BAKER & McKENZIE

Client Alert

August 11, 2010

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Dodd-Frank Act Repeals Securities Act Rule 436(g): Implications for Use of Credit Ratings in SEC Disclosure Documents

Title IX of the Dodd-Frank Reform and Consumer Protection Act (Dodd-Frank Act) repealed Rule 436(g) promulgated under the Securities Act of 1933 (Securities Act) effective July 22, 2010. As a result, issuers of rated securities must now obtain the consent of the ratings agency to disclose ratings information other than "issuer disclosure-related ratings information."[1] "Issuer disclosure-related ratings information" is defined as credit rating disclosure in a filing with the Securities and Exchange Commission (SEC) related only to changes to a credit rating, the liquidity of the issuer, the cost of funds for the issuer or the terms of agreements that refer to credit ratings. Absent a consent from a ratings agency, corporate issuers may also be required to amend existing SEC filings before their next offering to remove ratings disclosure that does not qualify as "issuer disclosure-related ratings information." If ratings agencies were to consent to issuers including their ratings in SEC filings, they would be exposed to potential liability as an "expert" under Section 11 of the Securities Act. Because of their increased liability exposure, the major rating agencies have thus far refused to give such consents. This Client Alert addresses:

- the impact of the repeal of Rule 436(g) on issuers and ratings agencies;
- recent guidance from the SEC for disclosing ratings; and
- practical considerations for new and existing debt issuers.

Executive Summary

Historically, Rule 436(g) permitted issuers to include the ratings assigned to a class of debt securities or preferred stock by a "nationally recognized statistical rating organization" in a registration statement and prospectus without obtaining the agency's consent to be named as an "expert" for Section 11 purposes. This changed effective July 22, 2010 when Congress eliminated Rule 436(g), presumably in the belief that the major rating agencies would simply consent to the use of their ratings included or incorporated by reference in registration statements and prospectuses. This assumption was off the mark as was evidenced by the July 21, 2010 statements issued by each of the major ratings

[1] See Compliance and Disclosure Interpretation 233.04 at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

agencies, Standard & Poor's, Moody's Investor Service and Fitch Ratings, which advised their clients that they would not consent to being named as an "expert" in any registration statement or prospectus. Absent relief from the SEC, this would have had the effect of prohibiting the disclosure of the credit rating in the registration statement or prospectus or in any document incorporated by reference into a registration statement or prospectus. To further complicate matters for asset-backed issuers, Items 1103(a)(9) and 1120 of Regulation AB *require* disclosure of any credit rating assigned to the asset-backed security being offered by a prospectus.

These actions left issuers with a number of unresolved questions. For issuers with outstanding debt securities and effective registration statements for delayed or continuous offerings, such as a shelf registration statement on Form S-3 or a registration statement on Form S-8 for securities offered to employees, questions arose as to whether issuers could continue to disclose credit ratings in their SEC reports for purposes such as a discussion of their liquidity and capital resources, risk factors or debt covenant compliance when such credit ratings would be automatically incorporated by reference into the outstanding registration statements. For many issuers, the requirement of Item 303 of Regulation S-K to disclose all known demands, commitments, events or uncertainties that are reasonably likely to result in a material change in the issuer's liquidity or capital resources may make disclosure of credit ratings information *mandatory*. Further, questions arose over whether those same issuers would be required to amend existing filings to eliminate or modify prior credit ratings disclosures immediately before their next offering. For asset-backed issuers considering a new offering, the market ground to a halt because of their inability to satisfy the requirements of Regulation AB.

To address these concerns, the Staff of the SEC quickly responded by issuing (i) Compliance and Disclosure Interpretations (CDIs), which permit issuer disclosure-related ratings information to be included in SEC filings even if included or incorporated by reference into a registration statement or prospectus, and (ii) a no-action letter providing that the SEC staff will not recommend enforcement if asset-backed issuers omit ratings information from any prospectus that is part of a registration statement for an offering of asset-backed securities on or before January 24, 2011.

