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October 10, 2008

Ms. Florence E. Harmon  
Acting Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

Re: Release Nos. 33-8940 (S7-18-08) and 34-58070 (S7-17-08)

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law of the American Bar Association in response to the request for comments by the Securities and Exchange Commission (the "Commission") in its July 11, 2008 releases referenced above, Release Nos. 33-8940; 34-58071 (the "Securities Act Release") and Release No. 34-58070 (the "Exchange Act Release," and together with the Securities Act Release, the "Proposing Releases"). As noted in the joint comment letter dated September 12, 2008 by the Committee on Securitization and Structured Finance and this Committee (addressing the Proposing Releases along with Release No. IC-2832, as they relate to or otherwise affect asset-backed securities), our comments in this letter are focused solely on those aspects of the Securities Act Release, and the Regulation M amendments proposed in the Exchange Act Release, that relate to NRSRO ratings of non-convertible debt, preferred and hybrid securities<sup>1</sup> (for ease of reference, referred to collectively as "corporate securities").

The comments presented in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors, and therefore do not represent the official position of the ABA. Moreover, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

<sup>1</sup> Hybrid securities include certain types of trust preferred securities or other securities that qualify for Tier I capital status for bank holding companies, as well as trust certificates, debt securities backed by insurance funding contracts, repackaged investment grade corporate debt, or other types of structured securities that are not considered asset-backed securities.

## I. Background and Summary

At a time when world markets are facing unprecedented stress and when credit conditions remain in turmoil, we believe that it would be potentially harmful to impose any new limitations on the use of Form S-3/F-3 and shelf registration by creditworthy issuers. For the reasons discussed in this letter, the Committee believes that the Commission should not proceed with its proposals to remove credit rating references from the transactional eligibility criterion in Form S-3/F-3, as well as various other forms and rules under the Securities Act, and Schedule 14A under the Exchange Act. Should the Commission nevertheless decide to remove references to credit ratings from the forms and rules applicable to issuers of corporate securities, we recommend a number of alternative, less problematic means of achieving its objectives.

The Committee recognizes that serious concerns have been raised over the past year regarding the integrity and reliability of the NRSRO credit ratings process, insofar as it relates to a discrete portion of the structured finance market – specifically, the market for RMBS and CDOs. However, the Commission already has taken a number of highly constructive steps to address the problems identified in this more limited market segment, including but not limited to the “aggressive[ ] use” of enhanced supervisory and rulemaking powers over credit rating agencies conferred by Congress in 2006, as manifested by the initiation of more than four dozen law-enforcement investigations into the activities of credit rating agencies and other participants in the subprime market,<sup>2</sup> the recent series of staff “examinations of the rating agencies processes for rating subprime residential mortgage-backed securities and collateralized debt obligations” that resulted in a July 2008 report to Congress and, last but not least, the Commission’s proposals of June 16 that directly target conflicts of interest and other perceived deficiencies of the NRSRO ratings system for certain structured finance products.<sup>3</sup>

All of these initiatives are notable in that they present no findings or conclusions with respect to the existence of any deficiencies in the procedures used by the NRSROs to assign ratings to corporate securities. In the absence of such findings, the fact that the broader credit markets may have been adversely affected by the subprime crisis that erupted last year and continues does not establish any causal connection between deficiencies identified in NRSRO analyses of RMBS and CDOs, on the one hand, and, on the other, the entirely different analytical tools employed by the NRSROs in connection with rating corporate securities.

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<sup>2</sup> These investigations are beginning to reach fruition. See, e.g., *SEC Charges Two Wall Street Brokers in \$1 Billion Subprime-Related Auction Rate Securities Fraud*, Litigation Release No. 20698 (Sep. 3, 2008); *SEC Charges Two Former Bear Stearns Hedge Fund Portfolio Managers with Securities Fraud*, Litigation Release No. 20625 (Jun. 19, 2008).

<sup>3</sup> Testimony of Chairman Christopher Cox, U.S. Securities Commission, Concerning Recent Developments in U.S. Financial Markets and Regulatory Responses, before the U.S. Senate Comm. on Banking, Housing and Urban Affairs (Jul. 15, 2008), available at <http://www.sec.gov/news/testimony/2008/ts071508cc.htm>; see also Release No. 34-57967 (Jun. 16, 2008); Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies (Jul. 2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

Moreover, we respectfully submit that there similarly is no indication that the predominantly institutional buyers of corporate securities in the United States rely either “unduly” or exclusively on NRSRO credit ratings in making their investment decisions.<sup>4</sup> In our experience, as counsel to issuers and underwriters, institutional investors in non-convertible corporate securities generally do not view an investment-grade rating as representing either an explicit or implicit Commission endorsement of the securities. Rather, as discussed below, credit ratings are but one of several criteria – including but not limited to the issuer’s Exchange Act reports and fixed-income analyst reports – that are considered by this sophisticated class of investors when analyzing the issuer’s creditworthiness.

## II. Discussion

### A. A Brief Overview of the Relevant Regulatory History

We believe that it is helpful to re-examine the regulatory history underpinning the current Form S-3/F-3 eligibility criterion that enables those companies unable to meet the minimum \$75 million public float test for primary offerings to register for delayed shelf offerings of corporate securities.

