SEC Publishes Final Rules for Credit Rating Agencies, Reproposes Others

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On February 2, 2009, the U.S. Securities and Exchange Commission (the "Commission") published new rules regulating certain activities of nationally recognized statistical rating organizations ("NRSROs"). Earlier versions of those rules were first published for comment in June 2008.[1] On December 3, 2008, the Commission voted to adopt some of the rules it had proposed in June 2008 (with modifications in response to comments) and voted to re-propose others in modified form for further comment. The rules published on February 2, 2009 include both the rules adopted in December and the ones the Commission decided to modify and re-propose for further comment.[2] In general, these new rules and re-proposed rules impose additional requirements on 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 recorded and retained by NRSROs for use in Commission examinations.[3] Some of the new rules adopted by the Commission apply only to ratings of structured finance products, while others apply to all types of ratings.

The Disclosure Rules just published represent one part of a package of proposals the Commission made in response to the subprime mortgage crisis and the role that reliance on credit ratings was perceived to play in that crisis. All of these proposals were made pursuant to the Credit Rating Agency Reform Act of 2006, under which the Commission received broad authority and under which it has already put in place a registration and oversight program for NRSROs. The other components of the package consist of a proposal to require NRSROs to differentiate their ratings of structured products from their ratings of corporate debt, and a set of proposed changes to the Commission's rules and forms to reduce their reliance on NRSRO ratings.[4] These two initiatives drew considerable public comment, and the Commission has not taken any further action on them yet. In contrast, many of the

[1] SEC Release No. 34-57967 (June 25, 2008).

[2] SEC Release Nos. 34-59342 (the "Adopting Release") and 33-9005 (the "Re-Proposing Release") (both dated February 2, 2009).

[3] We refer to the newly-adopted rules and the re-proposed rules together as the "Disclosure Rules."

[4] SEC Release Nos. 33-8940 (July 1, 2008) and 34-58070 (July 1, 2008).

Disclosure Rules elicited little fundamental objection when first proposed and so are being adopted with relatively minor changes.

The principal actions the Commission took on the Disclosure Rules are:

- Adopting requirements that NRSROs disclose prescribed ratings performance statistics for each class of securities they rate;[5]

- Adopting requirements that NRSROs disclose specific information about their methodologies for determining and maintaining ratings;

- Adopting requirements that NRSROs maintain internal records of the full rating histories for each credit rating they assign and make public the ratings histories for a 10% sampling of their issuer-paid ratings;

- Proposing for comment an additional rule requiring NRSROs to disclose rating histories for all of their issuer-paid credit ratings with a 12-month lag;

- Adopting requirements that NRSROs maintain internal records of material deviations in final structured finance ratings from those implied by the NRSRO's quantitative model;

- Adopting requirements that NRSROs maintain internal records of third-party complaints against credit analysts;

- Adopting prohibitions on NRSROs making "recommendations" to arrangers of structured finance products they rate concerning how to obtain a desired rating;

- Adopting prohibitions on NRSRO personnel involved in the credit rating process negotiating fees with arrangers or receiving gifts from them; and

[5] In adopting Form NRSRO, the Commission decided not to prescribe standardized performance metrics, but instead to require each NRSRO to explain in the form how its measures are derived. The NRSROs have fulfilled this requirement by reporting a variety of statistics on credit rating transition (such as the percentage of credit ratings assigned in each prior year that had been upgraded, downgraded or withdrawn, or for which the rated obligation had defaulted, by the end of the most recently ended year).

- Re-proposing for comment rules that would require information provided to any NRSRO to obtain an issuer-paid structured finance rating to be made available to competing NRSROs.

The Disclosure Rules adopted by Commission become effective on April 10, 2009, although one of the new rules has a later compliance date as noted below. The Commission is soliciting comments on the re-proposed rules; comments are due on or before March 26, 2009. The Commission releases containing the Disclosure Rules are available at http://sec.gov/rules/final/2009/34-59342.pdf and http://sec.gov/rules/proposed/2009/34-59343.pdf.

