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A legal update from Dechert's Financial Services Group

# SEC Proposes Rules for Registration of Credit Rating Agencies

## Introduction

On February 2, 2007, the Securities and Exchange Commission (the "Commission," or "SEC") issued a release (the "Release") proposing rules to effectuate the provisions of the Credit Rating Agency Reform Act of 2006 (the "Act").[1] The Act, which President Bush signed into law on September 29, 2006, provides authority for the Commission to adopt rules concerning registration, recordkeeping, financial reporting, and oversight (the "Proposed Rules") with respect to credit rating agencies seeking to register as Nationally Recognized Statistical Rating Organizations ("NRSROs").[2]

As the Commission explains in the Release, Congress designed the Act to address two issues. First, "the practice of designating NRSROs through staff no-action letters has been criticized as a process that lacks transparency and creates a barrier to entry for credit rating agencies seeking wider recognition and market share."[3] Second, "the importance of credit ratings to the financial markets has raised the question of whether greater supervision of credit rating agencies is warranted."[4]

The Act requires that the Commission adopt final rules within 270 days after the date of enactment, or by June 26, 2007.[5] Accordingly, the Commission considered a proposal from the SEC staff (the "Staff") at an Open Meeting (the "Open Meeting") on January 31, 2007 and voted to issue the Release. This *Dechert OnPoint* summarizes the Proposed Rules.

## Overview of the Proposed Rules

The Act mandates that the Commission adopt narrowly tailored provisions that do not "regulate the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings"[6] to effectuate its requirements.

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1 Exchange Act Release No. 34-55231 (Feb. 2, 2007) (the "Release").

2 For a more detailed discussion of the history of NRSROs and the Act, see "Credit Agency Reform Act Signed into Law," *Dechert OnPoint* (Dechert LLP), Dec. 2006, Issue 16.

3 72 Fed. Reg. 6379.

4 *Id.* Although the Staff has identified nine credit rating agencies as NRSROs since 1975, consolidation has led to a current count of five NRSROs. Two of the five, Standard and Poor's Division of the McGraw-Hill Companies Inc. ("S&P") and Moody's Investors Service, Inc. ("Moody's"), represent over 80 percent of the industry market share as measured by revenues. 72 Fed. Reg. 6415 (citing the *Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850*, Credit Rating Agency Reform Act of 2006, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) (the "Senate Report")). The Senate Report also states that S&P and Moody's rate more than 99 percent of the debt obligations and preferred stock issues publicly traded in the United States. *Id.*

5 Section 15E(n)(1) of the Securities Exchange Act of 1934 (the "Exchange Act").

6 Section 15E(c)(2) of the Exchange Act; *see also* 72 Fed. Reg. 6380.

- To apply for registration[7] as an NRSRO, the Proposed Rules would require a credit rating agency to furnish[8] two categories of information to the Commission on Form NRSRO.
  - Public Information – Form NRSRO would elicit information that the credit rating agency would need to make public upon registration and thereafter. The Proposed Rules would require the credit rating agency to keep the information current. The "public" category of information would "'facilitate informed decisions by giving investors the ratings' quality of different firms.'"[9]
  - Confidential Information – The second, or "confidential," category of information would be submitted confidentially to the extent permitted by law. Proposed Rule 17g-1 would not require the credit rating agency to update the information on the form, but would require it to keep the information current through the financial reporting requirements of Proposed Rule 17g-3.[10]

When the Commission approves a credit rating agency's application, the Proposed Rules would require the new NRSRO to "promptly" update the information on Form NRSRO if an item or exhibit has become materially inaccurate, with certain exceptions.[11]

- On a calendar year basis, the Commission would require each NRSRO to furnish it with an annual certification on Form NRSRO that the information and documents in the form are accurate. The Proposed Rules would require an NRSRO to update its Form NRSRO in certain instances.[12]
- The Proposed Rules also would require that, after registration, NRSROs be subject to several substantive provisions, such as a recordkeeping rule. The SEC intends the recordkeeping rule to assist it in monitoring whether an NRSRO complies with the requirements of the Act. Other records required under the proposed recordkeeping rule would aid the Commission in determining whether an NRSRO follows its own established policies and procedures.[13]
- On an annual fiscal year basis, the Proposed Rules would require an NRSRO to furnish the Commission with audited financial statements, a requirement designed to assist the Commission in monitoring whether the NRSRO has continued to maintain adequate financial resources to consistently produce credit ratings with integrity.[14]
- The Proposed Rules would require that financial reports include a schedule of the

7 Registration for recognition as an NRSRO is voluntary: "A credit rating agency that elects to be treated as an NRSRO must apply to the Commission to be registered as an NRSRO." 72 Fed. Reg. 6381.

