SEC Proposes New Requirements for Credit Rating Agencies

New York
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On June 16, 2008, the U.S. Securities and Exchange Commission (the "Commission") published for comment a series of new rules relating to credit rating agencies and credit ratings.[1] The proposals are a response to the subprime mortgage crisis and the role that reliance on credit ratings were perceived to play in that crisis.

The proposals published on June 16 consist of two parts. The first part imposes additional requirements on nationally recognized statistical rating organizations ("NRSROs") to regulate or prohibit certain conflicts of interest in the ratings process, require specified ratings related information to be publicly disclosed and require other information to be retained by NRSROs for use in Commission examinations.[2] The second part requires NRSROs to differentiate their ratings of structured products from their ratings of corporate debt.[3] In a related action, on July 1, 2008 the Commission published for comment proposed changes to its rules and forms to reduce their reliance on NRSRO ratings.[4] The July 1 proposals will be the subject of a separate memorandum. As a whole, the recent proposals are intended to increase the transparency of credit ratings, facilitate competition in the issuance of credit ratings, and encourage investors to make independent evaluations of the credit quality of prospective investments rather than relying solely on third-party credit ratings.

The principal changes proposed by the Commission on June 16 are:

- requiring public disclosure of the information used by an NRSRO to rate a structured finance product and specific information about their methodologies for such ratings;

[1] SEC Release No. 34-57967 (June 25, 2008) (the "Release").
[2] We refer to this first part of the proposals as the "Disclosure Proposals."
[3] We refer to this second part of the proposals as the "Differentiation Proposals."
[4] SEC Release Nos. 33-8940 (July 1, 2008) and 34-58070 (July 1, 2008).

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- prohibiting NRSROs from making "recommendations" to arrangers of structured finance products they rate concerning how to obtain a desired rating;
- prohibiting NRSRO personnel involved in the credit rating process from negotiating fees with arrangers or receiving gifts from them;
- requiring NRSROs to disclose their ratings actions and prescribed ratings performance statistics for all securities they rate (not only structured finance obligations); and
- requiring NRSROs to differentiate structured product ratings from other ratings by adopting separate rating symbols or, alternatively, to issue reports on the differences between their structured product ratings and other ratings.

The Commission is soliciting comments on its proposals. Comments on the Disclosure Proposals and the Differentiation Proposals are due by July 25, 2008. The Commission release containing these proposals, including the text of the proposed amendments, is available at http://sec.gov/rules/proposed/2008/34-57967fr.pdf

I. Background of the Proposals

The impetus for these proposals is the role of securitization, and therefore of credit ratings, in the current subprime market turmoil. The Commission describes in the Release how the growth of investor appetites for securitization structures increased demand for residential mortgage loans, which in turn led originators to lower underwriting standards and create non-traditional loan products. The NRSROs were central in this process, as they set the rating standards that originators of loans and arrangers of securitizations had to meet in order to obtain the investment-grade credit ratings that were the key requirement to structuring profitable securitization transactions. Once a residential mortgage securitization was created to a rating agency's standards, it was often purchased for a collateralized debt obligation transaction that was also structured to meet those standards, thereby concentrating both the credit risk inherent in the original loans and the role of the rating agencies' ratings criteria.

The current proposals are being made pursuant to the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"), under which the Commission received broad authority and under which it has already put in place a registration and oversight program for NRSROs.[5] Although the current proposals are aimed principally at the rating process for

[5] On July 8, 2008, the Commission released a summary report of its examinations of Fitch Ratings, Ltd., Moody's Investors Services, Inc. and Standard & Poor's Ratings Services, which were conducted beginning in August 2007 and focused on those rating agencies' roles in the subprime mortgage-related securities markets.

structured products, a number of them apply more broadly to all credit ratings issued by NRSROs, including for example, those on corporate and municipal debt.

