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A legal update from Dechert's Financial Services Group

Increased SEC Scrutiny of NRSROs and SEC Report Leads to New Rule Proposals Intended to Increase Accountability, Transparency, and Competition in the Industry

Introduction

On July 8, 2008, the Securities and Exchange Commission (the "SEC," or "Commission") released a report ("Report") discussing the policies and practices of credit rating agencies and summarizing the findings from examinations (the "Examinations") of three credit rating agencies initiated in August 2007 by the SEC's Staff (the "Staff"). The Examinations focused on the rating agencies' roles in the events leading up to the collapse of the subprime mortgage-related securities markets.[1]

On June 16, 2008, motivated in part by the then-ongoing Examinations, the SEC proposed amendments (the "Amendments") to various rules under the Securities Exchange Act of 1934 (the "Exchange Act") relating to the policies and practices of nationally recognized statistical rating organizations ("NRSROs").[2]

Background

The subprime mortgage crisis that began in 2007 and the resulting effects on credit markets and the economy as a whole has focused intense scrutiny on the participants in the subprime debt market. The Commission and others are particularly concerned with the role played by NRSROs.

Under the authority conferred by the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"),[3] the SEC investigated NRSROs' rating activities of structured products, including residential mortgage-backed securities ("RMBS") and collateralized debt

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1 *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, available at: http://www.sec.gov/news/studies/2008/craexamination070808.pdf (July 8, 2008). The three agencies the Staff examined were Fitch Ratings, Ltd., Moody's Investor Services, Inc. and Standard & Poor's Ratings Services.

2 Rel. No. 34-57967 (June 16, 2008).

3 *See 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) ("Senate Report"), p. 1; *see also DechertOnPoint* (Dechert LLP), July 2007, Issue 19, "SEC Allows Existing Credit Rating Agencies to Act as NRSROs" for a more detailed discussion of the Rating Agency Act.

obligations ("CDOs"), to review whether the NRSROs adhered to their stated and documented procedures and methodologies, with an eye toward assessing whether their ratings may have been impaired by conflicts of interest. The Commission also received input from other regulators and supervisors of the financial markets in developing recommendations and principles for NRSROs.[4] Through their efforts, the Commission has identified areas in which its current NRSRO rules can be augmented, with a stated goal of improving the quality of credit ratings determined by NRSROs generally, and, in particular, for structured finance products.

SEC Staff Examinations

Through the Examinations, the SEC sought to develop an understanding of the rating agencies' ratings of RMBS and CDOs and to identify issues related to these practices. The SEC Staff examined the NRSROs' ratings policies, procedures, and practices; the adequacy of the NRSROs' disclosure of ratings processes and methodologies used; whether NRSROs complied with their own ratings policies and procedures; reviewing the efficacy of the NRSROs' conflict of interests procedures; and whether ratings were unduly influenced by conflicts of interests. The Examinations included extensive onsite interviews of the NRSROs' staff; the review of the NRSROs' internal records, including written policies, documentation of conflicts of interest, and public disclosures of procedures and methodologies; the review of deal files for structured products ratings; the review of internal audit reports; the review of over two million emails and instant messages; and the review of all public disclosures and documents, including SEC filings.

Among several issues identified, the Report noted that: (1) some of the NRSROs have struggled with the growth in the number and complexity of RMBS and CDO deals since 2002; (2) significant aspects of the NRSROs' ratings processes were not disclosed; and (3) the documentation of policies and procedures for rating structured products was lacking. The Report noted that one of the major gaps in the ratings process was the inadequate documentation of rationales for deviations from models used for rating actions and decisions. Also, the Report noted that the ratings surveillance processes were less thorough than the processes used for initial ratings, as were the management of conflicts of interests and the variances in internal audit processes. The NRSROs that were examined have committed to taking remedial measures to address the issues identified in the Report.