Enhanced Performance Disclosure

One relatively non-controversial part of the Disclosure Rules as originally proposed was intended to enhance the disclosure NRSROs are already required to make concerning the performance of their rated transactions after the initial ratings are issued. The existing requirement is that NRSROs disclose in Form NRSRO[6] their ratings performance statistics over short, medium and long-term periods. The additional requirements adopted by the Commission:

- Require the ratings performance statistics to be separately calculated for each class of credit rating for which the NRSRO is registered,[7] with further subdivisions for government securities. The categories of ratings are:
  - Financial Institutions, Brokers and Dealers;
  - Insurance Companies;
  - Corporate Issuers;
  - Asset-Backed Securities (which the Disclosure Rules specify is intended to cover all structured finance products, and not only securities that would qualify as "asset-back securities" under the Commission's Regulation AB); and

[6] Form NRSRO is the Commission's prescribed form for registration as an NRSRO and for annual updates to certain of the information included in that registration. Although NRSROs are required to make the Form NRSRO and most of its exhibits publicly available on their web sites, certain portions of the Form and exhibits may be maintained as confidential, to be used only by the Commission.

[7] Under Form NRSRO, an applicant registers as an NRSRO with respect to one or more specified classes of securities for which it issues credit ratings.

- Government Securities, which the Disclosure Rules further require to be subdivided into the following classes for purposes of the ratings performance disclosure:
    - ◊ Sovereigns;
    - ◊ U.S. Public Finance; and
    - ◊ International Public Finance;

- Require that these class-by-class ratings performance measures be presented for the most recent one-, three- and five-year periods (corresponding to the existing "short, medium and long-term" requirement); and

- Specify that the actions to be reported include upgrades as well as downgrades and defaults, and that defaults must be shown relative to initial ratings (as opposed to ratings at time of default). However, the Commission withdrew the proposed requirement that NRSROs track and report defaults that occur after a rating is withdrawn, acknowledging the commenters' concern that this would be impractical.

Additional Disclosure of Ratings Methodologies

Form NRSRO currently requires disclosure of procedures and methodologies used by NRSROs to assign credit ratings, and specifies several aspects of the ratings process that must be described. The Disclosure Rules add three additional areas requiring specific disclosure:

- Whether information about verification performed on assets underlying a structured finance product is relied on in determining ratings for that product, and if so, how;

- Whether assessments of the underlying asset originators' quality are used in determining ratings of structured finance products, and if so, how; and

- How often ratings are reviewed; whether those reviews employ criteria different from the criteria used to assign initial ratings; whether changes made to ratings models and criteria used to determine initial ratings are applied in surveillance of existing ratings; and whether changes made to models and criteria used in surveillance are applied to the initial ratings process.

These three proposals, which are a clear response to practices that have been identified as having contributed to the role that ratings played in the current credit crisis, provoked no significant comment and were adopted as originally proposed. While the first two of these requirements apply only to structured product ratings, the third applies to all credit ratings.

Additional Recordkeeping Requirements

Commission rules adopted under the Credit Rating Agency Reform Act specify a number of records that must be made and retained by NRSROs (though not necessarily disclosed publicly). This requirement is intended primarily to facilitate Commission examinations of NRSROs. The Disclosure Rules add several items to the existing recordkeeping requirements and mandate that certain of the newly-required information be made public.

- Records of Ratings Actions

The Disclosure Rules require that each NRSRO make and maintain internally a record of the ratings history (initial rating, upgrades, downgrades, watch and withdrawal) for each credit rating it assigns. This internal record-keeping requirement applies to both issuer-paid and subscriber-paid ratings. As originally proposed, the rule would have required each rating action also to be disclosed on the NRSRO's web site in eXtensible Business Reporting Language ("XBRL") format within six months of the date the action is taken. In response to comments, the Commission substantially limited the public disclosure requirement it adopted and re-proposed more stringent requirements for further public comment:

  - As adopted, the rule only requires that an NRSRO make public the ratings histories of a random sample of 10% of its issuer-paid ratings[8] for each class of ratings for which the NRSRO has issued 500 or more ratings. As in the original proposal, ratings actions must be reported within six months of the date they are taken and the ratings histories must be posted on the NRSRO's web site in XBRL. In order to maintain the 10% sample, new randomly-chosen ratings histories must be added to the public disclosure as the instruments included in the initial ratings mature or their ratings are withdrawn. The Commission did not prescribe the manner in which NRSROs must make their random selections.

