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SEC Proposes New Rules for Disclosure by Issuers of Credit Ratings and Liability of Rating Agencies as "Experts"

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I. Introduction

Even when securities are highly rated, investors can suffer significant losses. Citing losses of 70% in the value of AAA-rated mortgage backed securities from January 2007 to January 2008, the Securities and Exchange Commission (the "SEC") on October 7, 2009, published proposed amendments to its disclosure rules aimed at better investor understanding of credit ratings and their limitations. The SEC is seeking to balance the reality that credit ratings are important to investors with the concern that investors place undue reliance on credit ratings by requiring disclosure of information about what a credit rating is and what it is not. If adopted, the new rules would require disclosure in registration statements of:

- Credit ratings used in connection with registered offerings;
- Potential conflicts of interest that could affect such credit ratings; and
- Preliminary credit ratings (if disclosure of a credit rating is otherwise required).[1]

To keep investors apprised of developments relating to credit ratings for their investments, the proposed amendments would also require the filing of a current report on Form 8-K within four business days of a registrant being notified by any credit rating agency that the agency will change or withdraw a credit rating previously disclosed by the registrant in connection with a registered offering.

In a companion concept release published on the same date, the SEC also sought comment on whether to rescind Rule 436(g) under the Securities Act of 1933 (the "Securities Act"), which exempts certain credit rating agencies from liability as "experts." Currently, credit rating agencies registered with the SEC, referred to as nationally recognized statistical rating organizations (or "NRSROs"), are exempted by Rule 436(g) from the liability scheme for "experts"[2] set forth in Sections 7 and 11 of the Securities Act.

Public comments on the SEC's proposed amendments and concept release are due no later than December 14, 2009. The SEC previously announced these proposed rulemaking actions at its open meeting held on September 17, 2009. At this open meeting, the SEC separately voted to (i) adopt previously-proposed amendments to remove references to credit ratings from rules under the Securities Exchange Act of 1934 (the "Exchange Act") regarding alternative trading

systems and certain rules under the Investment Company Act of 1940 (the "Investment Company Act") and (ii) re-open the comment period and seek further comment on its previously-proposed amendments to remove references to credit ratings in the anti-market manipulation provisions of Regulation M, the net capital rule for securities broker-dealers, Securities Act Rule 415 and Form S-3 as well as certain rules under the Investment Company Act and the Investment Advisers Act of 1940.[3]

This Client Advisory discusses how the proposed amendments would affect disclosure by issuers of credit ratings in registration statements and current reports as well as the liability of issuers and credit rating agencies for such disclosure.

II. Proposed Credit Ratings Disclosure

A. Concerns Leading To New Disclosure Requirements

The SEC's proposed amendments reflect its concern that investors may not have access to sufficient information about credit ratings, even though credit ratings appear to be a major factor in the investment decision for investors and play a key role in the marketing and pricing of securities. In particular, the SEC has identified four areas of concern.

First, the SEC is concerned that investors may not be provided with sufficient information to understand the scope or meaning of ratings being used to market various securities. Second, the SEC believes that investors may not have access to information allowing them to fully appreciate the potential conflicts of interest faced by credit rating agencies and how these conflicts may impact ratings. Third, the SEC is concerned that investors have not been informed about the practice of "ratings shopping," which occurs when a registrant (or someone acting on its behalf) seeks the highest credit rating available from multiple credit rating agencies. Fourth, because disclosure about credit ratings is not currently required in prospectuses, the SEC believes that investors may not be receiving basic information about a potentially key element of their investment decisions.

B. Overview of Required Disclosures

Currently, registrants may voluntarily disclose in their registration statements and periodic reports credit ratings assigned by rating agencies to classes of debt securities, convertible debt securities and preferred stock. The SEC's current policy regarding the disclosure of credit ratings, which is set forth in Item 10(c) of Regulation S-K, also describes matters that registrants should consider when disclosing credit ratings in these filings. The SEC's proposed amendments to Item 202 of Regulation S-K would mandate much of the specific disclosure currently permitted under Item 10(c) when a registrant uses a credit rating in connection with a registered offering.