II. The Disclosure Proposals

The Disclosure Proposals address perceived conflicts of interest in the ratings process. These proposals modify existing rules, adopted in June of 2007 pursuant to the Rating Agency Act, that require NRSROs to disclose and establish policies to address certain defined conflicts of interest (such as being paid to issue security ratings by the issuers, underwriters or obligors of the rated securities). The existing rules prohibit other conflicts entirely (such as issuing or maintaining a rating solicited by a person that accounts for 10% or more of the NRSRO's net revenue). The Disclosure Proposals include modifications and additions to both types of existing rules as described below.

Disclosure of Underlying Data

The Disclosure Proposals require disclosure, "through a means designed to provide reasonably broad dissemination," of all information that an NRSRO receives from the "issuer, underwriter, sponsor, depositor, or trustee" of a structured finance obligation[6] and that the NRSRO uses in determining the initial credit rating for that obligation, including information about the underlying assets and the structure of the obligation. The Release contemplates that this would include detailed asset-level data but would not include, for example, identifying information concerning individual borrowers.

The proposed rule requires that if the structured finance obligation is being offered publicly, the data must be disclosed on the date the rated securities are priced. In the case of an unregistered offering, the data must be disclosed at pricing to investors and other credit rating agencies (not only agencies registered with the Commission as NRSROs) and disclosed publicly on the business day after closing. The Release explains that the Commission selected pricing as the key date for disclosure because it is typically the date on which the asset pool and legal structure (presumably tranching in particular) are finalized. Data that reflected only preliminary pool composition or structure would not be required to be disclosed. Delaying the required public disclosure in non-registered offerings until after closing is intended to address potential private placement concerns; the Release suggests that between pricing and closing, investors and competing rating agencies would be provided with password-protected access to the required data.

[6] The proposed rule applies to ratings of any "security or money market instrument issued by an asset pool or as part of an asset-backed or mortgage-backed securities transaction" if the rating was paid for by the issuer, sponsor or underwriter. For convenience, we will refer to such securities as "structured products" or "structured finance obligations" in this memorandum.

The Disclosure Proposals do not require the NRSRO itself to disclose this information, but merely require that the information be disclosed by someone as a condition to the NRSRO issuing a rating. The Release notes "it may be that the issuer through the arranger and trustee would be in the best positions to disclose the information," in which case the NRSRO could require them to do so rather than undertaking the disclosure itself.

The principal purpose of the required disclosure of information underlying initial ratings is to permit competing rating agencies to issue unsolicited ratings before the structured finance obligations are purchased, thereby providing a market check on solicited ratings by rating agencies that are not subject to the inherent conflict of having the obligation's issuer or arranger pay for the rating. Given the fact that commitments to purchase the relevant securities will generally be taken at or shortly after pricing, and that evaluating what in many cases will be a large volume of data is a time-consuming process, it seems questionable whether this requirement can achieve its stated purpose. Indeed, because different rating agencies apply different analytical frameworks, it is entirely possible that the information actually used by the NRSRO assigning a solicited rating (which is what is required to be disclosed) may not include the data a competing rating agency needs to make its own assessment.

Although disclosing the data underlying solicited ratings to competing rating agencies may not result in the availability of robust independent ratings of structured finance obligations, the requirement to disclose such information to the public is even less likely to benefit investors and is certain to raise concerns about incremental liability to the underwriters or other arrangers of structured finance transactions if any of that data (much of which cannot practically be subject to complete independent verification) proves to be inaccurate. Indeed, the Commission notes in the release that such information would subject the issuer and underwriter to potential liability under Sections 11 and 12(a)(2) of the Securities Act of 1933 (the "Securities Act") if the structured finance obligation is being offered on a registered basis. Despite the Commission's emphasis on encouraging investors to rely on their own analysis, it seems unlikely that (especially in the time frame between pricing and closing) most investors will have the resources to model structured finance transactions from the asset level up, and even investors that do have the capability would not likely choose to devote the resources necessary to model a single transaction.