Overview of the Proposed Rules

The Amendments impose additional requirements on NRSROs and address concerns about the integrity of NRSROs' rating procedures and methodologies. The Amendments to Rules 17g-5, 17g-2, and 17g-3 would regulate and, in some cases, attempt to eliminate conflicts of interests in the credit rating agency industry. Amendments to Rule 17g-7 would impose new reporting and symbology requirements to differentiate credit ratings for structured finance products. In a related release, the Commission proposed additional rule changes intended to reduce reliance in the Commission's rules on NRSRO ratings, promoting increased investor due diligence.[5]

Increase Disclosure or Eliminate Conflicts of Interest

Amendments to Rules 17g-5, 17g-2, and 17g-3 are intended to increase disclosure of some conflicts of interest and prohibit others entirely. The Amendments would prohibit a credit rating agency from issuing a rating on a structured product unless there was information available on the assets underlying the product. Furthermore, the Amendments would require NRSROs to make all ratings publicly available. This disclosure is intended to allow the market to compare different NRSROs' performance. The Commission also seeks to address the issuer conflict inherent in the issuer pay model used by many NRSROs by prohibiting the individuals employed by a NRSRO that negotiate the ratings fees from participating in the rating of transactions.

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4 *See Policy Statement on Financial Market Developments*, from the President's Working Group on Financial Markets, March 2008 (available at: www.ustreas.gov); *The Role of Credit Rating Agencies in Structured Finance Markets*, from the International Organization of Securities Commissions ("IOSCO"), March 2008 (available at: www.iosco.org); and *The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, from the Financial Stability Forum, April 2008 (available at: www.fsforum.org).

5 Rel. No. IC-28327 (July 1, 2008).

The Commission also wants to increase competition by encouraging unsolicited ratings and imposing additional disclosure requirements, including requiring that NRSROs:

- publish performance statistics for 1, 3, and 10 year increments in each rating category, to facilitate comparisons with competitors in the industry,
- disclose reliance on the due diligence of others in verifying the assets underlying structured products,
- disclose how frequently they review their ratings and manage models used in the ratings process,
- issue annual reports on the number of ratings actions taken in each ratings class,
- maintain an XBRL[6] database of all ratings actions on the NRSROs' websites,
- disclose information used to determine the rating of structured products, including information on the underlying assets, and
- document the rationale for any significant out of model adjustments.

Differentiate Between Structured Product Ratings and Other Ratings

Amendments to Rule 17g-7 are intended to regulate how NRSROs differentiate their credit ratings for structured products from those for other debt securities. The Commission seeks to curb uninformed investor reliance on ratings of structured products because structured products contain different risks than do other debt instruments.

Historically, NRSROs have applied the same ratings symbols to all rated debt securities. The Amendments mandate the use of different symbols to rate structured products and bonds or, in the alternative, increased disclosure to make clear the differences between NRSROs' ratings for structured products and other debt securities.

6 eXtensible Business Reporting Language.

Discussion: The Proposed Amendments

Proposed Amendments to Rule 17g-5

Rule 17g-5 identifies and addresses a series of conflicts arising from the business of determining credit ratings, prohibiting some and requiring the disclosure and management of others.[7] "Being repeatedly paid by certain arrangers to rate structured finance products" is being added to list of conflicts that must be disclosed and managed. The Commission believes this type of conflict is particularly acute because certain arrangers of structured finance products bring substantial ratings business to NRSROs and at the same time bring the potential to exert undue influence on NRSROs.

Proposed new paragraph (a)(3) would require that as a condition of an NRSRO rating a structured finance product, information provided to and used by the NRSRO in determining the credit rating must be disclosed and broadly disseminated. The disclosure would allow other NRSROs the opportunity to use the information to rate the instrument, resulting in unsolicited ratings which could be used to evaluate the ratings issued by the NRSRO hired to rate the product and, in turn, potentially expose ratings influenced by a desire to obtain more business from the arranger.

Sources of information to be included in the disclosure include information provided by the "issuer, underwriter, sponsor, depositor or trustee." The SEC's goal is to promote the effective management of conflicts of interest and increase the transparency of the structured products rating process. An additional SEC goal is to promote the unsolicited issuance of ratings and the monitoring of instruments' creditworthiness by NRSROs that are not hired by the arranger, thus increasing competition and accountability in the industry.

These disclosure requirements would include only information that the NRSRO took into account in generating the credit rating or in performing rating surveillance. Information used in performing rating surveillance would need to be disclosed at the time it is provided to the NRSRO. The nature of the disclosures, including the manner and breadth and how widely the information is disseminated, would depend on the

7 The list of conflicts that must be disclosed and managed is set forth in subsection (a)(3) of Rule 17a-5.

nature of the offering for the rated structured finance product.

