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SECURITIZATION UPDATE

SEC Proposes to Reduce Reliance on Credit Ratings in its Rules and Forms

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The Securities and Exchange Commission has proposed changes that are meant to reduce reliance on credit ratings in the Commission's rules and forms. Issued as three separate Notices of Proposed Rulemaking (each, an "NPR") on July 1, 2008, one NPR relates to rules and forms administered by the Commission's Division of Corporation Finance,[1] one to rules administered by the Division of Investment Management[2] and one to rules and forms administered by the Division of Trading and Markets.[3] The NPRs complete a suite of rule changes commenced by a proposal published on June 25, 2008,[4] that dealt with rules applicable to the rating agencies themselves. Comments on these NPRs are due September 5, 2008.

The NPRs address Commission and other policy maker concerns that references to credit ratings in the Commission's rules and forms may have fed into the recent credit crisis by appearing to place an official seal of approval on these ratings. The Commission hopes that the NPRs will reduce undue reliance on credit ratings and encourage investors' due diligence and investment analysis.

Prohibiting ABS Sales to the General Public

A number of the proposed changes relate directly to asset-backed securities (ABS). Most importantly, the Commission has proposed changes to:

- The instructions to Form S-3 that permit shelf registrations for ABS under the Securities Act of 1933 (the "Securities Act");
- The portion of Rule 415 under the Securities Act that permits shelf registration of certain mortgage-related securities even if they do not satisfy the requirements for registration on Form S-3;[5] and
- Rule 3a-7, which many ABS issuers rely on to avoid registration under the Investment Company Act of 1940 (the "Investment Company Act").

One of the requirements for registering ABS on Form S-3 (which permits shelf registration) and for offering mortgage-related securities on a delayed or continuous basis under Rule 415 (independent of registration on Form S-3) is that the offered securities must be rated investment grade. The same requirement applies to the securities of an

issuer that relies on Rule 3a-7, except that some other securities can be offered and sold to qualified institutional buyers (as defined in Rule 144A under the Securities Act), to persons involved in the organization or operation of the issuer and their affiliates, and to institutional accredited investors (a subset of accredited investors, as defined in Regulation D under the Securities Act). The Commission proposes eliminating these investment grade requirements from Form S-3, Rule 415 and Rule 3a-7.

The Form S-3 and Rule 415 investment grade eligibility requirements for ABS and mortgage-related securities would be replaced with two new requirements:

- A minimum denomination of $250,000 for initial sales and resales; and
- Limitation of initial sales to qualified institutional buyers.

The Rule 3a-7 reference to investment grade securities would similarly be replaced with an "exclusion for structured financings offered to the general public."[6] Specifically, the rule would be revised to delete the provision that currently permits sales of investment grade fixed income securities without any restrictions on investor type. The provisions that currently permit sales of any securities to qualified institutional buyers (and persons involved in the organization or operation of the issuer and their affiliates) and fixed income securities to institutional accredited investors would be retained, with conforming grammatical changes.

The Commission believes that most ABS transactions already come close to satisfying these requirements.[7] Nevertheless, these proposed changes dramatically limit at least the theoretical, if not the historical, market for ABS. If the substance of these proposed changes is adopted, there are a few important technical points that we hope the Commission will address:

- In Rule 144A, a "reasonable belief" standard applies to the identification of qualified institutional buyers – a seller is protected by the Rule if the seller (and any person acting on its behalf) reasonably believed that the buyer was a qualified institutional buyer. The Rule also provides additional guidance on non-exclusive methods that sellers can rely on in determining qualified institutional buyer status. At present, none of this helpful guidance appears to apply to the proposed new limitations in Form S-3, Rule 415 and Rule 3a-7.
- If the proposed Rule 3a-7 change is adopted, it will also be important for the Commission to include appropriate grandfathering or other transition provisions, as many pre-existing issuers that rely on Rule 3a-7 have not limited the initial sales or resales of investment grade fixed income securities to any particular type of investor. No such transitional guidance appears in the Investment Management NPR.
- While the proposed changes to Form S-3 and Rule 415 only require that initial sales be made to qualified institutional buyers, Rule 3a-7 requires issuers and underwriters to exercise reasonable care to ensure that secondary market sales are limited to the same categories of investors as the initial sales (qualified institutional buyers and,

for fixed income securities, institutional accredited investors). It would be helpful if Rule 3a-7 was conformed to Form S-3 and Rule 415 on this point — at least with regard to sales to qualified institutional buyers.

- It might also be helpful if Form S-3 and Rule 415 were conformed to Rule 3a-7 by permitting sales of any ABS to persons involved in the organization or operation of the issuer and their affiliates.

Other Changes Relating Directly to ABS

The Commission has also proposed eliminating two other references to credit ratings from Rule 3a-7 and a number of references to credit ratings from Regulation AB. Initially, none of these changes appears to create significant obstacles for the market.

- In Rule 3a-7:
  - » a limitation on issuers acquiring or disposing of assets would be amended to delete a condition that such actions not impair the ratings of the issuer's securities, and replace that condition with a requirement that the issuer have procedures to ensure that such actions will not adversely affect the full and timely payment of the issuer's outstanding fixed income securities; and
  - » a requirement relating to the handling of cash flows from the securitized assets would be amended in a similar manner.
- In Regulation AB, Items 1100(c) (relating to presentation of certain third party financial information), 1112 (relating to disclosures about significant obligors of pool assets) and 1114 (relating to disclosure about credit enhancement) would all be amended to eliminate references to investment grade ratings as a condition affecting whether financial information relating to some significant obligors or credit enhancers must be disclosed, and the permitted method of disclosure.[8]

Also, the provisions of Regulation M that permit stabilizing transactions with respect to investment grade ABS would be amended to eliminate the reference to an investment grade rating.[9] Instead, stabilizing transactions would be permitted with respect to ABS registered on Form S-3. If a separate route for shelf registration of mortgage-related securities under Rule 415 is preserved (see footnote 5 above), it would seem that the Commission should also permit stabilizing transactions in those offerings.