The SEC is also proposing to require, in certain circumstances, disclosure of preliminary ratings, as well as final ratings not used by a registrant, in order to inform investors when a registrant may have engaged in "ratings shopping." Lastly, the SEC is proposing to amend Exchange Act reports Form 8-K and Form 20-F to require reporting of changes in credit ratings in certain circumstances. The SEC has proposed corresponding amendments to its disclosure rules for closed-end funds, so that similar disclosure obligations would be applicable to credit ratings of senior securities issued by closed-end funds registered under the Investment Company Act.

C. Triggers for Required Disclosure in Registration Statements

Under the proposed amendments, a registrant would be required to provide detailed disclosure regarding credit ratings whenever the **registrant, any selling security holder, any underwriter or any member of a selling group** "uses a credit rating in connection with a registered offering of securities."[4] A credit rating may be "used" in a variety of ways. For example, disclosure of a credit rating to potential investors in connection with any **oral or written** selling effort would constitute "use" of the credit rating in connection with a registered offering, even if disclosure were only made in response to inquiries from potential investors. In addition, the SEC would consider a credit rating to

be "used" in connection with a registered offering if it were disclosed in a prospectus or a term sheet filed as a free writing prospectus under Rule 433 or in an investment company advertisement filed under Rule 497 under the Securities Act. A credit rating would also be considered "used" in connection with a registered offering if it were used in connection with a private offering made in reliance on an exemption from registration under the Securities Act when the privately offered securities are exchanged shortly thereafter for substantially identical registered securities.

The SEC has **not** proposed to require that a registrant provide disclosure when it has not sought or otherwise solicited the credit rating unless the rating is used in connection with a registered offering of its securities. In addition, as proposed, the disclosure requirements would **not** be triggered if the only disclosure of a credit rating in a filing with the SEC were related to changes to a credit rating, the liquidity of the registrant, the cost of funds for the registrant or the terms of agreements that refer to credit ratings, as long as the credit rating is not otherwise used in connection with a registered offering. For example, the proposed disclosure requirements would not apply if a registrant merely disclosed its credit ratings in the context of a risk factor discussion or a liquidity discussion in the MD&A section of its periodic reports. Finally, the SEC has **not** proposed to **require** registrants to obtain credit ratings in connection with registered offerings.

Counseling Points:

- Companies will need to monitor roadshow presentations and communications with potential investors for use of credit ratings.
- When negotiating registration rights agreements with selling shareholders, companies should consider including a specific limitation on communications related to credit ratings by selling shareholders to avoid triggering future credit rating disclosures that may be adopted by the SEC.

D. Content of Required Disclosure in Registration Statements

The SEC's proposed amendments would require disclosure of certain general information regarding credit ratings, including the scope of the rating and any limitations on the scope of the rating. Specifically, the proposed amendments would require disclosure of the following information:

- The identity of the credit rating agency assigning the rating and whether such organization is an NRSRO;
- The credit rating assigned by the credit rating agency;
- The date the credit rating was assigned;
- The relative rank of the credit rating within the credit rating agency's classification system;
- A credit rating agency's definition or description of the category in which the credit rating agency rated the class of securities;
- All material scope limitations of the credit rating;
- How any contingencies related to the securities are or are not reflected in the credit rating;
- Any published designation reflecting the results of any other evaluation done by the credit rating agency in connection with the rating, along with an explanation of the designation's meaning and the relative rank of the designation;
- Any material differences between the terms of the securities as assumed or considered by the credit rating agency in rating the securities and (i) the minimum obligations of the securities as specified in the governing instruments of the securities and (ii) the terms of the securities as used in any marketing or selling efforts; and
- A statement informing investors that a credit rating is not a recommendation to buy, sell or hold securities; that it may be subject to revision or withdrawal at any time by the assigning credit rating agency; that each credit rating is applicable only to the specific class of securities to which it applies; and that investors should perform their own evaluation as to whether an investment in the security is appropriate.

