

## SEC ADOPTS PROPOSALS TO STRENGTHEN THE REGULATORY FRAMEWORK OF NRSROS

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THE SEC HAS TAKEN SEVERAL RULEMAKING ACTIONS TO ENHANCE OVERSIGHT OF CREDIT RATING AGENCIES BY IMPROVING DISCLOSURE AND THE QUALITY OF CREDIT RATINGS.

On September 17, 2009, the Securities and Exchange Commission (SEC) voted unanimously to adopt a series of proposals that affect the regulatory framework of nationally recognized statistical rating organizations (NRSROs). The proposals adopted impose additional disclosure and conflict of interest requirements on NRSROs and eliminate references to credit ratings by NRSROs from certain rules and forms under the Securities Exchange Act of 1934 (“Exchange Act”), the Investment Company Act of 1940 (“Investment Company Act”) and the Investment Advisers Act of 1940 (“Advisers Act”).

The SEC also voted to reopen the comment period regarding the elimination of additional NRSRO references in other rules and forms, and proposed new rules that will require certain disclosures about ratings in registration statements under the Securities Act of 1933 (“Securities Act”). Finally, the SEC opened for public comment the question of whether it should rescind Rule 436(g), which provides an exemption from certain liability for NRSROs in connection with registered offerings.

Congress passed the Credit Rating Agency Reform Act of 2006 (P.L. 109-291), which grants the SEC broad authority over rating agency regulation, and in connection with the financial crisis, the SEC has been criticized for not doing enough to oversee the NRSROs. Since 2006, the SEC has taken numerous rulemaking actions that have implemented enhanced oversight of the NRSROs.<sup>4</sup> The SEC’s actions on Sep-

tember 17, 2009, mark the latest in the agency’s efforts in this area.

### NRSRO OVERSIGHT AND DISCLOSURE—FINAL RULES

The final rules on disclosure deal with credit rating history, and past services and credit rating relationships.

#### Credit Rating History

Under Rule 17g-2, as amended, NRSROs will be required to disclose their history of credit rating actions, including certain information relating to upgrades, downgrades, affirmations, and withdrawals. The new requirements will apply to any rating that the NRSRO initially made as of June 26, 2007. The enhanced disclosure provisions will require that NRSROs make this information available online and in searchable format no less than two years after the action taken for subscriber-paid ratings, and no less than one year after the action taken for issuer-paid ratings.

#### Past Services and Credit Rating Relationships

Under Rule 17g-5, as amended, when an arranger (which includes an issuer, sponsor, or underwriter) has paid an NRSRO to rate a structured finance product, the NRSRO must disclose that information to other NRSROs that want to rate a structured product. The amendment also imposes an obligation on the arranger to provide a representation to the NRSRO that it will share the information with other NRSROs seeking to provide a credit rating for that structured finance product. Under the amendment, an NRSRO that wants to access information provided by an arranger will be permitted to do so only for determining a credit rating and only if it rates a certain percentage of products. Competing NRSROs will be required to file a cer-

tification to this effect annually with the SEC.

In connection with these changes, Regulation FD has been revised to enable issuers to permit NRSROs to access information in connection with determining credit ratings, even if the NRSROs customarily do not make their ratings publicly available for free.

### NRSRO OVERSIGHT AND DISCLOSURE—PROPOSED RULES

The proposed rules involve disclosure to the SEC, on Form NRSRO, and to the public.

#### Annual Compliance Report

Under the proposed rule, NRSROs will be required to provide the SEC with information describing their compliance reviews for the most recent fiscal year. The report must provide the process taken by the compliance officer to administer the NRSRO’s policies and practices and ensure compliance with the securities laws, as well as identify any material compliance issues and any steps taken to address instances of noncompliance. The report must also include a list of the people within the NRSRO that were advised of any compliance issues.

#### Conflicts of Interest Disclosure

The proposed rule will require NRSROs to disclose additional information about potential conflicts of interest on Form NRSRO, including the percentage of the NRSRO’s net revenue attributable to the 20 largest users of credit rating services of the NRSRO and the percentage of the NRSRO’s net revenue attributable to other NRSRO services and products.

#### Magnitude of Conflicts Disclosure

The proposed rule will require NRSROs to make publicly available information about each person who

paid for a credit rating. NRSROs will also be required to make available on their website a consolidated report at the end of each fiscal year that discloses the percentage of the net revenue earned by the NRSRO for that fiscal year as it directly relates to services and products provided to that person (other than credit rating services) and the percentage (top 10%, top 25%, top 50%, bottom 50%, or bottom 25%) of the net revenue earned by the NRSRO attributable to that person relative to other clients. Further, the proposed rule will also require the NRSRO to include the Web address where additional future information will be posted regarding related credit ratings, research reports, press releases, and announcements.

