



# SEC Proposes New Credit Rating Disclosure Requirements for Issuers

On September 17, 2009, the SEC continued its rule-making activity relating to rating agencies and credit ratings by voting to propose a number of new rules and to solicit additional comments on its prior proposals.<sup>1</sup> In a new release,<sup>2</sup> the SEC proposes to impose a variety of new disclosure obligations on issuers that have obtained or use credit ratings for their securities. The proposed rules reflect the SEC's efforts to help ensure that investors have an accurate understanding of the meaning or significance of a credit rating before making an investment decision that is based in whole or in part on that rating.

Several of the SEC's recent initiatives have involved an effort to reduce the prominence of credit ratings. For example, the SEC has proposed and adopted a variety of rule changes to remove references to, and reliance on, credit ratings in its own regulations.<sup>3</sup> However, in the new proposed rules, the SEC would appear to add additional prominence to ratings, by making a variety of disclosures about credit ratings mandatory.

## Current Credit Rating Disclosure Requirements

The SEC's proposed rules would, if adopted, represent a significant move away from the voluntary disclosure regime now applicable when an issuer elects to disclose a credit rating in a registration statement or report. The current SEC policy regarding credit rating disclosure is specified in Item 10(c) of Regulation S-K. Item 10(c) sets forth the SEC's policy of permitting the voluntary disclosure of securities ratings, and identifies important disclosure considerations to be taken into account when credit ratings are disclosed. When the current policy for securities ratings was initially adopted in 1981, the SEC noted that there was no "pressing need" for mandatory disclosure of credit ratings, based on its observation that the market viewed debt and preferred securities with comparable ratings and payment terms as essentially fungible.

When the SEC proposed to remove references to credit ratings from its rules and forms in 2008, it also indicated that the voluntary disclosure regime contemplated by Item 10(c) of Regulation S-K should be retained. However, the SEC solicited comments as to whether (1) the Item 10(c) policy should be retained and modified; (2) mandatory disclosure of ratings should be required; or (3) disclosure of credit ratings should be prohibited.<sup>4</sup>

<sup>1</sup> See "SEC Votes on Measures to Further Strengthen Oversight of Credit Rating Agencies," SEC Press Release 2009-200 (September 17, 2009).

<sup>2</sup> Release No. 33-9070 (October 7, 2009).

<sup>3</sup> Release No. 34-60789 (October 5, 2009); Release No. 33-8940 (July 1, 2008).

<sup>4</sup> Release No. 33-8940 (July 1, 2008).

## Reasons for the Proposed Rules

The proposed rules attempt to address four principal areas of the SEC's concern:

- Investors may not be provided with sufficient information to understand the scope or meaning of ratings that are used to market various types of securities.
- Investors may not have access to the information needed to understand and appreciate the potential conflicts of interest faced by credit rating agencies, and how these conflicts may impact the ratings that they assign to securities.
- "Ratings shopping" – the practice of seeking the highest credit rating available from multiple credit rating agencies – may lead to inflated ratings.
- Although credit ratings are often a key part of investment decisions and are used to market securities, disclosure about ratings is not required in prospectuses for registered offerings.

## Scope of Proposed Rules

The proposed rules would require disclosure by issuers regarding credit ratings in their registration statements under the Securities Act and the Exchange Act if the issuer uses the rating in connection with a registered offering.<sup>5</sup> In order to keep investors informed of developments relating to credit ratings for their investments, the proposed rules would also require issuers to disclose changes to their credit ratings in their Exchange Act reports.<sup>6</sup>

None of the proposals would require issuers to obtain credit ratings. Instead, the proposed rules would require disclosures about credit ratings when they are used by issuers and underwriters that participate in a registered offering.

The proposed rules would generally apply on a comparable basis to offerings by both U.S. and non-U.S. issuers, although the required reporting under the Exchange Act would be significantly delayed as to foreign issuers.

Any registered offering of securities that is subject to a credit rating, whether traditional debt securities, preferred stock, trust preferred structures, asset-backed securities, or structured products (such as equity-linked notes) would be subject to the new rules.

The proposed rules would apply only to registered offers of securities. Accordingly, unregistered offerings, such as EMTN programs and other Regulation S offerings, Rule 144A offerings, and commercial paper offerings would generally not be impacted by the proposed rules. However, the SEC is soliciting comments as to whether there are private placements in which ratings disclosures should be mandated.<sup>7</sup>

## When Disclosures of Credit Ratings Would Be Required

Under the proposed rules, issuers would be required to provide the new disclosures when they use a credit rating in connection with a registered offering of their securities. In addition, the requirement would be triggered when other participants in the offering, such as a selling security holder, an underwriter, or a member of a selling group, use a credit rating with respect to the issuer or a class of its securities. The disclosure requirements would be triggered whether a rating is obtained for a specific class of securities, or whether the issuer or underwriter refer to the issuer's general credit rating as to a class of securities. For example, an issuer's senior debt securities may be

<sup>5</sup> The proposed rules would also apply to closed-end management investment companies in registration statements filed under the Securities Act and the Investment Company Act.