The Commission first proposed Form S-3 in the early 1980s, as part of its comprehensive revisions of the rules and forms for registering securities offerings under the Securities Act. In doing so, it stated that it had made “a concerted effort to revise the eligibility requirements [for Form S-3] in a manner that is simple and rational and is consistent with its intention to classify registrants on the basis of the degree of information disseminated and analyzed in the marketplace.”<sup>5</sup> In particular, the Commission noted certain “theoretical inconsistencies” of predecessor forms that had variously relied on “quality of issuer” criteria that had “little or nothing to do with an efficient market.”<sup>6</sup> In deciding to permit the use of Form S-3 to register offerings of non-convertible investment-grade debt securities even where the issuer did not meet the otherwise-applicable “public float” test, the Commission explained that “[i]n addition to considering indicia of the quality of the registrant, security ratings are also based on marketplace information . . . about the registrant which is analogous to the efficient market for widely followed equity securities.”

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<sup>4</sup> In Section B.1. of the Securities Act Release, the Commission states that “[t]he recent turmoil in the credit markets” in fact “strongly suggests,” at least with respect to the structured finance market, “that there has been undue reliance on security ratings and that the ratings for many [asset-backed] issuers did not reflect the risks of the investment.” Accordingly, to the extent there is any evidence of “undue” investor reliance on NRSRO ratings, that evidence would appear to be derived solely from the structured finance market.

<sup>5</sup> Release No. 33-6331 (Aug. 6, 1981).

<sup>6</sup> *Id.* As the Commission notes in Section II.B.1. of the Securities Act Release, Form S-9 – which was the form available exclusively for the issuance of high quality debt securities – was rescinded when the Commission determined that the Form’s eligibility requirements were overly restrictive. At the same time, the Commission adopted the security ratings eligibility standard of Form S-3 for issuers of high quality debt, recognizing that security ratings were superior to the specified “quality of the issuer” tests set forth in Form S-9. This same rationale still holds true today.

When the Commission shortly thereafter adopted Securities Act Rule 415 on a permanent basis, it noted that the availability of shelf registration during the 18 months of the rule's temporary availability had resulted in significant cost savings attributable to the "flexibility to respond to rapidly changing markets, reduced legal, accounting, printing and other expenses and increased competition among underwriters."<sup>7</sup> The agency considered the comments that it had received on the rule and decided to address disclosure and due diligence concerns by confining use of the rule to offerings by companies eligible to use Form S-3 or Form F-3 and "traditional" shelf offerings. In doing so, the Commission cited the advantages of the integrated disclosure system that "ensure[d] that the marketplace is provided with a continuous stream of high quality corporate information about registrants widely followed in the marketplace," and it referred expressly to issuers of investment-grade debt as being among such issuers, even if they did not have the otherwise-required equity float.

The Commission's later expansion of Form S-3 eligibility over the years to investment-grade securities other than debt or preferred stock, e.g., foreign currency or other cash-settled derivative securities, is another indication that the Commission was not looking to the quality of an issuer or the certainty of an investor's return on its investment, but rather to the availability of information about the issuer.<sup>8</sup>

The Commission's reliance on an investment-grade rating as a criterion for Form S-3 eligibility has therefore never been the equivalent of an "official seal of approval" of the quality of the issuer, but rather a recognition that investment-grade securities are widely followed in the marketplace. Moreover, even though the Commission referred on some occasions to commenters' views that investment-grade securities were generally purchased on the basis of credit spreads and security ratings, it is clear that the Commission's consistent rationale for Form S-3 and Rule 415 eligibility has not been based on a judgment about the quality of the issuers of such securities, but rather a judgment about the availability of relevant information in the marketplace.

**B. The Commission Should Retain the Current Eligibility Requirement for Investment-Grade Non-Convertible Securities Issued by Public Companies**

After nearly 25 years of relying on investment-grade ratings as a proxy for the availability in the marketplace of information about the issuer, the Commission is now proposing to substitute for that standard a requirement that the issuer have issued \$1 billion worth of registered non-convertible securities for cash (regardless of investment-grade status) over the prior three years. While we recognize that the Commission codified this standard in 2005 as an alternative measure of widespread market following for purposes of determining WKSI eligibility, we nevertheless believe that the Commission's current proposal is not advisable for the following reasons:

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<sup>7</sup> Release No. 33-6499 (Nov. 17, 1983).

<sup>8</sup> Release No. 33-6964 (Oct. 22, 1992).

- The case has not been made that the credit rating model is broken for non-asset-backed securities.
- The Commission's original regulatory hypothesis that information about investment-grade rated issuers and/or securities is more likely to have been widely disseminated to the marketplace continues to be correct.
- The WKSI standard for automatic shelf registration is not a necessary or appropriate eligibility standard for short-form, shelf offerings of corporate securities.
- The number of issuers that would be adversely affected by the elimination of investment-grade credit ratings as a basis for qualifying to use Form S-3/F-3 is significantly larger than the Commission estimated in the Securities Act Release.
- The Commission's proposed elimination of NRSRO credit ratings from Form S-3/F-3 would result in a shift of corporate non-convertible securities offerings from the public to the private markets, or from domestic to foreign markets, with a consequent reduction in investor protection.
- The Commission's proposals would impair liquidity of the present market for certain types of non-asset-backed securities, including certain types of trust preferred or other hybrid securities that are investment-grade, sold to retail as well as institutional investors, and frequently listed on national securities exchanges.

Each of these points is addressed in greater depth below.