In addition, the SEC has proposed amendments that would require disclosure of potential conflicts of interest in the credit ratings context. In particular, the proposed amendments would require disclosure of the identity of the party who is compensating the credit rating agency for providing the credit rating. Moreover, if during the registrant's last completed fiscal year and any subsequent interim period prior to the date of the filing, the credit rating agency or its affiliates provided any non-credit rating services to the registrant or its affiliates, the proposed rules would require a description of the other non-credit rating services and separate disclosure of the fee paid for the credit rating required to be disclosed and the aggregate fees paid for any other non-credit rating services provided during that period. The SEC has **not** proposed to require disclosure of the fee paid for the credit rating unless disclosure of other non-credit rating services is required, as described above.

Finally, the SEC has proposed amendments to address the perceived problem of "ratings shopping." Ratings shopping occurs because a registrant can solicit a preliminary credit rating from a credit rating agency and, if the registrant believes the rating is too low, the registrant can seek a different credit rating from another credit rating agency. In addition to providing registrants an incentive to use the credit rating agency that provides the most favorable rating, the SEC is concerned that there may be incentives for rating agencies to inflate their ratings in order to keep the business of the registrant. Currently, investors are not advised when registrants seek preliminary ratings or obtain additional ratings but choose not to use them, nor are they advised of any differences between preliminary ratings and the final rating assigned to a security.

To address these issues, the SEC has proposed that if a registrant has obtained a credit rating and is required to disclose that credit rating, then all preliminary ratings of the same class of securities as the final rating that are obtained from credit rating agencies (other than the credit rating agency providing the final rating) must also be disclosed. In addition, the SEC has proposed that if a rating is disclosed pursuant to the preceding trigger, then any final credit rating obtained by the registrant but not used must also be disclosed. When disclosure of any preliminary rating or unused final rating is required, the SEC has proposed to require similar disclosures as is proposed to be required for a final rating used in connection with a registered offering.

The SEC intends the phrase "preliminary credit rating" to be read broadly and to include any rating that is not published, any range of ratings, any oral or other indications of a potential rating or range of ratings and all other preliminary indications of a rating. Furthermore, the required disclosure of preliminary ratings would not be limited to ratings specific to the registrant. For example, a "preliminary rating" would include ratings on a particular structure of a security, such as where an underwriter approaches a rating agency about a newly developed structure for an asset-backed offering of a certain class of assets even where the specific pool of assets or the registrant is unknown. Lastly, as proposed, disclosure of the preliminary rating would be required even if there were changes to the security for which a final rating is disclosed.

The SEC believes this disclosure requirement would provide investors with important information to assess whether any ratings shopping may have occurred, and whether any rating inflation may have occurred between the preliminary rating and the final rating obtained by a registrant as a result of the ratings shopping, or whether the registrant has obtained other credit ratings that it has not used in connection with the registered offering. However, the SEC has **not** proposed to require disclosure of preliminary ratings obtained by a registrant from the credit rating agency that issued the final rating used in connection with the registered offering due to its concern that such a disclosure requirement could impede useful communications between credit rating agencies and registrants.

E. Form 8-K To Be Filed for Changes to Ratings

If a credit rating that was previously disclosed under the proposed amendments described above has been changed, including when a rating has been withdrawn or is no longer being updated,

that change would be required to be disclosed in a current report on Form 8-K. Because the SEC has proposed to limit the disclosure regarding changes to a credit rating in a current report to credit ratings that were previously disclosed under the proposed amendments described above, a registrant would **not** be required to disclose changes to credit ratings that were obtained or used prior to the effectiveness of any new disclosure requirements adopted as a result of the SEC's proposed amendments.

