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SEC Allows Existing Credit Rating Agencies to Act as NRSROs

SEC Action Follows Adoption of Final Rules for Registration of Credit Rating Agencies

Introduction

On June 28, 2007, the Securities and Exchange Commission (the "SEC" or the "Commission") announced that each of the credit rating agencies previously identified as a nationally recognized rating agency ("NRSRO") may continue to represent themselves or act as NRSROs. The SEC staff had previously granted a no-action letter to each of these firms and each has applied to be registered with the Commission as NRSRO under the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act").[1] The Commission allowed these firms to continue to represent themselves or act as NRSROs during Commission consideration of their applications.[2]

The SEC's action comes on the heels of the Commission's approval on May 23, 2007, of final rules implementing provisions of the Rating Agency Act.[3] That legislation established a deadline of June 26, 2007, by which time the Commission had to review, amend, or revise its existing rules and regulations which use the term "nationally recognized statistical rating organization," and issue an application for registration in final form. The SEC adopted its final rules on June 5, 2007, and they include registration, recordkeeping, financial reporting, and oversight requirements for credit rating agencies registered with the SEC as NRSROs, and replace the no-action letter process of identifying NRSROs.[4] The rule and form prescribing the process for a credit agency to apply for registration are effective immediately. The remainder of the final rules,[5] those governing recordkeeping, financial reporting, and oversight requirements became effective on June 26, 2007.

Background

On September 29, 2006, President Bush signed into law the Rating Agency Act, a statutory registration and regulatory framework for credit rating agencies seeking to obtain NRSRO status. The Rating Agency Act provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies, and directs the Commission to issue final rules no later than 270 days after its

1 Public Law No. 109-291.

2 SEC Press Release, 2007-124. The firms are: A.M. Best Company, Inc.; DBRS; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; Moody's Investors Service; Rating and Investment Information, Inc. and Standard and Poor's Ratings Services.

3 Exchange Act Release No. 34-55857 (June 5, 2007); 72 Fed. Reg. 33564 (June 18, 2007)(the "Adopting Release").

4 For a more detailed discussion of the proposed rules, see *DechertOnPoint* (Dechert LLP), March 2007, Issue 9, "SEC Proposes Rules for Registration of Credit Rating Agencies."

5 Rules 17g-2, 17g-3, 17g-4, 17g-5, 17g-6.

enactment (or by June 26, 2007). In the past, there has been no official definition of NRSRO or formal application process, and the staff of the SEC provided limited oversight of the credit rating industry by providing certain firms with a NRSRO designation.[6]

Credit rating agencies play an important role in the market by issuing an assessment on the creditworthiness of a particular company or security, such as a municipal bond or an asset-backed security. Many state and federal laws and regulations, and many corporate bylaws require the use of ratings from NRSROs.

Prior to the Rating Agency Act, in order to obtain NRSRO status, a credit rating agency requested from the SEC a no-action letter stating that the SEC staff will not recommend that the SEC take any enforcement action against persons who use the firm's credit ratings for purposes of certain SEC Rules, including the Net Capital Rule (Rule 15c3-1 under the Exchange Act) and the money market fund rule (Rule 2a-7 under the Investment Company Act of 1940, which limits money market funds to investing in securities rated by NRSROs in the highest categories). The SEC has stated that the single most important factor in issuing the NRSRO designation is whether the firm has been "nationally recognized" as an issuer of credible and reliable ratings; but, in practice, to become "nationally recognized," a firm needs the NRSRO designation.

As noted above, there are currently only six NRSROs, two of which, S&P and Moody's, control over 80% of the credit rating industry. The SEC has been criticized for not awarding more NRSRO designations and thereby perpetuating an anticompetitive industry, and for failing to supervise and inspect NRSROs to ensure compliance with the federal securities laws and requirements. NRSROs have been criticized with respect to conflicts of interest, ratings that significantly lag the markets, and anticompetitive and abusive business practices.

The Rating Agency Act is intended to introduce greater transparency, accountability, and competition into the credit rating industry. Under the Rating Agency Act, each credit rating agency that elects to be treated as an NRSRO must register with the SEC. The application must contain, among other things:

- credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable);
- the procedures and methodologies that the applicant uses in determining credit ratings;
- policies or procedures adopted and implemented by the applicant to prevent the misuse of material, non-public information;
- the organizational structure of the applicants;
- any conflict of interest relating to the issuance of credit ratings by the applicant;
- on a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services of the applicant, by amount of net revenues received in the fiscal year immediately preceding the date of submission of the application; and
- on a confidential basis, certain written certifications from qualified institutional buyers.

The SEC has 90 days to approve the registration or institute proceedings to determine whether registration should be denied. At the end of each calendar year, each NRSRO must amend its registration, certifying that the information and documents in the application for registration continue to be accurate and list any material change that occurred to such information during the previous calendar year. Subject to Section 24 of the Exchange Act with respect to the public availability of information, the Rating Agency Act also requires the NRSRO to make the registration information and any amendments thereto publicly available on its web site, or through another comparable, readily accessible means.

