

SEC Proposes Rules that Seek to Enhance Transparency and Improve the Integrity of Credit Ratings and NRSROs

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On May 18, 2011, the Securities and Exchange Commission (SEC) unanimously approved for public comment proposed rules and amendments (Release) to pre-existing rules regulating credit rating agencies registered with the SEC as nationally recognized statistical rating organizations (NRSROs). According to Chairman Mary L. Shapiro, the proposals "are part of a concerted effort by the SEC to enhance the credit rating industry in light of the financial crisis" and seek to enhance transparency and to improve the integrity of credit ratings.¹

Under the SEC's proposal, NRSROs would be required to:

- file an annual report assessing the effectiveness of internal controls;
- protect against conflicts of interest that may arise when credit analysts participate in the sales and marketing of an NRSRO's products;
- establish professional standards of training, experience, and competence of credit analysts;
- publicly provide, together with the publication of the credit rating, disclosure about the credit rating and the methodology used to determine such ratings; and
- enhance public disclosure about the performance of credit ratings.

The proposed rules are subject to a 60-day public comment period.

Enhanced System of Internal Controls

Report on Internal Controls

The proposed rules implement Section 15E(c)(3)(B) of the Securities Exchange Act of 1934 (Exchange Act), which requires the SEC to issue rules requiring an NRSRO to submit an annual report to the SEC assessing the effectiveness of its internal controls (Internal Controls Report).

The SEC proposes amending Rule 17g-3 to add a new paragraph (a)(7) to require an NRSRO to file an Internal Controls Report with the SEC. The Internal Controls Report will include:

- a description of the responsibility of management in establishing and maintaining an effective internal control structure; and
- an assessment by management of the effectiveness of the internal control structure.

The Internal Controls Report will also have to be certified by the NRSRO's CEO, or such person serving in a similar capacity.

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Implementation of an Effective Internal Controls Structure and Record Keeping Requirements

Section 15E(c)(3)(A) of the Exchange Act as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires an NRSRO to "establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into account consideration such factors as the Commission may prescribe, by rule."

Although this requirement is self-executing, Section 15E(c) presently does not prescribe any factors relating to the implementation of an effective internal controls structure. The SEC has requested comment on whether at this time it would be appropriate for it to prescribe such factors. Based on the comments received, the SEC will decide whether to prescribe by rule or identify through guidance the factors an NRSRO must consider in establishing an effective internal controls structure in accordance with Section 15E(c).

Section 15E(c) also does not provide guidance as to how an NRSRO should maintain records to document its internal controls structure. In the Release, the SEC notes that the NRSRO should document its internal controls structure in accordance with the recordkeeping requirements set forth in Rule 17g-2 and proposes to add paragraph (b)(12) to that rule.

Conflicts of Interest Relating to Sales and Marketing

New "Absolute Prohibition"

Rule 17g-5(c) prohibits a person within an NRSRO from having any conflicts of interest relating to the issuance or maintenance of a credit rating or credit rating agency. Such prohibitions are referred to as "absolute prohibitions." The SEC proposes to add a new absolute prohibition. New paragraph (c)(8) will prohibit an NRSRO from issuing or maintaining a credit rating "where a person within the NRSRO who participates in the sales or marketing of a

product or service of the NRSRO or a product or service of a person associated with the NRSRO also participates in determining or monitoring the credit rating, or developing or approving the procedures or methodologies for determining the credit rating, including qualitative or quantitative models."²

Exemption for Smaller NRSROs from the New Absolute Prohibition

In an effort to promote competition among NRSROs of all sizes, the SEC has determined that the separation of the production of ratings and sales and marketing activities is not appropriate for all NRSROs. The proposed rules seek to exempt smaller NRSROs from the new absolute prohibition. The SEC proposes to add a new paragraph (f) to Rule 17g-5, which will provide the ability for smaller NRSROs to petition the SEC in writing for an exemption from the absolute prohibition. The SEC would be able to exempt an NRSRO if (1) the NRSRO applies for such exemption in writing, (2) the SEC determines that the size of the NRSRO is not appropriate to require separation within the NRSRO of the production of credit ratings from sales and marketing activities, and (3) such exemption is in the public interest.

