Use of Credit Ratings Information After Passage of Dodd-Frank Act

By Louis Lehot, John Tishler and Camille Formosa

The practice of marketing registered public offerings of debt securities with credit ratings information and related disclosure of issuer credit ratings in Securities and Exchange Commission filings will change with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

One of Dodd-Frank's many reforms was aimed at credit rating agencies. Effective immediately, Dodd-Frank Section 939G repealed SEC Rule 436(g) promulgated under the Securities Act of 1933. Rule 436(g) stated that in general, credit ratings were not deemed "expertized" portions of registration statements. As non-expertized content, issuers did not need consent from credit rating agencies to use their ratings in registration statements, and credit rating agencies were not subject to strict liability under Section 11 of the Securities Act for the opinion reflected in their ratings. As providing consents would subject credit ratings agencies to liability under Section 11 of the Securities Act, credit ratings agencies have announced they will not consent to the use of their ratings in registration statements or prospectuses.

The sudden repeal of Rule 436(g) left uncertainty in the capital markets, and the SEC quickly stepped in with interpretations that enabled public debt and asset-backed offerings to continue while the SEC develops additional rulemaking to address the role of credit ratings and credit rating agencies in registered public offerings.

Section 7 of the Securities Act and Rule 436(a) generally require an issuer to obtain written consent from an expert for use of its report or opinion in the issuer's registration statement. Section 11 of the Securities Act provides that the persons who sign a registration statement, the directors of the issuer, the underwriters and the experts who consent to be named in the registration statement are liable to purchasers of the securities sold under a registration statement for omissions and misstatements in the registration statement, subject to certain defenses. The standard of liability for the non-experts (i.e., the directors and underwriters) is lower for so-called "expertized" portions of a registration statement, where the experts themselves have the higher standard for liability.

Prior to the enactment of Dodd-Frank on July 21, 2010, Rule 436(g) provided that the credit rating assigned to debt securities, convertible debt securities, or preferred stock by a nationally registered statistical rating organization (such as S&P, Moody's or Fitch) would not be considered a part of the registration statement prepared or certified by an expert within the meaning of Sections 7 and 11 of the Securities Act. Thus, Rule 436(g) permitted issuers to include credit ratings information in a registration statement, prospectus or prospectus supplement without obtaining the consent of nationally registered statistical rating organizations or subjecting them to potential liability under Section 11.

The Section 7 consent requirement does not apply to free writing prospectuses in compliance with Securities Act Rule 433 or in a term sheet or press release issued in compliance with Securities Act Rule 134.

Historically, issuers of debt securities have included credit ratings in registration statements, prospectuses, term sheets and Rule 134-compliant press releases to market offerings and raise capital with debt. Corporate debt issuers often disclose their credit ratings in SEC filings that are subsequently incorporated by reference into registration statements and prospectuses. Underwriters of debt securities and broker-dealers typically disseminate credit ratings information with final pricing terms to purchasers through Bloomberg screens. Credit ratings affect the pricing of debt securities and also the ability of certain investors to purchase and hold the securities.

The intent of repealing Rule 436(g) was to make nationally registered statistical rating organizations more accountable for the quality of their ratings. However, with nationally registered statistical rating organizations refusing to provide their consents, the potential consequences were inability to include credit ratings information in registrations statements and related prospectuses for issuers, including information incorporated by reference from reports under the Securities Exchange Act of 1934 (e.g., Forms 10-K, 10-Q and 8-K), the need to amend Exchange Act reports to remove credit ratings information previously included, and a catch-22 for registered offerings of asset-backed securities, which are *required* to include credit ratings information in the prospectus.