#### **Enhanced Credit Ratings Access and Required Disclosure of Rating Shopping**

The SEC also proposed new rules under the Securities Act that would require the disclosure of credit ratings and related information in registration statements when these ratings are used in connection with the selling of registered securities; such disclosure is currently voluntary. Under the proposed rules, issuers would be required to describe in detail the following:

1. The scope of the credit rating and any material limitations.
2. Who paid for the credit rating service and the information regarding previous services provided by the credit rating agency or its affiliates to the registrant or its affiliates including fee information.
3. Any “preliminary ratings” obtained from a credit rating agency other than the one that provided the final rating.

The SEC also proposes to require registrants to disclose any changes in a credit rating on a current report on Form 8-K or Form 20-F.

#### **CONCEPT RELEASE: PROPOSAL TO REMOVE NRSRO EXEMPTION FROM LIABILITY AS “EXPERTS”**

The SEC voted to open for public comment the question of whether it should propose to rescind Rule 436(g) under the Securities Act of 1933. This rule provides NRSROs with an exemption from certain liability.

One of the immediate implications of rescinding the rule will be that an issuer that includes a credit rating issued by an NRSRO in a registration statement must file the consent of the rating agency with its registration statement. The filing of the consent will subject the rating agency to potential section 11 liability under the Securities Act. Under the current rules, credit rating agencies that are not NRSROs remain subject to Rule 436(g) liability, and issuers are required to file the consent of a firm where the firm’s credit rating is included in such a registration statement.

#### **ELIMINATING REFERENCES TO NRSRO RATINGS IN COMMISSION RULES AND FORMS**

The SEC adopted several amendments that eliminate references to NRSRO credit ratings in certain SEC rules and forms, and reopened the comment period on certain proposed amendments that were published last year regarding the elimination of NRSRO references in other rules and forms under the Exchange Act, Investment Company Act, Advisers Act, and Securities Act. The purpose of these actions is to reduce undue reliance on ratings by market participants. Because the concept of “investment grade” is entrenched in the SEC’s rules and forms, finding suitable substitutes that do not create unintended consequences is proving difficult, and the SEC has reopened the comment period on most of these changes.

#### **ADOPTED PROVISIONS—EXCHANGE ACT OF 1934**

Several changes regarding an alternative trading system have been adopted.

#### **Rule 3a1-1**

Under Rule 3a1-1, the SEC requires an alternative trading system (ATS) that qualifies as a “substantial market” in an enumerated category to register as an exchange. This amendment replaces two of the enumerated categories—investment grade corporate debt securities and non-investment grade corporate debt securities—with a single category, “corporate debt securities.”

#### **Regulation ATS**

The SEC adopted similar changes to Regulation ATS to establish a single class of “corporate debt securities” and eliminate the current classes of investment grade and non-investment grade corporate debt securities for purposes of meeting the “fair access” requirement, which requires an ATS that exceeds certain volume thresholds in any class of securities to establish written standards for granting access to trading on its system and complying with the standards for the capacity, integrity, and security of its automated systems.

#### **Form ATS-R and Form PILOT**

The SEC adopted similar changes to Forms ATS-R and PILOT.

#### **ADOPTED PROVISIONS—INVESTMENT COMPANY ACT**

Two amended rules under the Investment Company Act have been adopted.

#### **Rule 5b-3**

Rule 5b-3 is a “look-through” provision that allows an investment company to treat a refunded bond that it acquires as the U.S. government securities that refund the payments due to investors under the bond. As amended, an independent CPA must have certified that the government securities will meet the payments due to investors under the

refunded bond. There is no longer an exception for bonds with the highest NRSRO ratings.

#### **Rule 10f-3**

Rule 10f-3 permits registered investment companies to purchase securities in an underwritten offering in which a fund affiliate is a member of the syndicate. As amended, these funds will no longer look to the NRSRO rating of the municipal securities, but rather, the municipal securities must meet certain liquidity and credit risk standards designed to protect the fund and its investors.

#### **NEW PROPOSALS AND REOPENING OF THE COMMENT PERIOD FOR PREVIOUS PROPOSALS—EXCHANGE ACT**

Several amendments have been proposed.

#### **Regulation M**

The SEC is proposing to remove NRSRO references from the exceptions in Rules 101(c)(2) and 102(d)(2) of Regulation M for investment-grade non-convertible debt securities, investment grade non-convertible preferred securities, and investment grade asset-backed securities. The proposal would remove references to NRSRO ratings from the determination of whether these securities would be eligible for the exceptions, and would except non-convertible debt securities and non-convertible preferred securities based on the “well-known seasoned issuer” concept of Securities Act Rule 405. The proposal also excepts asset-backed securities, the offer and sale of which are registered on Form S-3.

#### **Rule 10b-10**

The SEC proposed to amend Rule 10b-10 to delete paragraph (a)(8), which requires a broker-dealer to include a statement in the confirmation if a debt security, other than a government security, is unrated by an NRSRO.