<sup>6</sup> See text below under the caption "Disclosure of Ratings in Exchange Act Reports."

<sup>7</sup> See the discussion below as to the impact of the proposed rules on "Exxon Capital" exchange offers.

offered by reference to the issuer's general credit rating for long-term senior debt, even if the relevant rating agency is not requested to specifically rate the class of securities that will be issued in the relevant offering.

Under the proposed rules, a credit rating may be deemed "used" in a wide variety of ways. Written disclosures in a prospectus or a free writing prospectus would trigger the requirement, as would oral statements. The proposed rules do not differentiate among the number and type of recipients that receive the communication – for example, a reference to a rating that is made to a single institutional investor in a registered offering will trigger the same disclosure requirements as a reference made in a broad public offering to retail investors.

As a result of this broad requirement, the proposed ratings disclosure, if adopted, would likely become virtually mandatory for a wide variety of issuers of rated securities. An oral statement by a single member of an underwriter's sales force would trigger the disclosure requirement, even if made in response to an investor's question, or if the oral statement was inadvertently made. In addition, Bloomberg communications used by underwriters in connection with the offering process routinely include ratings information. Since issuers cannot necessarily control all of the actions by an underwriters' representatives, they are likely to err on the side of caution, and make the required disclosures in their offering documents.

A credit rating would also be deemed to be used in a registered offering if it is used in connection with a private placement, if the privately placed securities are exchanged shortly thereafter by the issuer for a substantially identical class of registered securities. (i.e., an "Exxon Capital exchange offer.") This would be the case even if the rating was not disclosed in the registered exchange offer.

The disclosure requirements would not apply to ratings that were not solicited by the issuer, *unless* the rating is used in connection with a registered offering of its securities. In addition, the disclosure requirements would not be triggered if the only disclosure of the rating in a filing with the SEC related to changes to a credit rating, the liquidity of the issuer, the cost of funds for an issuer or the terms of agreements that refer to credit ratings, and the credit rating is not otherwise used in connection with a registered offering.<sup>8</sup>

## Required Disclosures

*Nature of Disclosures.* The new disclosures are intended to provide investors with a specific description of the ratings and to clarify for investors:

- the elements of the securities that the credit rating addresses;
- the material limitations or qualifications on the credit rating, if any; and
- any related published designation, such as non-credit payment risks, assigned by the credit rating agency with respect to the security.

*Specific Disclosure Requirements.* The proposed rules would require the following disclosures:

- the identity of the credit rating agency assigning the rating, and whether that organization is a nationally recognized statistical rating organizations ("NRSRO");
- the credit rating that was assigned, and the date that it was assigned;
- the relative rank of the credit rating within the applicable credit rating agency's classification system;
- the credit rating agency's definition or description of the category in which the credit rating agency rated the securities;

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<sup>8</sup> For example, instance, some issuers refer to their ratings in the context of their risk factor discussion regarding the risk of failure to maintain a certain rating, and the potential impact that a change in a credit rating would have on that issuer. Further, ratings may be discussed in the liquidity and capital resources section of an issuer's Management's Discussion and Analysis. See Release No. 33-8350 (December 19, 2003).

- the identity of the party that is compensating the rating agency for providing the rating;
- 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, along with an explanation of the designation's meaning and the relative rank of the designation;
- any material differences between the terms of the securities as assumed or considered by the credit rating agency in rating the securities and (i) the minimum obligations of the security as specified in the governing instruments of the security; and (ii) 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; that it may be subject to revision or withdrawal at any time by the assigning credit rating agency; that each credit rating is applicable only to the specific class of securities to which it applies; and that investors should perform their own evaluation as to whether an investment in the security is appropriate.<sup>9</sup>

*Specific Security Types.* The types of information listed above would be required for all types of securities. However, the issuers of certain types of securities would need to customize these disclosures to fit the relevant security. For example, it would be appropriate for an issuer of an equity-linked note to indicate that the credit rating relates to the issuer's ability to satisfy its payment obligation, and not to the likelihood that an investor would be entitled to receive more or less than his or her principal amount based upon the performance of the underlying asset.

