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News Bulletin

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An Update on Regulations Affecting Credit Rating Agencies

Background

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]

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. For more information on the SEC's February 2, 2009 Final Rules, see our February 4, 2009 client alert, which can be found at http://www.mofo.com/files/uploads/Images/090204SECAdoptsandProposesReforms.pdf.

New Final Rule Amendments – Current Status

Since the February 2, 2009 issuance of the Final Rules, the SEC issued additional amendments in August 2009 and November 2009. These amendments involve reporting format and additional disclosure and conflict of interest requirements on NRSROs.

August 5, 2009 Amendments

On August 5, 2009, the SEC amended the Final Rules regarding NRSROs subject to the disclosure provisions of paragraph (d) of Rule 17g-2. The amendment states that an NRSRO can satisfy the requirement to make ratings history information publicly available in an XBRL format or any other machine-readable format.[2]

November 23, 2009 Amendments

On November 23, 2009, the SEC adopted the following amendments:

- paragraph (d) of Rule 17g-2;
- paragraphs (a) and (b) of Rule 17g-5;
- a new paragraph (e) of Rule 17g-5; and

[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] Notice Regarding the Requirement to Use eXtensible Business Reporting Language Format to Make Publicly Available the Information Required Pursuant to Rule 17g-2(d) of the Exchange Act, http://www.sec.gov/rules/other/2009/34-60451.pdf, p. 1.

- a conforming amendment to Regulation FD.

These amendments were intended to address concerns about the integrity of the credit rating procedures and methodologies at NRSROs and to promote transparency and objectivity in the NRSRO credit rating process by increasing competition and making it easier for investors and other market participants to assess the credit rating performance of NRSROs.[3] The effect of the amendments is the implementation of registration, recordkeeping, financial reporting, and oversight rules under the Rating Agency Act.

In order to provide NRSROs with adequate time to implement the new requirements, the compliance date of the amendments is set for June 2, 2010.

Recordkeeping Requirements (Rule 17g-2)

The Final Rules require an NRSRO to make, keep, and preserve additional records under Rule 17g-2. Amended paragraph (d) of Rule 17g-2 requires greater disclosure of credit rating history information. The purpose of this amendment is to provide users of credit ratings, and other market participants, the raw data to compare the credit rating performance of NRSROs by showing how different NRSROs initially rate an obligor/security, and how the NRSROs later adjust those ratings, including the timing of the adjustments. The new amendments include the following requirements:

- an NRSRO must disclose rating action histories for all credit ratings initially determined on or after June 26, 2007, in an interactive data file that uses a machine-readable format ("100% requirement"); and
- the new disclosure requirement applies to all NRSRO credit ratings regardless of their determined business model. The requirement also applies to all types of credit ratings (e.g., issuer-paid, subscriber-paid, or unsolicited credit ratings).

Conflicts of Interest (Rule 17g-5)

Amendments were made to Rule 17g-5 to provide users of credit ratings with more views on the creditworthiness of structured finance products. In addition, the amendments were developed to reduce the ability of arrangers to obtain better-than-warranted ratings by exercising influence over NRSROs hired to determine credit ratings for structured finance products. It is believed that by opening up the rating process to more NRSROs, it will become easier for an NRSRO to resist influence due to the increased likelihood that inappropriate behavior or actions that favor an arranger could be exposed to the market through the credit ratings issued by other NRSROs.

The SEC intends the amendment to apply to a broad range of structured finance products, including, but not limited to: collateralized debt obligations, collateralized loan obligations, collateralized mortgage obligations, collateralized securities (in the areas of commercial and residential mortgages, corporate loans, auto loans, education loans, credit card receivables, and leases), structured investment vehicles, synthetic collateralized debt obligations, and hybrid collateralized debt obligations.[4]

Amendments to Paragraphs (a) and (b) of Rule 17g-5

The SEC adopted the following amendments to paragraphs (a) and (b) of Rule 17g-5 in order to address conflicts of interest and improve the quality of credit ratings for structured finance products. These amendments require an NRSRO that is hired by issuers, sponsors, or underwriters ("arrangers") to determine an initial credit rating for a structured finance product:[5]

[3] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, http://www.sec.gov/rules/final/2009/34-61050.pdf, p. 76.
[4] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, http://www.sec.gov/rules/final/2009/34-61050.pdf, p. 50.
[5] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, http://www.sec.gov/rules/final/2009/34-61050.pdf, p. 9.

