



## **SEC Issues Long-Awaited Releases on NRSRO's**

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*February 4, 2009-* Although the SEC took action concerning credit rating agencies (NRSROs) at its December 3, 2008 open meeting, only this week did the SEC issue its two resulting formal releases. Notwithstanding the delay, the releases reflect the SEC's efforts to meaningfully reform a flawed credit rating process that has significantly contributed to the current financial market disorders.

One of this week's releases adopts new rules that were proposed in June 2008. The other release proposes for public comment additional rules, most of which were previously proposed in different form, but not previously adopted. The two releases are discussed separately in the two sections below.

### ***Release Adopting New Rules***

In Forms NRSRO that they file with the SEC, credit rating agencies are required to provide aggregate statistical information about how the various types of ratings that they issue have "performed" over time, including information about the historical level of defaults and rating changes on instruments they have rated. The new rules refine these aggregate performance disclosure requirements, with the general object of making the information more useful to investors and more comparable as among different rating agencies.

Credit rating agencies also must describe in their Forms NRSRO the procedures and methodologies they use to determine credit ratings. The new rules require certain additional disclosure in this regard, particularly:

- Whether the NRSRO relies on any verification of the obligations underlying any

"structured finance product" that is being rated and, if so, how. (As used by the SEC, the term "structured finance product" refers broadly to any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities.)

- Whether the NRSRO relies on any assessment of the quality of the originators of the obligations underlying any structured finance product that is being rated, and, if so, how.
- How frequently the NRSRO reviews its credit ratings and what procedures and standards it follows for that purpose.

The new rules also expand the records that NRSROs must maintain and make available for SEC inspection, to include:

- The histories of all credit rating actions that the NRSRO takes, including initial ratings, upgrades, downgrades, placements on watch for upgrade or downgrade, and withdrawals.
- The NRSRO's rationale when it issues a rating of a structured finance product that materially deviates from the rating implied by any quantitative model that was used as a substantial component of the rating process.
- Written complaints received by an NRSRO concerning the conduct of any of its credit analysts, to the extent such complaints are lodged by persons not associated with that NRSRO.

Also, the new rules generally require an NRSRO to publicly disclose, on a six-month delayed basis, a random sample of 10% of certain credit ratings that the NRSRO has issued, together with the history of all credit actions taken with respect to those ratings. This 10% disclosure requirement, however, applies only to ratings that are (a) paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the instrument being rated and (b) within a class of ratings as to which the NRSRO has at least 500 ratings outstanding. The required public disclosures must be in XBRL format on the NRSRO's web site.

In order to assist the SEC in its examination function, the new rules require an NRSRO to provide to the SEC an annual report of the number of credit rating actions that the NRSRO has taken with respect to each class of ratings.

Finally, in addition to the conflicts of interest that already are addressed in the SEC's rules pertaining to NRSROs, the new rules will prohibit the following three additional conflicts:

1. An NRSRO or its affiliate making recommendations on how to achieve a desired rating and then rating the obligor or instrument that was the subject of the recommendation.
2. An NRSRO issuing or maintaining a rating whose fee was negotiated, discussed or

arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings or for developing or approving procedures or methodologies used for determining such ratings.

3. An NRSRO issuing or maintaining a rating as to which a credit analyst, or a person responsible for approving the rating, receives gifts (including entertainment) from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than certain gifts provided in the context of normal business activities and having an aggregate value of no more than \$25.

The full adopting release may be found [here](#).

### ***Release Proposing or Reproposing Additional Rules for Public Comment***

As discussed above, the SEC has adopted new rules that include a requirement that certain NRSROs publicly disclose specified information about a random sample of 10% of certain of their credit ratings. In a separate release, the SEC is proposing to expand this requirement so that:

- The public information would be required as to *all* credit ratings originally issued on or after June 26, 2007 that are paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the instrument being rated (rather than only as to a random sample of 10% of such ratings).
- In contrast to the rules that have already been adopted, the fact that the NRSRO has fewer than 500 ratings of a given class outstanding would not exclude that class of ratings from the public disclosure requirement.
- The delay period for the public disclosures would be 12 months (rather than 6 months).

In the proposing release, the SEC is also reproposing in modified form rules that it had previously proposed to address certain conflicts of interest that arise in connection with credit ratings for structured finance products, to the extent that the rating is paid for by the issuer, sponsor, or underwriter of the structured finance product. Under this proposal, an NRSRO would be required to disclose this type of conflict in its Form NRSRO and to follow written policies and procedures to manage the conflict, as well as to arrange for certain information sharing.

Under such proposed information sharing arrangements, the NRSRO issuing the rating would (a) at all times maintain on a password-protected web site a list of each structured finance product for which it is currently in the process of determining an initial credit rating that would be paid for by the issuer, sponsor or underwriter, together with certain related information and (b) arrange for each such issuer, sponsor or underwriter to post on a password-protected web site all of the information that those parties provide to the NRSRO for the purposes of determining the initial rating or of undertaking credit rating

surveillance on the structured finance product.

The NRSRO would be required, moreover, to make arrangements for any other NRSRO to have access to all of such information that is posted on a password-protected web site, upon delivery of a copy of a certification by such other NRSRO, among other things, that:

- It will access any such web site solely for the purpose of determining or monitoring credit ratings.
- It will maintain confidentiality of the information that it accesses on the web site.
- It will determine and maintain credit ratings for at least 10% of the structured finance products for which it accesses such web site information, if it accesses information about 10 or more structured finance products during the year covered by the certification.

The NRSRO also would be required to file this certification with the SEC and to renew such filing on an annual basis.

The details of the foregoing proposals for sharing of information are quite complex and include a proposed amendment to the SEC's Regulation FD to ensure that the proposed sharing of non-public information would not violate that regulation. The general objective of the information sharing proposals is to encourage the rating of any given structured finance product by a larger number of NRSROs, including particularly NRSROs that are not compensated by the issuer, underwriter or sponsor of the product. The SEC hopes that this would provide credit rating users with a broader range of views on the creditworthiness of the product, and potentially expose any NRSRO that was unduly influenced by the conflict inherent in receiving compensation from the issuer, underwriter or sponsor. The SEC also hopes that such NRSROs will find it easier to resist pressure from the issuer, underwriter or sponsor, to the extent that the rating process is "opened up" to more NRSROs.

The rule proposals will doubtless receive extensive comment from interested parties. The full proposing release may be found [here](#). The deadline for comments is 45 days after the release's publication in the Federal Register.

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We are continuing to consider these and other matters as they may affect funds, insurance companies, investment advisers, broker-dealers, NRSROs, and other market participants. Please contact any of our regulatory or litigation lawyers for more information.

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