The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 22619

June 19, 2008

SEC Proposes to Amend Rules for NRSROs; Conference Call Scheduled for June 30

[22619]

June 19, 2008

TO: SEC RULES COMMITTEE No. 42-08
EQUITY MARKETS ADVISORY COMMITTEE No. 26-08
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 24-08
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 15-08
INST. MONEY MARKET FUNDS ADVISORY COMMITTEE No. 10-08
FIXED-INCOME ADVISORY COMMITTEE No. 16-08 RE: SEC PROPOSES TO AMEND RULES FOR NRSROS; CONFERENCE CALL SCHEDULED FOR JUNE 30

The Securities and Exchange Commission has proposed amendments to the rules it adopted pursuant to the Credit Rating Agency Reform Act of 2006. [1] The proposed amendments are designed to address concerns that have been raised about nationally recognized statistical rating organizations ("NRSROs") in light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages. The Release explains that the Commission will be proposing three sets of related amendments. The first two, included in the Release, address concerns related to the integrity of the NRSRO's credit rating procedures and the differentiation between ratings for structured finance products and other products. The third set of amendments, which will be considered at an upcoming Commission meeting, will address the role of NRSRO ratings in Commission rules.

Comments on the proposed amendments are due to the SEC thirty days after publication in the Federal Register. We have scheduled a conference call for Monday, June 30, at 2:00 p.m. Eastern time to discuss the Institute's comment letter on the proposal. In

preparation for the call, please consider the requests for comment highlighted in the memorandum. We also intend to discuss some of the broader issues related to credit rating agency reform, including reliance on ratings in regulations, an oversight body for credit rating agencies, and a single rating scale for municipal and corporate securities. The dial-in number for the conference call will be 1-877-601-3546 and the passcode for the call will be 48015. If you plan to participate on the call, please contact Jennifer Odom by email at jodom@ici.org or by phone at 202-326-5833. In the meantime, if you have any views on any of the issues discussed below, please contact Heather Traeger by email at htraeger@ici.org or by phone at 202-326-5920.

According to the Release, the proposed amendments are in response to concerns that have been raised about NRSROs in light of the role they played in the subprime loan crisis. Specifically, the Release states that the proposed amendments are designed to further the mandate of the Credit Rating Agency Reform Act of 2006 to "improve ratings quality…by fostering accountability, transparency, and competition in the credit rating industry."

Conflicts of Interest

Currently, an NRSRO is required to disclose and manage certain conflicts of interest identified in the Commission's rules that arise from the business of determining credit ratings. Certain conflicts of interest are prohibited outright because they would be difficult to manage given their potential to cause undue influence. The proposed amendments would add to the list of mandated disclosures and prohibitions.

New Disclosures

The proposed amendments would enhance the disclosure of information used in the rating process by adding to the list of conflicts of interest that must be disclosed and managed by an NRSRO. Currently, NRSROs are required to disclose and manage conflicts arising from being paid by issuers and underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite. Under the proposed amendments, an NRSRO would be required to take the additional step of disclosing and managing the conflict of repeatedly being paid by an issuer, sponsor, or underwriter to rate structured finance products.

As a condition of rating a structured finance product, the proposed amendments would require that the information provided to the NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed through a means designed to provide reasonably broad dissemination of the information. The condition would apply to information provided to the NRSRO by the issuer, underwriter, sponsor, depositor, or

trustee. The proposed amendments do not specify, however, the party that would need to disclose the information. In addition, the proposed amendments do not provide a safe harbor for an NRSRO that relies on a representation from one of the listed parties that the necessary information would be disclosed as required.

Specifically, the proposed amendments would require disclosure of the following information provided to the NRSRO in generating the credit rating or performing surveillance on the structured finance product:

- All information used in determining the initial credit rating, including information about the characteristics of the assets in the pool underlying the structured finance products and the legal documentation setting forth the capital structure of the trust, payment priorities with respect to the tranches, and all applicable covenants regarding the activities of the trust, and
- All information used in undertaking credit rating surveillance on the structured finance product, including information about the characteristics and performance of the assets underlying or referenced by the structured finance product.