Impact of Repeal of Rule 436(g)

Impact on Issuers – Including Potential Need to Amend Prior Periodic Reports

In recent history, corporate issuers have disclosed credit ratings in registration statements and prospectuses for offerings of debt securities and preferred stock to the extent it was considered material to an understanding of the liquidity and capital resources of the issuer or compliance with applicable debt covenants. Similar disclosure is often included in the management discussion and analysis section of SEC periodic reports, which are frequently incorporated by reference into shelf registration statements. Occasionally, disclosure of credit ratings was also included in the risk factors section of periodic reports. For asset-backed issuers, Items 1103(a)(9) and 1120 of Regulation AB *require* disclosure of any credit rating assigned to the asset-backed security being offered by a prospectus. If consents of the ratings agencies were required to be able to disclose credit ratings in these SEC filings, both corporate and asset-backed issuers would be unable to satisfy their continuing disclosure obligations and may be required to

amend past periodic filings prior to filing future registration statements or prospectuses.

Impact on Ratings Agencies

Being named as an "expert" in any registration statement (assuming the registration statement correctly stated the credit rating) would cause a rating agency to be subject to liability under Section 11 of the Securities Act with respect to the "expertised" portion of a registration statement or prospectus (in this case, the ratings information would be the expertised portion). Unless the rating agency can establish that it had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein about the credit rating were true and that there was no omission to state a material fact required to be stated therein or necessary to make the credit rating statements therein not misleading—a very difficult and expensive affirmative defense to prove – it may be liable to the purchaser of the security in the offering. As a result, when the Dodd-Frank Act repealed Rule 436(g), the major ratings agencies immediately announced that they would not give such consents due to the significant increase in their risk of liability, which caused the asset-backed security market to shut down.

SEC Guidance for Issuers

CDI Guidance

After consultation with members of the securities bar, the SEC's Division of Corporation Finance addressed these issues in six new Securities Act CDIs[2] released on July 22, 2010. The CDIs were amended on July 27 to extend their application to asset-backed issuers, which had not received the benefit of the initial CDIs. The new CDIs, as amended, provide interpretative relief as to when disclosure of a credit rating in a registration statement or prospectus or in an SEC filing incorporated by reference into a registration statement or prospectus would not require the filing of a consent by the ratings agency:

- *Grandfathered Registration Statements*. Issuers will be allowed to continue to use existing registration statements that contain ratings information without filing a rating agency consent until the issuer's next post-effective amendment to the registration statement[3] as long as the issuer's future SEC reports, which are incorporated by reference into the registration statement, do not contain ratings information other than "issuer disclosure-related ratings information". See CDI 198.08 and CDI 233.07.

- *Ratings in Filings Included or Incorporated in a Registration Statement or Prospectus Without a Consent – Filed On or After July 22, 2010*. If credit rating information in a filing is "issuer disclosure-related ratings information," an issuer does *not* need to obtain consent from the relevant ratings agency to

[2] See CDIs 198.08 and 233.04-233.08 at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.

[3] The filing of an issuer's next annual report on Form 10-K is deemed to be a post-effective amendment of the registration statement for purposes of Section 10(a)(3).

include a credit rating (directly or through incorporation by reference) in its registration statement or Section 10(a) prospectus. See CDI 233.04.

- *Ratings in Free Writing Prospectus, Term Sheet or Press Release*. Except in cases where a free writing prospectus, term sheet or press release is filed under Rule 424, if ratings are included in a free writing prospectus that complies with Rule 433 or a term sheet or press release that complies with Rule 134, a consent will not be required. As amended, Rule 436 requires consents for information in a "registration statement" or "prospectus," and Rule 433 free writing prospectuses and Rule 134 term sheets and press releases are neither registration statements nor prospectuses for purposes of Rule 436. See CDI 233.06.