8 The Release states: "Paragraph (b)(1) of proposed Rule 17g-1 provides that an application would be considered furnished to the Commission on the date that the Commission receives a complete and properly executed Form NRSRO that follows all applicable instructions for the form." 72 Fed. Reg 6382 (citing Section 15E(a)(1)(A) of the Exchange Act). The word "furnished" is used in this context rather than "filed" so that submission of an incomplete application would not start the running of the 90-day period deadline for the SEC to grant the application or commence proceedings. *See* discussion under the heading "Timing for Review of Applications," *infra*.

9 72 Fed. Reg. 6380 (citing Sections 15E(a)(1)(B) and (b)(1) of the Exchange Act, Proposed Rule 17g-3, Form NRSRO, instructions for the form and the Senate Report).

10 *Id.* (Citing Sections 15E(a)(1)(B)(viii) and (ix) of the Exchange Act and Proposed Rule 17g-1.)

11 *Id.* (Citing Section 15E(b)(1) of the Exchange Act, Proposed Rule 17g-1, Form NRSRO, and instructions for the form.)

12 *Id.* The Proposed Rules would require an NRSRO to disclose any material changes that occurred during the year. The operative registration application (the "Operative Application") would be the most recently furnished Form NRSRO – be it initial, amended, or the annual certification – combined with public exhibits. The Proposed Rules would require an NRSRO to make the Operative Application public (with exceptions for certain confidential information).

13 *Id.*

14 *Id.*

NRSRO's largest customers to help alert the Commission to potential conflicts of interest arising from dealings with such customers.[15]

- The Proposed Rules also would subject all NRSROs to requirements designed to ensure their impartiality with respect to issuing credit ratings, such as a requirement to establish, maintain, and enforce specific written policies and procedures intended to prevent the misuse of material non-public information; a requirement to avoid, manage, and disclose conflicts of interests; and a prohibition against engaging in certain unfair, coercive, or abusive practices.[16]

## The Proposed Rules

The following summarizes each of the Proposed Rules and describes Form NRSRO.

## Proposed Rule 17g-1 – Registration Requirements; Form NRSRO; Instructions for Form NRSRO

Proposed Rule 17g-1 would require a credit rating agency to apply for registration as an NRSRO by furnishing an initial application on Form NRSRO to the Commission. Certain of the items of Form NRSRO proposed under the rule are unique to an NRSRO's initial application or an application to add one or more additional classes of credit ratings to its registration.[17]

Under Proposed Rule 17g-1, a credit agency could establish eligibility to apply for registration as an NRSRO if the SEC considers it to have satisfied the definitions for "credit rating agency" and "NRSRO" under the Act, and recognizes that it issues "credit ratings" as defined under the Act.[18]

**Timing for Review of Applications**

The Commission would consider an applicant to have furnished its application on the date that the Commis-

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15 72 Fed. Reg. 6380-81.

16 72 Fed. Reg. 6381 (citing Sections 15(E)(g), (h) and (i) and Proposed Rules 17g-4, 17g-5, and 17g-6, respectively).

17 For example, Proposed Rule 17g-1 would require a credit rating agency to complete Item 6 of proposed Form NRSRO only when it furnishes an initial application or when an NRSRO applies to expand the scope of its registration by adding an additional class of credit ratings. The proposed item would require an applicant to attach qualified institutional buyer ("QIB") certifications to the application. As proposed, Form NRSRO also includes thirteen exhibits. Exhibits 1-9 would be public, while Exhibits 10-13 would be confidential. The Proposed Rules would not require credit rating agencies to make confidential exhibits public, to the extent permitted by law, or update them after registration; however, Proposed Rule 17g-3 would require an NRSRO to update the information in the exhibits upon its submission of its annual audited financial statements to the SEC. *See* 72 Fed. Reg. 6385-86.

