News Bulletin

December 4, 2008

SEC's New and Proposed Credit Rating Agency Rules

On December 3, 2008, the Securities and Exchange Commission (SEC) approved final rule changes relating to Nationally Recognized Statistical Rating Organizations (NRSROs) and proposed additional NRSRO rules, but did not take action on the rule proposals relating to removal of references to credit ratings in SEC rules and forms. The final rules (Final Rules) include new prohibited conflicts of interest, new disclosure obligations and new reporting and recordkeeping requirements.

The following discussion of the Final Rules and the new proposed rules is based on the SEC's open meeting and press release and is subject to change upon publication of the Final Rules; the Final Rules and new proposed rules, when published, will be available at www.sec.gov.

Background

The SEC proposed rules on June 16, 2008 designed to address concerns about the integrity of NRSRO credit rating procedures and methodologies. 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.[1]

NRSRO actions have been identified as a contributing factor in the current financial crisis. The SEC found that ratings assigned to mortgage-backed and mortgage-related securities backed by subprime loans were based on limited diligence of the underlying assets and over-reliance on statistical models, without disclosure to investors. Additionally, the business models of the issuer-paid NRSROs are blamed for creating conflicts of interest that may have reduced the impartiality of the ratings assigned. Detailed results of the SEC's ten-month study of credit rating agencies are available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

Conflicts of Interest

Three new prohibited conflicts of interest are added to Rule 17g-5, all substantially as proposed.

- An NRSRO cannot issue a rating on an obligor or a security if NRSRO personnel, including affiliates, have made recommendations to the obligor, issuer, underwriter or sponsor of the security about the corporate or legal structure, assets, liabilities or obligations of that obligor or issuer of the security.
- An NRSRO cannot issue a rating if the personnel responsible for participating in determining the credit rating or developing or approving procedures or methodologies used for determining credit ratings have participated in fee discussions, negotiations or arrangements with the related issuer. An NRSRO that is

[1] For additional background, our Client Alerts on the proposed rules can be found at: http://www.mofo.com/news/updates/files/080702CreditAgencies.pdf and http://www.mofo.com/news/updates/files/080805AgencyReform.pdf.

unable, for example due to its limited number of employees, to separate the fee negotiation and ratings processes, may apply to the SEC for an exemption from this requirement.

- An NRSRO credit analyst that has participated in determining or monitoring the credit rating of an issuer cannot receive gifts, including entertainment, from the issuer, obligor, 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. This is the threshold originally proposed.

The proposed rules included as an additional new prohibited conflict of interest, the issuance by an issuer-paid NRSRO of any credit rating, absent public disclosure of the information used by that NRSRO in determining the initial rating. The proposal was intended to provide transparency in the ratings process and to encourage competition from subscriber-paid NRSROs. The proposal has been revised and is the subject of the re-proposal described below.

Recordkeeping Requirements

New recordkeeping requirements in amended Rule 17g-2 and are designed to enhance the SEC's ability to supervise NRSROs. NRSROs must retain records related to the following:

- All rating actions, including initial ratings, upgrades, downgrades and placements on watch lists for upgrades or downgrades.
- Any communications relating to complaints about the performance of a credit analyst in determining, maintaining, monitoring, changing or withdrawing a credit rating and the NRSRO response to the complaint.
- 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 SEC staff noted that the final rule is limited to structured products because quantitative models are an integral part of rating those instruments and, as a result, the risk that an NRSRO will impair model integrity to evade recordkeeping responsibilities under the rule is diminished. The staff also acknowledged that additional guidance will not be given during the rulemaking process regarding the terms "material" and "substantial," but noted that the interpretation of those terms will be the subject of conversation and development through the examination process.
- 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.

Reporting and Disclosure

The Final Rules provide for additional disclosure of information, through the annual report filed with the SEC, amendments to the exhibits to Form NRSRO and additional disclosure on the websites of issuer-paid NRSROs.

- Issuer-paid NRSROs must 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. These ratings, and their histories, must be disclosed on the NRSRO website no later than six months after a rating is made. The required format of the disclosure will be Extensible Business Reporting Language (XBLR), in order to enable easy analysis of both initial ratings and ratings change data. The NRSRO must disclose on Exhibit 1 to Form NRSRO where on its website the disclosures will be published.
- Disclosure is required 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 1, 3 and 10 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. This disclosure is required on Exhibit 1 to Form NRSRO.