1. The Current NRSRO Credit Rating System for Non-Convertible Corporate Securities Has Not Been Shown To Be Deficient

Whatever the merits of the Commission's stated concerns regarding the asset-backed securities credit rating process in the subprime area, there is nothing to suggest that the same or different deficiencies exist in the current ratings model for non-convertible corporate securities. The Proposing Releases do not indicate that the same flaws the Commission's staff uncovered during the recent examinations of the major rating agencies – including, but not limited to, a failure to adapt to the increase in volume and complexity of RMBS and CDO deals, the use of “out-of-model” adjustments without adequate explanation, and inadequate documentation – exist with respect to non-convertible corporate securities.

As some observers have pointed out, a moral hazard of the rating process for asset-backed securities may have been that the rating agencies competed with each other for the business of a relatively small group of deal-originating investment banking firms. This is not the case where the agencies compete for the business of thousands of traditional corporate issuers. For example:

[I]n structured finance, the agencies face pressures that did not exist when John Moody was rating railroads. On the traditional

side of the business, Moody's has thousands of clients (virtually every corporation and municipality that sells bonds). No one of them has much clout. But in structured finance, a handful of banks return again and again, paying much bigger fees. A deal the size of XYZ can bring Moody's \$200,000 and more for complicated deals. And the banks pay only if Moody's delivers the desired rating . . . [i]f Moody's and a client bank don't see eye to eye, the bank can either tweak the numbers or try its luck with a competitor like S&P, a process known as 'ratings shopping.'<sup>9</sup>

2. The Commission's Original Regulatory Hypothesis that Information Regarding Investment-Grade Rated Issuers or Securities Is More Likely To Have Been Widely Disseminated to the Marketplace Continues To Be Correct

The Commission has not indicated that anything has changed during the last 25 years regarding its hypothesis that information about investment-grade-rated issuers is more likely to have been disseminated to the marketplace. In fact, the significant expansion during the last 25 years of fixed-income research coverage, particularly of securities that are rated investment-grade, would suggest that the Commission's hypothesis today is more valid than ever.

Whether or not investors did place undue reliance on credit ratings has nothing to do with whether ratings should serve as a short-form shelf eligibility criterion. The role of NRSROs for purposes of Form S-3/F-3 and Rule 415 is to serve as a proxy for the widespread dissemination of information into the marketplace. If the efficient market hypothesis underlying short-form S-3/F-3 eligibility is correct, investors necessarily rely on that information whether or not they rely on credit ratings. Also, if corporate debt and preferred buyers ultimately are shown to place undue reliance on ratings, they are unlikely to do so to any lesser degree if certain issuers of investment-grade securities lose the benefits of Form S-3/F-3 and Rule 415(a)(1)(x).

We note that under the Commission's proposal many more high-yield, low-quality issuers would qualify to use short-form shelf registration and thereby avoid Commission staff review for post-effective takedowns. It seems to be inconsistent with the Commission's overall regulatory goals – going back to the adoption of shelf registration – that high-quality issuers of non-convertible securities that have been able to go to market “off the shelf” for the past 25 years will now be subject to staff review on an offering-by-offering basis, despite the continuing widespread availability of reliable market information regarding these issuers – including but certainly not limited to credit ratings – while highly leveraged issuers of non-investment grade debt and preferred securities, whose registration statements the staff conceivably might be more interested in reviewing on a deal-by-deal basis (if only because of the heightened default risk), will be able to shift from Form S-1/F-1 to Form S-3/F-3.

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<sup>9</sup> Roger Lowenstein, “Triple-A Failure,” *The New York Times Magazine* (Apr. 27, 2008).

3. The WKSJ Standard for Automatic Shelf Availability Is Not a Necessary or Appropriate Standard for All Primary Offerings of Non-Convertible Securities Made Off the Shelf

We do not believe the WKSJ standard for automatically-effective shelf registration statements is an appropriate standard for eligibility for delayed shelf offerings of corporate securities on Form S-3/F-3 under Rule 415(a)(1)(x), and the Commission has not explained why it should be. Even if \$1 billion of registered non-convertible securities cash offerings in three years is necessary to achieve special WKSJ status and automatically-effective shelf registrations, we do not see why the same activity should be necessary simply to file a registration statement that will be reviewed by the Commission staff on a pre-effective basis and thereafter used without prior staff review to effect subsequent takedowns. There is no evidence that investors need or want this level of "protection" in these situations, where the Commission has determined – and has identified no rationale to the contrary in the Securities Act Release – that an investment-grade credit rating is an effective proxy for a wide market following.

4. The Number of Issuers Adversely Affected by the Elimination of Investment-Grade Ratings as a Basis for Form S-3/F-3 Eligibility is Significantly Larger than the Commission Estimated in the Release

In the Securities Act Release, the Commission states that the proposed change would result in "approximately six" issuers filing on Form S-1 instead of on Form S-3, but we note that this statement is based on a sample limited to "issuances that have occurred thus far this year," i.e., during the first six months of 2008. Given that investment-grade issuers whose floats do not make them eligible to file on Form S-3 under General Instruction I.B.2. are probably infrequent issuers even under the best of market conditions, it is possible that many of these issuers have not engaged in a transaction thus far in 2008 because of the seriously depressed market, and therefore would not have been identified by the Commission.