In addition to the nine proposed publicly available exhibits, which describe credit ratings performance measurement statistics; procedures and methodologies used in determining credit ratings; organizational structure; an applicant's code of ethics, or reasons why an applicant does not have such a code; any conflicts of interest relating to the issuance of credit rating policies and procedures to address and deal with conflicts of interest; information regarding an applicant's credit analysts; and information regarding an applicant's designated compliance officers; the four proposed confidential exhibits are:

- Exhibit 10, which would require an applicant to provide a list of the twenty largest issuers and subscribers that use the credit rating services provided by the credit rating agency by amount of net revenue received by the credit rating agency in the fiscal year immediately preceding the date of submission of the application;
- Exhibit 11, which would require an applicant to furnish audited financial statements for the past three fiscal or calendar years immediately preceding the date of the application;
- Exhibit 12, which would require an applicant to provide information as to the amount of revenue generated from various credit rating services and a separate computation of total revenue from all other services; each amount would correspond to the most recently completed fiscal year or calendar year and would not have to be audited; and
- Exhibit 13, which would require an applicant to provide the amount of total aggregate annual compensation paid to its credit analysts and the median compensation for the most recently completed fiscal or calendar year and would not have to be audited.

18 The term "credit rating" means "an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments." Section 3(a)(60) of the Exchange Act.

sion receives a complete and properly executed Form NRSRO. In addition, Proposed Rule 17g-1 would require the Commission to grant the application for registration or commence proceedings on whether to deny it within 90 days from the date the application is furnished to the Commission or a longer period if the applicant consents.[19] If the Commission were to commence proceedings to deny the application, the proposed rule would require it to conclude such proceedings within 120 days of the date the credit rating agency furnished the application to the Commission. Consequently, the Commission would require a complete application before the 90-day and 120-day periods begin to run.[20]

Proposed Rule 17g-1 also would require a credit rating agency to provide the Commission with written notice if it intended to withdraw its application for NRSRO status prior to final Commission action.[21]

**Registration for The Five Categories of Credit Ratings**

The SEC proposes a registration system in which an NRSRO can register in one or more categories. The categories are:

- Credit ratings of financial institutions;
- Credit ratings of insurance companies;
- Credit ratings of corporate issuers;
- Credit ratings with respect to issuers of government, municipal, and foreign government securities; and
- Credit ratings of asset-backed securities.

If a credit rating agency applies to register as an NRSRO in fewer than all of the categories as an initial matter, Proposed Rule 17g-1 would allow the NRSRO to subsequently seek registration in one or more additional categories. The Proposed Rule also would require an NRSRO that has registered for fewer than five categories of credit ratings and wishes to register for an additional category to furnish an amendment to the Commission on Form NRSRO. The Release states that the Commission believes that nearly all NRSROs initially would apply to register for the first three categories of credit ratings; however, the Commission anticipates that credit ratings of issuers of asset-backed securities will be the least common category for which NRSROs will seek registration.

**Additional Requirements**

To register as an NRSRO under the Proposed Rules, a credit rating agency must meet a number of additional requirements:

- Proposed Item 6 of Form NRSRO would require a credit rating agency to list the approximate number of credit ratings issued in each category as of the date of the application, as well as the number of consecutive years preceding the date of the application that the credit rating agency has issued credit ratings with respect to each category indicated. The Release explains that the Commission would use this information to verify that the credit rating agency meets the definitional thresholds for registration as an NRSRO, including the requirement that the entity has been in business as a credit rating agency for the three consecutive years preceding the date of its application.[22]
- Item 6 of Form NRSRO also would require the applicant to provide qualified institutional buyer ("QIB") certifications under Section 15E(a)(1)(B)(ix) of the Exchange Act, which requires an applicant to submit a minimum of ten QIB certifications with the application.[23]

19 72 Fed. Reg. 6382.

20 *Id.*

21 *Id.*

22 72 Fed. Reg. 6385.

23 Existing NRSROs, however, are grandfathered as to QIB certification requirements. "Under Section 15E(a)(1)(D) of the Exchange Act, a credit rating agency is not required to submit QIB certifications if it was identified as an NRSRO in a Commission staff no-action letter issued before August 2, 2006." 72 Fed. Reg. 6386. Moreover, according to the Release: "[A]s a transitional measure, no-action letters issued before the effective date may continue to be relied upon by regulatory users of credit ratings after the effective date if the credit rating agency identified in the letter has a pending application for registration before the Commission." 72 Fed. Reg. 6380 (citations omitted). The Release continues, "[i]n this case, the letter becomes void after the Commission has acted on the application." *Id.*

