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The Impact of the Dodd-Frank Act's Credit Rating Agency Reform on Public Companies

The Dodd-Frank Act not only imposes a new regulatory regime on credit rating agencies, but also it will have a significant impact on public companies that use credit ratings.

By Danielle Carbone

Credit rating agency reform has been on the minds of Congress and the Securities and Exchange Commission (SEC) for years.¹ But it was not until the near collapse of the financial markets in 2008 and Congress' singling out of the rating agencies as one of the culprits for their role in the subprime mortgage-backed securities crisis that the call for reform intensified.² The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which was signed into law in July of this year, imposes a new regulatory scheme on rating agencies, tightens existing regulation, and sets the stage for more to come, with the primary goals of holding rating agencies accountable for the quality of their credit ratings and enhancing the transparency of credit ratings.³

While most of the Dodd-Frank rating agency reforms affect Nationally Recognized Statistical Rating Organizations (NRSROs), two

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provisions already have had a significant impact on public companies that use credit ratings in their periodic filings with the SEC. Among the most significant changes brought about by the new legislation was the immediate repeal of Rule 436(g) under the Securities Act of 1933 (Securities Act). The repeal of Rule 436(g) has the effect of exposing NRSROs to liability as experts under Section 11 of the Securities Act when credit ratings they provide are included or incorporated by reference into a Securities Act registration statement or prospectus. Prior to the enactment of the Dodd-Frank Act, Rule 436(g) provided an exemption for credit ratings issued by NRSROs from being viewed as a part of the registration statement or prospectus prepared or certified by an expert, so issuers that included or incorporated by reference disclosure of their credit ratings did not need the consent of the NRSROs to do so. In October 2009, the SEC staff issued a concept release that proposed the repeal of Rule 436(g), but did not act on it.⁴ The repeal of Rule 436(g), which became effective on July 22, the day after President Obama signed the Dodd-Frank Act, means that NRSROs are subject to the same consent requirements as rating agencies that are not NRSROs have been subject to and issuers are now burdened with securing that consent if the rating is included or incorporated by reference into a registration statement.

Before the enactment of the Dodd-Frank Act, the major NRSROs publicly stated that they were unwilling to provide consents to issuers, creating a stalemate between the NRSROs and the companies that disclose credit ratings

in their SEC filings.⁵ Perhaps unwittingly, with the stroke of a pen, President Obama single-handedly shut down the new offerings markets for both investment grade debt and asset-backed securities (ABS) on July 22 and left public companies unable to raise capital in offerings registered under the Securities Act.⁶

The SEC staff responded quickly to restart both the investment grade and the ABS markets (at least temporarily). On July 22, 2010, the staff of the Division of Corporation Finance issued a no-action letter to Ford Motor Credit Company LLC and Ford Credit Auto Receivables Two LLC, which allowed an asset-backed issuer to omit the ratings disclosure required by Regulation AB from a prospectus that is part of a registration statement relating to an offering of asset-backed securities. The no-action relief is temporary and will expire on January 24, 2011.⁷ In an effort to avoid a disruption in the public debt market, major Wall Street law firms discussed the issues raised by the repeal of Rule 436(g) with the SEC staff and issued a White Paper that set forth the possible approaches that could be available under current SEC rules. Late in the day on July 22, the SEC staff posted to its website a set of Compliance and Disclosure Interpretations (CD&Is) that address the issue of when the consent of a rating agency would need to be filed for companies not subject to Regulation AB disclosure requirements. On July 27, those CD&Is were expanded to address ABS issuers.

