

February 4, 2009



SEC Adopts and Proposes Reforms Relating to Credit Ratings Agencies

On February 2, 2009, the Securities and Exchange Commission (the “SEC”) issued final rule amendments (the “Final Rules”) relating to Nationally Recognized Statistical Rating Organizations (“NRSROs”) and proposed additional NRSRO rules (the “Proposed Rules”).¹ SEC oversight and regulation of NRSROs remains very much in the news as policymakers consider the future of rating agencies.

In the summer of 2008, the SEC had released for comment three series of proposed rules relating to NRSROs. On June 16, 2008, the SEC issued its proposed rules relating to NRSROs designed to address concerns about the integrity of NRSRO credit rating procedures and methodologies.² The SEC proposed additional rule changes on July 1, 2008 designed to reduce perceived undue reliance on credit ratings within the SEC’s rules and forms.³ At this time, the SEC has not taken action on the rule proposals relating to removal of references to credit ratings in the SEC rules and forms. For further information regarding the SEC’s proposed rules, please see our client alerts at <http://www.mofo.com/docs/pdf/080702CreditAgencies.pdf> and <http://www.mofo.com/news/updates/files/080805AgencyReform.pdf>.

The Final Rules are intended to increase the transparency of rating methodologies of the NRSROs, strengthen disclosures of ratings performance, prohibit certain practices that create conflicts of interest and enhance recordkeeping and reporting obligations. The Final Rules include new prohibited conflicts of interest, disclosure obligations and reporting and recordkeeping requirements. The Final Rules are effective after publication in the Federal Register, which should be around April 2009. The Final Rules must be complied with by approximately April 2009.

The SEC first approved these Final Rules and the Proposed Rules on December 3, 2008. See our December 4, 2008 client alert, which can be found at <http://www.mofo.com/news/updates/files/081204SECCredit.pdf>.

New Final Rule Amendments

Reporting and Disclosure

The Final Rules require an NRSRO to provide enhanced disclosure of performance measurements statistics and the procedures and methodologies used by the NRSRO in determining credit ratings for structured finance products and other debt securities on Form NRSRO. The Final Rules include amendments to Exhibits 1 and 2 to Form NRSRO.

¹ Copies of the Final Rules and Proposed Rules can be found at <http://sec.gov/rules/final/2009/34-59342.pdf> and <http://sec.gov/rules/proposed/2009/34-59343.pdf>.

² A copy of the June 16, 2008 proposed rules can be found at <http://sec.gov/rules/proposed/2008/34-57967.pdf>.

³ A copy of the July 1, 2008 proposed rules can be found at <http://sec.gov/rules/proposed/2008/34-58070.pdf>.

The Final Rules amend the instructions to Exhibit 1 of Form NRSRO to capture rating actions for credit ratings of structured finance products that do not meet the narrow statutory definition of “issuers of asset-backed securities,” as defined in Regulation AB. The Final Rules retain the use of the term “structured finance transactions” from the proposed rules. The term “structured finance transactions” is intended to include “any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction.” The SEC noted that this term is broad enough to pick up financial instruments such as residential mortgage-backed securities and other types of asset-backed securities, as well as other structured debt instruments such as collateralized debt obligations (including synthetic and hybrid CDOs).

Additional disclosure is required on Exhibit 1 to Form NRSRO, including:

- Disclosure of transition statistics for each asset class of credit ratings for which an NRSRO is registered with the SEC or is seeking registration, broken out over one, three and ten year periods.
- All ratings transitions, including upgrades and downgrades, must be included, as well as default statistics, in each case relative to the initial rating.

The SEC amended the instructions to Exhibit 2 to Form NRSRO, to include three additional areas that an applicant and a registered NRSRO must address in the description of its procedures and methodologies, if applicable:

- Whether and, if so, how much verification was performed on assets underlying or referenced by the structured finance transaction is relied on in determining credit ratings.
- Whether and, if so, how assessments of the quality of originators of structured finance transactions play a part in the determination of the credit ratings.
- More detailed information on the surveillance process used by the NRSRO, including whether different models or criteria are used for surveillance than are used for determining initial ratings.

The Final Rules also require issuer-paid NRSROs to disclose ratings of a random sample of 10% of the ratings in each class of ratings for which they are registered with the SEC, provided they have issued 500 or more ratings in that class. The SEC notes that the asset-backed securities class must include all structured finance products.⁴ Additionally, “withdrawals” have been added to the list of types of credit rating actions which must be included. These ratings, and their histories, must be disclosed on the NRSRO website no later than six months after a rating is made. This amended rule must be complied with by 180 days after publication in the Federal Register, which is approximately in August 2009.