[8] For convenience, we refer to ratings that are requested and paid for by "the obligor being rated or . . . the issuer, underwriter or sponsor of the security being rated" as "issuer-paid ratings."

- In the Re-Proposing Release, the Commission is requesting comment on a proposal to require that histories for all issuer-paid ratings determined on or after June 26, 2007 be disclosed in XBRL format, with a 12-month lag before any rating action would need to be reported—this would be in addition to the 10% sample required to be disclosed with a six-month lag. The Commission also requests comment on issues such as whether the 10% sampling requirement or the re-proposed requirement to disclose all ratings with a one-year lag should be expanded to apply to subscriber-paid ratings.[9]

The Commission's revisions to the ratings history disclosure requirements it originally proposed were made in response to concern in the ratings industry that the disclosure proposal as originally framed would have diminished the value of (and demand for) paid ratings data. The subscription-based NRSROs argued in essence that selling credit rating assessments to end users is the heart of their business, and that any requirement that they disclose such ratings for free, even after a six-month lag, would cause them serious commercial harm. Although NRSROs that primarily deal in issuer-paid ratings do typically make those ratings publicly available, they also sell access to databases of such ratings to market participants who use them regularly in their business. Like the subscriber-paid rating agencies, these NRSROs argued that a requirement that they publicly disclose their ratings in a format such as XBRL that can be easily used by customers who would otherwise have to pay for such access would harm their business even if the ratings were reported with a six-month lag.

In response to these comments, the Commission decided to require NRSROs to disclose only a 10% sampling of their issuer-paid ratings histories, reasoning that this sampling would be sufficient for the market to assess the accuracy of their ratings but not useful enough to discourage market participants that need ready access to full ratings histories from paying for such access. More concerned about the possible effect of even this modified requirement on NRSROs that depend primarily on subscriber-paid ratings, the Commission opted to exempt such ratings entirely from the adopted rules and instead seek comment on what the effect would be if they imposed on subscriber-paid ratings the requirements they are adopting for issuer-paid ratings. The Commission also noted that over 98% of outstanding credit ratings are issuer-paid ratings and that seven of the ten registered NRSROs have at least one class of ratings that will be subject to disclosure under the rule as adopted. While the new rules become effective on April 10, 2009, the requirement to disclose ratings histories publicly in XBRL format does not take effect until August 10, 2009 in order to allow the Commission time to develop the necessary XBRL "tags" and the NRSROs to implement the required reporting.

[9] For convenience, we refer to ratings that are unsolicited by issuers but instead are paid for by subscribers to the rating agency's services as "subscriber-paid ratings."

- Records of Material Deviations from Model Outputs

The Disclosure Rules as originally proposed would have required each NRSRO to maintain an internal record of the rationale for any credit rating that materially deviates from the rating implied by a quantitative model that was a substantial component of the ratings process. The Commission adopted this rule substantially as proposed except that the final rule is limited to ratings of structured finance products, which appeared to be the Commission's principal concern in this case. The Commission described the purpose of this requirement as being to permit the Commission to determine whether an NRSRO's rating of a given product was influenced by qualitative factors that are improper (such as pressure from an arranger) or not contemplated in its stated methodology.

- Records of Third-Party Complaints

The Disclosure Rules as adopted include a requirement that NRSROs retain records of any written complaints from unaffiliated parties about a credit analyst's conduct in relation to a credit rating. This rule drew little adverse comment and was adopted substantially as proposed.