New Standard for Suspending or Revoking an NRSRO's Registration for Violating a Rule Adopted under Section 15E(h) of the Exchange Act

Currently, the SEC only has the ability under Section 15E(d) of the Exchange Act to suspend or revoke the registration of an NRSRO for willful violations of Rule 17g-5 if the SEC makes a determination "on record after notice and opportunity for a hearing, that such sanction is necessary for the protection of investments and in the public interest."³ The proposed rules add new paragraph (g) to Rule 17g-5, which will allow the SEC to suspend or revoke the registration of an NRSRO or impose other penalties if the SEC finds during a proceeding that the NRSRO has committed a violation of a conflict of interest rule under Section 15E(h) that affected a rating.

Enhanced "Look-Back" Review

Section 15E(h), as amended by Dodd-Frank, requires NRSROs to establish and maintain policies and procedures regarding former employees who:

- participated in any capacity in determining a credit rating; and
- were subsequently employed within one year by an entity subject to such credit rating, or by the issuer, underwriter, or sponsor of a product subject to such credit rating.

Under such circumstances, the NRSRO must conduct a "look-back" review to:

- determine whether any conflicts of interest of the employee influenced the credit rating; and
- take action to revise the rating, if appropriate, in accordance with such rules as the SEC must prescribe.

The SEC proposes to add paragraph (c) to new Rule 17g-8. If the NRSRO look-back review determines that a conflict influenced a rating, then pursuant to new Rule 17g-8(c), the NRSRO would be required to, at a minimum:

- immediately place the credit rating on a credit watch;
- promptly determine whether the credit rating must be revised so that it is no longer influenced by a conflict of interest, and so that such rating solely reflects the "product of the NRSRO's documented procedures and methodologies for determined credit ratings"; and
- promptly publish the revised credit rating or affirm the present credit rating if appropriate.

Further, new Rule 17g-8(c)(1) will require an NRSRO to have policies and procedures in place that will require the NRSRO to immediately notify users that "a conflict influenced a credit rating assigned to an obligor, security, or money market instrument."⁴ The SEC, however, notes in the Release that it does

not expect an NRSRO to revise a credit rating in every instance in which an earlier rating was influenced by a conflict of interest.⁵ Rather, the SEC believes that the NRSRO's policies and procedures should be reasonably designed to ensure that the NRSRO takes action to revise the credit rating "if appropriate."

New Rule 17g-8, however, will require an NRSRO to publish an explanation as to why a credit rating was revised or affirmed after a conflict of interest has been determined. The enhanced look-back review will permit users of such information to evaluate the ability of the NRSRO to manage conflicts of interest in the production of credit ratings, and allow such users to consider the potential risks associated with using an NRSRO's credit rating to make investments or other credit-based decisions.

Standardized Disclosure of Information about Credit Rating Performance

Section 15E(q), as amended by Dodd-Frank, provides that the SEC must require each NRSRO to publicly disclose information on the initial credit ratings determined by such NRSRO for each type of (1) obligor, (2) security, and (3) money market instrument, and any information relating to any subsequent changes to such ratings, so that users of such information can evaluate the accuracy of the ratings and compare the performance of different NRSROs.

Section 15E(q) also provides that the rules adopted by the SEC must at a minimum require NRSROs to make certain disclosures that:

- are comparable among other NRSROs;
- are clear and informative for investors of different levels of sophistication to use;
- include performance information over a range of years and for a variety of types of credit ratings (including credit ratings withdrawn by the NRSRO);
- are published and made freely accessible by the NRSRO to the public;

- are appropriate to an NRSRO's business model; and
- require an NRSRO to include an attestation with any credit rating it issues that (1) no part of the rating was influenced by any other business activity, (2) the rating was based solely on the merits of the instruments being rated, and (3) the rating was an independent evaluation of the risks and merits of the instruments.