SEC staffers issued the following guidance to allow registered offerings to continue: For non-asset-backed issuers, consent from a nationally registered statistical rating organization is not required if credit ratings information is included in a registration statement or a statutory prospectus only for the purpose of satisfying disclosure requirements. This means that issuers may use credit ratings without obtaining consent when the disclosure of the credit rating is related only to changes to an issuer's credit rating, the issuer's liquidity, the issuer's cost of funds or the terms of agreements that refer to credit ratings, which information is classified by the SEC as "issuer disclosure-related information." Non-asset-backed issuers may continue to use a registration statement declared effective before July 22, 2010 that contains or incorporates by reference credit rating information beyond "issuer disclosure-related information," without consent from a nationally registered statistical rating organization until the next post-effective amendment to such registration statement. Reports incorporated by reference after July 22, 2010 should not contain credit ratings information other than "issuer disclosure-related information." The filing of the issuer's next annual report is deemed to be a post-effective amendment of any registration statement. Upon such filing, prior periodic reports and Form 8-Ks filed prior the beginning of the issuer's fiscal year then in progress will no longer be incorporated by reference. For registered offerings of asset-backed securities commencing before Jan. 24, 2011, an issuer can omit credit ratings disclosure otherwise required in a prospectus that is part of a registration statement.

For non-asset-backed issuers: If a registration statement includes or incorporates by reference any credit rating information beyond what is considered "issuer disclosure-related ratings information" in an SEC filing before July 22, 2010, no amendment is required until the next post-effective amendment to such registration statement. However, this position applies only if no subsequently incorporated periodic or current report contains credit ratings information other than "issuer disclosure-related ratings information." Thus, assuming consent from the a nationally registered statistical rating organization is not available, an issuer will have until the filing of the next post-effective amendment or annual report on Form 10-K, 20-F or 40-F to amend the registration statement to remove the consent. In many cases, such amendment will occur merely by filing the Form 10-K, 20-F or 40-F with no credit ratings information other than "issuer disclosure-related ratings information." Make certain that any registration statements and Exchange Act reports filed in the future limit references to credit ratings to "issuer disclosure-related ratings information."

For takedowns of rated securities, if disclosure of credit ratings information is desired, disclose the credit rating for the particular issue in a free writing prospectus, which would generally be a term sheet or Bloomberg screen, or in a Rule 134-compliant press release, rather than in the prospectus supplement.

For asset-backed issuers subject to Regulation AB: The SEC no-action letter to Ford Motor Credit Corp. was written for application to all asset-backed issuers, and until Jan. 24, 2011, issuers of registered asset-backed securities may rely on it to omit credit ratings disclosure otherwise required in prospectus or prospectus supplement.

For offerings to be commenced on or after Jan. 24, 2011, watch for SEC rulemaking or further Congressional action. If your offering may not commence until Jan. 24, 2011 or thereafter, consider structuring your offering of asset-backed securities as a private placement under Rule 144A or offshore under Regulation S as an alternative to a registered offering.

For non-asset-backed issuers, follow the guidance offered in the second and third provisions.

While it is too early to draw conclusions as to how the market will react to the repeal of Rule 436(g), a potential consequence may be that more issuers elect to issue securities in private placements pursuant to Rule 144A or offshore pursuant to Regulation S, particularly issuers of asset-backed securities. For issuers of non-asset-backed securities in registered offerings, the result may simply be that credit ratings information is moved from the registration statement to a free writing prospectus that complies with Securities Act Rule 433, which would generally be a term sheet or Bloomberg screen, or to a Rule 134-compliant press release.

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This photo, taken Aug. 19, 2010, shows traders at work on the floor of the New York Stock Exchange, in New York.

Letter to the Editor

Federal Bench Needs Socio-Economic Diversity

After reading *"As 9th Circuit Conference Kicks Off, Chief Judge Blisters Judiciary"* (August 16) I find myself greatly appreciative of Chief Judge Alex Kozinski's dissent in *U.S. v. Pineda-Moreno*. His analysis emphasizes the need to have greater diversity on the federal bench, not merely of race and gender, but also of socio-economic background; the latter sometimes more influential in the development of an individual's values and beliefs than the former. The federal bench has historically been the province upper-class white men. Professor Shaun Martin's statement, "I don't think the 9th Circuit is necessarily as one-sided as someone might read Judge Kozinski's critique to imply" is akin to insisting that the claim of male minorities being over-represented in prison populations is overstated. His attempt to qualify Judge Kozinski's critique by pointing out that some appointed to the bench have "fairly extensive contemporary exposure to poor people" (public defenders and legal-aid lawyers) is misleading in its failure to disclose the disproportionately low percentage of such persons appointed.

But I'm glad to know I have a shot at the federal bench.

David Fujimoto

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