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Legal Update

# SEC Adopts Final Rules Removing Credit Ratings References from Regulation M

On June 7, 2023, the US Securities and Exchange Commission (the "SEC") unanimously adopted final rules amending Regulation M (the "Final Rules") to remove its references to credit ratings, replace them with alternative measures of creditworthiness and impose related record-keeping obligations on broker-dealers.[1] The SEC had previously proposed amendments to Regulation M (the "Proposed Rules") in March 2022.[2] The Final Rules are largely similar to the Proposed Rules, with certain modifications made to address feedback received during the comment period.

## Background

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") directed the SEC to review its rules that use credit ratings to assess the creditworthiness of a security, remove any reference to or requirement of reliance on credit ratings and substitute such standard of creditworthiness as the SEC determines to be appropriate.[3] The SEC proposed amendments in 2008 and 2011 to remove credit ratings references from Regulation M, but these proposals encountered significant industry pushback and ultimately were not adopted.

### REGULATION M

Regulation M is intended to limit activities of certain participants in a distribution, which may have a manipulative effect on the market for the offered security.[4] In connection with a distribution, Rule 101 of Regulation M prohibits a distribution participant (such as an underwriter, broker or dealer) or an affiliated person of such person from, directly or indirectly, bidding for, purchasing, or attempting to induce any person to bid for or purchase a covered security (which includes the security that is the subject of the distribution (the "subject security"), as well as any "reference security" into which the subject security may be converted or exchanged) during the applicable restricted period. Rule 102 of Regulation M contains the same prohibitions as Rule 101 but is directed to issuers, selling securityholders and their affiliated purchasers rather than distribution participants.

### EXISTING EXCEPTIONS IN RULES 101 AND 102 FOR INVESTMENT GRADE SECURITIES

The general prohibitions in Rules 101 and 102 of Regulation M do not apply to certain securities (excepted securities) and to certain activities (excepted activities). Among such excepted securities, existing Rules 101(c)(2) and Rule 102(d)(2) of Regulation M exempt offerings of nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities that are rated investment grade by at least one nationally recognized statistical rating organization ("NRSRO"). Rule 101(c)(2) provides an exception that distribution participants can rely on, while Rule 102(d)(2) provides an exception for issuers and selling securityholders. We refer to these existing exceptions as the "Investment Grade Exceptions." The SEC excepted investment grade securities from the application of these rules because such securities are "less likely to be subject to the type of manipulation that Regulation M seeks to address because they are largely fungible and trade primarily on the basis of yield and creditworthiness (traditionally measured by credit ratings), rather than the identity of the particular issuer."[5]

## New Exceptions in the Final Rules

Under the Final Rules, the existing Investment Grade Exceptions in Rules 101 and 102 of Regulation M will be removed and replaced by new exceptions that employ alternative standards of creditworthiness, depending on the type of security in the distribution. For nonconvertible debt securities and nonconvertible preferred securities (collectively, "Nonconvertible Securities"), the new standard is based on the issuer's probability of default. For asset-backed securities, the new exceptions apply to asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3.

### NEW EXCEPTIONS FOR NONCONVERTIBLE SECURITIES: RULE 101(C)(2)(I) AND RULE 102(D)(2)(I)

Final Rules 101(c)(2)(i) and 102(d)(2)(i) except Nonconvertible Securities of issuers for which the probability of default, estimated as of the sixth business day immediately preceding the determination of the offering price and over a 12-calendar month horizon thereafter, is 0.055% or less, as determined and documented in writing by the lead manager of a distribution, using a "structural credit risk model," as such term is defined in Final Rule 100(b) of Regulation M. The lead manager of a distribution (or a person acting in a similar capacity) must make a written determination of the issuer's probability of default.