The proposed amendments would exclude from disclosure most, if not all, communications that, according to the Release, "do not contain information necessary for the NRSRO to determine an initial credit rating or perform surveillance on an existing credit rating." The Release states that the disclosure would not include any personal identifying information on individual borrowers or properties.

The proposed amendments would provide that that timing and scope of the disclosures related to the initial credit rating would depend on the nature of the offering: public, private or offshore. In a public offering, the information would need to be disclosed on the date the underwriter and the issuer or depositor set the offering price of the securities being rated ("pricing date"). In a private or offshore offering, the information would need to be disclosed to investors in the offering and to entities meeting the definition of "credit rating agency" [2] via a password-protected Internet Web site and on the pricing date. After the offering closes, the information would be required to be disclosed publicly. The Release provides detailed guidance on how the information would need to be disclosed under the proposed amendments and consistent with the Securities Act of 1933.

The Release states that the proposed amendments are designed to increase the transparency of the rating process by exposing it to greater scrutiny, and to increase competition by creating the opportunity for other NRSROs to use the disclosed information to also rate the structured finance product. The Release also states that this disclosure may operate as a check on the inaccuracy and incompetence of a credit rating.

The Commission seeks comment on several aspects of the new disclosures including:

- whether the information proposed to be disclosed is sufficient to permit the determination of an unsolicited credit rating;
- whether the Commission should require the disclosure of: (1) information about the steps, if any, taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying the structured finance product, (2) the fact that no steps were taken, or (3) the results of any steps taken; and
- the process related to the exchange of information, including the involvement of third-parties, personal identifying information about assets underlying the structured products, and proprietary information.

New Prohibitions

The proposed amendments would include three new prohibitions on issuing ratings because of conflicts of interest. First, the amendments would prohibit an NRSRO from issuing a credit 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. The proposed prohibition is intended to prevent NRSROs from making recommendations about how to obtain a desired credit rating during the rating process. The Release explains, however, that the proposed prohibition is not intended to prohibit all interaction between the NRSRO and the obligor, issuer, underwriter, or sponsor during the rating process (e.g., the bases, assumptions, and rationales behind rating decisions may be discussed).

Second, the amendments would prohibit an NRSRO from issuing a rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for (1) participating in determining credit ratings or (2) developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models. The Release states that the proposed prohibition is designed to effectuate the separation within the NRSRO of persons involved in fee discussions from persons involved in the credit rating analytical process.

Third, the amendments would prohibit an NRSRO from issuing a rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating, received gifts, other than items provided in the context of normal business activities that have an aggregate value of no more than $25. The Release states that the prohibition on gifts would be absolute with the exception of minor incidentals provided in business meetings to eliminate any influence the gift-giving might have on an analyst’s objectivity. The Release also states that $25 limitation for incidentals would be applied on a per meeting basis.

The Commission seeks comment on several aspects of the new prohibitions including:

- how the line drawing exercise regarding interaction between the NRSRO and issuers would work in practice and whether additional guidance should be provided on this issue;
- whether the prohibition should be limited to persons associated with the NRSRO only in the case of an NRSRO that is part of a large conglomerate because of practical difficulties;
- whether the proposed prohibition should also be extended to cover participation fee negotiations by NRSRO personnel with supervisory authority over the NRSRO personnel participating in determining credit ratings or developing or approving procedures or methodologies;
- difficulties in separating analytics and fee discussions for a small NRSRO, and asks whether an exemption should be provided from the proposed prohibition for small NRSROs; and
- the appropriateness of the $25 aggregate threshold as well as whether the Commission should adopt a recordkeeping requirement for the proposed prohibition.

Recordkeeping Requirements

Currently, an NRSRO is required to make and keep certain records relating to its business as prescribed by Commission rules. The proposed amendments would require NRSROs to make and retain certain additional records and to make some of these new records publicly available. [3]

Ratings Actions

The proposed amendments would enhance transparency regarding the results of NRSROs' rating processes. Specifically, the proposed amendments would require an NRSRO to make and retain a record showing all ratings actions (initial rating, upgrades, downgrades, and placement on watch for upgrade or downgrade) and the date of such actions identified by the name of the security or obligor and, if applicable, the CUSIP for the rated security or the Central Index Key number for the rated obligor. The amendments would require that the record be made publicly available on the NRSRO's corporate Internet Web site in an interactive data file that uses a machine-readable computer code that presents information in eXtensible Business Reporting Language ("XBRL") in electronic format ("Interactive Data File").

