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Economic Crisis Response Group

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SEC Aims to Improve Oversight of Credit Rating Agencies With New Rules

During the first week of October, the SEC took a number of steps intended to improve its oversight of credit rating agencies. First, the SEC released a final rule deleting references to credit ratings from various rules and forms; this addresses concerns that market participants may have relied too much on such ratings because the SEC rules and forms referred to them. The SEC also published a release seeking comments on the possibility of rescinding Rule 436(g) under the Securities Act of 1933, as amended (the "Securities Act"), which provides that credit ratings issued by certain agencies are not deemed to be a part of the registration statement for purposes of Sections 7 and 11 (Civil Liabilities) of the Securities Act of 1933.

The SEC also proposed amendments to its rules regarding disclosure of credit ratings information used by registrants for registered securities offerings. The proposed amendments are intended to improve disclosure so that investors will better understand credit ratings and their limitations and would require registrants to provide disclosure whenever a credit rating is used in connection with a registered offering. The proposed amendments would also require additional disclosures concerning credit ratings, including disclosures regarding potential conflicts of interest that could affect the credit rating (e.g., the identity of the party that paid for the rating). The SEC is also proposing mandatory disclosure of any preliminary or final credit rating that is not used in a registered offering; the SEC believes this requirement may help prevent ratings shopping. In addition, the proposed amendments would require certain general information about the rating to be disclosed, including the rating agency, the rank of the rating, a description of the rated category and any material differences between the agency assumptions and the minimum obligations or terms used in marketing or selling efforts. Much of the information that would be required under the proposed amendments is currently permitted under Item 10(c) of Regulation S-K. If the rules are adopted, continuing disclosure will be required in domestic current reports and domestic and foreign periodic reports, including mandatory disclosure of a change to the rating in 8-Ks and discussion of any material impact of such change within the next periodic report.

SEC Considers Additional Short Sale Rules

At the SEC's recent roundtable on securities lending, the Commission noted that it is re-examining its regulation of short selling and is considering a new rule that would require shares to be pre-borrowed before they could be sold short, a procedure known as a "hard-locate." Persons selling shares short are currently required to borrow such shares or have a reasonable assurance that they will be able to borrow them; the proposal would make it mandatory to actually identify the shares that will be borrowed prior to the short sale.

Treasury Department Announces Initial Closings of Legacy Securities Public-Private Investment Funds

On September 30, the Treasury Department announced the first two closings of Public-Private Investment Funds ("PPIFs") established under the Legacy Securities Public-Private Investment Program ("PPIP"). These funds are managed by Invesco Ltd. and the TCW Group, Inc., respectively. On October 5, the Treasury Department announced three additional closings of PPIFs, managed, respectively, by AllianceBernstein, LP, BlackRock, Inc. and Wellington Management Company, LLP. These five PPIFs have each raised at least $500 million of committed equity capital from private investors; to date, the aggregate equity and debt capital committed to these funds exceeds $12 billion.

Treasury expects the remaining four of the nine fund managers that prequalified in July for participation in the PPIP to close PPIFs by the end of October. Each PPIF will have the opportunity to receive matching equity and debt financing from Treasury following its initial closing; total Treasury equity and debt investments by Treasury in PPIF will then equal approximately $30 billion.

Lehman Bankruptcy Decision Requires Payment to Derivatives Counterparty

On September 23, the U.S. Bankruptcy Court for the Southern District of New York ruled that Metavante Technologies had to pay a Lehman Brothers entity on an interest rate swap, even though Lehman was in default because it had filed for bankruptcy.

Under the ISDA Master Agreements that generally govern such derivatives contracts, one counterparty may suspend performance during an event of default by the other, and is also permitted to close out and terminate the contract. Because closing out an unfavorable contract generally requires a large payment, some counterparties suspend payments but do not elect to terminate the contract. The rationale for the provision is that if the market conditions (in this case interest rates) later change, the party in bankruptcy will not pay, and therefore the non-defaulting party should be able to wait until the end of the contract to determine what amounts (if any) it still owes the party in bankruptcy. Safe harbor sections in the federal Bankruptcy Code provide an exception to the automatic stay to permit termination, netting, closeout, and setoff of swaps.

