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# Global Securities Group Client Alert

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## SEC PROPOSES NEW FORM S-3 ELIGIBILITY STANDARD TO ELIMINATE RELIANCE ON CREDIT RATINGS

*On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") was enacted. This client alert is part of a series of client alerts Milbank is releasing on particular aspects of the Dodd-Frank Act that are important to our clients.*

Section 939A of the Dodd-Frank Act requires each Federal agency, including the Securities and Exchange Commission (the "SEC"), to review any of its regulations that require the use of an assessment of the credit-worthiness of a security or money market instrument, modify its regulations to remove references to or requirements of reliance on credit ratings and provide an appropriate substitute for such ratings.

In response to these requirements, on February 9, 2011 the SEC issued a proposed rule (the "Proposed Rule") that would replace requirements that rely on or relate to credit ratings with alternative requirements for certain rules and forms promulgated under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act").<sup>1</sup>

In particular, the Proposed Rule would replace the transaction requirement that allows issuers to be eligible to use Form S-3 and F-3 for primary offerings of non-convertible investment grade securities with a new requirement. The Proposed Rule would also make corresponding and related amendments to Rules 134, 138, 139, 168, Form S-4, and Form F-4 under the Securities Act and Schedule 14A under the Exchange Act.

The amendments are substantially similar to amendments proposed by the SEC in 2008. At that time, many commentators opposed the proposal to modify Forms S-3 and F-3. The amendments have been re-proposed, however, because the Dodd-Frank Act now mandates the SEC to remove references to credit ratings from its rules and regulations.

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For further information about this Client Alert, please contact:

Arnold B. Peinado, III  
+1-212-530-5546  
apeinado@milbank.com

Douglas A. Tanner  
+1-212-530-5505  
dtanner@milbank.com

Robert B. Williams  
+1-212-530-5516  
rwilliams@milbank.com

Robert W. Mullen, Jr.  
+1-212-530-5150  
rmullen@milbank.com

Marcelo A. Mottesi  
+1-212-530-5602  
mmottesi@milbank.com

You may also contact any member of Milbank's Global Securities group. Contact information can be found at the end of this Client Alert or in the Practice Areas section at [www.milbank.com](http://www.milbank.com).

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<sup>1</sup> See SEC Release No. 33-9186; 34-63874; File No. S7-18-08.

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## Revisions to Form S-3 and F-3 Eligibility to Register Primary Offerings of Non-Convertible Securities

The Proposed Rule would revise the transaction eligibility criteria for registering primary offerings of non-convertible securities on Forms S-3 and F-3. Forms S-3 and F-3 are “short form” registration statements that may be used by eligible issuers to register securities offerings under the Securities Act and are often used for shelf registrations that permit offerings of registered securities (or takedowns) from time to time after the registration statement is declared effective. Eligibility to use these forms depends on satisfying both registrant requirements and transaction requirements. These forms have the advantage of permitting an issuer to utilize “incorporation by reference” to the issuer’s annual, quarterly and current reports filed with the SEC as a means to bring the issuer’s public disclosure into the prospectus.

Currently, one of the transaction requirements is that a registrant can use Form S-3 to register a primary offering of non-convertible securities if the securities are rated investment grade by at least one nationally recognized statistical rating organization. As proposed, this transaction requirement would be revised to eliminate the investment grade rating requirement and, instead, would allow a registrant to use Form S-3 to register a primary offering of non-convertible securities for cash, provided that the registrant, as of a date within 60 days prior to the filing of the registration statement on Form S-3, has issued in the last three years at least \$1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash, not exchange, registered under the Securities Act (the “New Standard”). The same change has been proposed for Form F-3. The Proposed Rule would not change the other alternate Form S-3 transaction eligibility requirements such as having \$75 million in common equity held by unaffiliated shareholders.

The proposed change to the eligibility criteria uses the same method and threshold by which the SEC defined an issuer of non-convertible securities, other than common equity, that does not meet the public equity float requirement to still qualify as a “well-known seasoned issuer” (“WKSI”). To determine compliance with the proposed \$1 billion threshold, the SEC proposes to use the same standards that are used in determining whether an issuer is a WKSI. In particular:

- the aggregate principal amount of non-convertible securities that would be permitted to be counted toward the \$1 billion threshold would be those issued in any registered primary offering on any form (other than Form S-4 or Form F-4);
- issuers would be permitted to include only such non-convertible securities that were issued in registered primary offerings for cash – they would not be permitted to include registered exchange offers; and
- parent company issuers only would be permitted to include in their calculation the principal amount of their full and unconditional guarantees, within the meaning of Rule 3-10 of Regulation S-X, of non-convertible securities, other than common equity, of their majority-owned subsidiaries issued in registered primary offerings for cash during the three-year period.

In calculating the \$1 billion amount, issuers generally would be permitted to include the principal amount of any debt and the greater of the liquidation preference or par value of any non-convertible preferred stock that were issued in primary registered offerings for cash. Issuers seeking to rely on the New Standard, however, would not be required to qualify as a WKSI. Unlike WKSI, issuers would not need to determine whether they are “ineligible issuers” as defined in Rule 405.