The proposed amendments would require that the record be made publicly available no later than six months after the date of the rating action. For purposes of the

internal record, however, the NRSRO would need to keep the record current as new credit ratings are issued and existing credit ratings are upgraded, downgraded, and put on ratings watch. The proposed amendments also would require the disclosure in Form NRSRO of the Web address where the XBRL Interactive Data File could be accessed.

The Release states that publication of this information should foster greater accountability of the NRSROs with respect to their ratings as well as competition among the NRSROs by making it easier for persons to analyze the actual performance of the credit ratings the NRSROs issue in terms of accuracy in assessing creditworthiness. The Release explains that the proposed six-month delay in public posting is designed to accommodate NRSRO business models in which NRSROs are paid for access to their current credit ratings or sell download access to their current credit ratings.

The Commission seeks comment on several aspects of the proposed record keeping requirements including:

- the appropriateness of the sixth-month delay;
- the categories into which the NRSROs should be required to sort the credit ratings contained in the proposed record;
- the use of XBRL in the proposed amendments, including whether the Commission should create a central database to store the information; and
- whether the information on the assets underlying a structured finance product (discussed above) should be provided in a specific format such as XBRL.

Material Deviation from Model Output

The proposed amendments would require an NRSRO to create a record of the rationale for any material difference between the credit rating implied by a model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining the credit rating. The Release states that an NRSRO would be responsible for making the determination of what constituted a “substantial component” of the rating process as well as what constituted a “material” difference. The Release explains that such records would assist the Commission in evaluating whether an NRSRO is adhering to its disclosed procedures for determining ratings.

The Commission seeks comment on whether the proposed amendments would have the impermissible effect of regulating the substance of credit ratings; whether it should define “substantial component” and “material;” and whether it should require that the information about material deviations be publicly disclosed by the NRSRO in the presale report or when the rating is issued.

Third-Party Analyst Complaints

The proposed amendments would require an NRSRO to retain records of any complaints regarding the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating. The Release states that the proposed amendment would assist the Commission in reviewing the integrity of an NRSRO's ratings process in addressing this particular conflict of interest.

The Commission seeks comment on whether an NRSRO should publicly disclose when an analyst has been re-assigned and whether an NRSRO should be required to retain any communications containing a request that an NRSRO assign a specific analyst to a transaction, in addition to the proposed amendment regarding complaints.

Form NRSRO

The proposed amendments would require certain additional information to be submitted with Form NRSRO, the means by which credit rating agencies apply to the Commission to become NRSROs.

Ratings Performance Measurement Statistics

The proposed amendments would prescribe greater specificity about how credit ratings performance statistics must be generated. [4] In particular, the proposed amendments would require the disclosure of separate sets of default and transition statistics [5] for each asset class of credit rating for which an applicant is seeking registration as an NRSRO or for which an NRSRO is registered and any other broad class of credit ratings issued by the NRSRO. [6] The proposed amendments would require that the class-by-class disclosures be broken out over 1, 3 and 10-year periods. In addition, the proposed amendments would specify that the required default statistics show defaults relative to the initial rating and incorporate defaults that occur after a credit rating is withdrawn.

According to the Release, the Commission believes that the requirements it is proposing would not intrude into the processes and methodologies by which NRSROs determine credit ratings. Moreover, it explains that the proposed amendments are designed to facilitate a comparison of the accuracy of NRSRO credit ratings on a class-by-class basis by requiring the capture of similar information and eliminating certain tactics that could be used to "pad" statistics.

The Commission seeks comment on whether, among other things, it should prescribe specific standards for the performance statistics (e.g., requiring an NRSRO to disclose how its credit ratings performed relative to metrics such as credit spreads) or require a more granular form than by class of credit ratings and whether the proposed time periods for the short-, medium-, and long-term statistics – 1, 3, and 10 years, respectively – are appropriate.