In the Metavante case, the Court ruled that because Metavante did not elect to terminate the swap agreement within a reasonable time, it must continue to pay Lehman. Under the court's decision, a counterparty of a party in bankruptcy must, within a reasonable time, either (1) continue to pay the monthly or other periodic payments due under a derivatives contract or (2) terminate such contract and pay the amounts due on termination, which represent the present value of the stream of all future payments based on current market conditions. The court was unmoved that Metavante had lost the benefit of its bargain: parties only enter into interest rate swaps so that they can receive payments if market conditions make their contract "in the money," but since Lehman was in bankruptcy, it would not pay if interest rates changed. The decision limits the availability of the bankruptcy safe harbor and gives derivatives counterparties in bankruptcy a potential advantage. If the contract is out of the money, the party in bankruptcy stops paying (though it would lose any collateral); if it is in the money, the party in bankruptcy either receives a large early termination payment or continues to receive payments, despite the fact that the party in bankruptcy would generally not pay the counterparty.

House Financial Services Committee Considers Derivatives Regulation

On October 5, Barney Frank, Chairman of the House Financial Services Committee (the "Committee") circulated a proposed bill for derivatives regulation within Congress. This bill was drafted as a more flexible and less costly alternative to the bill previously released by the Obama Administration.

In particular, Frank attempted to protect non-financial companies that use derivatives only to hedge their own commodities, interest rates and other expenses, from costly increased regulation. A key provision would exempt corporations from some requirements to the extent they use derivatives for "risk management" purposes. While the manufacturing and financial industries have generally responded positively to Frank's bill, federal regulatory authorities have opposed it.

On October 7, the Committee held a hearing on "Reform of the Over-the-Counter Derivative Market: Limiting Risk and Ensuring Fairness," which included discussion of the competing bills. Both Gary Gensler, Chairman of the CFTC, and Henry Hu, the SEC's Director, Division of Risk, Strategy, and Financial Innovation, testified that Chairman Frank's proposed bill left significant gaps in regulation of derivatives and called for changes to eliminate such gaps. In particular, they suggested that the exemption for derivatives used for "risk management" purposes should be eliminated and that any other exemptions should be narrowly tailored to exclude only non-financial entities that use swaps that are incidental to their businesses to hedge actual commercial risks. Gensler and Hu also spoke in favor of the broader provisions in the Administration's bill providing regulation to reduce risk (through increased capital and collateral requirements) and increase transparency, while arguing that even the Administration's bill needs to be tightened to remove any gaps in regulation. Chairman Frank himself stated that he would tighten provisions of his bill to prevent unintended loopholes and evasion of needed regulation.

Senate Committee on Banking, Housing and Urban Affairs Addresses the Mortgage Market and Housing Enterprises

On October 8, Senate Banking Committee Chairman Christopher Dodd held an oversight hearing concerning the state of the mortgage market, regulatory changes and possible future roles for Fannie Mae, Freddie Mac and the Federal Housing Finance Agency. Chairman Dodd set out the following goals to ensure a stable future for the mortgage and housing markets: (1) maintaining liquidity and stability of the mortgage market, (2) encouraging widespread availability of 30-year fixed rate mortgages without prepayment penalties and (3) maintaining availability, accessibility and sustainability of mortgage credit.

Chairman Dodd and the other speakers expressed concerns about the future of Fannie Mae and Freddie Mac, discussing three options for restructuring these enterprises: (1) converting them to government agencies focused on purchasing certain mortgages and issuing mortgage-backed securities; homeownership promotion would be transferred to the Federal Housing Administration, (2) reestablishing them as government-sponsored enterprises subject to additional control and oversight or (3) fully privatizing them (with the possible inclusion of a federal mortgage insurer).

Proskauer's Economic Crisis Response Group includes lawyers with extensive experience representing private and public companies, institutional investors, financial services companies, private equity and hedge funds, lenders, commercial banks and individuals in the complex and interrelated areas impacted by the current financial situation. Our multidisciplinary group brings together the talents of our business and transactional lawyers with our litigation capabilities, particularly as they pertain to acquiring, managing or disposing of distressed assets; issues concerning investments in financial services companies; and complex financial instruments and transactions, including structured finance products; as well as a broad range of other areas such as corporate governance and defense, insurance coverage, reductions in force and other employment and benefit-related issues, securities regulation, and bankruptcy and restructuring matters.

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