News Bulletin

August 1, 2011

Dodd-Frank Update: SEC Adopts New Criteria to Replace Credit Ratings to Determine Short-Form Eligibility

Section 939A of the Dodd-Frank Act requires federal agencies to review how existing regulations rely on credit ratings and remove such references from their rules and replace them with standards of creditworthiness as each agency deems appropriate. To comply with Section 939A, on February 9, 2011, the Securities and Exchange Commission ("SEC") proposed amendments to its rules that would remove credit ratings as one of the conditions for companies seeking to use short-form registration when registering securities for public sale.[1] On July 27, 2011, the SEC unanimously adopted rules to remove references to credit ratings in rules and forms promulgated under the Securities Act of 1933 ("Securities Act") and the Exchange Act of 1934 (the "Exchange Act").[2] The amendments will become effective 30 days after publication in the Federal Register, except for the rescission of Form F-9, which is to become effective December 31, 2012.

Forms S-3 and F-3

Forms S-3 and F-3 are the short forms that eligible issuers can use to register securities offerings under the Securities Act. These forms allow eligible issuers to register primary offerings on a shelf registration statement prior to planning any offering and, once the registration statement is effective, offer securities in various tranches or "takedowns" without any further SEC action. To be eligible to use Forms S-3 or F-3, an issuer must meet both (a) the eligibility requirements and (b) at least one of the form's transaction requirements. One such transaction requirement permits registrants to register primary offerings of non-convertible securities, if they are rated investment grade by at least one nationally recognized statistical rating organization ("NRSRO"). For issuers who do not have a public float to meet the required threshold, this has provided an alternate means of becoming eligible to register offerings on Forms S-3 or F-3.[3]

As originally proposed, the SEC would have replaced the investment grade rating eligibility requirement with only one alternate standard: an issuer that has issued more than $1 billion of non-convertible securities for cash, other than common equity, in registered, primary offerings within the previous three years would be eligible to use Forms S-3 and F-3. This proposed change mirrored the standard for an issuer to qualify as a well-known seasoned issuer ("WKSI"). The SEC sought comment on whether the proposed standard would change the pool of issuers eligible to use Forms S-3 and F-3 and whether alternative standards were appropriate. Responding to the comments received on this question, the new rules replace the investment grade rating requirement with four alternate standards, as discussed below.

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[1] *See* SEC Release Nos. 33-9186; 34-63874 (February 9, 2011), http://www.sec.gov/rules/proposed/2011/33-9186.pdf.
[2] *See* SEC Release Nos. 33-9245; 34-64975 (July 27, 2011), http://www.sec.gov/rules/final/2011/33-9245.pdf.
[3] Issuers who satisfy the $75 million public float requirement will remain eligible for registration on Forms S-3 and F-3, and are largely unaffected by the new rules.

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Investment Grade Rating Criterion Replaced with Alternative Criteria

Under the changes to Forms S-3 and F-3 adopted by the SEC, the investment grade rating transaction criteria will be replaced with the following four alternative criteria. Issuers will need to satisfy any one of the four criteria to use Forms S-3 or F-3 for offerings of non-convertible securities other than common equity. They are:

- The issuer has issued (as of a date within 60 days prior to the filing of the registration statement) at least $1 billion in non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act, over the prior three years; or
- The issuer has outstanding (as of a date within 60 days prior to the filing of the registration statement) at least $750 million of non-convertible securities, other than common equity, issued in primary offerings for cash, not exchange, registered under the Securities Act; or
- The issuer is a wholly-owned subsidiary of a WKSI as defined in Rule 405 under the Securities Act; or
- The issuer is a majority-owned operating partnership of a real estate investment trust ("REIT") that qualifies as a WKSI.

In addition, the SEC has permitted an issuer that has a reasonable belief that it would have been qualified to use Form S-3 or Form F-3 under the investment grade rating criteria to continue to use these forms for a period of three years from the effective date of the amendments.