In addition to requiring disclosure of data used to assign initial structured finance ratings, the Disclosure Proposals require data used for ongoing ratings surveillance of a structured finance issue by an NRSRO that issued a paid rating to be disclosed to the public at the same time it is provided to that NRSRO by the issuer, underwriter, sponsor, depositor or trustee. Similar to the requirement for disclosure of information used to provide initial ratings, the rationale for this requirement is that it will encourage NRSROs with paid ratings outstanding to downgrade those ratings promptly when the date indicate such an action is warranted.

Disclosure of Rating Actions and Performance Statistics

The Disclosure Proposals also require NRSROs to publicly disclose all ratings actions they take and related historical information about subsequent performance of their ratings. The proposed rules require each NRSRO to maintain a record showing all rating actions (i.e. initial ratings, upgrades, downgrades, and "watch" or similar prospective status changes) for each security that the NRSRO rates, and to make those records available on its website in eXtensible Business Reporting Language[7] no later than six months after the ratings action is taken. The Release explains that the six-month delay is intended to accommodate rating agencies that sell access to their current credit ratings. The requirement to post data on ratings actions would apply to all ratings that are in effect when the amendment becomes effective as well as ratings issued thereafter, and so a substantial amount of ratings history would be required to be made public initially. Further, this proposed requirement would apply to all credit ratings by NRSROs and not only to ratings of structured products.

The proposals would also amend form NRSRO, the form that credit rating agencies use to register with the Commission as NRSROs and to disclose prescribed information thereafter. The amendments would prescribe more specifically the credit rating performance measurement statistics that form NRSRO currently requires to be disclosed. Under the revised requirement, NRSROs would disclose default and ratings transition/migration statistics separately for each asset class or credit rating class, for one-year, three-year and ten-year periods. The statistics would be required to show actions relative to initial ratings, including defaults that occur after a rating is withdrawn.

These proposals requiring the disclosure of ratings actions and detailed rating performance measurements are likely to be broadly acceptable to rating agencies and other market participants, and would permit investors and independent analysts to analyze the accuracy of competing rating agencies' performance in a manner similar to the way in which independent services now evaluate, either on a public or subscription basis, the relative investment performance of competing mutual funds according to a variety of criteria that prospective investors may find relevant.

Disclosure of Ratings Methodologies

The Commission is also proposing to amend form NRSRO to require more detailed disclosures from NRSROs about three specific aspects of their ratings methodologies:

[7] "XBRL"; the Commission recently proposed rules that would require companies reporting under U.S. GAAP or IFRS to provide their financial statements to the Commission in XBRL format.

- Whether and how the NRSRO relies on information about the verification of asset-level data in determining ratings of structured products;
- Whether and how the NRSRO relies on assessments of the originators of assets underlying structured products in rating those products; and
- How frequently the NRSRO reviews its credit ratings, whether it uses different models for surveillance than for initial ratings, whether it applies changes to its initial ratings methodologies retroactively to its existing ratings; and whether it applies changes to its surveillance methodologies to its initial ratings process.

These proposals address specific criticisms that have been leveled at NRSROs in the wake of the subprime crisis. The proposal concerning reliance on asset verification procedures may cause special concern in combination with the requirement to disclose all data used in an NRSRO's analysis, as described above. Currently, underwriters undertake various measures to verify asset-level data. This verification exercise may involve the efforts of accountants, lawyers and/or independent due diligence firms on behalf of the underwriters, and is intended in part to assist the underwriters in establishing a "due diligence" defense to securities law liability. The exact procedures undertaken vary widely by transaction and asset type, and are normally determined solely between the underwriters and the parties performing the investigation on their behalf. It is possible that this requirement would create a standoff between NRSROs who feel compelled by this requirement to demand access to the underwriters' verification procedures and underwriters (and their service providers) who are reluctant to make these procedures themselves the subject of detailed disclosure, which could result in extending the service providers' liability much more broadly because their reports would be used for a purpose much different than it currently is.