The SEC believes that probability of default, calculated based on structural risk models, is an appropriate substitute as a standard of creditworthiness. The Final Rules define "structural credit risk model" in Rule 100(b) of Regulation M as "any commercially or publicly available model that calculates, based on an issuer's balance sheet, the probability that the value of the issuer may fall below the threshold at which the issuer would fail to make scheduled debt payments, or by the expiration of a defined period."[6]

The SEC notes that the use of structural credit risk models is practical and appropriately based on objective factors, since these models can independently verify the probability of issuer default based on market events and information on the issuer's balance sheet. For purposes of running the structural credit risk model, the SEC noted that establishing a specified bright-line threshold and a pre-determined time horizon is practical and should provide clarity as to what is expected in the evaluation and documentation.[7] For the SEC, a bright-line probability of default threshold of 0.055% and a pre-determined time horizon beginning six business days before pricing up to 12 months thereafter are model inputs that are uniform and predictable.[8]

## NEW EXCEPTIONS FOR ASSET-BACKED SECURITIES: RULE 101(C)(2)(II) AND RULE 101(D)(2)(II)

The SEC replaced the existing exceptions in Rules 101 and 102 for investment grade asset-backed securities, with exceptions under Final Rules 101(c)(2)(ii) and Rule 102(d)(2)(ii) for asset-backed securities offered pursuant to an effective shelf registration statement filed on Form SF-3 ("SF-3 registered asset-backed securities"). The SEC stated that SF-3 registered asset-backed securities trade primarily on the basis of yield and creditworthiness and are, therefore, less susceptible to manipulation. According to the SEC, the transaction requirements included in Form SF-3 allow for shelf offerings of only those asset-backed securities that share the same qualities and characteristics as investment grade asset-backed securities. Similar to investment grade asset-backed securities, which are excepted under the current rules, the principal focus of investors in SF-3 asset-backed securities is the structure of the class of securities and the nature of the assets pooled to serve as collateral for those securities rather than the issuer's identity. In particular, Form SF-3 eligibility is limited by the percentage of delinquent assets and, for certain lease-backed securitizations, by the portion of the pool attributable to the residual value. Under Form SF-3, delinquent assets cannot constitute 20% or more of the asset pool. The SEC states that this limit on delinquent assets offered pursuant to Form SF-3 focuses on the ability of the collateral in the underlying asset pool to generate cash flow, rather than on the identity of the issuer and its ability to convert the assets into cash.

Form SF-3 also includes transactional requirements regarding the structure of asset-backed securities being offered, including (1) a certification by the depositor's CEO that the securitization structure provides a reasonable basis to conclude that the expected cash flows are sufficient to service payments or distributions in accordance with their terms, (2) a review of the asset-backed security's pool of assets upon the occurrence of certain triggering events, including delinquencies, by a person unaffiliated with certain transaction parties, such as the sponsor, depositor, servicer, trustee, or any of their affiliates, and (3) a dispute resolution provision, contained in the underlying transaction documents, for any repurchase request.[9] According to the SEC, these transactional safeguards included in Form SF-3 provide incentives for parties to consider carefully the quality and character of the assets included in the pool, and, therefore, SF-3 registered asset-backed securities should trade based on yield and creditworthiness rather than based on the issuer's identity. As a result, applying Form SF-3 requirements would result in an offering of asset-backed securities having similar characteristics as the investment grade asset-backed securities currently excepted under existing Rule 101(c)(2) and Rule 102(d)(2).

## RECORDKEEPING OBLIGATIONS

The Final Rules amend Rule 17a-4(b) under the Securities Exchange Act of 1934 (the "Exchange Act"), the SEC's broker-dealer record retention rule, to require broker-dealers that are distribution participants or affiliated purchasers to keep written records of the probability of default determination relied upon by such broker-dealers in a distribution.