- disclose to non-hired NRSROs that have furnished the SEC with a required certification,[6] that the arranger is in the process of determining such a credit rating; and
- obtain a representation from the arranger that the arranger will provide information to the hired NRSRO and non-hired NRSROs that have furnished the SEC with the required certification. Non-hired NRSROs are furnished this information via a password-protected website maintained by the arranger and accessible only to the non-hired NRSROs.

New Paragraph (e) of Rule 17g-5

New paragraph (e) of Rule 17g-5 requires an NRSRO seeking to access information after June 2, 2010 (from internet websites maintained by arrangers), to provide the SEC with an annual certification stating that the NRSRO is accessing the information solely to determine credit ratings and will determine a minimum number of credit ratings using that information.[7] The certification requires the NRSRO to commit to the following:

- the NRSRO will keep the information it accesses confidential and treat the information as material non-public information;
- the NRSRO will maintain credit ratings for at least 10% of the issued securities and money market instruments it accesses, *if* it accesses such information for 10 or more issued securities or money market instruments in the calendar year covered by the certification; and
- the NRSRO certifies one of the following, as applicable: (1) in the most recent calendar year during which it accessed information, the NRSRO accessed information for [Insert Number] issued securities and money market instruments through internet websites and determined and maintained credit ratings for [Insert Number] of such securities and money market instruments; *or* (2) the NRSRO previously has not accessed information 10 or more times during the recently-ended calendar year.

Amendment to Regulation FD

The amendment to Regulation FD works with the new disclosure requirements under Rule 17g-5 by allowing the disclosure of material non-public information to an NRSRO regardless of whether the NRSRO makes its ratings publicly available. Specifically, the amendment requires:[8]

- that Regulation FD accommodate the information disclosure program established under paragraphs (a) and (b) of Rule 17g-5; and
- the disclosure of material, non-public information to an NRSRO, solely for the purpose of allowing the NRSRO to determine or monitor a credit rating, regardless of whether the NRSRO makes its ratings publicly available.

Additional Measures Contemplated by House Bill and Senator Dodd's Proposed Financial Reform Bill

In addition to the SEC's proposed amendments to the Final Rules regarding credit rating agencies, proposed legislation contemplates additional regulation. The Wall Street Reform and Consumer Protection Act of 2009 (passed by the House on December 11, 2009) addresses eroding investor confidence by implementing measures that address conflict of interest and disclosure concerns. Specifically, the bill calls for additional obligations in the areas of liability, disclosure, prohibited activities, conflict of interest, and oversight. On the Senate side, Senate Banking Committee Chairman Christopher Dodd's revised March 2010 Financial Reform Bill proposes a number of regulatory measures.

[6] Certification: stating that the NRSRO is accessing the information solely to determine credit ratings.
[7] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, http://www.sec.gov/rules/final/2009/34-61050.pdf, p. 9.
[8] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, http://www.sec.gov/rules/final/2009/34-61050.pdf, p. 69.

Conclusion

As evident by the numerous reform efforts proposed by the SEC and Congress, credit agency reform will remain a hot topic for quite some time. On the agency side, the SEC continues to seek comments from industry participants in an effort to make its rules effective yet practical. On the legislative side, Senate Democrats and Republicans have not reached an agreement at this time and there is a likely chance that the final bill that the Senate ultimately passes may differ from the House version passed in December 2009. See the attached chart summarizing the status of legislative initiatives.

Credit Rating Agency Reform (as of March 15, 2010)

The Credit Rating Agency Reform Act passed in 2006 requires credit rating agencies (CRAs) to register with the SEC and submit reports. However, the recent financial crisis further eroded investor confidence in CRA ratings and demonstrated that more needs to be done to address conflict of interest and disclosure concerns. Recently proposed amendments to SEC rules attempt to address these issues and recent legislation goes even further.