Additional Prohibited Conflicts of Interest

The rules under the Credit Rating Agency Reform Act identify various conflicts of interest to which NRSROs may be subject, some of which are required to be disclosed and managed and others of which are prohibited outright. The Disclosure Rules as adopted add three new conflicts to those that are prohibited outright:

- Issuing Ratings With Respect to Which the NRSRO has Made Recommendations

The first of the three new prohibited conflicts is issuing a rating on an obligor or a security if the NRSRO or someone associated with it has made recommendations to the security's obligor, issuer, underwriter or sponsor about the obligor's or issuer's structure, assets, liabilities or activities. This rule was adopted as proposed. In response to concerns that the line between impermissible recommendations and the normal back-and-forth that is part of the ratings process could be difficult to draw in practice, the Commission stated its view that transparency in the ratings process is enhanced when an NRSRO explains its assumptions and rationales to arrangers and discusses how asset characteristics (for example) may affect the ratings result. However, the Commission maintained its position that if this flow of information and feedback "turns into recommendations by the NRSRO about changes to the structure, assets, liabilities or activities," then the NRSRO would be violating the new rule. As an example, the Commission states that it would be proper for an NRSRO to inform the sponsor of a residential mortgage-backed security transaction that its model indicates the mortgage loan pool to be excessively concentrated in a given

geographical region for the desired rating level. The Adopting Release goes on to say that if, however, an analyst recommends "how to change the composition of the loans in the pool to achieve the desired rating," then he or she has violated the new rule. It remains to be seen whether market participants will perceive the distinction between these proper and improper communications as clearly as the Commission does. The Commission notes that this rule applies to all ratings, not just structured product ratings.

- Ratings Personnel Conducting Fee Discussions

The Commission also adopted substantially as proposed a rule prohibiting an NRSRO from issuing or maintaining a credit rating for which the related fee was negotiated, discussed or arranged by an employee who participates in determining or approving credit ratings or credit rating methodologies, including models. The Commission notes in the Adopting Release that this new rule is somewhat broader than the similar rule contained in the International Organization of Securities Commissions' Code of Conduct Fundamentals for Credit Rating Agencies (the "IOSCO Code"), principally insofar as the IOSCO Code covers only "employees who are directly involved in the rating process" whereas the Commission's rule also applies to those responsible for "developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models."

- Ratings Personnel Receiving Gifts

The final conflicts-related rule adopted by the Commission forbids NRSROs to issue ratings if an employee who participated in determining, monitoring or approving the rating received gifts from the issuer or arranger. The rule contains an exception for items provided in the normal context of business activities with a value of no more than $25. In response to comments, the Adopting Release clarifies that the $25 limit is per interaction (rather than per year, for example) but is not an exception from the no-gifts rule – that the Commission's intention is not to permit small gifts but rather to exempt items used in the conduct of a meeting such as note pads, pens and light refreshments. The prohibition applies to all types of ratings.

Re-Proposed Rule Requiring Disclosure of Information Provided in Connection With Issuer-Paid Ratings

The proposed rule that was probably of greatest significance to both rating agencies and other market participants was the proposed requirement for the public disclosure of information used by an NRSRO to determine an issuer-paid rating. The Commission did not adopt such a rule in their recent actions, but re-proposed it in modified form for further comment.

Like the original proposal, the re-proposed rule would add a new type of conflict of interest to the nine conflicts of interest that are not prohibited but are required to be disclosed and managed by NRSROs: issuing or maintaining an issuer-paid rating for a structured finance obligation.

The original proposal was that NRSROs could issue credit ratings subject to this conflict (i.e., any issuer-paid structured finance rating) only if all information they used to determine the product's initial credit rating and to perform surveillance on the rating thereafter was publicly disclosed (the proposed rule did not specify who would be directly responsible for the disclosure, and the comments reflected a sharp difference of opinion on this). The proposed rule made detailed provisions for how this disclosure would be accomplished to be consistent with the securities laws. For example, if the subject security was to be sold in a private placement, the information would be provided only to investors and other rating agencies before closing and would be made public only after closing. Nonetheless, the comments on this proposal reflected widespread concern over the liability consequences of such disclosure, as well as skepticism that the measure would have its intended effect of facilitating independent, unsolicited ratings that could serve as a check on the conflicts inherent in issuer-paid ratings.

