US Securities and Exchange Commission Proposes Mandatory Credit Ratings Disclosure and Other Actions Relating to Rating Agencies

In October 2009, the Securities and Exchange Commission proposed rules requiring disclosure of credit ratings used by registrants in connection with registered offerings of securities. See Release Nos. 33-9070; 34-60797; IC-28942, available at http://www.sec.gov/rules/proposed/2009/33-9070.pdf. The SEC stated that "even though credit ratings appear to be a major factor in the investment decision for investors and play a key role in marketing and pricing of the securities, investors may not have access to sufficient information about credit ratings." The SEC proposed specific categories of disclosure to address the following concerns:

- That investors may have insufficient information to understand the scope or meaning of ratings that are used to market securities;
- That investors may not have access to information that would enable them to fully understand the potential conflicts of interest faced by credit agencies and the impact of such conflicts on ratings;
- That registrants, or persons on their behalf, "shop" for ratings by approaching multiple credit rating agencies to obtain the highest credit rating available; and
- That while ratings are a key part of investment decisions, disclosure is not currently required in prospectuses.

In response to its four principal concerns, the SEC proposed mandatory disclosure of information regarding credit ratings used by registrants in securities offerings, including a detailed description of the scope and limitations of the ratings. These amendments would require disclosure about potential conflicts of interest that could affect credit ratings.

Under the proposal, registrants, in certain circumstances, would have to disclosure preliminary credit ratings, as well as the final ratings. The amendments would affect registration statements filed under the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940, and would require the updating of disclosure in Forms 8-K and 20-F. Comments on the proposing release are due by December 14, 2009.

Proposed Amendments

The SEC has proposed a new paragraph (g) to Item 202 of Regulation S-K. Under this new paragraph, much of the specific disclosure currently permitted as voluntary disclosure under Item 10(c) of Regulation S-K, as well as additional categories of information, would be required. Disclosure of the material scope and limitations of the credit rating and any related published designation, including a discussion of non-credit payment risks assigned by the rating organization with respect to the security, also would be required, as would the source of payment for the credit rating. If the credit rating agency has provided additional services to the registrant or its affiliates, disclosure of the services and the fees paid for those services would be required.

Trigger Requirements

The proposed credit ratings disclosure would be required if the registrant, any selling security holder, any underwriter, or any member of a selling group, "uses" a credit rating from a credit rating agency with respect to the registrant or a class of securities issued by the registrant in connection with an offering

registered pursuant to the Securities Act. This would include not only oral and written selling efforts, but also disclosure in a prospectus or a term sheet filed pursuant to Rule 433 or Rule 497. Credit ratings would also be considered to be used in connection with a registered offering in which privately offered securities are exchanged for substantially identical registered securities shortly after a private offering in which a credit rating was used. A credit rating would be considered to be used if it is disclosed orally, whether that information is volunteered or only provided in response to a question. Information about unsolicited ratings would not have to be disclosed unless the unsolicited rating is used in connection with a registered offering of securities.

Simply disclosing changes to a credit rating, the liquidity, the cost of funds or the terms of agreements that refer to credit ratings in risk factors or in management's discussion and analysis of financial conduction and results of operations, or elsewhere in an SEC filing, would not trigger the proposed mandatory credit ratings disclosure requirements if the credit rating is not otherwise used in connection with a registered offering.

Required Disclosure

Scope and Limitations. Under the proposed rules, a registrant would be required to disclose the following information for each credit rating that triggers disclosure:

- The identity of the assigning credit rating agency, including whether it is a nationally recognized statistical rating organization;
- The assigned credit rating;
- The date the credit rating was assigned;
- The relative rank of the credit rating within the assigning credit rating agency's classification system;
- The credit rating agency's description of the rating category assigned;
- 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, together with an explanation of the designation's meaning and relative rank;
- Any material differences between the terms of the securities as assumed or considered by the credit rating agency and
  - » the minimum obligations of the security as specified in its governing instruments, and
  - » 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;
  - » a credit rating may be subject to revision or withdrawal at any time by the assigning credit rating agency;
  - » each credit rating is applicable only to the specific class of securities to which it applies; and
  - » investors should perform their own evaluation as to whether an investment in the security is appropriate.

The preliminary prospectus would include the initial rating, if any, if the final is not assigned until after the effectiveness of a registration. If the rating were to change, or if a different rating becomes available, the final prospectus or final prospectus supplement would have to be updated to include the final rating assigned and all related disclosure.

Potential Conflicts of Interest. Under the proposed amendments, the registrant would be required to identify the party who compensates the credit rating agency for providing the credit rating. If, during the registrant's last completed fiscal year and any subsequent interim period up to the date of the filing, either the credit rating agency or any of its affiliates provided other services to the registrant or its affiliates, the registrant would have to describe the other non-rating services, along with the fees paid for the credit ratings required to be disclosed under the new rule, as well as

the aggregate fees paid for any other non-rating services provided during that period. (If disclosure of non-rating services is not required, the registrant will not have to disclose the fees paid for the rating.)

