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Use of Credit Ratings in SEC Rules and Forms

SEC Proposes to Remove References to Credit Ratings in a Number of Rules and Forms

SUMMARY

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires each federal agency to modify its regulations to replace references to credit ratings with alternative standards of credit-worthiness. To implement this requirement, the SEC has proposed the first of several intended sets of amendments to its rules and forms.

These proposals focus on eligibility requirements for the use of short-form registration statements in conducting offerings of non-convertible debt and preferred stock, including shelf offerings. The provision that currently permits the use of Form S-3 or F-3 for offerings of investment grade securities would be modified to instead require the issuer to have issued at least $1 billion in registered non-convertible securities (other than common equity) in primary offerings for cash during the prior three years. This test, which is similar to an SEC proposal released in 2008, would align this eligibility requirement for short-form registration with one of the prongs of the definition of "well known seasoned issuer" ("WKSI"). The proposals would similarly modify provisions of certain SEC rules and forms that incorporate this Form S-3 or F-3 eligibility criterion, including provisions that permit incorporation by reference in Forms S-4 and F-4 and Schedule 14A, and rules that provide safe harbors for research and certain other communications during the offering process. The proposals would also eliminate Form F-9, which is available for investment grade offerings by certain Canadian issuers. The proposals do not address eligibility requirements for offerings of asset-backed securities. Comments are due on the proposed amendments by March 28, 2011.

DISCUSSION

In July 2008, the SEC proposed a series of amendments to remove references to credit ratings from its rules and forms, citing a belief that the proposals "could reduce undue reliance on ratings and result in improvements in the analysis that underlies investment decisions."[1] In October 2009, the SEC adopted some of those amendments and reopened the comment period with respect to others.[2] Section 939A of the Dodd-Frank Act requires each federal agency to assess its regulations and ultimately replace references to credit ratings with alternative standards of credit-worthiness. Pursuant to this statutory requirement, the SEC has issued the current proposals,[3] which are substantially similar to those originally issued in 2008.

A. FORMS S-3 AND F-3

Forms S-3 and F-3 permit eligible issuers to incorporate certain information by reference to satisfy offering disclosure requirements under the Securities Act. In addition, issuers that are eligible to use these short forms may also register securities "on the shelf" under Securities Act Rule 415, thereby allowing offerings to be conducted on a delayed or continuous basis.

To be eligible to use Form S-3 or F-3, an issuer must meet certain issuer-specific criteria. For example, the issuer must have timely filed its Exchange Act reports during the prior twelve months, and the issuer must not have defaulted on a debt payment since the end of the most recent fiscal year for which certified financials are available.[4] In addition, to be registered on Form S-3 or F-3, the offering itself must meet at least one of the form's transaction-specific eligibility criteria. One of these criteria currently permits the use of the short form for a primary offering of non-convertible securities that are rated "investment grade" by at least one nationally recognized statistical rating organization ("NRSRO").[5]

The proposed amendments would replace this transaction-specific eligibility requirement with a requirement that the issuer have previously issued at least $1 billion of non-convertible securities (other than common equity) in registered primary offerings for cash over the prior three years, as measured from a date within 60 days of the filing of the registration statement. This requirement is derived from paragraph (1)(i)(B)(1) of the Rule 405 definition of WKSI, which permits an issuer to qualify as a WKSI if (among other things) it has met this offering threshold test.[6] The SEC notes in the proposing release its belief, also reflected in its approach with WKSIs, that the $1 billion offering requirement "would generally correspond with a wide following in the marketplace" and information about the issuer being readily available, such that it would be appropriate to permit the issuer to use short forms for securities offerings and to conduct delayed offerings off the shelf.

The SEC anticipates that the proposed change in short-form eligibility criteria would result in some high-yield issuers becoming eligible to use Form S-3 or F-3 for the first time. On the other hand, some issuers that currently rely on the investment grade eligibility criterion would lose their eligibility to use these forms.

Comments received in response to the 2008 proposal specifically noted that utility companies, issuers of insurance contracts and real estate investment trusts may be particularly affected by the proposed change, as a number of these entities would not be able to meet the $1 billion prior offering threshold or any other transaction-specific eligibility criteria.

