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Legal Update

SEC Proposes to Remove Credit Ratings References from Regulation M

On March 23, 2022, the US Securities and Exchange Commission (the "SEC") proposed amendments to remove references to credit ratings from Regulation M, replace them with alternative measures of creditworthiness and impose related recordkeeping obligations on broker-dealers (the "Proposal").[1]

Background

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") directed the SEC to: review its rules that use credit ratings to assess the creditworthiness of a security or money market instrument; remove any reference to or requirement of reliance on credit ratings; and substitute such standard of creditworthiness as the SEC determines to be appropriate.[2] The SEC has completed much of this work, with the only remaining references to credit ratings found in Rules 101 and 102 of Regulation M. The SEC had proposed amendments in 2008 and 2011 to remove credit ratings references from Regulation M and introduced, back then, alternative measures of creditworthiness. However, the SEC did not adopt those proposed rule changes. According to SEC Chair Gensler, enactment of the present Proposal would fulfill Congress's mandate to the SEC.[3]

REGULATION M

Regulation M is intended to limit the activities of certain participants in a distribution, which activities 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") during the applicable restricted period; provided that, if a distribution participant or affiliated purchaser is the issuer or selling securityholder of the securities subject to the distribution, that person will be subject to the provisions of Rule 102, rather than those of Rule 101 of Regulation M.

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 do not apply to certain activities (excepted activities). Among such exceptions, Rule 101(c)(2) and Rule 102(d)(2) of Regulation M exempt offerings of nonconvertible debt securities, nonconvertible preferred securities, and asset-backed securities rated investment grade by at least one nationally recognized statistical rating organization ("NRSRO"). We refer to these existing exceptions as the "Investment Grade Exceptions."[5] The SEC had excepted investment grade securities in these rules "based on the premise that these securities traded on the basis of their yield and credit ratings, are largely fungible and, therefore, are less likely to be subject to manipulation."[6]

Proposed Amendments

Under the Proposal, the SEC is proposing to replace the Investment Grade Exception in Rule 101 with two alternative standards that aim to assess creditworthiness. For nonconvertible debt securities and nonconvertible preferred securities (collectively, "Nonconvertible Securities"), the proposed standard is based on the issuer's probability of default. For asset-backed securities, the proposed amendment would except asset-backed securities that are offered pursuant to an effective shelf registration statement filed on the SEC's Form SF-3. In addition, the SEC proposes to eliminate the Investment Grade Exception in Rule 102 and not replace it with any alternative standard.

RULE 101(C)(2): NONCONVERTIBLE SECURITIES

The existing exception in Rule 101(c)(2) would be replaced by two separate exceptions: one under Rule 101(c)(2)(i), which would address Nonconvertible Securities, and another under Rule 101(c)(2)(ii), which would address asset-backed securities.

Under Rule 101(c)(2)(i), the Proposal would exempt Nonconvertible Securities of issuers having a probability of default of less than 0.055%, measured as of the pricing day of the offering and over a 12-calendar month horizon thereafter, and as determined and documented in writing by the distribution participant using a "structural credit risk model" defined in the rule.

The SEC believes the probability of default, calculated based on structural risk models, is an appropriate substitute as a standard of creditworthiness, and that Nonconvertible Securities of creditworthy issuers are less susceptible to the type of manipulation that Rule 101 seeks to prevent.

The proposed rule defines "structural credit risk model" as "any commercially or publicly available model that calculates the probability that the value of the issuer may fall below a threshold based on an issuer's balance sheet."[7] The SEC believes these models can independently verify the probability of issuer default based on market events and information on the issuer's balance sheet. According to the SEC, structural credit risk models provide a method to estimate the probability that an issuer might default on its liabilities based on the Black-Scholes option pricing model. The SEC observed that these structural credit risk models, such as the 1974 model adopted by economist Robert C. Merton and other successor models, have become widely relied upon to determine the probability of an issuer defaulting on its loan obligations. The SEC added that many commercial data providers employ these models as a way to measure the creditworthiness of companies. The models assume that equity owners of a company will continue to pay the company's liabilities if the company's value exceeds its liabilities, and therefore, there is a certain threshold for firm asset values below which the equity owner would choose to default on its obligations. The SEC refers to such threshold as the "Default Point."

