June 16, 2023

SEC Adopts Amendments to Regulation M

Replaces Investment-Grade Rating Exceptions With New Credit Risk Exceptions That Require Lead Managers to Assess Probability of Default

SUMMARY

On June 7, 2023, the Securities and Exchange Commission (the "SEC") adopted amendments to Regulation M, replacing the investment-grade exceptions for non-convertible debt or preferred equity securities with credit risk exceptions based on a specified probability of default threshold assessed by the lead manager in writing pursuant to a structural credit risk model.[1] The amendments also require broker-dealers relying upon the new exceptions to preserve the written determination of the probability of default for at least three years. Managers and issuers should consider appropriate modifications to transaction documentation and policies and procedures.

BACKGROUND

Regulation M is a set of prophylactic anti-manipulation rules designed to preserve the integrity of the securities trading markets as independent pricing mechanisms during a distribution of securities by prohibiting activities that could artificially influence the market for an offered security. Rule 101 of Regulation M prohibits certain participants in a securities distribution[2] from bidding, purchasing or attempting to induce any person to bid for such distributed securities[3] during a specified restricted period. The rule applies to underwriters, prospective underwriters, brokers, dealers and other persons who have agreed to participate or are participating in a distribution. Rule 102, like Rule 101, prohibits bidding, purchasing or attempting to induce any person to bid for or purchase securities in a distribution, but applies to issuers and selling security holders and their affiliated purchasers.

Currently, both Rule 101 and Rule 102 contain exceptions to allow purchasing or bidding on investment-grade non-convertible debt or preferred equity securities that are subject to a distribution on the premise

that those securities trade on the basis of their yield and creditworthiness, so are largely fungible and less susceptible to the type of manipulation that Regulation M seeks to prevent. Accordingly, participants in investment-grade non-convertible debt securities distributions are currently exempt from Rules 101 and 102 where such distributed securities are rated investment-grade by at least one nationally recognized statistical rating organization.

Section 939A(b) of the Dodd-Frank Act of 2010 required the SEC to remove references to rating organizations from their rules and forms. After several years and proposals, the SEC adopted largely as proposed significant changes to Rules 101 and 102.

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

NEW CREDIT RISK EXCEPTIONS AND RECORD-KEEPING REQUIREMENT

The adopted amendments to Regulation M include new exceptions to Rules 101 and 102, replacing the previous investment-grade credit rating exceptions with exceptions for non-convertible debt and preferred equity 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 the horizon of 12 full calendar months from such price determination day, is 0.055% or less, as determined and documented, in writing, by the distribution participant acting as the lead manager (or in a similar capacity) in a distribution (the "Credit Risk Exception").[4] The probability of default analysis focuses on the probability that the value of the issuer will fall below the threshold at which the issuer would fail to make scheduled debt payments. The probability of default analysis must be derived by reference to an issuer's balance sheet and by utilizing a commercially or publicly available structural credit risk model (including models provided by vendors). Other models, such as reduced-form models or other internal models, may not be used. The Credit Risk Exception does not contain a requirement that an issuer's balance sheet be audited and lead managers may rely on internal calculations or outside vendors in calculating the probability of default, as long as such calculations are based on a commercially or publicly available structural credit risk model.

Importantly, only a distribution participant acting as a lead manager (or in a similar capacity) can determine the probability of default, and non-lead managers or issuers and selling security holders relying on the Credit Risk Exception pursuant to Rules 101 and 102, respectively, would not be permitted to rely on their own determinations (or determinations made by outside vendors engaged by them) regarding the probability of default. This condition to the Credit Risk Exception means that issuers would not be able to rely on the exception at all when selling securities directly, unless a lead manager is involved in the distribution and had made (and documented) the qualifying probability of default determination. Likewise, underwriters participating in the distribution will not be able to rely on the Credit Risk Exception unless they receive the probability of default analysis from the lead manager.

In connection with the amendments to Rules 101 and 102, the adopting release introduces a new clause 17 to Rule 17a-4(b), requiring broker-dealers who rely on the Credit Risk Exception in Rule 101 or Rule 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 Credit Risk Exception since the determination will no longer be based on readily available and verifiable credit ratings.