The SEC states that the legislative history of the Dodd-Frank Act does not indicate an intent by Congress to change the types of issuers and offerings that could rely on certain forms. Consequently, much of the SEC's extensive request for comment on this proposal centers on how to avoid such a result. Potential alternatives identified by the SEC include replacing the investment grade criterion with alternate criteria that more closely replicate key characteristics of investment grade securities, or creating special eligibility criteria or grandfather status for issuers that would otherwise lose their short-form eligibility as a result of the new rules. The SEC's request for comment also includes questions on whether the $1 billion offering threshold and 3-year time horizon are generally appropriate, whether alternative criteria such as the amount of outstanding securities or average daily trading volume should be considered, whether there should be special considerations for foreign private issuers under Form F-3, for other classes of issuers such as rate-regulated utilities or insurance companies, and many other issues. In particular, in the proposal the SEC declined to give issuers credit toward the threshold for the value of securities sold in Rule 144A offerings that are followed by *Exxon Capital*[7] or A/B registered exchange offers of substantially identical securities. The release specifically requests comment on this point as well.

B. OTHER SEC RULES AND FORMS INCORPORATING THE ELIGIBILITY CRITERIA IN FORMS S-3 AND F-3

Certain other SEC rules and forms specifically refer to the "investment grade" criterion of General Instruction I.B.2 to Form S-3 or F-3 as part of their own eligibility requirements. Under the proposed amendments, these rules and forms would instead refer more generally to General Instruction I.B.2 (*i.e.*, the "investment grade" reference would be eliminated) and would thus similarly incorporate the new $1 billion prior offering requirement.

1. Forms S-4 and F-4 and Schedule 14A

Forms S-4 and F-4 are used to register securities in connection with business combinations or exchange offers. A registrant may incorporate by reference certain information required by these forms if, among other things, the offered securities are non-convertible debt or preferred securities that meet the "investment grade" eligibility criterion of General Instruction I.B.2 to Form S-3 or F-3. Similarly, a registrant may incorporate by reference certain information in its Schedule 14A proxy statement if, among other things, action is to be taken as described in Items 11, 12 or 14 of Schedule 14A concerning non-convertible debt or preferred securities that meet the "investment grade" eligibility criterion of General Instruction I.B.2 to Form S-3. These items of Schedule 14A discuss solicitations related to the

authorization, issuance, modification or exchange of securities, as well as solicitations related to mergers, consolidations, acquisitions and similar matters.[8]

The proposed amendments would replace the above references to the "investment grade" eligibility criterion of General Instruction I.B.2 to Form S-3 or Form F-3 with more general references to General Instruction I.B.2. Consequently, a registrant that wishes to incorporate information by reference in Form S-4 or F-4 or Schedule 14A as described above would not be able to rely on the relevant securities being rated investment grade and instead would be required to either meet the $1 billion prior offering threshold or meet one of the other transaction-related criteria permitted by those forms or schedule.

2. Securities Act Rules 138, 139 and 168

Securities Act Rules 138, 139 and 168 provide safe harbors for certain communications made during the offering process, deeming those communications not to be an offer to sell a security under the Securities Act. Rules 138 and 139 concern the publication of research by brokers and dealers. Rule 168 is a safe harbor for factual business information and forward-looking information released or disseminated as provided in the rule. Each of these rules extends the safe harbor to communications relating to certain offerings of non-convertible securities that meet the "investment grade" test.

In each case, as with Forms S-4 and F-4 and Schedule 14A, the reference to "investment grade" securities meeting the criterion of General Instruction I.B.2 to Form S-3 or F-3 would be replaced with a general reference to General Instruction I.B.2 itself. Consequently, brokers, dealers and issuers that previously relied on the investment grade rating of offered securities to qualify for the safe harbor would need to ensure that the relevant issuer either meets the new $1 billion prior offering threshold or qualifies under the $75 million aggregate market value requirement of General Instruction I.B.1, which would continue to be available as an alternative.

