicable securities. The SEC proposes to remove this from the

[1] Forms S-3 and F-3 are also permitted to be used by registrants that satisfy certain other criteria. For example, registrants whose common equity held by non-affiliates (i.e., market float) has a market value of at least $75 million may use S-3 or F-3 for offerings of any security (including common equity and convertible securities) regardless of rating.

list of permitted items. Although the Rule 134 safe harbor seems less clearly implicated by the Dodd-Frank mandate than the other provisions the SEC is proposing to revise (because unlike the other provisions, it does not set a minimum level of credit ratings and then grant more favorable treatment to issuers that have obtained that rating level, but merely permits, free of gun-jumping risk, disclosure of a rating if there is one, whatever it may be), the SEC states its belief that "providing a safe harbor that explicitly permits the presence of credit ratings assigned by an NRSRO is not consistent with the purposes of [Dodd-Frank]."

  - The SEC notes that removing credit rating references from the Rule 134 safe harbor "would not necessarily result in a communication that included this information being deemed to be a prospectus or a free writing prospectus." However, the result would be that the entire communication would then lose the safe harbor's protection and need to be evaluated under the necessarily more uncertain facts-and-circumstances criteria. Given the risks of such an exercise, especially in light of the relatively extensive and detailed offering-related information that a Rule 134 press release could otherwise contain, issuers and underwriters may well decide simply to exclude rating information from deal-related press releases.

- Rules 138, 139 and 168 under the Securities Act provide that certain communications (by a broker or dealer in the case of Rules 138 and 139 and by an issuer in the case of Rule 168) are not deemed to constitute an offer to sell a security if the related security is a non-convertible investment grade security.

Substituting Minimum Registered Debt Issuance for the "Investment Grade" Standard

The SEC has proposed to replace each of the qualifications in Forms S-3, F-3, S-4, F-4, Rules 138, 139 and 168 and Schedule 14A that currently require investment grade ratings with a qualification that will be met if the registrant has issued at least $1 billion of non-convertible, SEC-registered securities (other than common equity) for cash during the prior three years, as measured within 60 days of the date it files the registration or proxy statement (or, in the case of Rules 138, 139 and 168, when it seeks to rely on the rule's safe harbor).

- The standards used to determine whether the $1 billion threshold is met would be the same as those used in the similar current test for "well known seasoned issuer" status, including:
  - Securities issued in registered exchange offers -- including "A/B exchange offers" of registered securities for identical securities previously sold under Rule 144A -- would not count toward the $1 billion requirement;

  - Parent companies could count the amount of qualifying securities issued by majority-owned subsidiaries if the parent has guaranteed those securities; and

  - The calculation counts the par amount of debt and for preferred stock, the greater of liquidation preference or par.

- The SEC's proposing release notes that "the legislative history does not indicate that Congress intended to change the types of issuers and offerings that could rely on the Commission's forms," and so although they are compelled by Dodd-Frank to remove the references to investment-grade ratings, the SEC requests comments on what alternative standards could be used that would not render issuers that are currently able to use Form S-3 or F-3 or to incorporate by reference into Form S-4 or F-4 or Schedule 14A suddenly ineligible to do so.

  - The SEC estimates that 45 issuers that were eligible to use Form S-3 or F-3 between January 1, 2006 and August 15, 2008 <u>and</u> that actually made a registered offering during that period would be rendered ineligible to use those forms by the SEC's proposed change, including 29 utility companies, five issuers of certain types of insurance contracts and six operating partnership subsidiaries of REITS. Presumably the number of issuers that had effective registration statements on those forms (or were eligible to register on them) but did not happen to conduct a registered offering during that period is greater.

  - The SEC's proposed changes would, on the other hand, permit issuers of substantial amounts of non-investment grade debt that do not qualify for Form S-3 or F-3 currently to use those forms going forward. The SEC estimates that eight such issuers would be made newly eligible by their proposed changes.

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Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Capital Markets in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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