



SEC Proposes Reforms Relating to Credit Rating Agencies

On June 16, 2008, the Securities and Exchange Commission (the “SEC”) issued its proposed rules relating to Nationally Recognized Statistical Rating Organizations (the “Proposed Rules”). The Proposed Rules aim to increase transparency and avoid conflicts of interest in the credit rating process, principally in view of the ongoing sub-prime crisis. A copy of the Proposed Rules can be found at <http://www.sec.gov/rules/proposed/2008/34-57967.pdf>.

There are currently ten Nationally Recognized Statistical Rating Organizations (“NRSROs”),¹ and they play an important role in assessing the creditworthiness of public companies and the likelihood that a debt security or an asset-backed security will be repaid at maturity. Particularly in the world of asset-backed securities, credit ratings are critical to the marketing and distribution process. Most investors cannot independently value these securities without credit ratings, and many investors are subject to specific requirements as to the ratings of the asset-backed securities that they purchase.

Background

NRSROs are credit rating agencies that are registered with the SEC under the 2006 Credit Rating Agency Reform Act (the “Reform Act”). In June 2007, the SEC adopted Rules 17g-1 through 17g-6 under the Reform Act (the “Existing Rules”), setting forth the process for registering as an NRSRO, creating annual certification requirements for each NRSRO, and imposing a variety of record-retention, financial reporting and other requirements on NRSROs.

In the aftermath of the sub-prime crisis, various market participants, including regulators and disgruntled investors, have sought to identify parties that may be responsible for the situation. NRSROs have emerged as a significant target, and they have received a fair share of the blame for the adverse developments in the market.

NRSROs have been widely criticized for several reasons. First, NRSROs may have made inaccurate judgments in their initial ratings of mortgage-backed securities, and in their ongoing surveillance of these transactions. NRSROs have also frequently advised issuers and underwriters as to the specific structure that a transaction should have in order to obtain the desired ratings. Moreover, although NRSROs’ credit ratings are used by investors, the NRSROs are typically paid by issuers or underwriters. These factors raise concerns as to potential conflicts of interest. The SEC attempts to address these issues through the Proposed Rules.

Mortgage-backed securities have been the principal securities at issue in connection with the credit crisis. However, the Proposed Rules are directly targeted at all types of asset-backed securities. And as discussed further

below, because of the lack of clarity in the definitions included in the Proposed Rules, the full scope of the impacted securities may be much broader than initially expected. In addition, the proposed public disclosure requirements included in the Proposed Rules may have a chilling effect on a variety of transactions, as the parties are likely to be unwilling or unable to disclose some of the relevant information.

Prohibited Conflicts of Interest and Public Disclosure Requirements for Asset-Backed and Mortgage-Backed Securities

Conflicts of Interest

Rule 17g-5 currently prohibits NRSROs from having certain conflicts of interest, while requiring NRSROs to publicly disclose and manage certain other conflicts of interest through established policies and procedures.² Proposed paragraph Rule 17g-5(b)(9) would identify a new conflict of interest as existing when a rating is provided as to a securitization by an NRSRO that is being paid for the rating. This conflict of interest, however, would not violate Rule 17g-5 if the public disclosures described below are made.

It is currently uncertain what types of securities would be regulated under Rule 17g-5(b)(9). The proposed provision refers to securities issued by “asset pools” or as part of any “asset-backed or mortgage-backed securities transaction.” This term is different from the definition of “asset backed securities” provided in Item 1101(c)(1) of Regulation AB, and could be construed to apply to a wide variety of transactions that are not necessarily at the heart of the sub-prime crisis, including various structured products and trust-issued securities. Thus, it is possible that the final rules will have a larger impact on other forms of corporate debt and debt-like securities than has been initially anticipated, especially if they are subject to the public disclosure requirements.

Disclosure Requirements for Issuers and Underwriters

In these transactions, the Proposed Rules would require the public disclosure of information provided to an NRSRO by an issuer, underwriter, sponsor, depositor or trustee.³ The principal aim of this amendment is to provide all market participants access to information, so as to help monitor the ratings decisions of NRSROs, and to encourage the issuance of ratings by NRSROs that are not hired by the arranger of a transaction.

Information Required to Be Disclosed

All information provided to the NRSROs by the issuer, underwriter, sponsor, depositor or trustee that is used in determining the initial credit rating and performing credit rating surveillance on the security would be subject to the disclosure requirement. This includes information concerning the characteristics of the assets underlying or referenced by the security, and the security’s legal structure.