In contrast, many of our clients in the utilities and REIT industries have advised us that they will no longer be able to use Form S-3/F-3 to make shelf debt offerings if the Commission adopts the proposed amendments to these Forms. Turning first to utilities, which often are part of holding company structures, we understand that many high-quality operating subsidiaries of utility holding companies based in the United States tap the non-convertible markets here in reliance upon current Instruction I.B.2. of Form S-3. For regulatory and structural reasons, debt issued by utilities in holding company structures generally is not guaranteed by the parent, eliminating that alternative basis for using Form S-3. Few, if any of these companies otherwise meet the \$75 million float test for making primary offerings, for obvious reasons – they are generally wholly owned by their parents, which themselves often are WKSJs. Because many of these wholly-owned operating utilities go to market fairly sporadically, based on capital expenditure and refinancing needs, they quite frequently would not qualify under the Commission's proposed alternative WKSJ test, and therefore would be forced to move to a Form S-1 to seek financing from the public debt/preferred markets. This result makes little sense from an investor protection perspective, given that these companies are widely followed – suggesting a direct and strong correlation between their investment-grade rating and the availability of

information regarding these companies – and historically have been able to raise relatively low-cost debt capital efficiently in a delayed shelf context.

Similar structural considerations have prompted many REIT issuers to rely on Instruction I.B.2. to conduct primary shelf offerings of non-convertible securities. The typical corporate structure of a REIT is the “umbrella partnership REIT” or “UPREIT” structure. In this structure, a REIT, organized as either a corporation or a trust, is the sole general partner of an operating partnership. In addition, the REIT generally owns a majority of the equity interests of the operating partnership. The REIT indirectly owns its properties and conducts substantially all of its business through the operating partnership. The operating partnership is managed by the board of directors of the REIT for the benefit of both the REIT shareholders and the operating partnership’s minority partners. The REIT’s common shares generally are listed on a national securities exchange, while the interests in the operating partnership are not, and for tax reasons cannot be, exchange-listed. Interests in the operating partnership are usually exchangeable for common shares of the REIT, which makes the operating partnership interests and the REIT shares economic equivalents. For legal and other reasons, REITs generally borrow at the operating partnership level rather than the REIT level. These borrowings are comprised of public and private issuance of debt securities, including debt securities of the operating partnership that are exchangeable for common equity of the REIT, and various forms of secured and unsecured bank debt and other financings provided by institutional investors.

Many REITs are eligible to use Form S-3 based on the amount of the aggregate market value of their outstanding common equity. However, because there is no public market for the interests in their operating partnerships, the operating partnerships do not meet this standard. Generally, operating partnerships can only use Form S-3 pursuant to the eligibility standard for offerings of non-convertible investment grade securities.<sup>10</sup> They do not meet any of the other eligibility standards. In addition, many operating partnerships do not issue \$1 billion in debt for cash every three years, and therefore would not meet the proposed standard for Form S-3 eligibility. As a result, if the eligibility requirements are changed, these operating partnerships would need to issue debt securities in unregistered offerings in order to secure quick and cost-effective access to the debt capital markets.

#### 5. The Commission’s Proposals Would Result in a Shift of Offerings of Non-Convertible Securities into the Private and/or Offshore Markets

The Commission’s proposals will likely cause affected issuers to take advantage of market “windows” by conducting private placements, thus depriving investors of remedies under Sections 11 and 12(a)(2).<sup>11</sup> They may also engage in offshore offerings under Regulation S with the same result. Further, pushing corporate securities offerings into the private placement market or offshore would reduce availability of such securities to a more limited group of investors.

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<sup>10</sup> Primarily for tax reasons, the REIT is unable to guarantee the outstanding indebtedness of its operating partnership.

<sup>11</sup> See footnote 89 of the Securities Act Release.



Like asset-backed issuers, corporate securities issuers would have ample incentive to shift their capital-raising activities to the private non-convertible debt and preferred markets were the Commission to adopt the changes proposed. Pricing differentials between the public and private securities markets for non-convertible corporate securities are relatively small. The choice of a Section 4(2)/Rule 144A offering in the United States, alone or in combination with an offshore offering under Regulation S, becomes much more compelling for domestic and foreign companies alike when the higher costs and delays typical of a non-shelf offering on Form S-1 (assuming a continuous offering model, such as a medium term note program, is not an option) are added to the risk of heightened strict and negligence-based liability exposure attendant to a registered offering. Regardless of whether one accepts the bedrock proposition that “qualified institutional buyers” can fend for themselves and thus do not need the protections of registration and Sections 11 and 12(a)(2) remedies, this result would seem to be at odds with the Commission’s efforts, beginning with the adoption of delayed short-form shelf registration in 1982 and culminating most recently in the 2005 Securities Offering Reform amendments, to streamline and otherwise facilitate capital formation in the registered offering context. Given the Commission’s expectation that the streamlining of the Securities Act registration process effected in 2005 would “[p]rovid[e] flexibility for registered offerings . . . [and thereby] encourage issuers to raise capital through the registration process instead of through private placements,”<sup>12</sup> it seems incongruous now to take actions that would make registered non-convertible debt and preferred offerings much less attractive from an issuer perspective.<sup>13</sup>

The Commission has asked whether the \$1 billion threshold of registered offerings “in the prior three years presents any issues unique to foreign private issuers, especially those that may undertake U.S. registered public offerings as only a portion of their overall plan of financing. . . .”<sup>14</sup> In our view, those relatively few foreign private issuers that otherwise would be inclined to make registered shelf offerings of non-convertible securities in this country would be particularly hard hit by the proposed standard, assuming they don’t otherwise meet the \$75 million public float minimum. Such issuers ordinarily prefer to conduct public offerings under the comparatively less onerous regulatory schemes in their home jurisdictions and/or primary trading markets, accompanied at best by a U.S. tranche offered to qualified institutional buyers under the exemptive provisions of Section 4(2)/Rule 144A to which strict (Section 11) and

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<sup>12</sup> Section IX.C.3. of Release No. 33-8591 (Jul. 18, 2005).