The Proposing Release mentions that, generally, the following variables are needed to calculate the probability of default: (1) the value of the firm, which can be based on observed market prices of a firm's equity security or estimated based on a firm's balance sheet; (2) the volatility of the firm's equity or assets, which can also be based on market observations or estimated based on a firm's balance sheet; (3) the risk-free rate; (4) a time horizon; and (5) the Default Point.

In establishing the 0.055% threshold, the SEC conducted an analysis comparing probabilities of default with NRSRO credit ratings of a sample of Nonconvertible Securities available on the market as of October 22, 2021. Based on this analysis, the SEC stated it believes "the 0.055% threshold would effectively identify securities that trade based on yield and credit-worthiness, because this threshold appropriately captures most of those securities that meet the credit-worthiness standard under the existing Investment Grade Exception." [8] The SEC added that the use of this bright-line test, similar to the existing Investment Grade Exception, should address concerns that the new exception would impose new costs and delays in the offering process and would provide a subjective, rather than an objective, standard. The SEC did, however, acknowledge that a probability of default of less than 0.055% could be both under-inclusive and over-inclusive in capturing securities that are currently excepted under the existing Investment Grade Exception. Nonetheless, the SEC said this threshold could identify Nonconvertible Securities that are less susceptible to the manipulation that Regulation M is designed to prevent.

In establishing the 12 month-horizon from the date of pricing of the offering, the SEC stated that 12 calendar months provides a minimum period of time to estimate the probability of default and addresses investor concerns that a Nonconvertible Security would default during or shortly after the distribution of the securities. It added that 12 months is also the horizon that corresponds with vendor models that use structural credit risk models to calculate probability of default and map investment grade ratings.

RULE 101(C)(2): ASSET-BACKED SECURITIES

The SEC proposes to amend Rule 101(c)(2) to replace the existing exception for investment grade asset-backed securities, with an exception under Rule 101(c)(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 believes 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 aims to focus 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.

Moreover, 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 that is 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. Hence, 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).

ELIMINATION OF RULE 102(D)(2) EXCEPTION

The SEC proposes to eliminate the existing exception in Rule 102 for investment-grade Nonconvertible Securities, and asset-backed securities. Rule 102 contains fewer exceptions than Rule 101 because it applies only to issuers and selling security holders who have the greatest interest in an offering's outcome and do not have the same market needs as underwriters. The SEC observed that there are limited situations where issuers, selling security holders or their affiliated purchasers rely on the Investment Grade Exception in Rule 102.

According to the SEC, given this limited reliance and the fact that issuers, selling security holders and their affiliated purchasers security holders have an incentive to manipulate the market for the distributed security regardless of the credit quality of the security, the SEC believes that the current exception in Rule 102(d)(2) should be removed without any replacement.

RECORDKEEPING OBLIGATIONS

In connection with the proposed amendments to Rule 101(c)(2)(i), the SEC proposes to 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 who are distribution participants or affiliated purchasers to keep written records of their probability of default determination.

As discussed above, broker-dealers relying on the exemption under Rule 101(c)(2)(i) would need to determine and document in writing that the probability of default of the issuer of the Nonconvertible Securities, estimated as of the day of determination of the offering pricing and over a 12-calendar month horizon from such day, is less than 0.055% using a structural credit risk model. A new paragraph would be added to Rule 17a-4(b), requiring broker-dealers to retain the written probability of default determination to support their reliance on the exception. The rule would require such broker-dealers to preserve, for a period of not less than three years, with the first two years in an easily accessible place, the written probability of default determination made pursuant to Rule 101(c)(2)(i) of Regulation M.