It is possible that this disclosure requirement could stifle potential transactions in which the parties are unwilling to, or bound by contract not to, disclose all or part of this information. For example, if the rule is applied to a structured product, the returns of which are linked to a private investment fund, the sponsors of the transaction may be prohibited by contract or prevailing business practices from disclosing information as to the assets and investment strategy of the private fund. If the Proposed Rules are adopted in their present form, a transaction of this kind may only be able to proceed if it is not rated by an NRSRO, which may reduce its liquidity, marketability and feasibility.

We note that the type of information in question is likely to be of limited use to most investors. Individual investors, as well as many institutional investors, will not have the ability to analyze it in a manner that will

enhance their understanding of the relevant securities, or to evaluate the quality or appropriateness of the ratings assigned by an NRSRO. Accordingly, this information should not necessarily be construed as being intended by the SEC to replace or supplement an issuer's prospectus or offering memorandum; rather, this information seems principally intended to enable other NRSROs that are not paid to rate the security to step forward and to issue their own ratings. In practice, the additional information, and its relative importance to the overall mix of information, may be confusing to many parties in the offering process.

Information Not Subject to the Public Disclosure Requirements

On the other hand, according to the SEC's proposing release, the following information would be excluded from the new disclosure requirement:

- information about collateral pools provided by the arranger that contain a mix of assets that is different from the composition of the final collateral pool on which the credit rating is based; and
- communications between the NRSRO and the underwriter or issuer, if the communications do not contain information necessary for the NRSRO to determine an initial credit rating or perform credit rating surveillance.

The Proposed Rules do not describe which party must make the determination as to the information that will be excluded from the disclosure requirement. In the absence of more precise guidance from the SEC as to the information that may be excluded, the parties may prefer to err on the side of increased disclosure. This could increase the amount of public information available about an asset-backed security (and increase the cost of producing it), but limit the actual utility of the information to investors.

Timing of Disclosures of Information Used in Determining an Initial Credit Rating

The timing of the disclosures of information used in determining an initial credit rating will vary according to whether the offering is registered, private or offshore. For a registered offering, the information would need to be disclosed on the pricing date of the transaction. In offerings that are not registered under the Securities Act, the information would need to be disclosed to investors in the offering and to other credit rating agencies on the pricing date, and then disclosed publicly on the first business day after the transaction closes.⁴

If these provisions of the Proposed Rules are enacted, parties will need to consider additional implications of the disclosure of the new types of information under the securities laws. Will any parties take the position that the requirement to disclose this information indicates that this information is material to an investor's investment decision? If so, then in a registered offering, should it be disclosed using a "free writing prospectus"? The parties would need to consider the extent to which an issuer's representations, legal opinions and comfort letters would cover these materials in any respect, as well as whether timely "conveyance" has been made to investors.

Manner of Disclosure of Information Used in Determining an Initial Credit Rating

The proposed amendments to Rule 17g-5, which would require the disclosure of information about the underlying assets of a securitization, could obviously create some difficulties under the Securities Act for both registered and exempt transactions. The SEC addressed these concerns by providing guidance as to how this information should be disclosed when an initial credit rating is assigned. As in the case of the timing of the disclosures described above, the manner of the disclosure would depend upon the nature of the offering: registered, private or offshore.

With respect to registered offerings, the SEC indicates that the disclosure materials may constitute ABS informational and computational materials that would be filed on Form 8-K. Alternatively, the materials may constitute free writing prospectuses required to be filed under Securities Act Rules 426 and 433.

As for private offerings, the SEC indicated that general solicitation or advertising concerns could be avoided by providing the information to investors and NRSROs through a password-protected Internet website.⁵ Then, on the first business day after the offering closes, the password protection would be removed, so as to allow public access to the information. One unusual result under these provisions would be particularly noticeable in the Rule 144A market: Rule 144A offering circulars and details of the relevant transactions are rarely available to the public; however, this provision of the Proposed Rules would require a significant amount of data about the relevant transactions to enter the public domain, even though the terms of the offering itself would remain private.

Finally, in regards to offshore offerings, a foreign issuer making an offshore offering with no concurrent U.S. private offering would not be required to password-protect the Internet-based offering communication, as long as adequate measures are implemented to prevent U.S. persons from participating in the offering. That being said, U.S. issuers making an offshore offering should consider implementing similar procedures as those for private offerings, in order to limit the possibility that the Regulation S exemption could become unavailable.