Under the proposed amendments, a registrant (including a closed-end fund) would be required to file a report within four business days of receiving a notice or other communication from any credit rating agency that the agency has decided to change or withdraw a credit rating assigned to the registrant or any class of debt or preferred security or other indebtedness of the registrant (including securities or obligations as to which the registrant is a guarantor or has a contingent financial obligation) or take any similar action with respect to a credit rating that was previously disclosed pursuant to the proposed amendments described above. Foreign private issuers would be required to provide disclosure regarding changes to credit ratings annually in their reports on Form 20-F, rather than within four business days on Form 8-K.

The SEC is **not** proposing to require the registrant to also discuss in the Form 8-K the impact of the change in credit rating or other decision on the registrant, although it would be permitted to do so. Rather, the SEC believes that a discussion of any **material** impact of the change in credit rating would be required to be disclosed in the registrant's periodic reports, which is consistent with the SEC's current views. Furthermore, disclosure would not be required until the rating agency notified the registrant that the rating agency has made a decision to change the credit rating. If the registrant is still in negotiations or appealing a preliminary indication that a credit rating agency intends to take an action covered by the proposed item, no disclosure would be required. However, once good faith negotiations and appeals conclude, disclosure would be required.

F. SEC's Request for Comments

The SEC is still considering and seeking comment on significant issues in connection with the proposed amendments discussed above. In particular, the SEC has solicited comment with respect to the following issues, among others:

- Should the proposed amendments include a phase-in for registrants beyond the effective date to accommodate pending offerings?
- Is there a better model for providing disclosure about credit ratings?
- Would the amendments, as proposed, have an effect on the frequency with which registrants seek credit ratings?
- Does the proposed disclosure requirement add too much weight to credit ratings?
- Should the proposed disclosure requirements distinguish between corporate debt and structured finance products?
- Should the proposed amendments mandate disclosure of a credit rating obtained by a registrant regardless of whether the rating is used in connection with a registered offering?
- Would requiring the proposed disclosure for preliminary or unused final ratings enhance investors' understanding of, and therefore the value of, the ratings?
- How would the proposed amendments affect communications between registrants and credit rating agencies?
- Is the requirement to file a current report on Form 8-K necessary in view of the typical practice by credit rating agencies to promptly issue press releases about rating changes?

III. Liability of Credit Rating Agencies as Experts Under the Securities Act

A. Rationale For Proposed Credit Rating Agency Liability

Rule 436(g) under the Securities Act currently provides an exemption for certain credit ratings agencies from liability under Sections 7 and 11 of the Securities Act even if a credit rating assigned by that rating agency is disclosed in a registration

statement. Specifically, Rule 436(g) exempts NRSROs that assign credit ratings from being considered persons "who prepare or certify" a part of a registration statement within the meaning of Section 11 and from being considered an "expert" for purposes of Section 7 of the Securities Act. This exemption does not presently apply to credit rating agencies that are not NRSROs.

If the SEC adopts the proposed amendments described above to require disclosure regarding credit ratings in registration statements, and if it were to rescind Rule 436(g), then a registrant who uses a credit rating assigned by an NRSRO or any other credit rating agency in connection with a registered offering would be required to file the consent of that NRSRO or other credit rating agency as an exhibit to its registration statement. As a result, NRSROs and other credit rating agencies would become subject to potential liability under Section 11 of the Securities Act.

The SEC currently believes that it may be appropriate to rescind Rule 436(g) for four primary reasons. First, the SEC believes that the original reasons supporting adoption of Rule 436(g) may no longer provide a sufficient basis to continue to provide the exemption to NRSROs. Specifically, in originally proposing and adopting Rule 436(g), the SEC was concerned that registrants, in the absence of an exemption, would not voluntarily disclose security ratings in their registration statements due to the liability concerns of the NRSROs who provided the ratings. However, if the SEC adopts its proposed amendments **requiring** disclosure of credit ratings and related information in registration statements under certain circumstances, as described in greater detail above, the SEC believes that its original rationale for adopting Rule 436(g) would no longer be applicable.