The SEC adds that a broker-dealer that uses a vendor to determine the probability of default threshold could satisfy this recordkeeping 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. A broker-dealer calculating the probability of default on its own could satisfy the recordkeeping 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.

Practical Considerations

The Proposal would require distribution participants that rely on the new Rule 101(c)(2)(i) exception to gather the relevant data inputs required to calculate the probability of default threshold and determine the same utilizing the structural credit risk model defined in the rule. Implementing measures to comply with the requirement to make these calculations will result in added burdens and compliance costs, as distribution participants would need to perform the probability of default analysis themselves or hire third-party vendors to do so or assist them in the assessment. So the issues of operational feasibility, availability of the required technology and costs become crucial in assessing how proposed Rule 101(c)(2)(i) would be received by market participants.

In this regard, the SEC states in the Proposing Release that it believes that broker-dealers: already have the software and systems in place that would be required to make the calculations, have experience in using their own proprietary version of a publicly available structured credit risk model, and can comply with Rule 101(c)(2)(i) by reprogramming systems to a create a means to calculate electronically the probability of default based on inputs gathered and entered for financial modelling.[10] The SEC states it expects the process to be highly automated and it believes distribution participants would have employees that are familiar with how to gather the required inputs, since financial modeling and probability of default calculations are well-known by industry participants.[11] The SEC also mentions that broker-dealers usually have access to third-party vendors' software and systems as part of an existing subscription, so they would not need to procure further services or subscriptions from these vendors.[12]

However, this is not consistent with our understanding. Many of the calculations required by Rule 101(c)(2)(i), which are probability of default calculations, are not currently undertaken by the debt capital markets or syndicate areas or compliance areas of investment banks. Moreover, the proposed rules require the determination of the probability of default threshold as of the date of pricing of the deal, which would result in exposing issuers to additional market risk on the day the offering prices, which for investment grade debt offerings is usually also the day of the deal's launch. Operational questions remain: what happens if the issuer fails the threshold test on the day of pricing? Do the issuer and the distribution participants pull the deal from the market? Will a new restricted period then apply for the offering?

These feasibility concerns and operational challenges do not exist in connection with the new Rule 101(c)(2)(ii) exception for asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3, since there is no associated probability of default calculation to be performed or record-keeping requirement to be met for these asset-backed securities. That said, 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. In particular, Rule 144A transactions of asset-backed securities would still be subject to available exemptions under Rule 101 and 102 provided the requisites of Rule 144A are met.

The proposed amendments are open for public comment until May 23, 2022. Interested parties should assess whether they want to submit a comment letter to highlight issues that are of particular interest to them, and if so, begin work on any such comment letter promptly.

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Endnotes

[1] SEC Release No. 34-94499 available at https://www.sec.gov/rules/proposed/2022/34-94499.pdf (the "Proposing Release").

[2] *See* Pub. L. 111-203 secs. 931–939H, 124 Stat. 1376, 1872-90 (2010).

[3] *See* Press Release, *SEC Proposes Amendments to Remove References to Credit Ratings from Regulation M*, available at https://www.sec.gov/news/press-release/2022-47 (March 23, 2022).

[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] The SEC appears to be under the working assumption that the application of the Investment Grade Exception to Rules 101 and 102 is primarily limited to two cases: reopenings and sticky offerings (*See* Proposing Release, at 64). We believe, however, that this assumption is not necessarily true for nonconvertible preferred securities.

[6] *See* Regulation M Adopting Release, at 40; *see also* Proposing Release, at 18.

[7] *See* Proposing Release, at 98.

[8] *See* Proposing Release, at 26.

[9] *See* Proposing Release, at 39.

[10] *See* Proposing Release, at 55-56.

[11] ibid.

[12] *See* Proposing Release, footnote 130, at 56.