Rule 17a-4(b) would require broker-dealers to retain the written probability of default determination to support reliance on the exception for a period of not less than three years, with the first two years in an easily accessible place. If a broker-dealer was the lead manager in a distribution, it could satisfy the obligation by retaining the written determination it made. If the lead manager dealer calculated the probability of default on its own, it could satisfy the record-keeping requirement by maintaining documentation of the value of each variable used to calculate the probability of default, along with a record identifying the specific sources of such information for each variable. If the lead manager used a third-party vendor to determine the probability of default threshold, it could satisfy this record-keeping requirement by maintaining documentation of the assumptions

used in the vendor model, as well as the output provided by the vendor supporting the probability of default determination. If the broker-dealer was not the lead manager in the distribution, it could satisfy the obligation by either obtaining from the lead manager a copy of such written probability of default determination or by retaining a written notice that the broker-dealer received such a written determination from the lead manager.

### MODIFICATIONS MADE TO THE PROPOSED RULES AFTER PUBLIC FEEDBACK

The SEC implemented certain modifications to its original March 2022 proposed rule amendments after receiving and considering comments from the public. The following are some of the significant modifications made by the SEC to its original proposal that found their way into the Final Rules.

**Adopting the New Exceptions for Rule 102.** In the Proposed Rules, the SEC sought to eliminate altogether, without any replacement, the existing exceptions in Rule 102 for investment-grade Nonconvertible Securities and asset-backed securities. The SEC had reasoned there were limited situations where issuers or selling security holders rely on the Investment Grade Exception in Rule 102. Given this limited reliance, the SEC believed the current exception in Rule 102(d)(2) should be removed without any replacement. In the Final Rules however, the SEC acknowledged comments that eliminating the exception altogether for Nonconvertible Securities may impact such entities as broker-dealers, which, in certain instances, do not act as "distribution participants," but may still qualify for a comparable exception under Rule 102 because of such entity's status as an affiliate of an issuer or selling security holder. In the same vein, for Final Rule 102(d)(2)(ii), the SEC decided to use the same exception for asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3.

**Six Business Days Before Pricing Date.** The SEC adjusted the timing start date of the probability of default calculation from the pricing day of the offering (under the Proposed Rules) to the sixth business day prior the pricing date (under the Final Rules). This, according to the SEC, would allow for more time for the lead manager to account for any relevant market activities and for the distribution participants to know whether the exception is available, in advance of the pricing and the restricted period of the distribution. This change was prompted by earlier comments made by the Securities Industry and Financial Markets Association ("SIFMA") to the effect that requiring the probability of default calculations be made as of the date of pricing is unworkable and could delay the pricing of an offering in the case of a re-opening of debt securities. SIFMA added it would be damaging to the issuer to launch a re-opening, subsequently determine there is no exception under the probability of default calculation, and then have to extend the pricing of the offering by at least one (or five) business days.[10]

**Lead Manager To Make Probability of Default Determination.** The Proposed Rules provided that any distribution participant could make the probability of default calculation, whereas the Final Rules leave this to the lead manager (or equivalent person). According to the SEC, this change would ensure consistency and reliability of estimates within any particular distribution and reduce the potential non-uniformity of the probability of default estimations.

## Thoughts and Practical Considerations

**Significant Milestone for the SEC.** At a policy level, the adoption of the Final Rules represents a significant milestone for the SEC, a culmination of more than a decade-long rulemaking effort to finally remove references to credit ratings from its rules to fulfill its mandate under the Dodd-Frank Act. While a welcome development,

the solution approved by the SEC in the Final Rules is far from perfect and will require market participants to adapt, implement new processes and systems, and incur additional costs.

**Additional Incremental Burdens and Compliance Costs.** Broker-dealers, in particular lead managers, that seek to rely on the new exception for Nonconvertible Securities, will need to adopt new policies and procedures and incur additional costs connected with obtaining the estimate of the probability of default and with preserving records related to the probability of default estimation. Our understanding is that the calculations required by Rules 101(c)(2)(i) and 102(d)(2)(i) are not currently undertaken by the debt capital markets or syndicate teams or compliance divisions of investment banks. As noted by SIFMA in its first comment letter to the SEC, SIFMA member firms currently do not use commercially or publicly available structural credit risk models in the context of evaluating whether to underwrite a security.