The other provision of the Dodd-Frank Act that public companies should consider is the repeal of the exemption for credit rating agencies from Regulation FD.⁸ Regulation FD prohibits companies from making selective disclosure of material nonpublic information to securities professionals and shareholders. The rule currently excludes entities whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available.⁹ The deletion of the Regulation FD exception becomes effective on October 19,

2010. While most, including the NRSROs, do not believe that the change to Regulation FD will affect the way that public companies deal with the NRSROs, public companies should discuss Regulation FD compliance and review the confidentiality provisions that are contained in the engagement letters with the NRSRO.¹⁰

Rule 436(g)—A Brief History

Rule 436(a) under the Securities Act provides that if any portion of the report or opinion of an expert is quoted or summarized in a registration statement or prospectus, the written consent of the expert must be filed as an exhibit to the registration statement and must expressly state that the expert consents to such quotation or summarization. Rule 436(g) provided that the security rating assigned to any class of debt securities, convertible debt, or preferred stock by an NRSRO is not considered part of a registration statement prepared or certified by an expert. Thus, Rule 436(g) had the effect of insulating NRSROs from Section 11 liability for material misstatements or omissions in the part of the registration statement that includes a credit rating that they provided and not requiring issuers to obtain their consent.¹¹

Over the years, the issue of subjecting NRSROs to liability has been the subject of much debate by the SEC, the rating agencies and other market participants. As noted above, in October 2009, the SEC issued a rule proposal that if adopted would mandate disclosure of credit ratings in registration statements if a credit rating is used to market the issuer's securities and a Concept Release soliciting public comment on whether Rule 436(g) should be rescinded.¹² The Dodd-Frank Act has effectively implemented the SEC's Concept Release to rescind Rule 436(g).

Effect of Repeal of Rule 436(g) on Public Securities Offerings

The SEC's regulations permit voluntary disclosure of credit ratings, but the securities laws

do not currently mandate the disclosure of credit ratings, although the SEC has proposed requiring such disclosure.¹³ Some public companies, however, include disclosure of credit ratings in their periodic reports and registration statements because, for example, ratings could have an effect on the company's liquidity, cost of funds, or covenants in its debt instruments. The SEC has at least preliminarily expressed the view in its Credit Ratings Disclosure Release that a consent would not be required from an NRSRO "if the only disclosure of a credit rating in a filing with the Commission is related to changes to a credit rating, the liquidity of the registrant, the cost of funds for a registrant or the terms of agreements that refer to credit ratings, and the credit rating is not otherwise used in connection with a registered offering."¹⁴ This type of credit rating disclosure is referred to by the SEC staff as "issuer disclosure-related ratings information" and at least while the temporary relief under the Ford no-action letter is in place, it applies only to issuers not subject to Regulation AB disclosure requirements.

When Is the Consent of a Rating Agency Needed?

Pursuant to the SEC staff's guidance in the current CD&Is addressing Rule 436, the consent of a rating agency is not required under the following circumstances:

Disclosure of ratings in a registration statement filed pursuant to the Securities Act or a Section 10(a) prospectus for purposes of satisfying an issuer's disclosure obligations. No consent is required when an issuer includes a credit rating in a filing with the SEC in the context of a discussion of changes to a credit rating, the liquidity of the registrant, the cost of funds for a registrant, or the terms of agreements that refer to credit ratings, so long as the disclosure is consistent with the SEC's proposed rules in its Credit Rating Disclosure Release, footnote 53 of the SEC's Concept Release and CD&I 233.04.¹⁵

This type of disclosure typically appears in a risk factor discussion or the liquidity discussion in Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). For example, disclosure in the risk factor section of a Form 10-K that discussed the risk that failure to maintain a specified credit rating or the potential impact of a rating downgrade on the issuer, would not require the issuer to seek the consent of the rating agencies. Likewise, a discussion in the liquidity section of MD&A about the increased cost of borrowing should the issuer fail to maintain its specified credit rating or disclosure of the terms of a security with an interest rate step-up in the event of a rating decline would not require a consent. A statement in a prospectus of the company's credit rating likely would trigger the need for a consent.