The Commission has re-formulated this rule in response to comments and is re-proposing it in modified form. Under the re-proposed rule:

- NRSROs that issue issuer-paid ratings for structured finance products would be required to maintain a list of each such transaction they have been hired to provide an initial rating for; they would maintain the list on a password-protected web site accessible only to other NRSROs, to which they would post new transactions as soon as the transaction arranger provided the NRSRO with any information to be used in the ratings process (transactions would be removed from the list once a final rating was issued or the ratings process terminated without a final rating being issued);

- The NRSRO issuing the issuer-paid rating would be required to obtain an undertaking from the transaction's arranger to post, on its own password-protected web site, all information that the arranger provides to the NRSRO as part of the initial rating or surveillance process, and the pending-transaction listing on the NRSRO's web site would provide, for each listed transaction, the internet address where this information can be found;

- In order to gain access to these two web sites, other NRSROs would be required to certify annually to the Commission that:
    - they are accessing the information only to determine or monitor credit ratings;
    - they will keep the information confidential; and
    - they will determine and maintain credit ratings for at least 10% of the transactions for which they obtain information (unless they obtain information for fewer than 10 transactions in a year).

It is clear from the Re-Proposing Release that the Commission has focused on the operational and practical concerns and questions raised in the comment process and attempted to address them by providing a more comprehensive framework for the disclosure requirement. For example, the modified rule proposal requires the arranger to agree to post information on its web site at the same time it provides such information to the hired NRSRO, to maintain all information provided to the hired NRSRO on the web site (the original proposal required only final transaction information), and to flag for other NRSROs which of that information is current (for example, which loan listing reflects the currently proposed asset composition).

The Commission also indicates in the Re-Proposing Release that the commenters' concerns about securities law liability convinced the Commission to limit the required disclosures to NRSROs and to require those NRSROs to specifically agree to keep the information confidential and use it only for the intended purpose. Unlike the original proposal, the revised rule requires neither disclosure to the public nor disclosure to credit rating agencies that are not NRSROs (because the Commission's examination authority is limited to NRSROs, and so it would not be able to monitor other rating agencies' compliance with the required undertakings).

The Re-Proposing Release does note in passing the fact that particular information is provided to rating agencies may itself indicate that the information is material and should be disclosed to prospective investors in connection with the offering (quoting the adopting release for Regulation AB). Of course, nothing in the rating agency rules changes the general disclosure requirements, under which arrangers and their counsel have been making materiality judgments since the beginning of the mortgage-backed securities market. A mass of data is typically given to rating agencies, and it is likely that in any particular transaction, some of that data is unquestionably material and much of it would not be deemed material from any perspective. Disclosing such a mass of data may well not be the best way to provide investors with effective disclosure as to the material elements of a

transaction. It seems quite likely that whenever new issuances of asset-backed securities resume, disclosure practices will be changed in some respects, although as yet it is difficult to predict just how. However, with the new emphasis by the Commission on investors in structured products conducting their own analysis rather than relying on rating agencies alone, and with arrangers and the rating agencies themselves having good reason to err even more than previously on the side of disclosing more rather than less, it would not be surprising to find more asset-level data being disclosed to prospective investors in all types of asset-backed securities in a way that has previously been typical mostly for securities backed by commercial mortgage loans.[10]

As part of the re-proposal of this rule, the Commission also proposed to revise Regulation FD, its selective-disclosure rule, to make clear that the disclosures required to be made to NRSROs would not violate Regulation FD even if they include material non-public information. Currently, Regulation FD permits disclosure of material non-public information to any credit rating agencies for the purpose of developing a credit rating if the entity's ratings are publicly available. The re-proposed rule would limit this exclusion to NRSROs and would remove the "publicly available" requirement so that disclosure of information to subscriber-based NRSROs, and to other NRSROs that may request the information but then decide not to use it to issue a public credit rating, would be protected.

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[10] The practice of providing extensive property-level information in CMBS transactions developed because such securitizations involve a smaller number of underlying assets (and so each individual property is more material), because commercial mortgage properties and loans are less homogeneous than their residential equivalents, and because the typical purchasers of CMBS are generally institutional investors that expect to conduct their own detailed analysis before investing even if a transaction is rated. In contrast, loan pools in residential mortgage securitizations are relatively large and the individual loans are relatively small and homogeneous.

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