*Common Disclosures.* The discussion of certain ratings would be common to many issuers. For example, the investment-grade and non-investment grade categories used by rating agencies such as Moody's and Standard & Poor's are used by a broad segment of issuers. Accordingly, information about how these rating agencies categorize these ratings would likely be used by many issuers, and could become standardized to a certain extent, and perhaps repetitive. To facilitate these disclosures, if the rules are adopted in the proposed form, it is possible that the leading rating agencies will provide, on a website or by other means, the information needed to complete the required disclosures, and perhaps even recommended language.<sup>10</sup>

## Location of Required Disclosures

*General.* The disclosures would be required in both preliminary prospectuses and final prospectuses. Instead of disclosing the information in a preliminary prospectus, the issuer could also disclose the ratings information in a free writing prospectus ("FWP").<sup>11</sup> If a disclosed rating is changed or if a different rating becomes available before pricing, the issuer would need to convey information about the change to investors, and to update the final prospectus.

*Frequent Issuers.* Frequent issuers of rated securities would need to consider the most effective means of conveying all of the required information. On the one hand, the information could be stated in a base prospectus for a shelf registration statement, or a prospectus supplement for a medium-term note program. However, if the ratings information were to change after the date of that document, which is a quite common situation, the issuer

<sup>9</sup> Many issuers that currently disclose their ratings on a voluntary basis already make some form of this statement in the relevant offering documents.

<sup>10</sup> By way of example, the Depository Trust Company ("DTC") provides issuers with a form of disclosure to be included in prospectuses for debt securities in order to describe the nature of the DTC clearing system.

<sup>11</sup> The SEC indicates that an issuer could disclose the credit rating in a free writing prospectus as long as it is also included in the registration statement. This could be accomplished by disclosure in a prospectus supplement that becomes part of the registration statement under Rule 430B.

would need to amend the applicable base document, or to disclose the updated ratings information in all subsequent prospectus supplements or pricing supplements.

WKSI's<sup>12</sup> that receive an upgrade or a downgrade in their ratings would presumably be able to incorporate some or all of this information by reference from their Exchange Act reports, as permitted by Rule 430B. As to other issuers, in the context of a short-form pricing supplement, such as that used under a medium-term note program to offer plain vanilla debt securities, adding the new updated ratings disclosures may not be a very effective or desirable means of conveying the information. Accordingly, some issuers may wish to create an additional document to include in their suite of offering documents, perhaps called a "ratings supplement," which would contain only the current ratings information.<sup>13</sup>

*Preliminary Term Sheets.* The requirement to set forth the ratings information in a preliminary term sheet may raise filing questions under Rule 433. Rule 433(d)(5)(i) exempts an FWP or a portion of an FWP from the SEC's filing requirements to the extent that the FWP contains only the preliminary terms of a proposed offering. Many issuers rely on this provision in order to convey in writing the preliminary terms of a proposed security to one or more investors, without publicly filing those terms. Perhaps the addition of all of the required rating disclosure described above would remove the FWP from this exemption from filing, since the FWP would now consist of more than simply the preliminary terms of the security. In order to preserve the exemption from filing, arguably, the issuer could file, instead of the entire preliminary term sheet, a separate FWP that included only the ratings disclosure, but not the disclosure as to the preliminary terms of the offering. With that "credit rating FWP" being filed, the issuer would (a) rely on Rule 433(d)(3) as to the credit rating FWP, which indicates that an FWP need not be filed if a prior FWP was filed with similar disclosures, and (b) rely on Rule 433(d)(5)(i) so as not to file the preliminary terms portion of the new FWP. If the proposed rules are adopted, it would be useful for the SEC to clarify the issuer's filing obligations under these circumstances.

### Disclosure of Potential Conflicts of Interest

The proposed rules would require an issuer to disclose the identity of the party that is paying the credit rating agency for providing the credit rating. (This will usually, but not always, be the issuer.) In addition, if during the issuer's most recent fiscal year and any subsequent interim period up to the date of the filing, the rating agency or one of its affiliates has provided non-rating services to the issuer or its affiliates, the proposed rules would require a description of the other non-rating services and separate disclosure of the fee paid for the applicable credit rating, and the aggregate fees paid for any other non-rating services provided during the period. However, the proposed rules do not require disclosure of the specific fee paid for the credit rating, unless disclosure of other non-rating services is required.<sup>14</sup>

### Measures Against "Ratings Shopping"

Under the proposed rules, if an issuer has obtained a credit rating and is required to disclose that credit rating, then 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 must also be disclosed. In addition, if a rating is required to be disclosed, then any credit rating obtained by the issuer but not used must also be disclosed. Disclosure as to a preliminary credit rating would be required even if it was oral, or unpublished. A similar level of disclosure would be required for a preliminary rating as for a final rating.