#### **Net Capital Rule**

The SEC proposed to delete, with limited exceptions, all references to NRSRO ratings from the net capital rule for broker-dealers, that is, Rule 15c3-1 under the Exchange Act (“net capital rule”). Under the net capital rule, broker-dealers are required to maintain at all times a minimum amount of net capital, plus certain subordinated liabilities, less certain assets that are not readily convertible into cash and less a percentage of certain other liquid assets. When calculating net capital, the rule permits broker-dealers to take a lower capital charge, or “haircut,” for certain types of securities that are rated investment grade by an NRSRO. Under the proposal, the SEC will replace the current NRSRO ratings-based criterion with new requirements subject to the determination of certain credit and liquidity risks.

#### **NEW PROPOSALS AND REOPENING OF THE COMMENT PERIOD FOR PREVIOUS PROPOSALS—SECURITIES ACT**

The SEC will reopen the comment period for proposals to replace investment grade ratings in certain eligibility criteria that permit issuers to conduct primary offerings “off the shelf” pursuant to Securities Act Rule 415 and Forms S-3 and F-3, and in other rules that refer to these eligibility criteria.

#### **NEW PROPOSALS AND REOPENING OF THE COMMENT PERIOD FOR PREVIOUS PROPOSALS—INVESTMENT COMPANY ACT AND ADVISERS ACT**

Three rules may be amended.

#### **Investment Company Act Rule 3a-7**

Rule 3a-7 excludes from the definition of investment company under the Investment Company Act structured finance vehicles if, in part, the securities offered to retail investors are rated by at least one NRSRO in one of the four highest ratings categories. The SEC is proposing to eliminate Rule 3a-7’s exclusion for structured financing vehicles offered to the general public.

#### **Investment Company Act Rule 5b-3**

In addition to the amendment to Rule 5b-3 adopted at the meeting, the SEC is proposing an amendment to the provision of Rule 5b-3 that allows an investment company to treat the acquisition of a repurchase agreement (“repo”) as the acquisition of the securities collateralizing the repurchase agreement, if the securities are government securities or have received certain NRSRO ratings. The proposed amendment would require that a fund’s board of directors (or its designee) determine the credit and liquidity risks associated with non-government collateral securities rather than requiring a specific rating for the collateral securities.

#### **Advisers Act Rule 206(3)-3T**

The SEC is proposing to eliminate NRSRO rating requirements from Rule 206(3)-3T under the Advisers Act, which provides a temporary alternative means for investment advisers that also are registered broker-dealers to satisfy the notice and consent requirements of section 206(3) of the Advisers Act when they act in a principal capacity with certain of their advisory clients.

#### **POSTSCRIPT**

When this article was written, the full text of the proposed and final rules and amendments were not yet available, and accordingly, the descriptions provided in this article were based on SEC press releases and statements made by the Commissioners and SEC staff at the September 17 open meeting.<sup>2</sup> Subsequently, on October 9, 2009, the SEC published in the Federal Register the Final Rule, “References to Ratings of Nationally Recognized Statistical Rating Organizations,” effective November 12, 2009.<sup>3</sup> At the same time, the SEC also published the Proposed Rule, “References to Ratings of Nationally Recognized Statistical Rating Organizations,” along with the reopening of the comment period for certain pro-

posed rule amendments and the requesting of additional comments, due by December 8, 2009.<sup>4</sup> ■

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<sup>1</sup> See "Amendments to Rules for Nationally Recognized Statistical Rating Organizations," Release No. 34-59342; File No. S7-13-08 (February 2, 2009), at [www.sec.gov/rules/final/2009/34-59342.pdf](http://www.sec.gov/rules/final/2009/34-59342.pdf), and "Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations," Release No. 34-55857; File No. S7-04-07 (June

5, 2007), at [www.sec.gov/rules/final/2007/34-55857.pdf](http://www.sec.gov/rules/final/2007/34-55857.pdf).

<sup>2</sup> See SEC Press Release 2009-200 at [www.sec.gov/news/press/2009/2009-200.htm](http://www.sec.gov/news/press/2009/2009-200.htm).

<sup>3</sup> See 74 Fed. Reg. 52358 (October 9, 2009) at [www.sec.gov/rules/final/2009/34-60789fr.pdf](http://www.sec.gov/rules/final/2009/34-60789fr.pdf).

<sup>4</sup> See 74 Fed. Reg. 52374 (October 9, 2009) at [www.sec.gov/rules/proposed/2009/33-9069fr.pdf](http://www.sec.gov/rules/proposed/2009/33-9069fr.pdf).

IF RULE 436(g) IS  
RESCINDED, AN ISSUER  
THAT INCLUDES A CREDIT  
RATING ISSUED BY AN  
NRSRO IN A REGISTRATION  
STATEMENT MUST FILE THE  
CONSENT OF THE RATING  
AGENCY WITH ITS  
REGISTRATION STATEMENT.

BECAUSE THE CONCEPT OF  
"INVESTMENT GRADE" IS  
ENTRENCHED IN THE SEC'S  
RULES AND FORMS, FINDING  
SUITABLE SUBSTITUTES THAT  
DO NOT CREATE  
UNINTENDED  
CONSEQUENCES IS PROVING  
DIFFICULT.