Free writing prospectuses and Rule 134 compliant term sheets and press releases. In a somewhat anomalous result, the repeal of Rule 436(g) does not affect the use of ratings in Rule 433 free writing prospectuses or in term sheets or press releases that comply with Rule 134. That is because Section 7 of the Securities Act and Rule 436(a), which requires the filing of written consents by experts, only apply by their terms to "registration statements" and "prospectuses." The term "prospectus" is defined in Rule 405 to mean only a prospectus which meets the requirements of Section 10(a) of the Securities Act. A Rule 433 free writing prospectus is not part of a registration statement, nor is it a "prospectus" as defined in Rule 405, because it is a Section 10(b) prospectus, not a Section 10(a) prospectus. Accordingly, Rule 436(a) does not apply to "free writing prospectuses" or to term sheets or press releases that comply with Rule 134 (since communications that comply with Rule 134 are not considered Section 10(a) prospectuses). It is important for issuers to note that if a free writing prospectus is filed with the SEC not only as a free writing prospectus but also as a prospectus pursuant to Rule 424, the free writing prospectus would constitute a "prospectus" for the purposes

of Rule 436 and, accordingly, unless the disclosure contained in it was “issuer disclosure-related rating information,” a consent would be required.

Registration statements that became effective prior to July 22, 2010. The SEC Staff has confirmed that issuers can continue to use currently effective registration statements without regard to any information about credit ratings included or incorporated by reference into the registration statement until the next post-effective amendment to such registration statement, unless a new Section 10(a) prospectus or prospectus supplement filed under Rule 424 contains ratings disclosure that is not “issuer disclosure-related rating information.”¹⁶ The duration of this relief is limited to the period of time prior to the issuer’s next Annual Report on Form 10-K, 20-F, or 40-F filing, since the filing of an issuer’s annual report is deemed to be a post-effective amendment for purposes of updating the prospectus contained in the registration statement pursuant to Section 10(a)(3). If the filing of the issuer’s next annual report includes ratings information (other than issuer disclosure-related ratings information), then it must be accompanied or preceded by the filing of a consent from the rating agency that provided the rating.

Pursuant to the SEC Staff’s guidance in the CD&Is addressing Rule 436, the consent of a rating agency will be required under the following circumstances:

Prospectuses and prospectus supplements. A consent must be filed as part of the registration statement prior to filing a prospectus or prospectus supplement that is first filed on or after July 22, 2010, and includes ratings information (other than issuer disclosure-related ratings information or any ratings information that was filed prior to July 22, 2010).

Amendments to registration statements filed on or after July 22, 2010. Amendments to registration statements (other than post-effective

amendments which are addressed below) filed on or after July 22, 2010 (including the filing of quarterly and other reports pursuant to the Securities Exchange Act of 1934 (Exchange Act), that are incorporated by reference into a registration statement) must be preceded by the filing of a consent from the rating agency if the amendment contains ratings information (other than issuer disclosure-related ratings information).

Registration statements and post-effective amendments that become effective on or after July 22, 2010. Registration statements and post-effective amendments to registration statements that become effective on or after July 22, 2010, must include the consent of the rating agency if the registration statement includes or incorporates by reference any ratings information (other than issuer disclosure-related ratings information) regardless of when the report that contains ratings information was originally filed. This is one of the more troubling scenarios for public companies that have disclosed ratings information (other than issuer disclosure-related ratings information) in an annual, quarterly, or other report filed pursuant to the Exchange Act, which would be incorporated by reference into a new registration statement or a post-effective amendment. Because the NRSROs are currently unwilling to provide a consent, the issuer would be faced with having to amend the reports to be incorporated into the registration statement prior to the filing of the registration statement or post-effective amendment with the SEC to delete the ratings information. Alternatively, the issue could take one the paths described below.

Other Avenues for Issuers Who Determine a Consent Is Required

The Rule 144A Road Is Open

For those issuers that determine a consent from a rating agency is required, it may be that conducting a Rule 144A offering, an offshore Regulation S offering or possibly a traditional Section 4(2)

private placement may be the only avenues open until the consent roadblock is removed. Because these types of offerings do not require registration under the Securities Act, expert consents are not required.

