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SEC removes references to credit ratings from Regulation M

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In its third attempt over the past 15 years, the SEC adopted amendments to Regulation M to remove references to credit ratings, the last step in completing Dodd-Frank's mandate to eliminate reliance on credit ratings from SEC rules.

On June 7, 2023, the Securities and Exchange Commission voted unanimously to adopt amendments to eliminate the current exception in Rules 101 and 102 of Regulation M for investment grade securities and replace it with an exception based on a probability of default standard determined using a structural credit risk model. These amendments complete the SEC's mandate to remove reliance on, and references to, credit ratings from its rules and forms as required by Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. As part of these amendments, the SEC also adopted recordkeeping requirements that will apply to broker-dealers in connection with their probability of default determinations.

While most investment grade debt offerings will be unaffected by the changes since investment grade debt offering participants and their affiliates generally do not engage in the activities restricted by Regulation M, there are a number of offerings, including reopenings of existing issues, that could be impacted.

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

Background on Regulation M

Regulation M is designed to prevent anyone with a financial interest in a distribution from manipulating the market price and thereby misleading potential investors as to the "true" state of the public market for the securities being distributed.

Specifically, Rules 101 and 102 of Regulation M prohibit issuers, selling security holders, distribution participants, and any of their affiliated purchasers, 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. Covered securities are the securities being distributed or any "reference security," into which a subject security may be converted, exchanged or exercised, or under which the terms of the subject security may "in whole or significant part" determine its price.

In addition to the existing exception for investment grade securities, Rules 101 and 102 also contain other exceptions and exemptions, including an exception for transactions in Rule 144A securities, which would not be modified by the amendments.

New exception for Rules 101 and 102

The new exception relating to nonconvertible debt securities and nonconvertible preferred securities is identical in Rules 101 and 102 (in a change from the rule proposal, which would have eliminated the investment grade exception from Rule 102 without replacement). Instead of an investment grade rating, the new exception relies on an issuer's probability of default as determined by the lead manager in a distribution (for example, the lead underwriter) using a "structural credit risk model" as defined under the amendments.

- **Probability of default of 0.055% or less.** The amendments replace the existing investment grade exception in Rules 101 and 102 for nonconvertible debt securities and nonconvertible preferred securities with a probability of default criterion. The amendments require the probability of default, which must be estimated as of the sixth business day before pricing (changed from as of the day of pricing under the rule proposal) and over 12 full calendar months from that day, to be 0.055% or less.
- **Based on a structural credit risk model.** The probability of default must be derived from a structural credit risk model. The amendments introduce the new defined term "structural credit risk model," which means "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."
- **Determined by the lead manager.** The probability of default determination must be documented in writing and made by the distribution participant acting as the lead manager (or in a similar capacity) in the relevant distribution. This is a change from the rule proposal, which would have allowed any distribution participant to make the determination.

Recordkeeping requirement

The amendments require broker-dealers who rely on the new exception in Rules 101 or 102 to preserve the written probability of default determination supporting their reliance on the exception for at least three years, the first two of which must be "in an easily accessible place." This requirement is intended to facilitate the SEC's examination of broker-dealers that rely on the new exception and, the SEC stated, "…is appropriate to help deter improper adjusting of the estimation to meet the conditions of either of the exceptions."

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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