

**MEMO# 18798**

April 22, 2005

## **SEC PROPOSED RULE DEFINING THE TERM "NRSRO"**

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [18798] April 22, 2005 TO: SEC RULES MEMBERS No. 52-05 CLOSED-END INVESTMENT COMPANY MEMBERS No. 22-05 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 7-05 FIXED-INCOME ADVISORY COMMITTEE No. 9-05 UNIT INVESTMENT TRUST MEMBERS No. 6-05 RE: SEC PROPOSED RULE DEFINING THE TERM "NRSRO" The Securities and Exchange Commission has published for comment a proposed new rule under the Securities Exchange Act of 1934 (Rule 3b-10), which would define the term "nationally recognized statistical rating organization" ("NRSRO").<sup>1</sup> The most significant aspects of the proposed rule are summarized below. Proposed Definition of NRSRO The term "NRSRO" is currently not defined under the federal securities laws. Credit rating agencies request designation as NRSROs through the Commission's no-action process. If the proposed definition of "NRSRO" is adopted, it will no longer be necessary for credit rating agencies to seek designation as such through the no-action process, although they may continue to do so if they wish.<sup>2</sup> The proposed definition of NRSRO contains three components that must be met in order for a credit rating agency to be considered an NRSRO. These components incorporate many of the factors currently used by Commission staff in determining whether to grant a no-action letter. Specifically, the Commission is proposing to define the term "NRSRO" as an entity that (1) issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (2) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the 1 SEC Release Nos. 33-8570; 34-51572; and IC-26834 (April 19, 2005) ("Release"). The Release can be found on the SEC's website at <http://www.sec.gov/rules/proposed/33-8570.pdf>. Comments on the proposed rule must be received by the SEC no later than June 9, 2005. 2 The Release notes that, in light of the longstanding reliance by broker-dealers, issuers, investors and others on the existing staff no-action process, if the Commission were to adopt a definition of NRSRO, the staff would continue to provide no-action letters, as appropriate, to those entities that choose to seek it. 2 predominant users of securities ratings; and (3) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures. The First Component The first component of the proposed NRSRO definition would limit the definition to entities that issue publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments. The Release states that "publicly available" would mean that credit ratings used for regulatory purposes under Commission

rules must be disseminated on a widespread basis at no cost. In this context, the rating could be published in a readily accessible manner on the credit rating agency's website. The Release also states that the Commission is aware that credit rating agencies often issue different types of credit ratings that can reflect, among other things, the creditworthiness of specific securities or obligations, or the general creditworthiness of specific entities. The Release notes that because the Commission's regulatory use of the term "NRSRO" primarily relates to credit ratings on specific securities or obligations, the Commission, in its proposed definition of the term "NRSRO," is limiting the availability of the NRSRO concept to entities that issue such ratings. Finally, the Release states that the proposed definition attempts to ensure that only "current" credit ratings, i.e., ratings that are actively monitored and updated appropriately on a continuous basis, can be used for regulatory purposes under the federal securities laws. The Commission would interpret "current assessments" to mean that a credit rating agency's published credit ratings reflect its opinion as to the creditworthiness of a security or money market instrument as of the time the rating was issued and until the rating is changed or withdrawn. Under this interpretation, a credit rating agency could meet the "current assessments" element of the proposed definition if it has and follows procedures designed to ensure that its ratings are reviewed and, if necessary, updated on the occurrence of material events, including significant sector or issue-specific events.

**The Second Component** The second component of the NRSRO definition would require a credit rating agency to be generally accepted in the financial markets. The Commission proposes that a credit rating agency could meet the second component of the NRSRO definition through a variety of objective means. For example, in appropriate circumstances, a credit rating agency could point to statistical data that demonstrates market reliance on the credit rating agency's ratings (e.g., market movements in response to ratings changes). A credit rating agency also might be able to satisfy the second component of the proposed definition if authorized officers or users of securities ratings representing a substantial percentage of the relevant market attest that the credit rating agency's ratings are credible and actually relied on by the users.

**3 The Release notes that, based on Commission staff experience in issuing no-action letters to credit rating agencies, a credit rating agency that has developed a general acceptance in the financial markets for a limited sector of the debt market or a limited geographic area could meet the NRSRO definition.**

**The Third Component** The third proposed component of the NRSRO definition is intended to ensure that in order to meet the definition of the term "NRSRO," a credit rating agency uses systematic procedures designed to ensure credible and reliable ratings, to manage conflicts of interest, and to prevent the misuse of nonpublic information. The Release states that the Commission preliminarily believes that a number of factors would be important for assessing whether a credit rating agency meets this component. For example, the experience and training of a firm's rating analysts, the average number of issues covered by analysts, and the information sources reviewed and relied upon by the credit rating agency (and how the integrity of information utilized in the ratings process is verified), would be considered in determining whether a credit rating agency should be considered an NRSRO. Other factors would include the extent of contacts with the management of issuers (including access to senior level management and other appropriate parties), the organizational structure of the credit rating agency, how the credit rating agency identifies and manages or proscribes conflicts of interest affecting its ratings business, how the credit rating agency monitors and enforces compliance with its procedures designed to prohibit the misuse of material, nonpublic information, and the financial resources of the credit rating agency.

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