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ALERT MEMORANDUM

SEC Removes References to Credit Ratings from Regulation M

On June 7, 2023, the Securities and Exchange Commission (the "SEC") adopted amendments to Regulation M to remove references to credit ratings in exceptions for nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities and replace them with alternative standards of creditworthiness.

The final rule largely tracks the SEC's proposing release from March 2022 (the "Proposing Release"),[1] finally implementing Section 939A(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[2] which was enacted in the wake of the 2008 financial crisis.

Regulation M is designed to preserve the pricing integrity of the securities trading markets by prohibiting issuers, selling security holders, distribution participants and their affiliated purchasers from engaging in activities that could artificially influence the market for an offered security. Currently, Rule 101 of the regulation, which governs activities by distribution participants and their affiliated purchasers, and Rule 102, which governs activities by issuers, selling security holders and their affiliated purchasers, except nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities that are rated investment grade by at least one nationally recognized statistical rating organization (the "Investment Grade Exceptions"). The Investment Grade Exceptions reflected the principle that investment grade nonconvertible securities and asset-backed securities are less likely to be subject to the type of manipulation that Regulation M seeks to prevent 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.

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[1] SEC Release No. 34-94499 (March 30, 2022), available at https://www.sec.gov/rules/proposed/2022/34-94499.pdf.
[2] The SEC previously proposed in 2008 and 2011 to remove the references to credit ratings in Regulation M, but those proposals were not adopted.

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The new rules:

— for nonconvertible debt securities and nonconvertible preferred securities, substitute the Investment Grade Exceptions with exceptions based on a probability of default threshold derived from a structural credit risk model;

— for asset-backed securities, substitute the Investment Grade Exceptions with exceptions for securities offered pursuant to an effective shelf registration statement filed on Form SF-3, a special form for asset-backed offerings; and

— impose a recordkeeping requirement for broker-dealers when relying on the new exceptions.

The amendments will become effective 60 days after the date of publication in the Federal Register.

1. Probability of Default Threshold to be Used for Distributions of Nonconvertible Securities

The amendments remove the Investment Grade Exceptions for nonconvertible debt securities and nonconvertible preferred securities and substitute a determination of the issuer's probability of default as derived from a structural credit risk model. The SEC concluded that a probability of default measure derived from a structural credit risk model is an appropriate substitute method of identifying creditworthy nonconvertible securities.

The new exceptions except nonconvertible debt securities and nonconvertible preferred securities of issuers:

— having a probability of default of **0.055%** or less;

— as estimated as of the **sixth business day** immediately preceding the determination of the offering price, over the horizon of 12 full calendar months from such day;

- The SEC revised its proposal to have the probability of default determination be made as of the sixth business day prior to the price determination date, rather than as of the day of pricing, to allow the lead distribution participant sufficient time to determine the probability of default and adjust market activities as necessary prior to pricing.

— as determined and documented in writing, by the **distribution participant acting as the lead manager** (or in a similar capacity); and

- Acknowledging the concern around inconsistency across distribution participants in their structural credit risk models and applicability of exceptions, the SEC requires that the probability of default determination be made by the distribution participant acting as the lead manager (or in a similar capacity) of a distribution, instead of allowing any distribution participant to make the determination.
- The SEC also noted that lead managers are allowed to rely on third-party vendors rather than internally calculating the probability of default.
- A lead manager is not required to share the probability of default determination with others (i.e., other distribution participants or, in the case of Rule 102, issuers, selling security holders and their affiliated purchasers), which may result in their inability to rely on the exception. This is likely to result in changes to underwriting agreements and the Master Agreement Among Underwriters to provide for such sharing (as well as, in the latter, of the designation, in the case of co-lead managers, of the lead manager having responsibility for this determination).
- The exception also will be unavailable if there is no lead underwriter, such as with self-underwritten offerings or at-the-market offerings (to the extent such an offering meets the definition of a "distribution" under Regulation M).

— using a "**structural credit risk model**," as newly defined in Rule 100(b) of Regulation M.

- "Structural credit risk model" is defined as "any commercially or publicly available model that calculates, based on an issuer's balance sheet, the probability that the value of the issuer will fall below the threshold at which the issuer would fail to make scheduled debt payments, at or by the expiration of a defined period."
- For private companies or companies with thinly traded equity, it may be difficult to calculate the probability of default, and thereby benefit from the new exceptions, because structural credit risk models typically require the market value and volatility of the issuer's equity for its calculations. However, the Adopting Release[3] notes that some structural credit risk models rely on estimates of value and asset volatility based on the issuer's balance sheet, rather than the issuer's equity market prices.

The Proposing Release contemplated eliminating, without replacement, the Investment Grade Exception in Rule 102. However, the SEC ultimately decided also to replace the Investment Grade exception with the probability of default exception in Rule 102, thereby allowing issuers, selling security holders and their affiliated purchasers to be able to rely on the new exception. In particular, this will result in the continued availability of an exception under Rule 102 for broker-dealers that are affiliated with an issuer but are not serving as an underwriter or other participant in connection with the distribution of creditworthy nonconvertible securities. As with Rule 101, the exception under Rule 102 requires that the probability of default determination be made by the distribution participant acting as the lead manager (or in a similar capacity), and cannot be made by issuers, selling security holders or their affiliated purchasers, any non-lead manager or any other third party. This requirement is designed to prevent abuse of the exception by issuers, selling security holders and their affiliated purchasers by taking into account that these market participants have the greatest interest in an offering's outcome and generally do not have the same market access needs as underwriters.

2. Shelf-eligibility Requirement to Apply for Asset-backed Securities

By replacing the Investment Grade Exception for asset-backed securities offerings with the requirement that asset-backed securities be offered pursuant to an effective shelf registration statement on Form SF-3, the SEC leveraged the form's eligibility requirements, which are designed to ensure creditworthiness.

3. Record Preservation Requirement for Broker-Dealers Relying on new Exceptions

Consistent with other record retention requirements, a broker-dealer that relies on the probability of default determination must preserve it for at least three years, with the first two years in an easily accessible place.

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[3] SEC Release No. 34-97657 (June 7, 2023), available at https://www.sec.gov/rules/final/2023/34-97657.pdf.