Additional Prohibited Conflicts of Interest

In order to help ensure the impartiality of the ratings process and to restore investor confidence in the credit rating agency industry, the proposed amendments would:

- Prohibit an NRSRO from rating a debt security where the obligor or issuer received rating recommendations from the NRSRO or a person associated with the NRSRO.⁶ Note that the SEC has acknowledged that it is often difficult to draw a line between providing feedback during the rating process and making recommendations about how to obtain a desired rating. Thus, the SEC explicitly seeks comments on the types of interactions that would constitute prohibited recommendations for purposes of this rule. We note that this provision will probably need to address, probably by explicitly permitting, the broad communications that the NRSROs often release to the marketplace to help inform the industry as to their review of specific types of products. These types of broad communications do not appear to involve the types of communications that have attracted the SEC's scrutiny.
- Prohibit anyone who engages in the credit rating process from negotiating the fee that the issuer pays for it.⁷
- Prohibit those who receive ratings from giving gifts, including entertainment, to those who rate them. However, there is an exemption for items provided in the context of normal business activities, such as meetings, that have an aggregate value of no more than \$25, such as writing instruments or minor refreshments.⁸ The SEC seeks comments as to whether a threshold that is higher or lower than \$25 should be applied.

Public Disclosure of Ratings Actions and Record Retention

In order to enhance the transparency and accountability of rating agency actions, the SEC has proposed several amendments to its rules.

Revisions to Rule 17g-2—Record Retention

Rule 17g-2 currently requires NRSROs to make and preserve certain records relating to their business. The rule prescribes the time periods and manner in which these records are required to be maintained. The proposed amendments would supplement Rule 17g-2 by requiring NRSROs to:

- Retain records of all of their rating actions, which include their initial ratings, upgrades, downgrades and placements on watch for upgrades or downgrades.⁹
- Maintain a database of all of their rating actions on their websites no later than six months after the rating is issued. The required format of the database would be Extensible Business Reporting Language (“XBRL”), in order to enable easy analysis of both initial ratings and ratings change data.¹⁰
- Retain any communications relating to complaints about the performance of a credit analyst in determining credit ratings.¹¹ This provision, among other things, may prevent NRSROs from reassigning or terminating a credit analyst for assigning a rating on the basis of inappropriate business considerations.
- If a quantitative model is a substantial component in the process of determining a credit rating, the proposed amendments would require NRSROs to record the reasons for any material difference between the credit rating implied by the model and the final credit rating issued. Note that the SEC has acknowledged that the definitions of terms such as “substantial component” and “material” are arguably unclear, and the SEC seeks comments on these issues.

Revisions to Form NRSRO Disclosure Requirements

The proposed new NRSRO public disclosure requirements will be primarily achieved through amendments to Form NRSRO. Form NRSRO sets forth the information requirements that NRSROs must make publicly available on an annual basis under Rule 17g-1(i).

The proposed amendments would require NRSROs to disclose separate sets of default and transition statistics for each class of its ratings. The default statistics would include defaults relative to the initial rating, and those that occur after a rating is withdrawn. NRSROs would be required to publish these statistics for one, three and ten years within each rating category in a manner that fosters comparison with their competitors in the industry.

The proposed requirements would require NRSROs to provide additional disclosures about the procedures and methodologies that they use to determine credit ratings. For example, they would be required to address how often the credit ratings are reviewed, whether rating surveillance uses different models as compared to initial ratings, and the reasons for any significant out-of-model adjustments. In addition, NRSROs would be required to disclose the way in which they rely on the due diligence of other parties to verify the assets underlying a securitization.

Rule 17g-3 currently requires NRSROs to furnish to the SEC certain financial reports, including both audited and

unaudited financial statements.¹² The proposed amendments would require NRSROs to include in information in their annual reports as to the number of rating actions that they conducted in each ratings class during the prior year.¹³

Use of Symbols to Differentiate Credit Ratings for Structured Finance Products

The proposed new Rule 17g-7 would require credit rating agencies to introduce a separate rating scale between asset-backed securities and traditional forms of debt securities, so as to alert investors to the differences among the structures, cash flows and volatility of such investments. This may be achieved either by using different credit rating symbols, or by publishing a report that states the differences between the ratings of asset-backed securities and other securities.