- Sections 15E(a)(1)(C)(i),(ii), and (iii) further provide, respectively:
  - The certifying QIB cannot be affiliated with the applicant;
  - The certification may address more than one of the categories of credit ratings for which the applicant is seeking registration; and
  - At least two of the certifications must address each category of credit ratings for which the applicant is seeking registration.
- Section 15E(a)(1)(C)(iv) provides that the QIB must state in the certification that it meets the definition of a QIB in Section 3(a)(64) of the Exchange Act and that the QIB has used the credit ratings of the applicant for at least three years immediately preceding the date of the application in the subject category or categories of subscribers.[24] It is very unusual, with regard to the federal securities laws, for a statute to require that an applicant for a particular status supply a federal agency with certifications of facts by commercial entities.
- The proposed instructions to Item 6 prescribe the format of the QIB certification, *e.g.*, consistent with Section 15E(a)(1)(C)(i)(I) of the Exchange Act and the Senate Report explaining that section, the form would require the QIB certification to include a representation that the QIB has seriously considered the credit ratings of the credit rating agency in the course of making investment decisions for at least three years immediately preceding the date of the certification and that the certification list the categories of credit ratings to which the representation pertains.[25]
  - Proposed Rule 17g-1 also would require a person duly authorized by the QIB to execute the certification on its behalf – a requirement designed to ensure that the certification is that of the QIB, rather than an employee of the QIB who may have an interest (distinct from that of the QIB) in providing the certification to the applicant. In addition, the proposed rule would require the QIB to certify it had not received compensation for providing the certification to ensure the impartiality of the QIB's assessment.[26]

In addition, Item 8 of Form NRSRO would address potential statutory disqualifications. Section 15E(a)(2)(C)(ii)(II) of the Exchange Act requires that the Commission deny a credit rating agency's application for registration as an NRSRO if it finds that the applicant, if granted registration, would be subject to suspension or revocation of its registration under Section 15E(d) of the Exchange Act. Section 15E(d) of the Exchange Act requires that the Commission, by order, must censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of an NRSRO, if the Commission finds that the NRSRO or a person associated with the NRSRO has committed certain acts,[27] been convicted of certain offenses,[28] been convicted of certain other offenses or if a person associated with the NRSRO is subject to an SEC order suspending or barring the person from association with an NRSRO.[29]

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24 72 Fed. Reg. 6386 (noting that "[t]he Senate Report explained that the term 'used' was intended to mean the QIB 'seriously considered the ratings in some of [its] investment decisions.'").

25 *See* 72 Fed. Reg. 6429 for a sample QIB certification; the instructions to Form NRSRO also state that "[t]he required certifications must be signed by a person duly authorized by certifying entity, must be notarized, must be marked 'Certification from Qualified Institutional Buyer,' and must be in substantially the following form [ ]."

26 72 Fed. Reg. 6386.

27 The Release describes these acts in Sections 15(b)(4)(A), (D), (E), (G), and (H) of the Exchange Act. *Id.*

28 The Release describes these offenses in Section 15(b)(4)(B) of the Exchange Act. *Id.*

29 *Id.*

Item 8 also would require an applicant or NRSRO to state whether the acts, convictions or orders described in Section 15E(d) of the Exchange Act apply (or applied) to the credit rating agency or any person associated with the credit rating agency. If a credit rating agency or NRSRO answered the question in Item 8 in the affirmative, the credit rating agency would be required to provide additional information on a Disclosure Reporting Page ("DRP") NRSRO as set forth in the instructions for Form NRSRO. Proposed Rule 17g-1 would then mandate that the Commission evaluate whether an applicant's registration could be granted given such disclosure. The proposed rule also would require an NRSRO to update the information in the item if a change were to occur after registration. Proposed Rule 17g-1 would then mandate that the Commission evaluate whether it would be appropriate to issue an order censuring, placing limitations on the activities, functions, or operations of, suspending for a period not exceeding 12 months, or revoking the registration of the NRSRO.[30]

- Proposed Rule 17g-1 would require an NRSRO to make the information and documents it submits in its application publicly available through its Web site or through another comparable readily accessible means within five business days of the Commission's granting of NRSRO registration status to a credit rating agency, the furnishing of an amendment to Form NRSRO, or the submission of the annual certification.