<sup>12</sup> "Well Known Seasoned Issuers", as defined in Rule 405.

<sup>13</sup> For example, issuers that frequently offer equity-linked notes linked to a common index, such as the S&P 500 Index, may create a short "index supplement" that describes that index, so that they need not repeat the disclosures in many offering documents. That supplement would be provided to investors together with the applicable pricing supplement and base prospectus.

<sup>14</sup> For a class of securities that is specifically rated, the issuer would appear to be required to disclose the amount paid for that issuance. It is less clear what amount an issuer would disclose in the case of the disclosure of the rating of a class of its securities generally – perhaps the fee for that general rating would be disclosed in the case of each specific offering.

The SEC believes that these disclosures would provide investors with important information to assess whether any “ratings shopping” has occurred, and whether any rating agency may have “inflated” its rating in order to win the issuer’s business from an agency that was not willing to provide a higher rating.<sup>15</sup> This disclosure requirement may be designed by the SEC to modify the behavior of issuers with respect to acquiring ratings, because issuers will likely be unwilling to make any disclosures about preliminary ratings that are unrelated to the final rating.

### Disclosure of Ratings in Exchange Act Reports

The proposed rules would amend an issuer’s Exchange Act reporting requirements to provide updated disclosure regarding changes to a credit rating that was previously subject to the new disclosure rules.<sup>16</sup>

If such a credit rating is changed, such as when a rating has been withdrawn or is no longer being updated, that change would be required to be disclosed in a current report on Form 8-K within four business days. (Foreign private issuers would be required to disclose this information in their subsequent Form 20-F.<sup>17</sup>) Under the proposal, disclosure is required for changes in a rating, but *not* for the placement of an issuer on “credit watch” or assigning a different “outlook” to the issuer’s securities. Once a credit rating agency stops rating the securities, an issuer would be required to disclose that information in a Form 8-K, and to update the relevant prospectus.

The required disclosure would include the date that the issuer received the credit rating agency’s notice or communication, the name of the rating agency, and the nature of the rating agency’s decision. An issuer may decide to, but would not necessarily be required to, discuss the impact of the change or other decision on its business and finances. The proposing release suggests that issuers think carefully as to whether such additional disclosures would be appropriate, or even required, in their subsequent quarterly reports, such as in their MD&A discussion.

The new Exchange Act disclosures would not be required until the rating agency notifies the issuer that the rating agency has made a decision to change the credit rating. If the issuer is still in negotiations or is appealing a preliminary indication that a credit rating agency intends an action covered by the proposed item, no disclosure would be required.

### Potential Rescission of Rule 436(g)

In a companion concept release,<sup>18</sup> the SEC is seeking comment on the possible rescission of Securities Act Rule 436(g), which currently exempts NRSROs from liability under Sections 7 and 11 of the Securities Act. In 2008, the SEC had proposed to amend Rule 436(g) to expand the exemption beyond NRSROs to all credit rating agencies. If Rule 436(g) were rescinded as proposed, then issuers would have to endure the potentially costly and time consuming process of obtaining consents from credit rating agencies for any disclosure of the ratings included in Securities Act registration statements, and credit rating agencies may become more reluctant to provide ratings if they know that they will face potential Securities Act liability based on required, “expertized” ratings disclosure.

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<sup>15</sup> However, the proposed rules would not require disclosure of preliminary ratings obtained by an issuer from the credit rating agency that issues the final rating. Such a rule might limit the flow of communications between an issuer and a rating agency.

<sup>16</sup> The new Exchange Act reporting requirements would only apply to credit ratings that were previously disclosed under the new rules. That is, an issuer would not be required to comply with the new Exchange Act rules as to ratings that were obtained or used before the effectiveness of the new disclosure requirements (if adopted). However, issuers who make a market in their previously-issued securities through affiliated broker dealers by means of a market-making prospectus may need to consider whether that activity would subject those prior issuances to the new Exchange Act rules as well.

<sup>17</sup> The proposed rules do not, for example, require foreign private issuers to make a prompt Form 6-K filing to disclose this information.

<sup>18</sup> Release No. 33-9071 (October 7, 2009).

## Conclusion

The SEC is soliciting comment for 60 days following publication of the releases in the Federal Register, and we expect that public companies and other participants in the securities industry will be very interested in submitting comments. The proposed rules apply in a wide range of offerings, and for some issuers, will require substantial additional disclosures in prospectuses and Exchange Act reports. The proposed rules may make ratings more time-consuming to obtain, and increase the cost of raising capital in rated securities offerings.

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