In order to rely on the exceptions for Nonconvertible Securities, broker-dealers must update their processes and procedures to enable them to make the required probability of default determinations. This will be relevant and applicable only for a few limited situations such as re-openings and sticky offerings, where distribution participants have historically relied on the existing Investment Grade Exceptions. The Final Rules afford the lead manager some flexibility in selecting the structural credit risk model and making the probability of default determination. The lead manager may itself perform the probability of default analysis internally, or it may employ third-party vendors or commercial data providers to do so or assist in the assessment. Lead managers must bear in mind that there are minimum standards to be observed, including that the model employed must be a commercially or publicly available model, and that it should calculate, based on an issuer's balance sheet, the probability that the value of the issuer will fall below the Default Point by the expiration of the defined time period.

**Some Offerings Will Not Be Covered by the New Exceptions.** The Final Rules require that there be a lead manager (or a distribution participant acting in a similar capacity) in a distribution, as it is the lead manager that makes and documents in writing the probability of default estimate for the purposes of relying on the new exceptions for Nonconvertible Securities. Also, for Rule 102(d)(i), note that the issuer, selling security holder or affiliated purchaser must also rely on the probability of default determination made by the lead manager of the distribution. This means an issuer, selling security holder or affiliate purchaser would not be able to rely on the Final Rule 102(d)(2)(i) exception when directly selling securities.

**The 0.055% Threshold Is Not Perfect.** As the SEC itself acknowledged, a probability of default threshold of 0.055% is an imperfect measure for evaluating creditworthiness[11] and could be both under-inclusive and over-inclusive in capturing securities that are currently excepted under the existing Investment Grade Exception.[12]

**No Significant Impact on ABS Deals.** We do not expect the Final Rules to have a significant impact on asset-backed securities offerings. The standard of creditworthiness is much simpler and can be easily verified (i.e., if the asset-backed securities are registered on an effective Form SF-3, then they enjoy the exceptions). That said, we note that there are not many registered asset-backed securities offerings. Issuers, distribution participants and market participants should also remember that replacing the investment grade asset-back exception under the existing rules with an exception for SF-3 registered asset-backed securities does not mean that unregistered offerings of asset-backed securities would be automatically subject to the general prohibitions in Rules 101 and 102. Rule 144A transactions of asset-backed securities would still be subject to available exemptions under Rules 101 and 102.

## Effectiveness Date

The Final Rules go into effect 60 days after publication in the Federal Register.

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## ENDNOTES

[1] SEC Release No. 34-97657 available at https://www.sec.gov/rules/final/2023/34-97657.pdf (the "Adopting Release").
[2] SEC Release No. 34-94499 available at https:// www.sec.gov/rules/proposed/2022/34-94499.pdf (the "Proposing Release").
[3] *See* Pub. L. 111-203 secs. 931–939H, 124 Stat. 1376, 1872-90 (2010).
[4] SEC Release Nos. 33-7375 and 34-38067 available at https://www.sec.gov/rules/final/34-38067.txt (the "Regulation M Adopting Release").
[5] *See* Regulation M Adopting Release, at 40 and Adopting Release, at 6. The SEC says these securities are less susceptible to manipulation because other similar nonconvertible securities or asset-backed securities are available to investors as alternatives; hence, the ability of investors to substitute similar nonconvertible securities or asset-backed securities for the subject security in distribution, limits the ability of a distribution participant to impact the market and distribution of such security. *See* Adopting Release, note 38 at 11.
[6] *See* Adopting Release, at 39.
[7] *See* Adopting Release, at 30.
[8] *See* Adopting Release, at 30.
[9] *See* Adopting Release, at 45. *See also* Proposing Release, at 39.
[10] *See* Letter from Joseph Corcoran, Managing Dir. & Assoc. Gen. Counsel, Secs. Indus. & Fin. Mkts. Ass'n, to Vanessa Countryman, Sec'y, SEC available at https://www.sec.gov/comments/s7-11-22/s71122-20129392-295219.pdf (May 23, 2022).
[11] *See* Adopting Release, at 35.
[12] *See* Proposing Release, at 26.

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