The Rating Agency Act mandates that the Commission adopt narrowly tailored provisions and provides the SEC with rulemaking authority to prescribe:

- the form of the application (including requiring the furnishing of additional information);
- the records an NRSRO must make and retain;

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

- the financial reports an NRSRO must furnish to the SEC on a periodic basis;
- the specific procedures an NRSRO must implement to manage the handling of material non-public information;
- the conflicts of interest an NRSRO must manage or avoid altogether; and
- the practices that a NRSRO must not engage in if the Commission determines they are unfair, coercive, or abusive.

The Rating Agency Act provides that the SEC has exclusive authority to enforce provisions of the Rating Agency Act with respect to any NRSRO. However, the SEC is prohibited from regulating the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings.

The SEC had until June 26, 2007, to review, amend, or revise its existing rules and regulations that use the terms "nationally recognized statistical rating organization" or "NRSRO," and issue an application for registration in final form.

The Final Rules

On February 2, 2007, the SEC proposed a package of rules pursuant to these grants of rulemaking authority.[7] On May 23, 2007, the SEC adopted the following six rules and a registration form to implement provisions of the Rating Agency Act, substantially as proposed.[8]

Rule 17g-1 requires a credit rating agency to apply to the Commission for registration as an NRSRO and, if approved, to provide updated information (when certain information provided becomes materially inaccurate) and an annual certification on Form NRSRO. The credit rating agency is required to provide information on Form NRSRO such as:

- the classes of credit ratings for which it is applying to be registered;
- credit ratings performance measurement statistics;
- a general description of its procedures and methodologies for determining credit ratings;
- organizational structure;
- procedures to prevent the misuse of material nonpublic information;
- conflicts of interest;
- procedures to address and manage conflicts of interest;
- a description of the minimum qualifications of its credit analysts and credit analyst supervisors; and
- information regarding the designated compliance officer.

The credit rating agency also must provide certifications from qualified institutional buyers; a list of its largest customers; audited financial statements; and certain summary financial information. An applicant may request that the Commission keep this information confidential. The Commission will keep this information confidential to the extent permitted by law.

Rule 17g-2 requires an NRSRO to make and retain certain records relating to its business as a credit rating agency. The rule also prescribes the time periods and manner in which the records must be maintained.

Rule 17g-3 requires NRSROs to furnish the Commission, on a confidential basis, certain financial reports, on an annual basis, including audited financial statements. In addition to the audited financial statements, the rule also requires NRSROs to furnish separate unaudited financial reports that will assist the Commission in carrying out its statutory responsibilities under the Rating Agency Act.

Rule 17g-4 requires an NRSRO to have written policies and procedures reasonably designed to prevent:

- the inappropriate dissemination within and outside the NRSRO of material nonpublic information obtained in connection with the performance of credit rating services;

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7 Exchange Act Release No. 34-55231 (Feb. 2, 2007); 72 Fed. Reg. 6378 (Feb. 9, 2007)(the "Proposing Release").

8 SEC Press Release, 2007-104.

- a person within the NRSRO from purchasing, selling, or otherwise benefiting from any transaction in securities or money market instruments when the person is in possession of material nonpublic information obtained in connection with the performance of credit rating services that affects the securities or money market instruments; and

- the inappropriate dissemination within and outside the NRSRO of a pending credit rating action before issuing the credit rating.

Rule 17g-5 requires an NRSRO to disclose and manage those conflicts of interest that arise in the normal course of engaging in the business of issuing credit ratings. For example, one conflict of interest for NRSROs will include being paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.

Rule 17g-6 prohibits the NRSRO from engaging in certain unfair, coercive, or abusive practices. For example, an NRSRO may not threaten to issue a credit rating that is not determined in accordance with the NRSRO's established procedures and methodologies for determining credit ratings, based on whether the rated person will purchase or purchases another product of the NRSRO.

Rule 17g-6 also prohibits an NRSRO from 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 or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the NRSRO, where such practice is engaged in by the NRSRO for an anticompetitive purpose.

The Proposing Release also included a provision under Rule 17g-6 that would have banned the practice of issuing an unsolicited rating and then soliciting the rated person to pay for the credit rating or another product or service. In light of comments, however, the SEC recommended that this prohibition be removed from the final rule until it has gained better understanding through its examination function of how credit rating agencies define "unsolicited credit ratings" before it revisits this provision.[9] Furthermore, in the Adopting Release, the SEC notes that it intends to monitor for now how the NRSRO regulatory program impacts other SEC rules, such as the Net Capital Rule (Rule 15c3-1 under the Exchange Act) and the money market fund rule (Rule 2a-7 under the Investment Company Act of 1940.)[10]

Conclusion

The Rules achieve a number of Congress's goals. Specifically, the Rules provide greater transparency in the registration process as well as objective standards. In addition, by adopting Rules, the SEC undertakes to comply with Congress's mandate that the 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 a credit determines credit ratings. Nonetheless, there is a possibility that the elaborate and detailed disclosure and substantive provisions of the Rules may deter further access to the field.

The Commission's action of allowing existing credit rating agencies to continue to represent themselves or act as NRSROs is significant because it will allow other market participants that rely on ratings to continue to operate without waiting for the SEC's action on each firm's application.

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9 Adopting Release at 178; 72 Fed. Reg. 33605.

10 *Id.* at 9; 72 Fed. Reg. 33566.

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