Rule 437—Dispensing with the Need for a Consent

While a road less traveled, Rule 437 of the Securities Act does allow issuers to make an application to the SEC to dispense with any written consent of an expert pursuant to Section 7 of the Securities Act if the issuer can show that obtaining such consent is impractical or involves undue hardship on the issuer. However, it is not likely that the SEC staff, acting pursuant to delegated authority, will be willing to grant relief under Rule 437 under most circumstances.

Regulation FD and the Credit Rating Agencies

Regulation FD, which has been in effect since 2000, prohibits senior executives and other company representatives of public companies who regularly communicate with the market from making selective disclosure of material nonpublic information to four enumerated categories of persons: (i) broker-dealers and their associated persons, (ii) investment advisers and institutional investment managers and their associated persons, (iii) investment companies and their associated persons, and (iv) holders of the issuer's securities, under circumstances in which it is reasonably foreseeable that the holder will trade on the information. Regulation FD does not apply if the person to whom the disclosure is made is either someone who owes the company a "duty of trust or confidence" or who expressly agrees to maintain the disclosed information in confidence. Regulation FD also does not apply to disclosures made to rating agencies provided that the ratings are made publicly available. Given the explicit exemption in the rule for rating agencies, public companies should be comfortable sharing material nonpublic

information with the rating agencies. The Dodd-Frank Act requires that the SEC revise Regulation FD to remove the credit rating agency exemption not later than October 19, 2010.¹⁷

The NRSROs that have publicly addressed the issue do not believe that the removal of the exemption will affect the way in which issuers share material nonpublic information with the rating agencies as part of the ratings process. In this regard, they do not believe that they fall within any of the enumerated categories of persons to whom selective disclosure is prohibited and their policies prohibit trading on material nonpublic information. In addition, the engagement letter that the rating agency enters into with the issuer contains confidentiality provisions which should allay concerns that companies may nonetheless have about the effect of the removal of the exemption.

What Lies Ahead?

Most of the reforms in the Dodd-Frank Act related to credit rating agencies will not take effect until one year after enactment, and the Act, in many cases, directs the SEC to issue rules implementing the law and, in other cases, authorizes various studies of issues related to credit ratings.

The staff of the SEC also has a number of proposed rule makings related to credit ratings pending that it has not yet acted upon. Of those, the Credit Rating Disclosure Release, if adopted as proposed, will have a significant impact on issuers. That rule proposal would require issuers to make disclosures about their credit ratings in prospectuses for registered public offerings if they use a credit rating to market their securities. The release takes a broad view of what it means for a credit rating to be "used in connection with a registered offering of securities" and the rule would be triggered under a wide variety of circumstances, including if the rating is used in oral selling efforts. Issuer disclosure-related ratings information would not trigger the rule. The

scope of information that an issuer would need to disclose if it used a credit rating in connection with a public offering is relatively expansive and could even require disclosure of preliminary ratings. If the rule is adopted as proposed, issuers will be faced with being required to disclose credit ratings if the rating is used in connection with a public offering and the disclosure is not otherwise issuer disclosure-related ratings information, but being unable to secure the required consent from the rating agency issuing the rating—the position that ABS issuers currently find themselves in—caught in the crossfire.

Absent further action by the SEC staff, ratings disclosure will be required in Regulation AB offerings and rating agency consents will necessary once the temporary relief provided by the Ford no-action letter expires, but it is very likely that the SEC staff will take some further action to prevent another shut-down of the ABS market. It is clear that the issue of the use of credit ratings and how the credit rating agencies conduct the business of issuing credit ratings is evolving and rules of the road are likely to continue to change in the not too distant future.