The Commission is also proposing Amendments to Rule 17g-5(c) to add three additional paragraphs that would function to prohibit three specific conflicts of interest in the credit rating industry. The first prohibition, in new paragraph (c)(5), would prohibit an NRSRO from issuing a rating where the NRSRO or person affiliated with the NRSRO has made recommendations to the issuer about the corporate or legal structure, assets, liability, or activities of the obligor or issuer of the security. The goal of new paragraph (c)(5) is to prevent credit analysts from making recommendations about how to obtain a desired credit rating during the rating process.

The second prohibition, in new paragraph (c)(6), would prohibit persons within the NRSRO who have responsibility for participating in determining credit ratings from negotiating fees paid for a rating. The goal of new paragraph (c)(6) is to separate the role of those engaged in fee discussions from those engaged in analysis, thus preventing business considerations from undermining the objectivity of the rating process.

The third prohibition, in new paragraph (c)(7), would prohibit obligors, issuers, underwriters, and sponsors from giving gifts, including entertainment, over $25 in value to credit analysts and persons on credit rating committees. This prohibition is intended to prevent influence on the objectivity of credit rating analysts.

Proposed Amendments to Rule 17g-2

Rule 17g-2 requires NRSROs to make and retain certain business records. The Commission is proposing to amend Rule 17g-2 to require NRSROs to make and retain certain additional records, and to make some of these new records publicly available.

The proposed Amendments include new paragraph (8), requiring NRSROs to keep records of all rating actions, including initial ratings, upgrades, downgrades, and placements on watch for upgrade or downgrade, and make them publicly available on their websites. Other information to be required in these records includes dates of rating actions, and, if applicable, the CUSIP for the rated security or the CIK number for the rated obligor. In a related Amendment, the Commission is proposing to amend Rule 17g-2(d) to require these records to be available in XBRL format. The purpose of these Amendments is to make available the raw data with which market participants can compare how NRSROs initially rate obligors and securities and subsequently adjust those ratings. An SEC goal of these Amendments is to foster both accountability and competition among NRSROs.

The Commission is also proposing Amendments to paragraph (a)(2) of Rule 17g-2 to require an additional record to be made for each current credit rating. If a quantitative model is a "substantial component" in the process of determining a credit rating, a record must be made to document the rationale for any material difference between the credit rating implied by the model and the final credit rating issued. The substantial component determination is left to the discretion of the NRSRO issuing the rating, as is the determination of which differences are "material." The SEC's goal of this Amendment is to increase the accountability of NRSROs by determining whether the NRSROs followed their disclosed and internally documented procedures for determining credit ratings.

Proposed Amendments to Rule 17g-3

Rule 17g-3 requires an NRSRO to submit annually to the Commission, within 90 days of the end of its fiscal year, certain reports including: audited financial statements; unaudited financial statements; unaudited consolidated financial statements of the parent of the NRSRO, if applicable; an unaudited report concerning the revenue categories of the NRSRO; an unaudited report concerning the compensation of the NRSRO's credit analysts; and an unaudited report listing the largest customers of the NRSRO. The Commission is proposing to add a new paragraph, (a)(6), to Rule 17g-3 to require an additional annual report on the number of credit rating actions taken during the fiscal year in each class of security for which the NRSRO is registered. The new paragraph is intended to ensure the inclusion of credit ratings actions on structured products that would not otherwise be included in the current Rule 17g-3 reporting requirements. Such a report would improve the focus of SEC examination resources.

Proposed New Rule 17g-7

Proposed new Rule 17g-7 is intended to improve investor understanding of the differences between the credit ratings for structured finance products and those for other rated debt securities. The Commission is concerned that some investors are not aware that the risk characteristics for structured finance products are different than other types of rated instruments.

Under the proposed rule, each time an NRSRO publishes a credit rating for a structured product, the NRSRO would also be required to publish a report describing how the credit rating procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments. As an alternative to such a report, an NRSRO could use ratings symbols for structured finance products that differentiate them from the credit ratings for other types of debt securities. The SEC's goal is to foster greater investor independence, and the Commission believes that under this new rule investors will be able to perform a more vigorous risk analysis.

Conclusion

The SEC has solicited comments to the proposed rules. Comments on the Amendments by the credit rating and securities industries and others may result in modification of some of the details. Comments are due by July 25, 2008. As the Amendments may have substantial and perhaps unintentional impacts on many participants in the structured product industry (including asset classes other than RMBS and CDO's such as credit cards, auto loans and CMBS), we urge our clients to contact us with any questions and to submit comments to the SEC prior to the deadline.

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