$1 Billion of Non-convertible Securities or $750 Million of Non-Convertible Securities Outstanding

In addition to the $1 billion of non-convertible securities, other than common equity, issued over three years criterion, an issuer that has at least $750 million of non-convertible securities, other than common equity, issued in primary offerings for cash, not exchange, registered under the Securities Act outstanding will be eligible to use Forms S-3 or F-3, if the issuer meets the other requirements of the form. The thresholds would be calculated consistent with the standards used to determine WKSI status. In determining compliance with both the $1 billion issued and the $750 million outstanding thresholds, issuers can do the following:

- Aggregate the amount of non-convertible securities, other than common equity, issued in registered primary offerings that were issued within the previous three years (measured as of a date within 60 days prior to the filing of the registration statement) or, for the non-convertible securities (other than common equity) outstanding threshold, that are outstanding as of a date within 60 days prior to the filing of the registration statement;
- Include only such non-convertible securities, other than common equity, that were issued in registered primary offerings for cash and not registered exchange offers; and
- Parent company issuers can only include in their calculation the principal amount of their full and unconditional guarantees, within the meaning of Rule 3-10 of Regulation S-X, of non-convertible securities, other than common equity, of their majority-owned subsidiaries issued in registered primary offerings for cash over the prior three years or, for the non-convertible securities (other than common equity) outstanding threshold, that are outstanding as of a date within 60 days prior to the filing of the registration statement.

In calculating the $1 billion or the $750 million amount, as applicable, issuers generally will be permitted to include the principal amount of any debt and the greater of liquidation preference or par value of any non-convertible preferred stock that were issued in primary registered offerings for cash. Insurance company issuers, when registering offerings of insurance contracts, will be permitted to include in their calculation the amount of

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insurance contracts, including variable insurance contracts, issued in offerings registered under the Securities Act over the prior three years, or for the non-convertible securities (other than common equity) outstanding threshold, that are outstanding as of a date within 60 days prior to the filing of the registration statement. An insurance company may include the purchase payments or premium payments for insurance contracts issued in registered offerings over the prior three years. For the non-convertible securities threshold, the contract value as of the measurement date, of any outstanding insurance contracts issued in registered offerings can be included.

Securities issued in unregistered offerings, registered exchange offers, or Regulation S offerings cannot be included in calculating the $1 billion or $750 million calculations.

Subsidiaries of WKSIs

The new rules permit issuers that are wholly-owned subsidiaries of WKSIs to use Forms S-3 and F-3 for offerings of non-convertible securities other than common equity. Majority-owned or partially owned subsidiaries are not permitted under the new eligibility criteria to use Forms S-3 or F-3.

Although the new criteria for subsidiaries of WKSIs are generally limited to wholly-owned subsidiaries, there is a limited exception for certain operating partnerships of REITs. A majority-owned operating partnership subsidiary of a REIT is permitted to register offerings of non-convertible securities, other than common equity, on Forms S-3 or F-3, so long as the REIT parent is a WKSI.

Grandfathering of Other Currently Eligible Issuers

To ease transition to the new rules, the SEC has permitted issuers that reasonably believe they would have qualified to use Forms S-3 or F-3 under the investment grade rating criteria to continue to use these forms for a period of three years from the effective date of the amendments. The issuer must have a *reasonable belief* that it would have been eligible to use the form and *disclose* that belief and the basis for it in the registration statement (emphasis added). Factors that indicate a reasonable belief of eligibility would include, but are not limited to:

- An investment grade issuer credit rating;
- A previous investment grade credit rating on a security issued in an offering similar to the type the issuer seeks to register that has not been downgraded or put on a watch list since its issuance; or
- A previous assignment of a preliminary investment grade rating.

Impact of Amendments

The SEC estimates that most issuers that were previously eligible to use Forms S-3 or F-3 will continue to remain eligible to use these forms. In fact, the final rules were designed to avoid the possibility that a substantial number of issuers could lose their eligibility to use short-form registration statements. According to the SEC release, several issuers in the insurance industry will become newly eligible to use Forms S-3 or F-3.

Particularly once the grandfathering period has ended, issuers that do not satisfy Form S-3 or Form F-3 $75 million public float requirement will need to review their prior and outstanding issuances of registered securities every three years to determine whether they satisfy the new eligibility requirements for short-form registration.