<sup>13</sup> We also note that the Commission has recently expanded primary eligibility for the use of Form S-3/F-3, on a limited basis, by certain issuers that fall below the \$75 million public float threshold. In adopting these revisions, the Commission stated “[b]y having more control over the timing of their offerings, these companies can take advantage of desirable market conditions, thus allowing them to raise capital on more favorable terms (such as pricing) or to obtain lower interest rates on debt. As a result, the ability to take securities off the shelf as needed gives issuers a significant financing alternative to other widely available methods, such as private placements with shares usually priced at discounted values based in part on their relative illiquidity.” Section I.A.3 of Release No. 33-8878 (Dec. 19, 2007).

<sup>14</sup> Section II.B.1. of the Securities Act Release. Because the Commission has eliminated the option, previously available to foreign private issuers, of complying with the less onerous U.S. GAAP reconciliation requirements of Form 20-F’s Item 17 (except in limited circumstances), we express no view on whether the Commission should require issuers that use Form F-3 to make shelf offerings of non-convertible securities to provide Item 18-level financial information.

negligence-based (Section 12(a)(2)) liability exposure would not attach. If the Commission expressly excludes, as proposed, all non-convertible securities issued pursuant to any exemptive provision, including but not limited to Regulation S and Rule 144A, as well as U.S.-registered exchange offers conducted under the Exxon Capital line of letters, foreign private issuers now eligible to use Form F-3 solely for investment-grade shelf offerings would be unlikely ever to qualify under the proposed \$1 billion/three-year test. With only a long-form offering on Form F-1 as an alternative to the liquidity, efficiency and reduced liability risks attendant to tapping the institutional Rule 144A markets for non-convertible debt and preferred in the United States (alone or in conjunction with a global combined offering conducted outside the United States in reliance upon Regulation S), foreign private issuers unable to satisfy the public float test simply will not make U.S.-registered debt offerings here absent extraordinary circumstances. This result would appear to undermine the Commission's stated goals of providing a regulatory regime that encourages participation by foreign private issuers and simplifying the registered offering process to make it more cost-effective for foreign as well as domestic issuers.

6. The Commission's Proposals Will Have an Adverse Effect on Hybrid Securities that are Investment-Grade Rated

The Commission's proposals will affect hybrid securities, including certain types of trust preferred securities or other hybrid securities that are investment-grade rated, currently sold to retail and institutional investors, and frequently listed on securities exchanges. As noted above, there is no evidence of concerns with the ratings process outside of ratings for RMBS and CDOs.

Hybrid securities represent an important funding source for issuers and remain attractive for investors, and issuers often rely on the availability of shelf registration on Form S-3/F-3 for offerings of these securities. For example, insurance companies rely on the availability of General Instruction I.B.2. to Form S-3 in order to offer trust certificates or debt securities backed by insurance company funding agreements, because these structures are attractive for capital purposes. Further, pooled trust preferred securities have generally been issued based on the investment grade eligibility criterion of Form S-3/F-3, as have been programs designed for repackaging investment grade corporate debt for sale to retail investors. These hybrid structures typically cannot be restructured in such a way that they could otherwise be eligible to use Form S-3/F-3 for primary offerings, and often would not have the \$1 billion issuance "track record" that the Commission proposes for Form S-3/F-3 eligibility.

**C. Recommended Alternatives to the Proposed WKSI-Based Test**

If the Commission believes that modification of the current Form S-3 eligibility standard set forth in General Instruction I.B.2. of this form (and its counterpart in Form F-3) is necessary and appropriate, despite the lack of a sufficient empirical predicate and the potentially significant negative consequences outlined above, we recommend that the Commission consider the following alternatives (which could be used in combination) to elimination of the investment-grade credit rating criterion.

1. Retain the existing investment-grade rating transactional eligibility criterion in combination with an additional indicator of widespread market following, such as the total amount of non-convertible debt and/or preferred securities outstanding (or issued over the preceding three years), regardless of whether the consideration sought was cash or other non-convertible securities (in the case of an Exxon-Capital exchange offer) or the subject securities were issued pursuant to a registered offering or a Section 4(2)/Rule 144A- or Regulation S-exempt offering. In our view, both domestic and foreign issuers that have chosen to rely on these exemptive safe harbors made available by the Commission should not be penalized for having taken advantage of the flexibility thus afforded over the years to tap the well-developed private markets for fixed-income securities. This point is particularly compelling when one considers that the Commission's exemptive provisions actually had the desired effect – they fostered a deeper and more liquid institutional debt market in this country, without any concomitant evidence of investor harm (the only abuses shown were in connection with Regulation S equity offerings by U.S. issuers, which abuses were curbed by the Commission in the late 1990's).

Since the advent of Rule 144A and Regulation S, it has become much easier for U.S. and non-U.S. issuers alike to make global combined offerings of non-convertible debt and preferred securities. Now that the Commission has amended Rule 144 to reduce holding periods for restricted securities (six months for reporting issuers, one year for non-reporting issuers), the need for registration rights (whether taking the form of an Exxon-Capital exchange offer or resale) is rapidly diminishing. If the Commission eliminates the availability of a short-form shelf for investment-grade debt issuers with little or no public float, we expect that there will be even fewer registered offerings of non-convertible securities made in this country by these issuers because of the significantly greater costs and inefficiencies associated with long-form registration on Form S-1/F-1.

