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SEC Adopts New Rules for Credit Rating Agencies

The Securities and Exchange Commission has issued new rules under the Credit Rating Agency Reform Act of 2006 that will become effective on April 10. The Act for the first time required registration of nationally recognized statistical rating organizations ("NRSROs") and gave the SEC authority to impose reporting and recordkeeping requirements on NRSROs and to conduct examinations of NRSROs. The Act prohibits the SEC from regulating the "substance of the credit ratings or the procedures and methodologies" by which a credit rating agency determines its ratings.

The new SEC rules are designed to address practices identified by the SEC staff in its initial examinations of the three largest NRSROs and, specifically, to address concerns about the integrity of the process by which NRSROs rate structured finance products, particularly mortgage related securities. The new rules require:

- Enhanced disclosure of performance measurement statistics and ratings methodologies,
- Website disclosure of the rating histories of a sample of issuer-paid credit ratings (with new rating actions reflected within six months),
- Additional record-keeping and annual reporting, and
- Adherence to additional restrictions designed to prevent conflicts of interest, including restrictions on providing advice to issuers on how to obtain favorable ratings.

The SEC also re-proposed rules relating to data disclosure and additional website disclosure of issuer-paid ratings.

Final Rules

Enhanced disclosure of performance measurement statistics and ratings methodologies

The new rules amended the instructions to Form NRSRO to require the following additional disclosures:

- Statistics on all upgrades, downgrades or defaults (relative to the initial rating) for each asset type over one-, three- and 10-year periods,
- Disclosure on whether and how information about verification performed on assets underlying or referenced by a security issued as part of an asset-backed securities ("ABS") transaction is relied on in determining credit ratings,

- Disclosure on whether and how the assessments of the quality of originators of assets underlying ABS play a role in the determination of a credit rating, and

- More detailed information on ongoing credit surveillance process, including the use of different models or criteria used for ratings surveillance in contrast to criteria used for the initial ratings.

Website disclosure of issuer-paid rating actions

The new rules require an NRSRO to publish a 10% sample of its rating actions for each class of credit rating for which the NRSRO is registered and has issued 500 or more issuer-paid credit ratings (*i.e.*, ratings that resulted from an issuer paying for the service) on its website in eXtensible Business Reporting Language ("XBRL") format after six months have elapsed since the date of each such rating action. Limiting the disclosure to a random 10% sample of rating actions is meant to alleviate concerns that publishing this data would reduce competition among NRSROs.

Record-keeping requirements

The new rules impose the following new record-keeping practices on NRSROs:

- NRSROs will be required to make and retain records of all rating actions from the initial rating to the current rating (including initial ratings, upgrades and downgrades, placements on watch for upgrades and downgrades, and withdrawals),

- If a quantitative model is a substantial component of the credit rating process for a structured finance product, NRSROs must keep records of the rationale for any material differences between the credit rating implied by the model and the final credit rating issued, and

- NRSROs will be required to retain records of any third-party complaints regarding the performance of a credit analyst in initiating, determining, maintaining, changing or withdrawing a credit rating.

Annual report on credit rating actions

The SEC's current rules require NRSROs to file a series of annual reports addressing, among other things, revenue categories, customers and compensation of analysts. The new rules require an additional annual report on the number of credit rating actions that occurred during the year for each class of security for which the NRSRO is registered.

Prohibited conflicts

The new rules impose additional restrictions on certain activities that could give rise to conflicts of interest. Importantly, the rules prohibit an NRSRO from issuing or maintaining a credit rating with respect to an obligor or security where the NRSRO made recommendations about the corporate or legal structure, assets, liabilities or activities of the obligor or issuer of the security. This prohibition, which is designed to prevent an NRSRO from rating its own work, will make it more difficult for issuers and credit rating agencies to engage in dialogue about the consequences of different structuring options.

The new rules also prohibit rating agency personnel who have made recommendations about a particular issuer, or were involved in determining credit ratings or in developing methodologies for such issuer, from taking part in any fee discussions, negotiations or arrangements with that issuer. In addition, rating agency personnel will now be prohibited from accepting gifts worth more than $25 from issuer clients.

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Proposed Rules

The SEC has also re-proposed two rules, which are open for public comment through March 26, 2009.

Disclosure of data by an NRSRO

The SEC has indicated an interest in encouraging rating agencies (including rating agencies that are not NRSROs) to share their competing ratings. The SEC originally proposed that an NRSRO publicly disclose significant data relating to the structured finance products provided to the NRSRO by the deal arranger. After receiving comments on this proposal, the SEC has scaled back the proposal by placing the burden on the deal arranger to disclose such data instead of the NRSRO. The SEC has also proposed that NRSROs seeking competing ratings certify that the information is being accessed solely to determine credit ratings.

Additional internet disclosure of issuer-paid ratings

A second proposal would require an NRSRO to publish all of its issuer-paid rating actions on its website in XBRL format. To protect the revenues NRSROs derive from selling downloads and data feeds of their credit ratings, a rating action would not need to be disclosed until 12 months after the action is taken. The SEC is also seeking comment on whether this proposal should be extended to ratings agencies that sell their ratings to investors.

Deferred Proposals

Rating symbols

The SEC has deferred action on whether to impose rules that would require NRSROs to change their rating symbols specifically for structured finance products.

SEC reliance on credit ratings

The SEC has also deferred action on whether to substantially eliminate references to NRSRO credit ratings in its rules and forms and whether, in lieu of citing credit ratings, to place greater emphasis on management's analysis of the assets.

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Links to the SEC's releases are as follows:

Final rule release:
http://www.sec.gov/rules/final/2009/34-59342.pdf

Re-proposing release:
http://www.sec.gov/rules/proposed/2009/34-59343.pdf

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum may be addressed to any of the following:

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