The proposed requirement that NRSROs disclose information about whether they factor assessments of originators into their ratings is likely to encourage them to more explicitly monitor the performance of asset originators, and especially their adherence to their stated asset underwriting standards and procedures. Although this may introduce a certain amount of incremental delay and expense into the rating process by requiring another party to be evaluated by the rating agency before a rating is issued, it is likely that at least in the case of active originators of securitized assets, this type of monitoring could be implemented on an ongoing basis similar to the manner in which some NRSROs currently monitor the performance of asset servicers (which are often also the originators of the serviced assets) and use them to assist in ratings determinations. In light of recent disclosures about the role that the conduct of certain loan originators played in setting the stage for the subprime crisis, clarifying the extent to which originators are monitored, and perhaps encouraging a greater degree of such monitoring, seems a logical step.

The proposal concerning the review of outstanding ratings and of the interaction between changes in initial ratings requirements and changes in surveillance standards is similarly intended to clarify to the markets an area that has historically been vague, and perhaps encourage further evolution in practices in this area. This appears to be a relatively straightforward requirement that at a minimum will provide the markets with a better understanding of the comparability of ratings issued at different times for similar products.

Prohibition of Certain Additional Conflicts

In addition to requiring disclosure aimed at minimizing the effects of the conflicts inherent in the "issuer-pays" model of ratings, the Disclosure Proposals include several prohibitions on specific activities that are considered to increase the risk that an arranger can influence ratings. These prohibitions apply to all credit ratings and not only to ratings of structured products.

The first of the proposed new prohibited conflicts is for an NRSRO to issue or maintain a credit rating if it or its associated persons have "made recommendations to the obligor or the issuer, underwriter, or sponsor of the securities about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security." The discussion at the Commission meeting announcing the Disclosure Proposals suggested that this prohibition was aimed at NRSROs effectively charging an issuer or arranger for consulting services that consist of providing advice on how to obtain the desired ratings from that same NRSRO. However, the rule as proposed is not limited to this or similar arrangements, and it is difficult to see how it could be applied in practice because the line between an NRSRO making "recommendations" concerning a rating and providing normal and necessary feedback to issuers and arrangers on the ratings process and its results seems impossibly fine. The Commission acknowledges this tension in the Release, but states that it is desirable and expected on the one hand for a rating agency to provide feedback and then for the arranger to "consider the feedback and determine independently the steps it will take, if any, to adjust [the transaction parameters]," but problematic if on the other hand "the feedback process turns into recommendations by the NRSRO about changes the arranger could make . . . that would result in a desired credit rating."

In the case of structured products, strict adherence to the rule would appear to require arrangers to engage in a guessing game with NRSRO personnel because those personnel would be concerned that they were prohibited from making affirmative statements about which characteristics of a proposed asset pool were the limiting factors to attaining, for example, a given ratings level or tranche size. It would seem that prohibiting such an exchange of information not only imposes unnecessary obstacles to the normal ratings process but is also inconsistent with the Commission's desire to increase the transparency of structured finance ratings methodologies. Similarly, in the case of corporate credit ratings it is difficult to imagine what purpose would be served by limiting the dialogue between an

issuer and an NRSRO concerning, for example, whether the NRSRO views the issuer as too highly leveraged to issue further debt and still maintain its current rating, or believes that the issuer's credit rating is constrained by the quality of its assets.

The second of the proposed new conflicts rules prohibits NRSROs from issuing or maintaining a rating if anyone who "negotiated, discussed or arranged" the NRSRO's fee for the rating also "has responsibility for participating in determining credit ratings or for approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models". This would appear to be relatively straightforward for most rating agencies of any size to implement, although its efficacy in preventing rating agencies on an institutional basis from considering the importance of ongoing solicited ratings to their business model seems limited.

The final new conflicts rule being proposed by the Commission prohibits any "credit analyst who participated in determining or monitoring" a credit rating and anyone responsible for approving the rating from receiving gifts from the obligor, issuer, underwriter or sponsor of the rated security (except for items provided in normal business activities such as meetings that have a value of $25 or less). Like the similar rules previously implemented for investment bank research analysts, this seems both unobjectionable and reasonably easy to administer.