Ratings Shopping. If a registrant is required to disclose a credit rating, it must disclose 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. This is intended to counter "ratings shopping." Also, if a registrant triggers the credit ratings disclosure requirements, it would have to also disclose any credit rating it obtained but did not use. A credit rating would be considered obtained by or on behalf of the registrant if it is solicited by the registrant, or by another party by or on behalf of the registrant, such as an underwriter or others involved in structuring a deal.

Disclosure in Exchange Act Reports

The proposed amendments would add a new item 3.04 to Form 8-K, which would trigger a Form 8-K filing requirement if a credit rating previously disclosed under the rules is changed. This report would be due within four business days of notice of the change. Changes would include the withdrawal of a rating or a decision not to update the rating. The Form 8-K would have to disclose the date the registrant received notice of the rating agency's action, the name of the rating agency and the nature of the rating agency's decision. The SEC noted that a change in a credit rating may require disclosures under other Form 8-K items, such as triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement.

The Form 8-K would not be required to discuss the impact of any ratings change. Instead, that would be described in the registrants next periodic report.

Registrants would only be subject to the new Form 8-K requirement for credit ratings that were disclosed under the new rules. As a result, there would not be any Form 8-K requirement with respect to changes to credit ratings that were obtained and used solely prior to the effectiveness of the rules.

Closed-end funds would be required to make the same disclosures regarding changes to credit ratings on Form 8-K as other issuers. Foreign private issuers would be required to provide disclosure regarding changes to credit ratings annually in their Form 20-F.

Other SEC Credit Ratings Proposals and Actions

Expert Liability under the Securities Act. At the same time that it proposed mandatory credit ratings disclosure, the SEC issued a companion concept release, Release Nos. 33-9071; 34-60798; IC-28943, available at http://www.sec.gov/rules/concept/2009/33-9071.pdf, through which it is seeking comments on whether it should rescind Rule 436(g) under the Securities Act. Rule 436(g) provides an exemption for credit ratings provided by nationally recognized statistical rating organizations so that they are not considered part of the registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act. Comments on this concept release are also due by December 14, 2009.

Section 7 of the Securities Act requires that registrations statements filed under the Securities Act include the written consent of "any person whose profession gives authority to a statement made by him, is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement," which persons are considered experts for the purposes of the securities laws.

Section 11 provides that an expert may be held liable under the Securities Act if the part of the registration statement purporting to be made on the expert's authority contained an untrue statement of material fact or omitted to state a material fact necessary to make the statements therein not misleading. A due diligence defense exists if the expert can establish that, after reasonable investigation, it had reasonable grounds to believe, and did believe, that such statements in the registration statement were true and that there was no omission to state a material fact necessary to

make the statements therein not misleading. If the SEC were to repeal the Rule 436(g) exemption, all rating agencies, whether or not they are nationally recognized statistical rating organizations, would be subject to Section 11 liability as experts and registration statements referring to the credit rating agencies would require the written consent of those agencies.

Elimination of Certain References to Rating Agencies. Release Nos. 34-60789, IC- 28939, available at http://www.sec.gov/rules/final/2009/34-60789.pdf, was also adopted by the SEC in October 2009. These final rules eliminate certain references to credit ratings issued by nationally recognized statistical rating organizations in rules and forms under the Exchange Act regarding self-regulatory organizations and alternative trading systems, and in rules under the Investment Company Act that affect an investment company's ability to purchase refunded securities and securities in underwritings in which an affiliate is participating. At the same time, the SEC re-opened the comment period on proposed amendments that would eliminate other credit ratings references in rules and forms under the Securities Act, Exchange Act, Investment Company and Investment Advisers Act. See Release Nos. 33-9069; 34-60790; IA-2932; IC-28940, available at http://www.sec.gov/rules/proposed/2009/33-9069.pdf.

Practical Considerations

In response to the credit crisis, the SEC has been examining, and taking action in, a number of areas involving credit ratings. To the extent that the SEC adopts a final rule requiring specific credit ratings disclosures, such a rule could impact not only the additional information that registrants would have to add to prospectuses used to market securities in a registered offering, but also possibly some of the methods used in seeking credit ratings. In addition, the actions that the SEC has taken, and is considering, with respect to nationally recognized statistical ratings organizations may lessen the role of rating agencies as "gatekeepers" in connection with securities matters. If expert liability is imposed on such agencies, it may make them more cautious, which could potentially increase the time it takes to obtain a ratings and a written consent for use in a registration statement.

If you have any questions about the credit ratings disclosure proposal or other ratings matters discussed above, please contact the author of this Securities Update, Laura D. Richman, at +1 312 701 7304, any of the lawyers listed below or any other member of our Corporate & Securities practice.

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