**Requests for Comment**[31]

The Commission requests comment on all aspects of Proposed Rule 17g-1. In addition, the Commission seeks comment on whether the five-day time limit for making non-confidential information in the application publicly available is appropriate, whether there are alternatives for making the requisite information public other than by means of an NRSRO's Web site, and whether it should define the term "promptly" in the provision of the Proposed Rule requiring an NRSRO to "promptly" update the information on the form to the extent an item or exhibit becomes materially inaccurate, with certain exceptions.

## Proposed Rule 17g-2 – Recordkeeping

Proposed Rule 17g-2 would require an NRSRO to make and keep current certain records relating to its business. In addition, the proposed rule would require an NRSRO to preserve those and other records for certain prescribed time periods. Such recordkeeping requirements would enable the Commission to monitor and examine whether an NRSRO is complying with the requirements of the other Proposed Rules. Proposed Rule 17g-2 also would require an NRSRO that uses a third-party record custodian and a non-resident NRSRO to provide the Commission with undertakings.[32]

## Proposed Rule 17g-3 – Annual Audit

Section 15E(k) of the Exchange Act requires an NRSRO to furnish to the SEC, on a confidential basis and at intervals determined by the SEC, financial statements and information concerning its financial condition. The SEC can prescribe as necessary or appropriate in the public interest or for the protection of the investors that NRSROs submit financial statements and information. Proposed Form NRSRO would require an NRSRO to submit the following information, in addition to financial statements, as of, or for the previous fiscal year: a list of large customers in terms of net revenues, information about revenues, and information about credit analyst compensation.[33]

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30 This course of action is provided for in Section 15E(d) of the Exchange Act. 72 Fed. Reg. 6386-87.

31 This memorandum does not contain a list of all requests for comment contained in the Release.

32 72 Fed. Reg. 6393-96. See 72 Fed. Reg. 6396 for a definition of "non-resident NRSRO."

33 72 Fed. Reg. 6396. For a definition of "net revenue," *see* instructions to Form NRSRO regarding Exhibit 10:

> *Net revenue* means all fees, sales proceeds, commissions, and other revenue received by the credit rating agency and its affiliates for any type of service or product, regardless of whether related to credit rating services, and net of any fees, sales proceeds, rebates, and other monies paid to the customer by the credit rating agency and its affiliates.

72 Fed. 0Reg. 6430 (emphasis in original). "Credit analyst" is defined in the instructions to Form NRSRO regarding Exhibit 8: "*Credit analyst* means an individual associated with the credit rating agency who is responsible for determining a credit rating using either a quantitative model, a qualitative model and analysis, or a combination of these methods." *Id.* (Emphasis in original).

Section 15E(k) also allows the SEC, by rule, to require that the financial statements be certified by an independent public accountant. Proposed Rule 17g-3 would effectuate this provision by requiring each NRSRO to furnish audited annual financial statements and certain schedules to the SEC. The Release states that the Commission believes that a 90-day period after the end of the fiscal year to prepare and furnish the financial statements and schedules required under Proposed Rule 17g-3 would be sufficient. If an NRSRO were to need additional time, it would be required to request an extension in writing, which the Commission could then grant either unconditionally or subject to certain conditions.[34]

## Proposed Rule 17g-4 – Procedures to Prevent the Misuse of Material Non-Public Information

Proposed Rule 17g-4 would require an NRSRO to establish, maintain, and enforce written policies and procedures to prevent the misuse of material, nonpublic information in violation of the Exchange Act. Under Proposed Rule 17g-4, the Commission would require an NRSRO to establish three specific types of policies and procedures:

- Procedures designed to prevent the inappropriate dissemination both inside and outside the NRSRO of material nonpublic information obtained for the purpose of issuing a credit rating. Some credit rating agencies, as part of their analyses, contact senior management of the obligors and issuers subject to their credit ratings. If conversations stemming from these contacts result in an issuer or obligor providing the credit rating agency with nonpublic information including contemplated business transactions or estimated financial projections, the rule would require the NRSRO to disclose such information solely for the purpose of developing a credit rating available to the public.