C. REFERENCES TO CREDIT RATINGS IN OTHER SECURITIES ACT RULES AND FORMS

1. Securities Act Rule 134(a)(17)

Securities Act Rule 134 provides a safe harbor for certain communications that are deemed not to be a prospectus or free writing prospectus. Rule 134(a)(17) permits such safe harbor communications to include disclosure of security ratings assigned or reasonably expected to be assigned by an NRSRO. The SEC's proposals would remove such disclosures from the safe harbor. Although it considered instead extending the safe harbor to disclosure of ratings assigned by all credit rating agencies (as originally proposed in 2008), the SEC states that "such an approach without any limiting principle would not be consistent with the otherwise limited disclosures covered by Rule 134." The SEC has requested comment on whether it should continue to allow Rule 134 communications to include ratings information, and it notes in the proposing release that removal of this item from the safe harbor would not necessarily

result in such a communication being deemed a prospectus or free writing prospectus. Rather, such a determination would be made "in light of all of the circumstances of the communication."

2. Form F-9

Form F-9 is the Multijurisdictional Disclosure System ("MJDS") form that eligible Canadian issuers may use to register certain investment grade debt or preferred securities. The primary advantage over Form F-10 (which is available for securities that are not rated investment grade) historically has been that Form F-9 does not require issuers to reconcile their financial statements to U.S. generally accepted accounting principles ("GAAP"). However, this advantage will be eliminated as a result of recent changes to Canadian regulations that require Canadian filers to prepare their financial statements pursuant to International Financial Reporting Standards ("IFRS"). Because foreign private issuers that prepare financial statements in accordance with IFRS need not reconcile their financial statements to U.S. GAAP, reconciliation will no longer be required on Form F-10. The SEC states that Form F-9 has been used infrequently, and notes that its disclosure requirements will be identical to those for Form F-10. The SEC has proposed therefore to eliminate Form F-9 in its entirety, rather than removing its "investment grade" eligibility criterion. Note that Form F-10 does not include an eligibility criterion based on prior debt issuances, such as the $1 billion prior offering requirement being added to Forms S-3 and F-3; its use is limited to issuers meeting a $75 million public equity float test.

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ENDNOTES

[1] Proposed Rule: Security Ratings, Rel. No. 33-8940 (July 1, 2008). *See also* Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Rel. No. 34-58070 (July 1, 2008); Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Rel. No. IC-28327 (July 1, 2008).

[2] *See* Final Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Rel. No. 34-60789 (October 5, 2009); Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Rel. No. 33-9069 (October 5, 2009).

[3] *See* Proposed Rule: Security Ratings, Rel. No. 33-9186 (February 9, 2011).

[4] *See* General Instruction I.A to Forms S-3 and F-3.

[5] *See* General Instruction I.B.2 to Forms S-3 and F-3. A separate transaction-specific eligibility requirement that applies to offerings of investment grade asset-backed securities, at General Instruction I.B.5, is not addressed by these proposals. The SEC notes that Section 941 of the Dodd-Frank Act requires the SEC to issue rules jointly with bank regulators regarding risk retention for asset-backed securities. In light of this requirement, and because an April 2010 SEC proposal that would have removed references to credit ratings as a requirement to shelf eligibility for asset-backed offerings also incorporated a risk retention requirement, the SEC did not address this requirement in the current release.

[6] As with the definition of WKSI in Rule 405, under the proposal parent company issuers could include in their calculation the principal amount of their full and unconditional guarantees (within the meaning of Rule 3-10 of Regulation S-X) of non-convertible securities, other than common equity, issued for cash by their majority-owned subsidiaries during the prior three years. Unlike the WKSI definition, issuers that are "ineligible issuers" as defined in Rule 405 could nonetheless meet the new Form S-3 and F-3 eligibility test.

[7] *See* Exxon Capital Holdings Corp., SEC No-Action Letter (available May 13, 1988).

[8] A registrant may also qualify to incorporate by reference in Form S-4 or F-4 or Schedule 14A if, for example, it meets the $75 million aggregate market value threshold of General Instruction I.B.1 to Form S-3 or F-3. In all cases, the registrant would also need to meet the issuer-specific requirements of General Instruction I.A of Form S-3 or F-3.

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