

**MEMO# 23248**

February 12, 2009

## **SEC Adopts Amendments to NRSRO Rules**

[23248]

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TO: SEC RULES MEMBERS No. 15-09  
EQUITY MARKETS ADVISORY COMMITTEE No. 4-09  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 2-09  
FIXED-INCOME ADVISORY COMMITTEE No. 2-09  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 3-09  
INST. MONEY MARKET FUNDS ADVISORY COMMITTEE No. 3-09     RE: SEC ADOPTS  
AMENDMENTS TO NRSRO RULES

Over the summer, the Securities and Exchange Commission proposed three related actions to foster increased transparency, accountability, and competition in the credit rating agency industry. The first proposal was designed to improve investor understanding of credit ratings through enhanced disclosure of nationally recognized statistical rating organizations (“NRSROs”) methods and performance data, and to promote investor confidence in credit ratings by minimizing conflicts of interest. [\[1\]](#) The second proposal would require NRSROs to distinguish their ratings for structured finance products from other classes of credit ratings. [\[2\]](#) The third proposal would end the use of NRSRO credit ratings in certain SEC rules. [\[3\]](#) In December 2008, the Commission voted to adopt the first proposal but the Adopting Release was not issued until February 2, 2009. [\[4\]](#) The Commission has yet to act on the second or third proposals.

Specifically, the Commission adopted, with revisions, a series of amendments to its existing rules governing the conduct of NRSROs and the transparency of the ratings process. The rule amendments generally require an NRSRO (1) to provide enhanced disclosure of performance measurement statistics and the procedures and methodologies used by the NRSRO in determining credit ratings for structured finance products and other debt securities; (2) to make, preserve, and provide to the Commission and the public certain additional records; and (3) to avoid engaging in certain practices that create conflicts of

interest. The Institute's comment letter supported the Commission's goals in proposing the amendments. [5] The adopted rule amendments are summarized below.

## **Amendments to Form NRSRO**

Credit rating agencies applying for NRSRO status and existing NRSROs must annually complete Form NRSRO. The amended rules make several changes to the instructions for Form NRSRO to enhance the disclosure information about an applicant credit rating agency or an NRSRO.

### **Enhanced Ratings Performance Measurement Statistics**

The amended rules will require disclosure of separate sets of default and transition statistics [6] for each class of ratings, [7] over 1, 3, and 10-year periods, [8] for which an NRSRO applicant is seeking registration or an NRSRO is registered. As proposed, the rule amendments included a catchall provision that would have required an applicant or NRSRO to provide statistics for any other broad class of credit ratings issued by the NRSRO. The Commission eliminated the proposed catchall provision from the final rule amendments. It added, however, language to the Form NRSRO instructions dividing the category of ratings entitled "government securities" into three classes: sovereigns, United States public finance, and international public finance. Accordingly, an applicant or NRSRO will be required to disclose separately default and transition statistics for each of these three classes of government securities.

The Commission also clarified that the class of "issuers of asset-backed securities" includes any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. In the Adopting Release, the Commission stated that this clarification will ensure that ratings actions for credit ratings of structured finance products that do not meet the narrower statutory definition of "issuers of asset-backed securities" provided in the Exchange Act are encompassed in the amended rules. The Commission also stated that generation of performance statistics as proscribed will assist users of credit ratings to compare the accuracy of NRSRO credit ratings on a class-by-class basis.

### **Enhanced Disclosure of Ratings Methodology**

The amended rules will require additional disclosure regarding the methodologies used by an NRSRO to determine credit ratings. First, an NRSRO will be required to disclose whether and, if so, how information about verification performed on the assets underlying a structured finance product is relied on in determining credit ratings. Second, it must disclose whether it considers qualitative assessments of the originator of assets underlying a structured finance product in the rating process for such products. Third, an NRSRO will be required to disclose the frequency of its surveillance efforts and how changes to its quantitative and qualitative ratings models are incorporated into the surveillance process. This third requirement will apply to all classes of credit ratings for which the NRSRO determines credit ratings, not solely to structured products. In adopting these rule amendments, the Commission stated its belief that the changes would provide greater

clarity around these particular areas of an NRSRO's rating process and allow users of credit ratings to better evaluate the quality of their ratings process.

## **Amendments to Recordkeeping Requirements**

The amended rules will require an NRSRO to make and retain certain additional records and to require that a portion of these new records be made publicly available.

### **Record of Ratings Actions**

The amended rules will require an NRSRO to make and retain a current record of the ratings history of each outstanding credit rating as part of its internal records that are available to Commission staff. In the Adopting Release, the Commission stated that this requirement will aid it in performing its examination and oversight functions.

In addition, the amended rules will require that an NRSRO make publicly available, on a six-month delayed basis, a random sample of 10% of the issuer-paid credit ratings and their histories for each class of credit rating for which the NRSRO is registered and has issued 500 or more issuer-paid ratings. The information must be made public on the NRSRO's corporate Internet Web site in XBRL format. [\[9\]](#) In addition, as an NRSRO withdraws ratings and rated instruments mature, the rule amendments will require the NRSRO to replace the rating to replenish the sample at the 10% level. The replacement must be a new randomly-selected rating from the impacted class of credit ratings. The Commission explained in the Adopting Release that this disclosure will aid it in performing its examination and oversight functions and will foster accountability and comparability – and hence, competition – among NRSROs. Further, use of the XBRL format will benefit market participants seeking to develop their own performance statistics using the ratings history data to be made public by the NRSROs.