  The Release states that the Commission believes NRSROs should have flexibility to develop procedures tailored to their specific needs; however, the Commission also suggests safeguards such as requiring credit analysts to receive training in the laws governing misuse of nonpublic information, defining the persons within the NRSRO with whom a credit analyst can share the information, and requiring the credit analyst to take steps to safeguard documents containing the information. In addition, an NRSRO that does not use management contacts could prohibit credit analysts from contacting rated issuers or obligors;[35]

- Procedures designed to prevent an associated person or member of an associated person's household from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person possesses or has access to material nonpublic information obtained for the purpose of issuing a credit rating. Suggested, but not required, procedures could include those prohibiting associated persons from purchasing or selling a security or money market instrument subject to a pending rating action, requiring associated persons to obtain pre-approval before purchasing or selling a security or money market instrument, and requiring notification to associated persons that particular securities or money market instruments are on a "do not trade" list; and

- Procedures designed to prevent the inappropriate dissemination both inside and outside the NRSRO of a credit rating action prior to making the action readily accessible. While specific procedures are not prescribed under Proposed Rule 17g-4, as noted above, policies could include procedures designed to ensure that a credit rating action is issued in a way that makes it readily accessible to the market place, such

[34] *See* 72 Fed. Reg. 6396-97.

[35] It should be noted that credit rating agencies have commented that confidential information provided by issuers and obligors is extremely helpful to them in issuing credible and reliable ratings. Moreover, the Commission's Regulation FD, which governs the disclosure of material nonpublic information by issuers, contains an exception that allows issuers to intentionally disclose material nonpublic information to a credit rating agency without making a simultaneous public disclosure of the information. The selective disclosure to the credit rating agency, however, must be solely for the purpose of developing a publicly available credit rating. Rule 100(b)(2)(iii) of Regulation FD. *See also* 72 Fed. Reg. 6398.

as posting the credit rating or an announcement of the credit rating action on the NRSRO's Web site or through a news or information service. The policies also could include procedures prohibiting credit analysts from disclosing the pending action to persons outside the NRSRO and to persons inside the NRSRO who do not require knowledge of the pending action. Should the NRSRO require conversation with the issuer or obligor, the Commission states in the Release that the rule would require such an NRSRO to have procedures in place to ensure that the discussions with the issuer or obligor do not lead to the disclosure of the information to anyone not authorized to receive it.

The Commission also states in the Release that it expects most credit rating agencies already have procedures in place to address misuse of material nonpublic information. Nevertheless, the Commission states that it anticipates that some NRSROs will need to modify their procedures to comply with the Proposed Rule.[36]

## Proposed Rule 17g-5 – Management of Conflicts of Interest

Proposed Rule 17g-5 would require an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed, taking into consideration the nature of its business, to address and manage the following types of conflicts of interest relating to issuance of credit ratings:[37]

- Receiving compensation from a rated person for a service or product of an NRSRO or its affiliates;
- Having an ownership interest (securities or otherwise) in an issuer or obligor subject to a credit rating of the NRSRO;
- Receiving compensation from subscribers that use the credit ratings of the NRSRO for regulatory purposes;
- Having an ownership interest in a subscriber that uses the NRSRO's credit rating for regulatory purposes;
- Having a business relationship or affiliation with a rated issuer or obligor, underwriter of a rated issuer's securities, or a subscriber that uses the credit ratings for regulatory purposes;
- Being an officer or director of a rated issuer or obligor, underwriter of a rated issuer's securities, or subscriber that uses the NRSRO's credit ratings for regulatory purposes; and
- Any other type of conflict that the NRSRO identifies on proposed Form NRSRO.

Proposed Rule 17g-5 would prohibit the following four types of conflicts of interest:

- Conflicts relating to the issuance of a credit rating where the person soliciting the credit rating was the source of 10 percent or more of the total net revenue of the NRSRO and its affiliates in the most recently ended fiscal year;
- Conflicts relating to the issuance of a credit rating where the NRSRO, a credit analyst responsible for the credit rating, or a person associated with the NRSRO responsible for approving the credit rating, owns securities of, or has any other ownership interest in the rated person, or is a borrower or lender with respect to the rated person;
- Conflicts relating to the issuance of a credit rating where the rated entity is a person associated with the NRSRO; and
- Conflicts relating to the issuance of a credit rating where the credit analyst responsible for the credit rating, or a person associated with the NRSRO responsible for approving the credit rating, also is an officer or director of the person that is the subject of the credit rating.[38]

[36] *See* 72 Fed. Reg. 6397-99.

[37] Exchange Act Rule 17g-5(b).

[38] *See* 72 Fed. Reg. 6399-6401.