Offerings of Investment Grade Asset-Backed Securities

General Instruction 1.B.5 to Form S-3 provides transaction requirements for offerings of investment grade asset-backed securities. That instruction cross-references General Instruction I.B.2 of Form S-3, where the definition of investment grade securities is currently found. In April 2010, the SEC proposed to remove references to credit ratings as a requirement for shelf eligibility for offerings of asset-backed securities.[4] That proposal is still outstanding. On July 26, 2011, the SEC re-proposed rules relating to registrant and transaction requirements for the shelf registration of asset-backed securities and changes to exhibit filing deadlines under Regulation AB. The new rules adopt an amendment to General Instruction 1.B.5 of Form S-3 that move the definition of investment grade securities to that instruction until new rules regarding shelf eligibility for asset-backed issuers are adopted.

Additional Amendments

The new rules also make a variety of other amendments relating to credit ratings, which will be important to market participants.

Offering communications: Rule 134(a)(17)

Securities Act Rule 134 is a safe harbor that permits certain communications to be issued after the filing of a registration statement without being deemed to be a "prospectus" or a "free writing prospectus." It is commonly used as a basis for issuing "tombstones" or press releases with limited information about a registered offering. Securities Act Rule 134(a)(17) permits the disclosure of security ratings in these documents. The new rules eliminate this safe harbor for disclosure of credit ratings. The removal of this safe harbor would not necessarily result in a communication that includes rating information being deemed to be a prospectus or a free writing prospectus. Instead, the determination as to whether disclosure of security ratings in certain communications constitutes a prospectus should be made in light of all the circumstances of the communication. However, in order to ensure the desired treatment of these documents, we anticipate that credit rating information is likely to be removed, particularly when the documents are used in connection with significant syndicated offerings of debt securities.

Canadian issuers: Rescission of Form F-9

The final rules rescind Form F-9. Form F-9 is a form under the Multi-Jurisdictional Disclosure System ("MJDS") that allows certain Canadian issuers to register non-convertible investment grade debt or preferred securities that are offered for cash or in connection with an exchange offer, and that are either non-convertible or not convertible for a period of at least one year from the date of issuance. The investment grade rating criteria is one of the Form's eligibility requirements. In addition, an eligible issuer can register investment grade securities on Form F-9 without reconciliation to U.S. generally accepted accounting principles ("U.S. GAAP"). Prior to changes in applicable Canadian regulations, issuers that used Form F-10 had to reconcile their financial statements to U.S. GAAP. The Canadian Securities Administrators ("CSA") have adopted rules that will require Canadian reporting companies to prepare their financial statements according to International Financial Reporting Standards ("IFRS") beginning in 2011. Foreign private issuers that prepare their financial statements in accordance with IFRS need not reconcile with U.S. GAAP. As a result of this change, Forms F-9 and F-10 will have the same disclosure requirements, and Form F-9 is rescinded effective December 31, 2012.

Issuers that do not satisfy the parent guarantee or public float requirements of Form F-10 are still allowed, for a period of three years from the effective date of the amendments, to register securities on that form as along as the issuer has a reasonable belief that it would have qualified to use Form F-9 on the effective date of the amendments.

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[4] *See* SEC Release No. 33-9117 (April 7, 2010), http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

The final rules also permit issuers who file annual reports on Form 40-F to continue to satisfy their reporting obligations on that form as to previously sold securities if those securities were sold under a registration statement on Form F-9.

Business combinations and exchanges: Forms S-4 and F-4 and Schedule 14A

Conforming amendments were made in Forms S-4 and F-4 and Schedule 14A, so that registrants will be eligible to use incorporation by reference to satisfy their disclosure requirements under Forms S-4 and F-4 if they meet one of the new transaction requirements. Similarly, Schedule 14A was amended to refer to requirements of General Instruction I.B.2 of Form S-3, rather than to "investment grade securities."

Communications safe harbors: Rules 138, 139, and 168

Rules 138, 139, and 168 under the Securities Act provide that certain communications are deemed not to be an offer to sell a security under Sections 2(a)(10) and 5(c) of the Securities Act when these communications relate to an offering of non-convertible investment grade securities. These rules were revised to reflect the new eligibility requirements in Forms S-3 and F-3. The legal and compliance departments of investment banks will now be required to set up alternative procedures in advance of relying on the Rules 138 and 139 research safe harbors and undertake to verify the issuer's form eligibility.

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