### **Record of Material Deviation from Model Output**

The amended rules will require an NRSRO to make a record documenting the rationale when a final credit rating materially deviates from the rating implied by a quantitative model used in the rating process if the model was a substantial component of the rating process. This requirement will be limited to ratings of structured finance products. In the Adopting Release, the Commission explained that an NRSRO will be responsible for making the determinations related to “substantial component” and “material” as used in the requirement. An NRSRO should, therefore, document in its ratings methodologies the models it deems to be substantial components of a ratings process for structured finance products and the magnitude of deviation from the rating implied by the model and rating issued that it deems material. The Commission also stated its belief that this disclosure requirement will assist it to evaluate whether an NRSRO is adhering to its disclosed procedures for determining ratings.

### **Records Concerning Third-Party Analyst Complaints**

The amended rules will require an NRSRO to retain records of any complaints about the performance of a credit analyst. This requirement will apply (1) only to written communications (2) from persons not associated with the NRSRO. In adopting this requirement, the Commission explained that it will permit the Commission to review external complaints and how the NRSRO addressed them – in other words, how the NRSRO handled this particular conflict of interest.

## **Report of Credit Rating Actions**

The amended rules will require an NRSRO to provide the commission with an unaudited report of the number of credit rating actions (upgrades, downgrades, placements on credit watch, and withdrawals) during the fiscal year in each class of credit rating for which the NRSRO is registered with the Commission. As described in the Adopting Release, this report was designed to assist the Commission in its examination function of NRSROs.

## **Conflicts of Interest**

The current NRSRO regulatory regime identifies a series of conflicts of interest which are either prohibited outright or must be disclosed and managed. The amended rules add three additional conflicts to the outright prohibitions.

### **Prohibition from Rating Where the Obligor or Issuer Received Ratings Recommendations from the NRSRO**

The amended rules will prohibit an NRSRO from issuing or maintaining a rating where the NRSRO or a person associated with the NRSRO made recommendations about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. This prohibition will apply across all ratings classes and will not be limited to ratings for structured finance products. In the Adopting Release, the Commission stated that this prohibition is necessary to eliminate the conflicts that arise from NRSROs rating their own work. The Commission explained, however, that the prohibition is not meant to eliminate all communications between the NRSRO and the issuers, obligors, or underwriters – observing that feedback from the NRSRO allows the person seeking the rating to make adjustments. Instead, the amended rules were designed to target recommendations from the NRSROs. The Commission noted that NRSROs providing the greatest clarity to the marketplace about their ratings methodologies will need to provide less explanation during the ratings process.

### **Prohibition Related to the Participation of Certain Personnel in Fee Discussions**

The amended rules will prohibit an NRSRO from issuing or maintaining a rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in, determining, or approving credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including quantitative and qualitative models. The Commission clarified in the

Adopting Release that the rule captures persons involved in determining and approving credit ratings because either person could, in the context of negotiating fees, let business considerations undermine the objectivity of the rating process. This determination could create difficulties for a small NRSRO that may need to have some analysts or model developers participate in fee discussions given their staffing levels. Accordingly, the Commission determined that it will review request by small NRSROs for exemptions from the new prohibition based on their specific circumstances.

### Prohibition Related to the Receipt of Gifts

The amended rules will prohibit an NRSRO from issuing a rating where a credit analyst who participated in determining or monitoring the rating, or a person responsible for approving the rating, received gifts, including entertainment, from the obligor, issuer, or underwriter of the rated security, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than \$25. The \$25 limit is per analyst and per interaction, not a one-time or annual limit. In the Adopting Release, the Commission stated that the application of the prohibition is prospective and it will apply across all classes of credit ratings.

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### endnotes

[\[1\]](#) See Memo to SEC Rules Members No. 54-08, dated June 19, 2008 [22623].

[\[2\]](#) Id.

[\[3\]](#) See Memo to SEC Rules Members No. 58-08 and Investment Company Directors No. 9-08, dated July 8, 2008 [22659].

[\[4\]](#) See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 59342 (February 2, 2008) (“Adopting Release”). In addition to the Adopting Release, the Commission re-proposed certain rule amendments to its existing rules governing the conduct of NRSROs. The re-proposed rules will be described in a separate Institute memo.

[\[5\]](#) See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, SEC, dated July 25, 2008.

[\[6\]](#) The measurement statistics must include historical ratings transition and default rates within each of the credit rating categories, notches, grades, or rankings used by the applicant or NRSRO as an indicator of the assessment of the creditworthiness of an obligor, security, or money market instrument in each class of credit rating. The amended rules will not require the inclusion in the reported statistics of defaults that occur after a credit rating is withdrawn.

[\[7\]](#) The class of credit ratings include: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; (5)

issuers of government securities, municipal securities, or securities issued by a foreign government; or (6) a combination of one or more categories of obligors described in any of the previously listed categories. See Section 3(a)(62)(B) of the Securities Exchange Act of 1934.

[\[8\]](#) In the adopting release, the Commission clarified that the default statistics are for the most recent 1, 3, and 10-year periods, not the average over multiple 1, 3, and 10-year periods.

[\[9\]](#) To allow NRSROs subject to this requirement sufficient time to implement it, and the Commission time to develop the list of XBRL Tags for NRSROs, the compliance date for this provision is delayed until 180 days after publication in the Federal Register.

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