Second, the SEC believes that when credit ratings are used to sell securities, investors rely on NRSROs and other credit rating agencies as experts and, therefore, it may be appropriate for the SEC's liability scheme for experts to apply to all credit rating agencies. Third, in a similar vein, the SEC believes that rescinding Rule 436(g), and therefore potentially increasing the risk of liability under the federal securities laws, could significantly improve investor protection. In particular, the SEC has stated that enhancing the accountability of NRSROs may help to address concerns about the quality of credit ratings. Finally, the SEC believes that the distinction in Rule 436(g) between NRSROs and other credit rating agencies may contribute to competitive disadvantages for non-NRSRO credit rating agencies because they are subject to a higher standard of liability under the federal securities laws than NRSROs.

Registrants would be subject to liability for false or misleading statements under the proposed credit ratings disclosure amendments described above just as they are liable for false or misleading statements under the federal securities laws generally. However, given the importance that investors often place on credit ratings, and therefore their materiality, registrants should be especially careful in complying with the new credit ratings disclosure requirements, if adopted.

Counseling Points If Rule 436(g) is Rescinded:

- Companies will need to build time into their offering schedule to provide ratings disclosure.
- Companies should be mindful of when consents will need to be filed and ascertain that consents can be obtained well in advance. For example, an offering registered on Form S-1 would require that consents be filed prior to effectiveness of the registration statement. Shelf offerings on Form S-3 for which credit ratings are applicable to the issuer and do not change with each offering would need to be filed prior to the time the registration statement is declared effective. However, shelf offerings where issuer ratings or ratings on classes of securities change with the offering, such as a medium-term note facility, would require that consents be filed by post-effective amendment or by filing a Form 8-K which is incorporated by reference into the registration statement prior to a take-down off the shelf.

B. SEC's Request for Comments

The SEC is soliciting comments on the impact that rescinding Rule 436(g) would have on securities markets and their participants. In particular, the SEC has solicited comment with respect to the following issues, among others:

- What effects would rescinding Rule 436(g) have on the practice of offering securities?
- If the SEC were to subject all credit rating agencies to Sections 7 and 11 of the Securities Act, would registrants be able to obtain the consent required to use ratings in connection with registered offerings of rated securities?
- If the SEC proposes to rescind Rule 436(g), should it distinguish among issuers of corporate debt, issuers of structured finance products and closed-end management investment company securities?
- Are there reasons to continue to distinguish between NRSROs and credit rating agencies that are not NRSROs for purposes of potential Section 11 liability?
- How would the financial markets be affected if NRSROs and other credit rating agencies temporarily or permanently stopped issuing credit ratings in registered offerings?
- How would the elimination of Rule 436(g) affect the quality of credit ratings?
- What effect would rescinding Rule 436(g) have on investors' reliance on credit ratings?

[1] SEC Proposed Rule, Credit Ratings Disclosure, Release Nos. 33-9070, 34-60797 and IC-28942.

[2] SEC Concept Release, Possible Rescission of Rule 436(g) under the Securities Act of 1933, Release Nos. 33-9071, 34-60798 and IC-28943.

[3] SEC Final Rule, References to Ratings of Nationally Recognized Statistical Rating Organizations, Release Nos. 34-60789 and IC-28939; and SEC Proposed Rule, Re-Opening of Comment Period and Request for Additional Comments, References to Ratings of Nationally Recognized Statistical Rating Organizations, Release Nos. 33-9069, 34-60790, IA-2932 and IC-28940.

[4] The applicable disclosure requirements would be set forth in Item 202 of Regulation S-K, Item 12 of Form 20-F and Item 10.6 of Form N-2, as proposed to be amended by the SEC.

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