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New SEC Proposal To Modify Short Form Registration Statement Eligibility Requirements And Repeal Credit Rating-Based Eligibility For Public Offerings Of Non-Convertible Debt Securities

As previously discussed in our August 17, 2010 blog posting "Registered Public Offerings Of Debt Securities And The Use Of Credit Ratings Information In SEC Filings After Dodd-Frank," the practice of marketing registered public offerings of debt securities with credit ratings information and related disclosure of issuer credit ratings in SEC filings is undergoing changes mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). On February 9, 2011, SEC commissioners voted unanimously to propose new eligibility requirements for short-form registration of public offerings of debt securities and related communications that will no longer be tied to an issuer's credit rating from a nationally recognized statistical ratings organization, or NRSRO. If adopted as proposed, eligibility for offerings of non-convertible debt securities using short-form registration will be satisfied if the issuer has issued at least $1 billion of non-convertible securities in transactions registered under the Securities Act, other than equity securities, for cash during the past three years (as measured from a date within 60 days of the filing of the registration statement) and satisfies the other relevant requirements of Form S-3 or Form F-3.

Background

A credit rating measures a borrower's ability to reimburse principal and pay interest on its debt. The more creditworthy a borrower, the higher its credit rating. In the aftermath of the credit crisis of recent years, many commentators have posited that the investing public's reliance on credit ratings contributed to the recent financial crisis. In particular:

- investors treated ratings as exclusive buy/sell criteria instead of performing their own research and due diligence review prior to purchase;
- various regulations limited the securities that funds could purchase to those with credit ratings at or above certain thresholds;
- other regulations conferred benefits on issues that maintained credit ratings at or above certain thresholds; and
- as a result, incentives were created throughout the system to exploit flaws in NRSRO methodology to increase credit ratings without regard to actual creditworthiness.

In response to perceived over-reliance on credit ratings, Congress included special provisions in Dodd-Frank explicitly requiring that the SEC "review any regulation issued by the SEC that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings." Section 939A of Dodd-Frank directed the SEC to use the results of that review to modify existing regulations to "remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness" as determined to be appropriate by the SEC. In the February 9 proposing release, the SEC recognizes

that credit ratings play a significant role in investment decisions, but emphasizes the need for the proposed rules in order to avoid uses of credit ratings that suggests a "seal of approval on the quality of any particular credit rating or nationally recognized statistical rating organization."

What would change if the SEC's proposals are adopted?

Under the requirements for eligibility to use Form S-3 or F-3, the issuer must meet at least one of the form's transaction requirements in addition to issuer requirements. The transaction requirement affected by the February 9 proposal (general Instruction I.B.2 "*Primary Offerings of Non-convertible Investment Grade Securities*") permits registrants to register primary offerings of non-convertible securities for cash if they are rated "investment grade securities" by at least one NRSRO. For these purposes, a non-convertible security is an "investment grade security" if, at the time of sale, at least one NRSRO has rated the security in one of its generic rating categories which signifies investment grade. Typically, the four highest rating categories signify investment grade.

The SEC proposal would modify Instruction. I.B.2. of Form S-3 and Form F-3 such that an offering of non-convertible securities would be eligible to be registered on such forms if the issuer, as of a date within 60 days prior to the filing of the registration statement on Form S-3 or Form S-4, has issued in the last three years at least $1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash (excluding exchange offerings), in registered offerings under the Securities Act of 1933.

How could the SEC proposals impact the capital markets?

It is likely that the SEC's proposals would give greater access to the public markets to a greater number of high yield debt issuers that are not currently eligible to use Form S-3.

It is also likely that the SEC's proposals would result in some issuers currently eligible to use Form S-3 and Form F-3 becoming ineligible. Based on recent statistical data, the SEC estimated that approximately 45 issuers who were previously eligible to use Form S-3 (and who had made an offering during the review period) would no longer be able to use Form S-3 for offerings of non-convertible securities other than equity securities. In addition, an untold number of first-time REIT or electric utility issuers would likely be excluded from short-form registration. This is significant as it can be impractical to do a registered offering of debt securities on a long-form registration statement because of the inability to know market interest rates on the date of effectiveness and the possible adverse effect on the market for the securities that advance notice might have. Long-form registrations also involve greater time and expense than short-form registrations or exempt offerings (Rule 144A or Regulation S). Given the disadvantages of long-form registration, issuers ineligible to use a short-form may find that exempt offerings are their only practical choice for debt offerings. Given that investors in the exempt markets tend to be financial institutions with strict statistical maximum "caps" on their holdings of unregistered securities, the cost of capital for issuers that become ineligible for short-form registration may increase. Moreover, because Form S-3 or F-3 eligibility would depend on the volume of prior registered offerings of debt securities, issuers initially excluded from short-form eligibility may never become eligible.

What should you do next?

Issuers contemplating a primary offering of non-convertible debt securities and expecting to register such securities on Form S-3 or Form F-3 should consider whether they are relying on the ratings of their securities as investment grade by an NRSRO in order to be eligible for short-form registration. If this is the case, such an issuer should carefully consider the proposed rule change discussed above and the timing of such offering in order to ensure it will eligible for short-form registration at the contemplated time of the offering.

When is the law effective?

These are proposed rules and will not be effective unless finally adopted by the SEC. Comments should be received on or before March 28, 2011.

The SEC noted this release was the first in a series of upcoming SEC proposals required by Dodd-Frank to remove references to credit ratings contained within existing SEC rules and replace them with alternative criteria. Market participants should therefore expect more SEC rule making in this area in the near future.

What if you have questions?

For any questions or more information on these or any related matters, please contact Louis Lehot, John Tishler, Camille Formosa or any attorney in the firm's corporate and securities practice group.

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