Changes to Rule 2a-7

The Commission has also proposed four principal changes[10] to Rule 2a-7, which governs the operation of money market funds. These changes are of interest to ABS market participants given the importance of money market funds as investors in short-term ABS.

Only two of the proposed principal changes to Rule 2a-7 relate directly to credit ratings. The first, and most important, is that the Commission proposes to eliminate a minimum rating requirement as one of the eligibility criteria for purchase by a money market fund. Instead, eligibility would be based on a determination by the fund's board that a security presents minimal credit risks. External credit ratings could be one of the factors considered.

The second change relates to the board's monitoring obligations with respect to portfolio securities. Currently, a board is required to reassess the credit quality of a security and take appropriate actions if the board receives notice of a rating downgrade. Consistent with the elimination of a minimum credit rating as an eligibility requirement, the Commission has proposed that the reassessment and loss mitigation actions should be triggered by any information received by the fund's investment manager about a portfolio security or its issuer that suggests the security may present more than minimal credit risks.

The third and fourth principal changes relate to other concerns raised by recent turbulence in the credit markets. The third change would limit a money market fund's investment in illiquid securities to not more than 10 percent of its total assets, defining illiquid securities as those that cannot be sold in the ordinary course of business within seven days at approximately the fund's carrying value.[11] The fourth change would require money market funds to notify the Commission promptly if an affiliate of the fund (or its promoter or principal underwriter) purchases from the fund a security that is no longer an eligible investment for the fund.

Other Proposed Changes

The NPRs propose numerous other changes relating to other types of securities,[12] regulation of investment companies and investment advisers,[13] and market regulation.[14]

Endnotes

1 Release No. 33-8940, available at http://sec.gov/rules/proposed/2008/33-8940.pdf (the "Corp Fin NPR").

2 Release No. IC-28327, available at http://sec.gov/rules/proposed/2008/ic-28327.pdf (the "IM NPR")

3 Release No. 34-58070, available at http://sec.gov/rules/proposed/2008/34-58070.pdf (the "Trading and Markets NPR").

4 Release No. 34-57967, available at http://sec.gov/rules/proposed/2008/34-57967.pdf. See our Securitization Update dated June 25, 2008, available at http://mayerbrown.com/publications/article.asp?id=5003&nid=6.

5 The Commission has also requested comment as to whether this separate route for shelf registration of mortgage-related securities should be eliminated, so that shelf registrations of mortgage-backed securities would have to use Form S-3. The proposals relating to Form S-3 and Rule 415 are discussed in the Corp Fin NPR at pp. 10-18.

6 IM NPR, p. 16.

7 Corp Fin NPR, p. 13.; IM NPR, pp. 15-16.

8 Corp Fin NPR, pp. 32-35.

9 Trading and Markets NPR, pp. 30-35.

10 The Commission has also proposed conforming changes to Rule 2a-7's record keeping and reporting requirements. See generally the IM NPR, pp. 6-14.

11 If changes in a fund's portfolio or external events cause a fund to exceed this limit, the fund would be required to rectify the situation as soon as reasonably practicable, but funds would not be required to sell securities at a loss for this purpose.

12 The Corp Fin NPR proposes changes to (a) Forms S-3 and F-3 relating to the registration of non-convertible securities (replacing the investment grade requirement with a minimum prior issuance amount drawn from the well-known seasoned issuer criteria), (b) the US GAAP reconciliation requirements for foreign filers, (c) Form F-9 (relating to certain offerings by Canadian issuers), (d) Forms S-4 and F-4 and Schedule 14A, (e) Securities Act Rules 138, 139 and 168 (which provide that certain communications will not be deemed an offer for certain purposes under the Securities Act) and (f) Rule 436(g) (which requests, but does not require, additional disclosure if a registration statement discloses an issuer rating).

The Corp Fin NPR also requests comment as to whether the Commission should require disclosure about issuers' ratings in registration statements and periodic reports.

[13] The IM NPR proposes changes to Rule 5b-3 (relating to the treatment of certain repurchase agreements by mutual funds) and 10f-3 (relating to the purchase of municipal securities by a registered investment company in a primary offering where an affiliate of the investment company is a member of the underwriting syndicate) under the Investment Company Act and Rule 206(3)-3T under the Investment Advisers Act of 1940 (relating to principal transactions between advisers and their clients).

[14] The Trading and Markets NPR proposes changes to (a) Rule 3a1-1, Regulation ATS, Form ATS-R and Form PILOT (all relating to the regulation of exchanges and alternative trading systems), (b) Rule 10b-10 (relating to transaction confirmations), (c) the net capital rules for broker-dealers and broker-dealer reserve requirements and (d) stabilizing transactions in non-convertible securities.

If you have any questions with regard to the topic above, please feel free to contact the following attorneys or any of your regular contacts at the firm. To learn more about our Securitization practice, please visit http://www.mayerbrown.com/securitization/overview/index.asp.

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