The SEC stated that, despite the comments received on their proposed rule in 2008, it believes that the current proposal is the most workable alternative for determining whether an issuer is widely followed in the marketplace so that Form S-3 and Form F-3 eligibility and access to the shelf offering process would be appropriate.

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## Potential Impact

The SEC anticipates that, applying the New Standard, some high yield debt issuers that are not currently eligible to use Form S-3 would become eligible to use it and some issuers that have used or that could rely upon the investment-grade criteria but could not meet the New Standard would lose Form S-3 or F-3 (and thereby shelf) eligibility.

Based on a review of non-convertible securities issued in the U.S. from January 1, 2006 through August 15, 2008, the SEC estimates that approximately 45 issuers who were previously eligible to use Form S-3 (and who had made an offering during the review period) would no longer be able to use Form S-3 for offerings of non-convertible securities other than equity securities. The SEC further estimates that approximately eight issuers who were previously ineligible to use Form S-3 or Form F-3 would be eligible to use those forms if the proposals are adopted. Note that these SEC estimates do not consider the significant increase in notes offerings in 2009 and 2010 and do not take account of issuers who were eligible to make a registered offering on Form S-3 or Form F-3 and choose not to do so. Note also that the proposal would affect other forms that use the same eligibility criteria as Form S-3 and Form F-3. Given this, the SEC stated that it has considered several mechanisms to avoid this consequence and to provide consistency in the treatment of these issuers for purposes of establishing eligibility for Form S-3 or Form F-3. The SEC specifically requested comments regarding potential mechanisms that might allow more consistent treatment of these issuers.

## Other Amendments to Rules and Forms

The SEC proposed related revisions to Rules 138 and 139 (relating to the publication or distribution of research reports by brokers or dealers) and Rule 168 (relating to communications of regularly released factual business information and forward-looking information). The revisions would eliminate the references to investment-grade securities and instead make reference to an issuer that is issuing non-convertible securities and that meets the New Standard under Form S-3 or F-3, as applicable.

The Proposed Rule also includes changes to Forms S-4, F-4 and Schedule 14A to allow a registrant to be eligible to use incorporation by reference if it meets the New Standard along with other requirements specific to the respective form or schedule. The credit rating of the securities being issued would no longer be relevant to such eligibility.

## Public Comments

The SEC made a general request for public comments on the Proposed Rule and, in light of the comments received on its 2008 proposal, the SEC specifically requested comments on whether the proposed approach is appropriate, what the impact on issuers and other market participants would be and whether there are alternatives that should be considered. Comments should be received on or before March 28, 2011.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any member of our Global Securities group listed below.

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**Beijing**

Edward T. Sun +86-10-5969-2772 esun@milbank.com

**Frankfurt**

Thomas Inghoven +49-69-71914-3436 tingenhoven@milbank.com

**Hong Kong**

Anthony Root +852-2971-4842 aroot@milbank.com  
Dieter Yih +852-2971-4888 dyih@milbank.com  
Joshua M. Zimmerman +852-2971-4811 jzimmerman@milbank.com

**London**

Peter Schwartz +44-20-7615-3045 pschwartz@milbank.com

**Los Angeles**

Kenneth J. Baronsky +1-213-892-4333 kbaronsky@milbank.com  
Deborah J. Ruosch +1-213-892-4671 druosch@milbank.com  
Neil J. Wertlieb +1-213-892-4410 nwertlieb@milbank.com

**Munich**

Peter Nussbaum +49-89-25559-3630 pnussbaum@milbank.com

**New York**

James H. Ball, Jr. +1-212-530-5515 jball@milbank.com  
Paul Denaro +1-212-530-5431 pdenaro@milbank.com  
Michael L. Fitzgerald +1-212-530-5224 mfitzgerald@milbank.com  
Joy K. Gallup +1-212-530-5211 jgallup@milbank.com  
Taisa Markus +1-212-530-5165 tmarkus@milbank.com  
Marcelo A. Mottesì +1-212-530-5602 mmottesì@milbank.com  
Robert W. Mullen, Jr. +1-212-530-5150 rmullen@milbank.com  
Arnold B. Peinado, III +1-212-530-5546 apeinado@milbank.com  
Douglas A. Tanner +1-212-530-5505 dtanner@milbank.com  
Robert B. Williams +1-212-530-5516 rwilliams@milbank.com

**Sao Paulo**

Andrew Janszky +55-11-2787-6280 ajanszky@milbank.com  
Tobias Stirnberg +55-11-2787-6328 tstirnberg@milbank.com

**Singapore**

Naomi J. Ishikawa +65-6428-2525 nishikawa@milbank.com  
Giles Kennedy +65-6428-2425 gkennedy@milbank.com

**Tokyo**

Gary S. Wigmore +813-5410-2840 gwigmore@milbank.com

**Washington, DC**

Winthrop N. Brown +1-202-835-7514 wbrown@milbank.com