The issuance of a new rating scale could be highly problematic to the securities industry. As pointed out by the Securities Industry and Financial Markets Association (“SIFMA”),¹⁴ the existing rating scales are deeply embedded in existing regulatory and contractual guidelines that are applicable to a wide variety of institutional investments. Changes to these ratings scales may require many securityholders to sell off a substantial portion of their holdings until these guidelines are updated to reflect the new ratings systems. In addition, imposing a single new scale for securitization transactions will not necessarily differentiate between different types of asset classes that are associated with different types of economic and structural risks. Moreover, the software systems of many market participants will require substantial modifications in order to address any new rating scales.

Additional Proposals

On July 1, 2008, the SEC released additional proposed rules under the Investment Company Act and the Investment Advisors Act. These additional rules are designed to reduce the reliance of the SEC’s rules on NRSRO ratings. For example, Rule 2a-7 under the Investment Company Act relies upon ratings of NRSROs to determine certain permitted investments by “money-market funds,” as opposed to other methods to evaluate the riskiness of the securities in question.

This set of proposed rules addresses the SEC’s concern that its own rules may have encouraged market participants to place undue reliance upon the ratings issued by NRSROs. However, to the extent that credit ratings serve such a critical role in the market for debt securities and asset-backed securities, both in the U.S. and outside of the U.S., it remains to be seen whether these amendments can actually decrease the emphasis that investors place upon them.

Conclusion

The Proposed Rules, in their present form, may provide greater transparency and integrity to the credit rating process, particularly as to the conflicts of interest that may exist. They could, however, have a dramatic impact on the manner in which NRSROs participate in the structuring of transactions and the interactions between issuers, underwriters and NRSROs. Specifically, they would appear to prohibit issuers and their investment bankers from engaging in an iterative review of transactions with NRSROs, in which the NRSROs have the opportunity to comment on proposed transactions and to indicate how they would be rated. Moreover, by requiring the disclosure of information that certain types of issuers would not want to make public, the Proposed Rules could reduce financial innovation and the issuance of some types of securities. Finally, unless the SEC refines some of the terms used in the Proposed Rules, it is possible that the final rules will have a larger influence on non-asset

backed securities than is currently demanded by even the loudest critics of the NRSROs.

The public may submit their comments to the SEC until July 25, 2008.

We expect to see final rules from the SEC later this year. However, additional regulatory action will likely impact the conduct of the NRSROs. For example, in June 2008, the New York Attorney General's office announced an agreement with Standard & Poor's, Moody's and Fitch that was designed to enhance their independence, provide them with adequate data to issue their ratings and to increase transparency in the market. Additional legislation has been introduced in the U.S. Congress that would substantially impact NRSROs. Accordingly, it is very possible that the NRSROs may find themselves operating under a very different set of rules in the not so distant future.

Footnotes

1. The existing NRSRO's are A.M. Best Company, Inc., DBRS Ltd., Fitch, Inc., Japan Credit Rating Agency, Ltd, Moody's Investor Services, Inc., Rating and Investment Information, Inc., Standard & Poor Rating Services, Egan-Jones Rating Company, LACE Financial Corp., and the newest NRSRO, Realpoint LLC.
2. Rule 17g-5.
3. Proposed new paragraph (a)(3)(i)(A) to Rule 17g-5.
4. Proposed new paragraph (a)(3)(B)(i) to Rule 17g-5. Depending upon the jurisdictions in which the securities are offered, the parties to the transaction will need to consider whether the disclosure of information after the pricing date would give rise to any put right or right of rescission on the part of the investor.
5. By doing so, the parties would help ensure that the disclosure of this information would not result in the loss of the exemption from the SEC's registration requirements under the Securities Act.
6. Proposed new paragraph (c)(5) to Rule 17g-5.
7. Proposed new paragraph (c)(6) to Rule 17g-5.
8. Proposed new paragraph (c)(7) to Rule 17g-5.
9. Proposed new paragraph (a)(8) to Rule 17g-2.
10. Proposed amendment to Rule 17g-2(d).
11. Proposed new paragraph (b)(8) to Rule 17g-2.
12. 17 CFR 240.17g-3.
13. Proposed new paragraph (a)(6) to Rule 17g-3.
14. See SIFMA's June 10, 2008 letter to the SEC, which may be found at:
http://www.sifma.org/capital_markets/docs/SEC-CreditRatingModifiers6-10-08.pdf

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