	The Wall Street Reform and Consumer Protection Act of 2009, passed by the House on December 11, 2009	Senate Discussion Draft released by Senator Dodd on November 10, 2009	Senate Draft Bill: Restoring American Financial Stability Act, released by Senator Dodd on March 15, 2010
Liability	– Subject to Section 11 liability for use of credit ratings in registration statements – Revocation of Regulation FD exemption – Revocation of "expert" exemption under Rule 436(g) – CRAs not covered by forward-looking safe harbor	– Subject to Section 11 liability for use of credit ratings in registration statements – Duty to report issuer violations of law to appropriate authorities	– Subject to Section 11 liability for use of credit ratings in registration statements – Duty to report violations of law to appropriate authorities – Statements made by CRAs are not forward-looking statements for purposes of safe harbor – Enforcement and penalty provisions of the Exchange Act apply to CRA statements – Modifies "state of mind" requirement for private securities fraud actions against CRAs for money damages
Disclosure	– Conflicts of interest – Qualitative and quantitative methodologies and assumptions used – Prior rating errors made – Other information required by SEC	– Qualitative and quantitative methodologies and assumptions used – Prior rating errors made – Third party reports and credible information received from independent sources – Other information required by SEC	– Qualitative and quantitative methodologies and assumptions used – Prior ratings errors made – Third party reports and credible information received from independent sources – SEC to issue rules requiring CRAs to disclose information on initial ratings and subsequent changes; disclosures to be comparable across CRAs – SEC must require each CRA to accompany publication of each rating with a prescribed form that details, among other things, ratings methodologies
Prohibited Activities	– If providing ratings, CRAs cannot provide: - Risk management services; - Advice or consultation relating to mergers, sales or disposition of assets, or not related to a	– SEC to adopt rules separating rating activities from sales and marketing activities	– SEC to promulgate rules separating rating activities from sales and marketing activities – SEC may impose fines, including fines for failure to supervise – Each CRA must establish internal controls and procedures

	securities issuance; - Any other activity according to SEC rules		– CRAs must submit an annual report to the SEC, including a certification regarding internal controls and procedures
Conflict of Interest	– Reduce conflict of interest concerns by maintaining a website disclosing fees earned, number of issuances rated and issuer standings for current year and two prior years	– Compliance officers cannot participate in determining ratings or methodologies, or participate in sales activities or setting of compensation levels for certain employees – Maintain CRA records of ratings over time on CRA website for investors to review	– Compliance officers cannot participate in determining ratings or methodologies, or in sales activities or setting of compensation levels for certain employees – Compliance report required annually – CRA must maintain record of ratings over time and publish on website for investors to review – SEC to promulgate additional regulations; SEC may suspend or revoke a CRA's registration for violations
Oversight	– SEC to set rules, review due diligence and methodologies used – CRAs must have Board of Directors with at least 1/3 (minimum of two) members being independent for policy and procedure oversight – CRAs that earned less than $250 million in comp in last full fiscal year may deregister as NRSRO	– SEC to set rules – Annual internal control reports submitted to SEC – SEC may suspend CRA's right to rate certain types of securities	– Establishes SEC Office of Credit Ratings; director of Office reports to SEC Chairman – Establishes fines, penalties for CRAs; administers SEC rules applicable to CRAs – SEC to conduct annual exam of each CRA; SEC to report on CRA exams
Other	– Due diligence reports prepared by third parties for issuers must be certified and provided to CRAs – SEC may propose additional rules relating to ratings of structured products	– Due diligence reports prepared by third parties for issuers must be certified and provided to CRAs – CRA analysts must pass exams and continue education – SEC study of independence and alternative models	– Due diligence reports prepared by third parties for issuers must be certified and provided to CRAs – SEC to conduct a study and promulgate rules regarding requisite standards, experience and qualifications for CRA analysts – SEC must issue rules regarding ratings procedures and methodologies – SEC rules must require that CRAs establish, maintain and enforce policies and procedures that define and disclose the meaning of any ratings symbol – SEC to conduct a study regarding independence of CRAs – Additional studies required to be conducted, including studies regarding alternative business models; reliance on ratings within various markets; reliance on ratings by various federal agencies

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