Retention of Certain Records

Finally, the Disclosure Proposals would require NRSROs to make and maintain records of certain events. Unlike the matters discussed above, these would not be required to be disclosed in connection with the issuance of a rating or on form NRSRO, but would be maintained in the NRSRO's records and available to the Commission during examinations of the NRSRO. The matters required to be recorded would be:

- The rationale for any "material difference" between any final credit rating issued and the rating implied by the NRSRO's quantitative model if that model was a "substantial component" of the rating process; and

- Any complaint the NRSRO receives about a credit analyst's performance in initiating, determining, maintaining, monitoring, changing or withdrawing a credit rating.

The stated purpose of these proposals is not to prohibit so-called "out of model" adjustments to ratings or the taking of actions in response to complaints about credit analysts, but to permit the Commission staff to confirm whether the adjustments or other action are consistent with the NRSRO's stated policies. There is considerable ambiguity concerning the determinations that an NRSRO would have to make in connection with the

first requirement above. The Release stipulates that it would be up to the NRSRO to determine when a model is a "substantial component" of a rating and what constitutes a "material difference" between the model's output and the rating that is issued. Presumably these matters would be a subject for discussion between the Commission staff and the individual NRSRO during the course of examinations, and since this information is not required to be disclosed, comparability between rating agencies is perhaps less critical an issue than it otherwise would be.

III. The Differentiation Proposals

In the second part of the new proposals, the Commission proposes to require that when issuing ratings of structured products, an NRSRO must either use ratings symbols for structured finance obligations that are different from those it uses for other types of securities or attach a report to each published credit rating for a structured finance obligation that describes:

- The rating methodology used to determine the credit rating;
- How that methodology differs from the way in which ratings for "any other type of obligor or debt security" are determined; and
- How the credit risk characteristics associated with a structured finance obligation differ from those of any other type of obligor or debt security.

In the Release, the Commission explains that this proposal is intended to "alert investors that there are different rating methodologies and risk characteristics associated with structured finance products" than those applicable to corporate and municipal bonds and other instruments. The Commission suggests that this would "spur investors to perform more rigorous internal risk analysis on structured finance products," and perhaps "cause certain investors to seek to better understand risks that are not necessarily addressed in credit ratings of structured products, such as market and liquidity risk."

Commissioner Atkins dissented from the Differentiation Proposals, citing costs, concerns as to whether the proposal would achieve the intended purpose, and potential unintended consequences. The most salient potential consequence is the prospect that investors whose investment guidelines are based on existing ratings scales will need to liquidate (or could not purchase) investments that bear a new structured-obligation rating designation. It appears that, partly as a result of this concern, it may be more likely that rating agencies will opt to release reports instead. Such a report would not be especially onerous to produce and could be prepared on a relatively general basis applicable to a class of structured finance obligations rather than an issue-by-issue basis. However, neither a separate rating identifier for structured finance obligations nor a generalized description of

the difference between the basis on which ratings are determined for structured finance transactions and the basis on which they are determined for operating companies or municipalities is likely to convey any new information to any investor that meets the suitability standard to invest in structured products.

In addition, it is important to note that the proposal requires NRSROs to disclose the differences between the credit risk characteristics of structured finance obligations and those of other types of rated investments. This is an appropriate requirement to impose on rating agencies, whose ratings typically speak only to credit risk. As the Release suggests, the lessons of the subprime crisis include the notion that investors—especially investors in structured finance obligations—need to focus more than they have on risks such as liquidity and price volatility, which are not covered by credit ratings. By their nature, these risks must be assessed by each investor in the context of its own potential liquidity needs and the consequences to that investor of volatile market valuations. The importance of such risks will be vastly different, for example, for a structured investment vehicle funded by short-term borrowings than they will for a yield-oriented buy-and-hold investor. However, the disclosure documents for most structured finance obligations make clear the limits of any applicable NRSRO ratings, and it would not be appropriate to require risk disclosure by the rating agencies themselves to extend beyond credit risk characteristics. Accordingly, it is not clear how the Commission's second purpose, of encouraging investors to look more closely at the risks that are not addressed by ratings, would be advanced by this rule.

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