NEW EXCEPTION FOR ASSET-BACKED SECURITIES FILED ON FORM SF-3

The amendments to Regulation M also add a new exception in Rules 101 and 102 with respect to asset-backed securities that are offered pursuant to an effective shelf registration statement filed on Form SF-3. The shelf eligibility requirements included in Form SF-3 are designed to help ensure that the securitization is designed to produce expected cash flows sufficient to service payments or distributions in accordance with their terms, and, like investment-grade debt, primarily trade on the basis of yield and creditworthiness, rather than on the identity of a particular issuer and its idiosyncratic risk. Because use of a structural credit risk model would not be appropriate with respect to asset-backed securities given the unique nature of the underlying assets and fluctuating asset values, the SEC instead opted to except from Regulation M any asset-backed security offered pursuant to an effective shelf registration statement filed on Form SF-3.

IMPLICATIONS AND CONSIDERATIONS

Based on current market practice, we expect that distribution participants and issuers will rely upon the Credit Risk Exception to Rules 101 and 102 in the limited circumstances of:

- Re-opening transactions where an issuer sells additional securities that are fungible with an existing issue for U.S. federal income tax purposes, which are less common in corporate debt markets but are relatively more common in the sovereign debt markets; and
- "Sticky" transactions where some securities purchased in a committed underwriting continue to be held by the underwriters after the initial distribution is complete.

In light of the new rules, issuers and distribution participants should consider the following:

1. **Probability of Default Should Be Assessed Continuously and Availability of Credit Risk Exception Is More Uncertain:** Unlike the investment-grade credit exception, the new Credit Risk Exception has the potential to evolve over time as structural credit risk models and methods develop. Furthermore, relative to credit ratings, which are relatively static, changes in trading of an issuer's credit default swaps or other markets indicative of default probabilities could more quickly render the Credit Risk Exception unavailable to distribution participants and issuers. As such, the probability of default determination must be assessed continuously as issuers prepare to launch a transaction and may become suddenly inapplicable if market conditions or trading in an issuer's securities change. Accordingly, underwriters for less creditworthy issuers may be required to stay out of the market for the distributed security until pricing.

2. **Modifications to Transaction Documentation and Document Retention Policies**: Issuers and underwriters, as applicable, should consider the following modifications to transaction documentation and document retention policies:

    a. Underwriting agreements should be modified to require the lead manager to provide the probability of default determination to the issuer and any selling security holders (and their affiliated purchasers) in a securities distribution subject to Regulation M so that they may rely upon it for the Credit Risk Exception in Rule 102. This is particularly relevant for affiliate broker-dealers that are participating in the offering as purchasers but not as underwriters.

    b. Agreements among underwriters should be modified to require the lead manager to disclose to other underwriters the probability of default determination for each offering. This allows non-lead managers to rely on the lead manager's determination and qualify for the Credit Risk Exception in Rule 101.

    c. Broker-dealers' document retention policies and procedures should be modified to preserve the written probability of default determination supporting their reliance on the Credit Risk Exception for at least three years, the first two of which must be "in an easily accessible place."

* * *

ENDNOTES

[1] *See Removal of References to Credit Ratings from Regulation M* ("Adopting Release"), Release No. 34-97657 (June 7, 2023), *available at*: [Final rule: Removal of References to Credit Ratings from Regulation M (sec.gov)].

[2] *See* 17 CFR 242.100(b) (defining "distribution" as "an offering of securities, whether or not subject to registration under the [Securities Act of 1933 (the "Securities Act")], that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods").

[3] The term "security" also includes reference securities, which means a security into which a security that is the subject of a distribution ("subject security") may be converted, exchanged, or exercised or which, under the terms of the subject security, may in whole or in significant part determine the value of the subject security. 17 CFR 242.100(b). However, even a minor change in any term or condition of a security offered (e.g., a single basis point of interest) is enough to regard such security offered as different from a security in the market. Accordingly, issuers and underwriters taking part in a securities distribution may bid for and purchase slightly different securities from the market without violating Regulation M.

[4] The SEC did not adopt its initial proposal to remove the Credit Risk Exception from Rule 102 entirely, see *Removal of References to Credit Ratings From Regulation M*, Release No. 34-94499 (Mar. 23, 2022) [87 CFR 18331 (Mar. 30, 2022)], *available at*: [Proposed rule: Removal of References to Credit Ratings From Regulation M (sec.gov)].

Copyright © Sullivan & Cromwell LLP 2023

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.