## Proposed Rule 17g-6 – Prohibited Unfair, Coercive, or Abusive Practices

Section 15E(i)(1) of the Exchange Act provides that the SEC must adopt rules prohibiting any act or practice by an NRSRO that it determines is unfair, abusive, or coercive, including certain specified acts and practices.[39] Proposed Rule 17g-6 would define the following acts and practices as unfair, abusive, or coercive:

- Conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor or an affiliate thereof of other services or products, including pre-credit rating assessment products of the NRSRO or any person associated with such NRSRO;
- Modifying or threatening to modify a credit rating or otherwise departing from systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases or will purchase the credit rating or any other service or product of the NRSRO or any person associated with the NRSRO;
- Lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such a pool or part of such transaction, as applicable, also is rated by the NRSRO; and
- Notching, which is defined as issuing or threatening to issue a lower credit rating; lowering or threatening to lower an existing credit rating; refusing to issue a credit rating; or withdrawing a credit rating with respect to a structured product unless the NRSRO also rates a portion of the assets underlying the structured product.[40]

Because entities with lower credit ratings must pay higher interest rates to borrow funds or issue debt (in some cases, a low credit rating could block an entity's access to credit), it is in a borrower's economic interest to have a high credit rating. Thus, the potential for an NRSRO to have inappropriate leverage over an issuer or obligor is significant. The NRSRO could use such leverage to obtain business, or issue a lower rating or lower an existing rating to punish an issuer or obligor for not purchasing the credit rating or another service of the NRSRO or its affiliates.[41]

An additional reason to prohibit the practices listed above is that they could lead to credit ratings that would mislead the marketplace, undermining the regulatory use of NRSRO credit ratings. According to the Release, agreements between NRSROs (or their affiliates) and obligors or issuers should have no bearing on the NRSRO's credit assessment of an issuer or obligor. The Commission points out, however, that it recognizes the limitation in Section 15E that prevents it from adopting rules that regulate the substance of credit ratings. The Commission states in the Release that it does not believe the prohibitions described above would interfere with the process by which an NRSRO assesses the creditworthiness of a security, money market instrument, or obligor because agreements between NRSROs (or their affiliates) and issuers or obligors are not necessarily relevant to credit assessment.[42]

In addition to the acts and practices specified in the Act, Proposed Rule 17g-6 would define issuing credit ratings that are not initiated at the request of the issuer, obligor, or underwriter ("Unsolicited Credit Rat-

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39 *See* Section 15E(i)(1)(A)-(C) of the Exchange Act. The Commission proposes to prohibit the specified practices and acts with one conditional exception. 72 Fed. Reg. 6401.

40 72 Fed. Reg. 6401-03. Nonetheless, the SEC states in the Release that it believes there can be legitimate reasons for an NRSRO to refuse to rate a structured product unless it has rated the underlying assets; therefore, it proposes that an NRSRO may refuse to initiate a rating or withdraw an existing rating in certain circumstances. This exception only would apply to the prohibition (in paragraph (a)(4) of Proposed Rule 17g-6) against refusing to rate the security or withdrawing a rating; it would not apply to issuing or threatening to issue a lower credit rating or lowering or threatening to lower an existing credit rating. According to the Release, the Commission proposes this "conditional exception" because it "preliminarily does not believe it would be appropriate" to require an NRSRO to issue or maintain a rating when the NRSRO has rated less than 85 percent of the market value of the underlying assets. 72 Fed. Reg. 6403.

41 72 Fed. Reg. 6402. Conversely, an NRSRO could promise to issue or modify a credit rating in a manner that results in a higher rating than would have resulted from use of established methodologies as a reward for purchasing a credit rating or other services or products. *Id.*

42 *Id.*

ings") as unfair, coercive, or abusive, and thus would prohibit NRSROs from issuing Unsolicited Credit Ratings.[43]

## Conclusion

Congress has created a unique regulatory scheme for NRSROs. A comparison of the NRSRO requirements with the more typical requirements for broker-dealers is illustrative. The Exchange Act generally requires all broker-dealers to register with the Commission.[44] By comparison, Section 15E of the Exchange Act does not require credit rating agencies to register for NRSRO status; registration is voluntary. Moreover, not every credit rating agency qualifies to register as an NRSRO, but rather rating agencies eligible to register as NRSROs include only those that have been in operation for at least three years immediately preceding submission of their applications and for which QIBs – commercial entities – will vouch. Of course, Congress was not simply attempting to register all credit rating agencies – it sought only to convey special status on those credit rating agencies that are "nationally recognized."