Rating Methodologies

The proposed amendments would add three additional areas to the disclosure requirements related to ratings methodologies with an eye toward providing greater clarity around an NRSRO's rating processes, particularly for structured finance products. First, an NRSRO would be required to disclose whether and, if so, how information about verification performed on assets underlying a structured finance product is relied on in determining credit ratings. [7] Second, an NRSRO would be required to disclose whether and, if so, how assessments of the quality of originators of assets underlying a structured finance product play a part in the determination of credit ratings. [8] Third, an NRSRO would be required to disclose: how frequently credit ratings are reviewed; whether different models or criteria are used for ratings surveillance than for determining initial ratings; whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings; and, whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings.

The Release states that these disclosures should assist users of credit ratings to determine the potential accuracy of NRSRO's credit ratings, including the ability of the NRSRO's model to predict the performance of the underlying assets in a structured finance product.

The Commission seeks comment on whether there are other areas of the ratings process where enhanced disclosure on Form NRSRO would benefit users of credit ratings.

Report of Credit Rating Actions

The proposed amendments would require an NRSRO to furnish the Commission with an annual report of the number of credit rating actions (upgrades, downgrades, and placements on watch for an upgrade or downgrade) during the fiscal year in each class of security for which the NRSRO is registered. The Release states that the proposed amendment would assist the Commission in its examination function of NRSROs.

The Commission seeks comment on whether the proposed report would be redundant in light of the proposed amendments to Form NRSRO regarding performance statistics and whether it should require NRSROs to furnish an “early warning” report to the Commission when the number of downgrades in a class of credit ratings passes a certain percentage threshold.

Differentiating Credit Ratings for Structured Finance Products

The second set of proposed amendments to the Commission rules governing NRSROs would require an NRSRO to incorporate special reporting or symbology into its ratings for structured finance products. Specifically, each time an NRSRO published a credit rating for a structured finance product, it also would be required to publish a report describing how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments. In the alternative, an NRSRO would have to employ ratings symbols for structured finance products that differentiated them from the credit ratings for other types of debt securities. The Release states that the objective of the proposed amendments is to alert investors that there are different rating methodologies and risk characteristics associated with structured finance products.

The Commission seeks comment on several aspects of the proposed differentiation requirement including:

- whether the use of different rating symbols would impact automated securities trading, routing, settlement, clearance, trade confirmation, reporting, processing, and risk management systems and any other systems that are programmed to use standard credit rating symbols across all product classes;
- whether the use of different rating symbols have consequences for investment guidelines and covenants in legal documents that use credit ratings to distinguish finance instruments;
- whether the proposed reports could cause investors to ignore other relevant disclosure or lead to confusion;
- whether the proposed differentiation should be expanded to require reports or different rating symbols for each class of credit rating (e.g., financial institutions, insurance companies, and issuers of government securities); and
- whether the Commission can and should prohibit an NRSRO from using a common set of symbols to rate different types of obligors and debt securities where the NRSRO uses different methodologies for determining such ratings.

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endnotes

[1] See Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-57967 (June 17, 2008) ("Release"). The Release may be found at: http://www.sec.gov/rules/proposed/2008/34-57967.pdf.

[2] As defined by Section 3(a)(61) of the Securities Exchange Act of 1934, a "credit rating agency" means any person (A) engaged in the business of issuing credit rating on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and, (C) receiving fees from either issuers, investors, or other market participants, or a combination thereof.

[3] The proposed amendments would clarify that the recordkeeping rules extend to all aspects of the credit rating surveillance process as well as the initial rating process. This would be achieved by adding the word "monitoring" to the following list: an NRSRO must retain all internal and external communications that relate to "initiating, determining, maintaining, changing, or withdrawing a credit rating."

[4] As discussed above, the proposed amendments would require the disclosure of the historical ratings actions relating to each current credit rating.

[5] The amendments would clarify that upgrades as well as downgrades should be included in the statistics by replacing the current term "down-grade and default rates" with the new term "ratings transition and default rates."

[6] To ensure that all structured products are encompassed by the proposed amendments, an NRSRO registered in the class of security for "issuers of asset-backed securities" would be required to include credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction.

[7] The proposed amendments would not require that the NRSRO incorporate verification into its rating processes.

[8] The proposed amendments for these first two disclosures also would apply to assets "referenced by a security or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction."

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