NOTES

1. See Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78; Amendments to Rules for Nationally Recognized Statistical Rating Organizations Release No. 34-61050; File No. S7-04-09 (Nov. 23, 2009), available at <http://www.sec.gov/rules/finall/2009/34-61050.pdf>.
2. Financial Crisis Inquiry Commission (FCIC), Preliminary Staff Report—Credit Ratings and the Financial Crisis (2010), available at: <http://www.fcic.gov/reports/pdfs/2010-0602-Credit-Ratings.pdf>.
3. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Title IX, Subtitle C—Improvements to the Regulation of Credit Rating Agencies, §§ 931—939H.
4. Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, Release Nos. 33-9071; 34-60798; IC -28943; File No. S7-25-09 (October 7, 2009), available at: <http://www.sec.gov/rules/concept/2009/33-9071.pdf>.
5. The NRSROs have long taken the position that they are not experts within the meaning of Section 7 and Section 11 of the Securities Act and that therefore, their consent is not required if an issuer includes a credit rating in a registration statement. They have also put forth the view that

ratings are essentially an opinion about risk, not statements, and as such subjecting them to Section 11 liability is not appropriate.

6. It was widely reported that Ford Motor Credit was forced to postpone the launch of a \$1 billion ABS public offering because of the SEC requirement in Regulation AB to disclose credit ratings and the inability of the issuer to secure consents from the NRSROs in light of the repeal of Rule 436(g).
7. Ford Motor Credit Company LLC, SEC No-Action Letter (July 22, 2010), available at: <http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm>.
8. Dodd-Frank Act, Title IX, § 939B.
9. The FD exemption for credit rating agencies was added in the final rule. In its comment letter to the SEC Staff in response to the rule proposal, Standard & Poor's (S&P) asked the SEC to make clear, preferably by means of a specific exemption, that the submission of material nonpublic information to a rating agency by an issuer solely for rating purposes is not selective disclosure. The Staff opted for the exemption. See Letter from Vickie A. Tillman, Executive Vice President, Standard and Poor's Investment Ratings Services (Mar. 27, 2009), available at: <http://www.sec.gov/comments/s7-04-09/s70409-18.pdf>; and Letter from Michel Madelain, Chief Operating Officer, Moody's Investor Service (Mar. 28, 2009), available at: <http://www.sec.gov/comments/s7-04-09/s70409-20.pdf>.
10. Letter from Devin Sharma, President of Standard & Poor's (Jul. 16, 2010); Moody's Investors Service Special Comment, Moody's to Begin Implementing Changes Relating to U.S. Regulatory Reform Act (Jul. 15, 2010); Press Release, Fitch Ratings, Fitch Comments on U.S. Financial Reform Act's Implication for Credit Rating Agencies (Jul. 19, 2010).
11. Rating agencies that are not NRSROs were not covered by the Rule 436(g) exemption and consents have been necessary to include ratings issued by these rating agencies in registration statements, with the rating agencies being subject to liability under Section 11. The repeal of Rule 436(g) has the effect of putting NRSROs on equal footing with other credit rating agencies.
12. Credit Ratings Disclosure, Release Nos. 33-9070; 34-60797; IC-28942; File No. S7-20-09 (October 7, 2009), available at: <http://www.sec.gov/rules/proposed/2009/33-9070.pdf> (SEC Release No. 33-9070) and Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, Release Nos. 33-9071; 34-60798; IC -28943; File No. S7-25-09 (October 7, 2009), available at: <http://www.sec.gov/rules/concept/2009/33-9071.pdf>.
13. Regulation S-K, § 229.10 (Item 10). See SEC Release No. 33-9070 for the SEC's rule proposal mandating disclosure when ratings are used in connection with a public offering.
14. SEC Release No. 33-9070, at 19; SEC Release No. 33-9071, n. 53. See Securities Act Rules CD&I, Question 233.04.
15. SEC Release No. 33-9070. This rule proposal would require an issuer to include in its registration statement information regarding credit ratings

(other than issuer disclosure-related ratings information) used by the issuer in connection with a registered public offering. The SEC has not acted on this rule proposal. If this proposal is adopted, the application of the consent requirement would change since ratings used in securities offerings would be required to be disclosed in the registration statement.

16. Rule 401(a) provides that the form and content of a registration statement and prospectus shall conform to the applicable rules and forms as in effect on the initial filing date of such registration statement and prospectus.

17. Dodd-Frank, Title IX, Subtitle C, § 939B.

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