2. Permit continued use of short-form shelf registration for offerings of non-convertible securities by majority-owned subsidiaries of issuers eligible to use Form S-3/F-3 based on the parent's compliance with the minimum \$75 million public float test, without the need for issuance of a parent (or other affiliate) guarantee. Examples of issuers that would fall into this category are utilities and REITs, as discussed, but there may be others. Should the Commission wish to eliminate the NRSRO rating criterion entirely, which as noted we do not support, there should be a sufficient showing of the requisite wide market following based on the subsidiary's own "timely and current" Exchange Act reporting status under General Instruction I.A., coupled with the demonstrably efficient market for the parent's securities presumptively established by the parent's satisfaction of the public float test in General Instruction I.B.1. Prospective investors would have the assurance of the subsidiary's Exchange Act reporting, along with the presentation of its financial results in the consolidated financial statements of the parent company.

We recognize that this "piggybacking" on the parent's market following is a less than ideal solution to the perceived problem. Still, it is preferable in our view to the proposed substitution of the WKSI test of \$1 billion in registered offerings for cash over three years for an investment-grade rating, which if adopted would have the effect of depriving many companies

with a wide market following tied to one or more investment-grade credit ratings of the choice of making a registered offering because a Form S-1/F-1 offering is not an attractive financing alternative. As we explained above, there are various, perfectly legitimate economic and regulatory reasons for consolidated subsidiaries in holding company structures to issue fixed-income securities without a parent (or affiliate) guarantee, thus foreclosing the ability to rely on Instruction I.C. to make a short-form shelf offering of such securities.

#### **D. The Commission Should Not Mandate Disclosure of Credit Ratings**

We support the Commission's proposal to retain its disclosure policy on security ratings specified in Item 10(c) of Regulation S-K, with some minor changes to accommodate proposed changes to Securities Act Rule 436(g). Any further changes to Item 10(c), by either rescinding the policy altogether or by making specific disclosure about security ratings mandatory, could have the effect of reducing the flexibility of issuers to tailor their security ratings disclosure to their own particular circumstances and to meet the needs and expectations of their investors. We believe that the principles set forth in Item 10(c) strike the right balance in terms of what disclosure should be made when an issuer decides to include disclosure about security ratings. If, however, the Commission decides to adopt a "mandatory" ratings disclosure item, we believe that it should conform to the policy currently specified in Item 10(c).

Whatever course the Commission decides to take with respect to the use of security ratings in its own rules, it will not change the importance of security ratings to issuers, investors and market participants. Commission action will not prevent the use of security ratings in covenants in loan agreements, swap agreements and many other types of agreements where security ratings are used to help limit a counterparty's credit risk. In turn, security ratings will remain important information for all of an issuer's investors – not just those investors making an investment decision with respect to the issuer's debt securities, but also equity investors who may be impacted should a downgrade in the company's credit rating trigger the acceleration of obligations or otherwise negatively impact the issuer's liquidity. The recent events in the credit markets, including the near-collapse of AIG following a ratings downgrade, demonstrate the continued need for the flexible, principles-based framework for security ratings disclosure embodied in Item 10(c) of Regulation S-K.

##### **1. There Is No Evidence that Any Change to the Disclosure Policy on Security Ratings is Necessary**

We believe that the Commission's proposed approach of retaining Item 10(c) of Regulation S-K is the best course for ensuring that investors continue to receive timely and accurate information about an issuer's ratings and the impact of those ratings on its financial position.

We do not believe there has been a significant shift in credit rating disclosure practices since at least 1994<sup>15</sup> – or indeed 1981<sup>16</sup> – when the Commission last considered its policy on

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<sup>15</sup> Release No. 33-7086 (Aug. 31, 1994).

“voluntary” disclosure of securities ratings. When the current policy for securities ratings was initially adopted in 1981, the Commission noted that there was no “pressing need” for mandatory disclosure, based on an observation that the market viewed debt and preferred securities with comparable ratings and payment terms as essentially fungible. This observation largely remains true today with respect to issuers of corporate securities, and over the last two decades ratings have continued to be relevant for many aspects of corporate finance, even beyond the initial and continuing investment decision with respect to the securities rated (e.g., as a part of covenants in financing arrangements).

The Commission’s 1994 proposals for mandatory disclosure of security ratings were driven in part by an evolution in financial instruments, including structured products and derivatives. Even with the proliferation of those products and the extent to which the meaning of ratings was viewed as “more variable” with respect to those types of products, the Commission did not elect to proceed with mandatory disclosure of ratings at that time. To the extent that any of these same concerns have again surfaced, we believe that the Commission’s June 16 proposals that directly target the deficiencies of the NRSRO ratings system for structured finance products can address the problems, rather than imposing a mandatory disclosure requirement that leaves the task to issuers to explain all of the perceived deficiencies with ratings.

In the absence of a “pressing need” now for a mandatory disclosure requirement that reflects the Commission’s judgment that security ratings (and potentially additional facts about the securities rating process) are *per se* material, we think that issuers are much better served, without diminishing investor protection, by the current policy, which affords them the opportunity to make appropriate materiality judgments about the need for security ratings disclosure.

2. The Commission’s Disclosure Policy on Security Ratings Provides Appropriate Guidance for Issuers When Disclosing Ratings Under Other Requirements

The Commission’s existing disclosure requirements often necessitate disclosure of security ratings in the appropriate context. For this reason, the Commission does not need to revisit the policy expressed in Item 10(c), nor does it need to establish a separate mandatory disclosure requirement for issuers concerning security ratings.