Additionally, the SEC will require the inclusion in the NRSRO’s annual report of the number of credit rating actions that occurred during the fiscal year in each rating class for which the NRSRO is registered.

Recordkeeping Requirements

The Final Rules require an NRSRO to make, keep and preserve additional records under Rule 17g-2. The amended rules are intended to foster accountability and competition among the NRSROs. NRSROs must maintain and retain records relating to the following:

- All rating actions, including initial ratings, upgrades, downgrades and placements on watch lists for upgrades or downgrades.
- Any written communications relating to complaints about the performance of a credit analyst in determining, maintaining, monitoring, changing or withdrawing a credit rating and the NRSRO’s

⁴ An NRSRO must include credit ratings on “any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction.”

response to the complaint. This requirement only applies to complaints from persons not associated with the NRSRO.

- The rationale for any material difference between the credit rating implied by a quantitative model and the final credit rating issued if the quantitative model is a substantial component in the process of determining a structured finance product's rating. The purpose of this amendment is to enable the SEC and internal auditors to understand the methodologies through which analysts developed the credit rating issued by the NRSRO. The SEC notes that the NRSROs will be responsible for making the determination of what constitutes a "substantial component" and what is deemed "material."
- Communications related to monitoring of ratings. This amends the current Rule 17g-2(b)(7) requirement to retain communications in connection with initiating, determining, maintaining, changing or withdrawing a credit rating.

Conflicts of Interest

The Final Rules set forth the following three new prohibited conflicts of interests under Rule 17g-5:

- An NRSRO is prohibited from issuing or maintaining a credit rating with respect to an obligor or security where the NRSRO or a person associated with the NRSRO made recommendations to the obligor or the issuer, underwriter or sponsor of the security about the corporate or legal structure, assets, liabilities or activities of the obligor or issuer of the security. The SEC clarified that this prohibited conflict would apply across all ratings classes, not just structured finance ratings.
- An NRSRO is prohibited from issuing or maintaining a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining or approving credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models. The SEC clarifies that the terms "determine," "determined" and "determining" include both persons who develop credit ratings and persons who approve credit ratings.
- An NRSRO is prohibited from issuing or maintaining a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating, received gifts, including entertainment, from the obligor being rated or from the issuer, underwriter or sponsor of the securities being rated. An exception exists for items received in the context of normal business activities, such as meetings, with an aggregate value of no more than \$25.

Effectively, this will require that NRSROs adopt new procedures and guidelines for interacting with working group members in connection with structuring transactions that will be the subject of a rating. Also, NRSROs will be required to establish "Chinese wall" procedures or similar compliance type procedures to separate the negotiation of fees from any ratings determination.

New Rule Proposal and Rule Re-Proposal

On December 3, 2008, the SEC proposed a new rule and a proposed modification from the June 16, 2008 proposal.

The SEC has proposed an amendment to Rule 17g-2(d) (which currently requires disclosure by issuer-paid NRSROs of 10% of ratings, by class of rating) that would require NRSROs to disclose ratings actions histories for all credit ratings issued on or after June 26, 2007 at the request of the obligor being rated or the issuer, underwriter or sponsor of the security being rated, no later than 12 months after ratings action is taken, and in an XBRL format. The SEC is seeking comments on whether the requirement to publicly disclose ratings actions should be applied to subscriber-paid credit ratings. Comments should be received by the SEC by mid-March 2009.

Originally, on June 16, 2008, the SEC proposed prohibiting an NRSRO from issuing or maintaining a credit rating for a structured finance product paid by the product's issuer, sponsor or underwriter unless the information provided to the NRSRO by the issuer, sponsor, or underwriter to determine the rating is disseminated to other persons. The amendment as proposed raised significant securities law liability and Regulation FD concerns. The SEC re-proposed the amendment, with significant revisions. As re-proposed, it would be a prohibited conflict of interest for an NRSRO to rate a structured finance product whose rating is being paid for by the product's issuer, sponsor or underwriter, unless information about the product provided to the NRSRO to determine and monitor the rating is made available to the NRSROs not retained to issue a credit rating. Additionally, the re-proposal includes an amendment to Regulation FD to permit disclosure of material non-public information to NRSROs, whether or not the NRSROs make their ratings publicly available. We expect that, if the final rule retains a requirement to disclose non-public information to parties with whom issuers have no relationship or meaningful opportunity for dialogue, there will be developed protocols, standardized formats and disclaimers used on all information provided throughout the ratings process.

We expect that there will be continued dialogue regarding SEC or other regulatory oversight of NRSROs, since, even with these Final and Proposed Rules, many questions regarding future NRSRO practice remain unanswered.

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