- *New Registration Statements, Post-Effective Amendments (including filing Annual Reports on Form 10-K) and Shelf Takedowns*. To include or incorporate by reference ratings information (other than "issuer disclosure-related ratings information") in a new registration statement or in a post-effective amendment to a registration statement, including in an annual report on Form 10-K deemed to be a post-effective amendment, a consent of the ratings agency must be filed with the registration statement, post-effective amendment or Form 10-K. To the extent that prior SEC filings incorporated by reference into a registration statement already contain ratings information (other than "issuer disclosure-related ratings information"), the issuer filing a new registration statement, post-effective amendment or Form 10-K or initiating a shelf takedown would either need to obtain the consent from the ratings agency (which is not likely to be forthcoming) or amend the prior SEC filing to either eliminate disclosure of the credit rating or modify the disclosure so that it qualifies as "issuer disclosure-related ratings information." See CDI 233.05 and CDI 233.08.

No-Action Letter Regarding Asset-Backed Issuers

As disclosed in our July Banking & Finance Client Alert, [4] on July 22, 2010, the SEC's Office of Chief Counsel of the Division of Corporate Finance issued a no-action letter to Ford Motor Credit Company[5] that provides a six-month grace period permitting asset-backed issuers to omit ratings disclosure that would have otherwise been required in registration statements and prospectuses for asset-backed securities offerings. The no-action letter stated that the Staff of the SEC would not recommend enforcement if an asset-backed issuer omits the information required under Items 1103(a)(9) and 1120 of Regulation AB. This temporary no-action position will expire for any registered offerings of asset-backed securities commencing on or after January 24, 2011, giving the SEC, the ratings agencies, asset-backed issuers and Congress approximately six months to find a solution.

[4] http://www.bakermckenzie.com/files/Uploads/Documents/North%20America/Securities/al_nybf_repealrule436_jul10.pdf.

[5] See http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm.

Practical Considerations for Issuers

- *Issuer with Outstanding Registration Statements and/or Debt*. Issuers that have outstanding registration statements on Form S-3 or Form S-8 should review their registration statements and SEC reports carefully for disclosure of credit ratings and the context under which the credit rating is disclosed. Since ratings agencies are unlikely to consent to inclusion of ratings information in the near future, going forward these issuers should make sure that any ratings disclosure is related only to changes to the credit rating, the liquidity of the issuer, the cost of funds for the issuer or the terms of an agreement that refers to a credit rating. For prior SEC filings, until the filing of the next post-effective amendment to the registration statement or annual report on Form 10-K, 20-F or 40-F, the issuer may rely on Rule 401(a), which provides that a registration statement or prospectus shall conform to the applicable rules as in effect on the initial filing date of such registration statement or prospectus. As interpreted by the Staff of the SEC in CDI 233.07, the issuer may continue to use the registration statement so long as no subsequently incorporated periodic or current report contains ratings information that is not limited to "issuer disclosure-relating ratings information."

- *Issuers Considering an Offering of Securities from a Shelf Registration Statement*. Issuers considering a new offering should review their existing SEC filings to identify any and all ratings disclosures that will be incorporated by reference into a prospectus supplement. If this information is not "issuer disclosure-related ratings information," the issuer should consider amending their filings to remove this disclosure or modify the disclosure so that it is clear that it constitutes "issuer disclosure-related ratings information." See CDI 233.05. During the offering process, any credit ratings for the offered security should be communicated to potential investors exclusively in a free writing prospectus that complies with Rule 433 or a term sheet or press release that complies with Rule 134.

- *Asset-Backed Issuers*. Based on the no-action letter issued by SEC Staff, asset-backed issuers may omit ratings information from their registration statements and prospectuses until the expiration of the no-action letter position on January 24, 2011. In advance of the expiration date of the no-action letter, issuers should look for additional guidance from the SEC and statements from the ratings agencies on their approach to rating asset-backed offerings.

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