For example, Item 303 of Regulation S-K, *Management’s Discussion and Analysis of Financial Condition and Results of Operations*, requires issuers to specifically address their liquidity and capital resources. For issuers financing with corporate securities or bank financings, security ratings typically play an important part in their ongoing liquidity and access to capital resources. While the principles-based requirements of Item 303 do not specifically require a discussion of security ratings, the Commission has stated that to the extent material, a company must provide “disclosure regarding its historical financing arrangements and their importance to cash flows, including, to the extent material, information that is not included in the financial

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<sup>16</sup> Release No. 33-6336 (Aug. 6, 1981).

statements. A company should discuss and analyze, to the extent material . . . the potential impact of known or reasonably likely changes in credit ratings or ratings outlook (or inability to achieve changes).”<sup>17</sup>

Another context in which ratings disclosure may be relevant is in reporting on triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement under Item 2.04 of Form 8-K. In providing a brief description of the triggering event under Item 2.04(a)(1), it is often necessary to describe a change in a credit rating that, by virtue of the fact that the credit rating has been incorporated into the terms of the agreement establishing the direct financial obligation or off-balance sheet arrangement, would cause an acceleration increase in the issuer’s obligation.

In each of these examples, an issuer would be guided in providing the required disclosure by Item 10(c), which would generally require the issuer to provide a balanced and complete picture of the rating itself and its relevance to the issuer’s particular circumstances. These existing disclosure requirements demonstrate that the Commission’s rules already compel, in some circumstances, mandatory disclosure of security ratings and changes in security ratings, making any attempt to establish a specific ratings disclosure line item largely superfluous.

### 3. The Commission’s Should Not Prohibit Disclosure of Security Ratings

If the Commission were to return to its pre-1981 policy of prohibiting disclosure of security ratings by issuers, we believe that investors could be deprived of valuable information regarding an issuer’s view of external ratings in the context of the issuer’s own circumstances. While, under such a scenario, ratings information would remain publicly available for investors from the rating agencies, the context in which the particular ratings should be considered – and the relevance to the issuer’s situation – would be unavailable. As a result, a prohibition on ratings disclosure might serve to inappropriately emphasize ratings for the purposes of investment decisions (which is clearly contrary to the Commission’s objectives expressed in the Proposing Releases), because an issuer would not be given the opportunity to explain other considerations that may impact the relevance of the rating to the issuer’s overall financial position.

### 5. The Commission Should Amend Rule 436(g) as Proposed

We support the Commission’s proposal to amend Rule 436(g) so that it would no longer be limited to just NRSROs. We do not believe that any references to ratings, as a policy matter, should be considered “expertized” disclosure under Securities Act Section 7 and Rule 436 for which consents should be required. If the Commission were not to amend Rule 436(g), then issuers would be faced with the possibility of having to go through the potentially costly and time consuming process of obtaining consents from a credit rating agency that is not a NRSRO, or choose to deny investors a complete picture of the available ratings by omitting disclosure about any rating from a non-NRSRO rating agency. Further, the ability to withhold consent for disclosure about a rating may inappropriately place too much leverage in the hands of a non-

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<sup>17</sup> Release No. 33-8350 (Dec. 19, 2003).

NRSRO rating agency with respect to an issuer that is compelled, on the basis of the materiality of the information, to disclose that agency's rating in a prospectus.

6. **The Commission Should Not Adopt Amendments to Form 8-K Specifically Requiring Ratings Disclosure**

The Commission has asked whether it should revive its prior proposals to require Form 8-K disclosure of material changes in security ratings. More specifically, the Commission seeks comment on whether a Form 8-K would provide investors with material and timely information about an issuer's security ratings and changes in those ratings, and further whether any such requirement should be limited to issuer-solicited ratings. Consistent with our general view that a mandatory disclosure regime is neither necessary nor appropriate in this area given the adequacy of existing requirements as discussed above, we recommend against any amendment to Form 8-K that would elicit disclosure beyond what is now prescribed by Items 2.03 (creation of a material direct financial obligation or off-balance sheet arrangement – material terms of such obligations or arrangements, including but not limited to credit-rating covenants) and 2.04 (triggering events that accelerate or increase such obligations or arrangements).

**E. Other Proposals**

The Commission has proposed to amend Forms S-4 and F-4, and Schedule 14A, to preclude the ability of registrants using these forms or schedules to incorporate by reference certain information if they are not eligible to use Form S-3/F-3 to make shelf offerings of investment-grade debt or preferred securities under the proposed \$1 billion WKSI standard. For the reasons set forth above, we urge the Commission either to retain the current issuer and transactional eligibility standards for such offerings or, should the Commission nevertheless decide to eliminate references to credit ratings in Form S-3/F-3, to adopt our recommended alternatives to the proposed \$1 billion WKSI standard for purposes of Form S-4/F-4 and Schedule 14A.

We respectfully take the same position with respect to the Commission's proposal to eliminate provisions in Securities Act Rules 138, 139 and 168 that are tied to credit ratings.

**F. Proposed Amendments to Regulation M that Would Eliminate Current Exceptions for Investment-Grade Debt and Preferred Securities**

Regulation M is intended to protect the integrity of the securities trading market as an independent pricing mechanism by prohibiting activities that could artificially influence the market for a security being offered in a distribution. Rules 101 and 102 of Regulation M thus prohibit distribution participants from directly or indirectly bidding for, purchasing, or attempting to induce another person to bid for or purchase, a covered security until the applicable restricted period has ended.