- Disclosure on Exhibit 2 to Form NRSRO is being enhanced to require the following:
  - 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; and
  - more detailed information on the surveillance process used by the NRSRO, including whether different models or criteria are used for surveillance than for determining initial ratings.
- Inclusion in the NRSRO's annual report of the number of credit rating actions that occurred during the fiscal year in each ratings class for which the NRSRO is registered.

The SEC's press release describing the Final Rules retains the use of the term "structured finance transactions" from the proposed rules. The proposed rules noted an intentional use of a term other than "asset-backed issuer," the term currently defined in Regulation AB. The proposal described the new term as intended to capture "any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction."

New Rule Proposal and a Rule Re-Proposal

Also adopted on December 3 were a new rule proposal and a proposal modified from the June 16, 2008 proposals.

Disclosure of Ratings

The Final Rules require disclosure by issuer-paid NRSROs of 10% of ratings, by class of rating. The SEC has proposed an amendment to this new rule; that issuer-paid NRSROs disclose ratings history information for all credit ratings determined after June 25, 2007, no later than 12 months after ratings action is taken, and in an XBRL format. Comments are requested on whether the disclosures should also be required by subscriber-paid NRSROs and, if so, how long after issuance. For example, would publication two years following issuance of a credit rating provide meaningful information to the public and not cause disproportionate harm to the NRSROs, given their subscriber-based business model.

Conflict of Interest

The June 16 proposal included as a new prohibited conflict of interest the rating of a structured finance transaction by an NRSRO, paid by a party to the transaction, unless all information provided to the NRSRO in connection with its rating determination was publicly disclosed. This raised numerous securities law liability and Regulation FD concerns. The proposal has been revised as described below.

As currently 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 NRSROs not retained to issue a credit rating. The information used to determine the initial rating and to monitor the rating will be subject to the disclosure requirement. The arranger for the product, the issuer, sponsor or underwriter would be required to represent to the NRSRO that it will provide all information provided to the retained NRSRO to all other NRSROs. To be eligible to receive the information, NRSROs not retained by the arranger would be required to provide the SEC with an annual certification that they are receiving the information for the sole purpose of evaluating an independent rating of the security. They would also be required to certify that a stated minimum number of independent ratings will be issued based on information provided under the proposed disclosure rule. As revised, the re-proposed rule addresses the concerns raised regarding potential securities law

liability for disclosure of offering related material by transaction participants and identifies the party responsible for making the disclosure. It also imposes upon the recipient NRSROs some level of responsibility for use of what would be, in many cases, confidential and proprietary information.

The re-proposal includes an amendment to Regulation FD to permit the disclosure of material non-public information to NRSROs, whether or not they make their ratings publicly available. While the re-proposal resolves the inherent risk of violating Regulation FD by complying with the disclosure requirements, it may not resolve the concern of issuers. Information shared with NRSROs is currently provided in the context of an ongoing dialogue and a meaningful opportunity for an arranger to answer questions and provide additional information upon request. It is for these reasons, in part, that the information has had limited distribution in the past. 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.

Conclusion

The SEC noted that the July 1 proposals to remove references to NRSRO ratings identified 38 such references. While some posed no concerns, others generated significant comments that highlighted complexities that would result from the proposed removal. No specific time frame was disclosed for final rulemaking based on those proposals. Additionally, there was no discussion of the June 16 proposal to mandate alternate symbols for ratings of structured finance products – a proposal that was the subject of numerous adverse comments from diverse market participants.

Comments on the new proposal and re-proposal will be due 45 days after publication in the Federal Register. The effective date for the Final Rules has not been provided, but will be available as soon as they are published in the Federal Register.

Contacts

Amy Moorhus Baumgardner
(202) 887-1532
abaumgardner@mofo.com

Lloyd S. Harmetz
(212) 468-8061
lharmetz@mofo.com

David M. Lynn
(202) 887-1563
dlynn@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

About Morrison & Foerster

With more than 1000 lawyers in 17 offices around the world, Morrison & Foerster offers clients comprehensive, global legal services in business and litigation. The firm is distinguished by its unsurpassed expertise in finance, life sciences, and technology, its legendary litigation skills, and an unrivaled reach across the Pacific Rim, particularly in Japan and China. For more information, visit www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.