The contrast between the Proposed Rules for NRSRO registration and the substantive regulatory approach of the Investment Company Act of 1940 (the "Investment Company Act") is similarly noteworthy. For example, an Investment Company Act rule requires management to obtain a fidelity bond for officers and employees of the fund when registering an investment company, which is true substantive regulation.[45] By contrast, Section 15E of the Exchange Act specifically prohibits the SEC from using its authority to regulate the substance of credit ratings. The SEC attempts in the Proposed Rules to track these unusual requirements faithfully; however, they reflect a somewhat different statutory mandate.

Nonetheless, the Proposed Rules achieve a number of Congress's goals. Specifically, the Proposed Rules provide greater transparency in the registration process as well as objective standards. In addition, by issuing the Proposed Rules, the SEC undertakes to comply with Congress's mandate that the Proposed Rules consist of narrowly tailored provisions that effectuate the Act's objectives without regulating the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings. It remains to be seen whether the elaborate and detailed disclosure and other substantive requirements of the Act and the Proposed Rules will effectively allow or deter additional entrants in the credit rating agency business.

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This update was authored by Elliott R. Curzon (+1 202 261 3341; elliott.curzon@dechert.com), Stuart J. Kaswell (+1 202 261 3314; stuart.kaswell@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), and Cortney L. Scott (+1 949 442 6022; cortney.scott@dechert.com).

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43 72 Fed. Reg. 6403. This prohibition is not specifically identified in Section 15E(i)(1) of the Exchange Act; however, the Release states that it is related to the unfair, coercive, and/or abusive practices described in the statute. That is, the Commission states that it has preliminarily determined that it would be unfair, coercive, or abusive to issue an Unsolicited Credit Rating and communicate with the rated person to induce or attempt to induce the rated person to pay for the rating or another product or service of the NRSRO or its affiliates. *Id.*

44 Section 3(a)(4) of the Exchange Act defines "broker" and Section 3(a)(5) defines "dealer" (although both provisions include a number of exceptions); Section 15(a)(1) requires all broker-dealers to be registered with the Commission; and Section 15(a)(2) allows the Commission to exempt broker-dealers from registration either conditionally or unconditionally.

45 Rule 17g-1 under the Investment Company Act.

## Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.


**Margaret A. Bancroft**
New York
+1 212 698 3590
margaret.bancroft@dechert.com

**Allison R. Beakley**
Boston
+1 617 728 7124
allison.beakley@dechert.com

**Sander M. Bieber**
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

**Stephen H. Bier**
New York
+1 212 698 3889
stephen.bier@dechert.com

**Christopher D. Christian**
Washington, D.C.
+1 202 261 3321
christopher.christian@dechert.com

**Timothy M. Clark**
New York
+1 212 698 3652
timothy.clark@dechert.com

**Elliott R. Curzon**
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

**Douglas P. Dick**
Newport Beach
+1 949 442 6060
douglas.dick@dechert.com

**Steven S. Drachman**
New York
+1 212 698 5627
steven.drachman@dechert.com

**Jennifer O. Epstein**
London
+44 20 7184 7403
jennifer.epstein@dechert.com

**Ruth S. Epstein**
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

**Susan C. Ervin**
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

**Joseph R. Fleming**
Boston
+1 617 728 7161
joseph.fleming@dechert.com

**Brendan C. Fox**
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

**Wendy R. Fox**
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

**David M. Geffen**
Boston
+1 617 728 7112
david.geffen@dechert.com

**David J. Harris**
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

**Robert W. Helm**
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

**Jane A. Kanter**
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

**Stuart J. Kaswell**
Washington, D.C.
+1 202 261 3314
stuart.kaswell@dechert.com

**George J. Mazin**
New York
+1 212 698 3570
george.mazin@dechert.com

**Jack W. Murphy**
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

**John V. O'Hanlon**
Boston
+1 617 728 7111
john.ohanlon@dechert.com

**Fran Pollack-Matz**
Washington, D.C.
+1 202 261 3442
fran.pollack-matz@dechert.com

**Jeffrey S. Puretz**
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

**Jon S. Rand**
New York
+1 212 698 3634
jon.rand@dechert.com

**Robert A. Robertson**
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

**Keith T. Robinson**
Washington, D.C.
+1 202 261 3386
keith.robinson@dechert.com

**Patrick W. D. Turley**
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

**Anthony H. Zacharski**
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

**Alan Rosenblat**
Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

**Brian S. Vargo**
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

**Frederick H. Sherley**
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

**David A. Vaughan**
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Dechert LLP

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