Rules 101 and 102 of Regulation M currently except transactions in non-convertible debt and preferred securities with an NRSRO investment-grade rating. The Commission now proposes to eliminate these exceptions – by replacing them with an exception tied to non-

convertible debt and preferred securities issued by WKSIs that, within the preceding three years, have issued at least \$1 billion aggregate principal amount of such securities for cash in registered primary offerings.

The current exceptions were included in the original version of Regulation M, adopted in 1996 and effective in early 1997, and had been in place since at least 1983 in the form of predecessor Rule 10b-6. In its release adopting Regulation M, the Commission stated that the exceptions were intended “to relax restrictions in cases where either the risk of manipulation is small or the costs of the restrictions are disproportionate to the purposes they serve.”<sup>18</sup> In fact, the codification in 1983 of these exceptions was predicated on a no-action position that the staff had taken as far back as 1975 (*American Telephone and Telegraph Co.*, SEC No-action letter (avail. Feb. 26, 1975)). As such, these exceptions have been available and relied upon by distribution participants for one-third of a century.

The Commission’s consistent rationale for the current exceptions (and their predecessors) has been that investment grade securities trade on the basis of yield and spread to comparable securities, and are generally fungible with other, similarly rated securities. Based on these qualities, such securities are less susceptible to manipulation.<sup>19</sup> The Commission has not cited any precedent from the preceding 33 years that would suggest that the Commission’s original rationale, carried forward in Rules 101 and 102 of Regulation M, was in any way unjustified. There is no indication in the regulatory history that the Commission’s anti-manipulation purposes were in any way tied to investor perceptions of whether a particular class of securities subject to a distribution was somehow less prone to manipulation by issuers and distribution participants because of the investment grade caliber of the securities themselves. Nor has the Commission otherwise demonstrated that investors have relied to their detriment on an investment-grade rating as the sine qua non of non-manipulation of the securities being distributed. For all these reasons, we strongly believe that the Commission should retain the current exceptions.

The Commission explains the new \$1 billion WKSI standard as being “based on the same premises as the current exceptions (such as high liquidity and fungibility),” but offers no explanation of how simply having issued \$1 billion worth of non-convertible securities, without regard to credit ratings, is any guarantee of either liquidity or fungibility. Instead, the Commission appears to be relying on a belief that the \$1 billion WKSI standard is a proxy for the market’s access to “useful and high-quality public information . . . that may assist investors in assessing the creditworthiness of the issuer on their own without needing to unduly rely on an NRSRO.” But while the availability of information arguably may be relevant, in some circumstances, to the Commission’s disclosure and Securities Act registration requirements, it has questionable relevance to the way in which securities trade. As the Commission itself says, exceptions from Regulation M must be justified by a security’s trading “in such a way that it is

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<sup>18</sup> Release No. 33-7375 (Dec. 20, 1996).

<sup>19</sup> See Section III.E.2. of the Exchange Act Release (“The current exceptions for certain investment grade debt and preferred securities rated by a NRSRO were originally based on the premise that these securities are traded on the basis of their yields and credit ratings, are largely fungible and, thus, are less likely to be subject to manipulation.”).



resistant to manipulation,” and the Commission has not shown that the \$1 billion WKSI standard, in contrast to the investment grade standard, justifies or is even relevant to this conclusion.

The Commission also refers to its proposed exceptions as providing a “bright line demarcation and objective criteria.” This may be true for an issuer that will know at any given time the amount of qualifying securities that it has issued during a three-year period prior to its filing an automatic shelf registration statement, but it will be much less obvious to a broker-dealer that has been invited to participate in a new offering and may not be able easily to determine whether the exception is available. Such broker-dealers are more likely, in our view, to effect inadvertent transactions that would violate Rule 101.

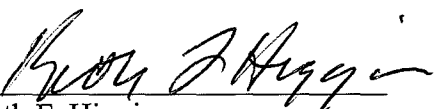
To summarize, we believe that the requirements for WKSI status based on historic non-convertible debt/preferred issuance levels fail to track the qualities of liquidity and fungibility as effectively – if at all – as the current NRSRO rating-based standard has done for more than 30 years. The proposed amendments would impose the restrictions of Regulation M on issuers of previously excepted investment grade securities that historically have been proven to be less vulnerable to manipulation, while creating new and unprecedented exceptions for issuers of high yield securities (assuming the Rule 144A exception is not otherwise available) that arguably would be much more vulnerable to possible manipulation.

As the Commission is undoubtedly aware, many non-investment grade debt offerings are conducted in reliance on Rule 144A because of the unavailability of any other exception to Rule 101. As with the proposed changes to Form S-3/F-3 eligibility discussed above, investment grade issuers that would not meet the proposed WKSI standard would be compelled to conduct offerings in reliance on Section 4(2)/Rule 144A or Regulation S, while some non-investment grade debt issuers would now be able to rely on the proposed WKSI exception. If the Commission wishes to adopt the \$1 billion WKSI standard as a Regulation M exclusion to encourage the registration of these offerings under the Securities Act, it should do so *as an alternative to the current exceptions*.

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The Committee appreciates the opportunity to comment on the proposal and respectfully requests that the Commission consider the recommendations set forth above. We are prepared to meet and discuss these matters with the Commission and its Staff and to respond to any questions.

Respectfully submitted,



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