The SEC proposes to adopt in substantial part the rulemaking prescribed by Section 15E(q). However, the SEC proposes to significantly enhance the requirements for generating and disclosing such information by amending Form NRSRO, Exhibit 1, Instruction H and Rules 17g-1, 17g-2, and 17g-7.

Standardized Methodology to Calculate and Present Performance Measurement Statistics

The SEC's proposals amend Instruction H to standardize the way an NRSRO calculates and presents aggregate information about how (1) its ratings change over time (the transition rate), and (2) how often a rated entity or product subsequently defaulted.⁶ Currently, Instruction H does not prescribe the methodology an NRSRO must use to calculate and present the performance measurement statistics. As a result, NRSROs use different types of methodologies to produce performance measurement statistics. Inconsistency in the presentation of performance measurements limits the ability of investors and other users of credit ratings to compare the performance of certain credit ratings among NRSROs. The SEC's rule proposals seek to significantly enhance the disclosure requirements relating to performance measurement statistics in Exhibit 1, by limiting disclosure to transaction and default rates and certain supplemental information.

Enhancing Accessibility of Certain NRSRO Information

The SEC proposes to amend Rule 17g-1 to require an NRSRO to publicly display information about the

performance of credit ratings on an "easily accessible" portion of its website, and in writing upon request. Rule 17g-1 will also be amended to require an NRSRO to make its current Form NRSRO and Exhibits 1-9 publicly available on its website within 10 business days of being granted an initial registration (or a registration in an additional class of credit ratings), and within 10 business days of furnishing a Form NRSRO to (1) update information previously provided on the form, (2) provide the annual certification, or (3) withdraw a registration.

Enhancing the 100% Rule

The SEC also proposes to enhance Rule 17g-2, the so-called "100% Rule." This pre-existing rule requires an NRSRO to publish on its corporate website any information relating to a ratings action for credit ratings that the NRSRO initially determined on or after June 26, 2007. Presently, obligors, securities, and money market instruments assigned a credit rating by an NRSRO prior to June 26, 2007, are excluded from this disclosure requirement even if a ratings action was taken after that date. The 100% Rule applies to all types of credit ratings. The SEC proposes to enhance the 100% Rule by moving it to Rule 17g-7, which includes certain non-Form NRSRO disclosure requirements.

The 100% Rule as proposed will be codified in a new paragraph (b)(1) and will require an NRSRO to do the following:

- publicly disclose the ratings history for free on an easily accessible portion of its corporate website;
- disclose each credit rating assigned to an obligor, security, and money market instrument in every class of credit ratings for which the NRSRO is registered that was outstanding as of June 26, 2007, and any subsequent upgrades or downgrades of a credit rating or action taken;
- include all outstanding credit ratings as of June 27, 2007, in an XBRL file and

then disclose subsequent actions taken with respect to such credit ratings; and

- increase the number and scope of the data fields that must be disclosed about a rating action to include seven categories (e.g., the identity of the NRSRO disclosing the rating action and the date of the rating action) and subclassification fields (e.g., classification of the class or subclass of credit rating).

In addition, NRSROs will need to disclose any rating action taken within 12 months after determination for ratings that are issuer paid and within 24 months after determination for ratings that are not issuer paid. Finally, under the SEC's proposals, an NRSRO may stop disclosing a rating history no earlier than 20 years after the withdrawal of the credit rating.

Strengthening Credit Rating Methodologies

Under Exchange Act Section 15E, the SEC must also adopt rules to require an NRSRO to have policies and procedures governing the way it determines credit ratings. Under new Rule 17g-8, an NRSRO would be required to adopt and have in place board-approved policies and procedures that are reasonably designed to ensure, among other things, that:

- credit ratings are determined using procedures and methodologies (including qualitative and quantitative data and models) that are in accordance with the policies and procedures of the NRSROs;
- material changes (including changes to qualitative and quantitative data and models) are applied consistently and changes to surveillance procedures are applied within a reasonable period of time;
- the NRSRO promptly publishes notice of material changes to rating methodologies and of the discovery of

significant errors in rating methodologies; and

- the NRSRO discloses the version of the methodologies used with respect to a particular credit rating (including any qualitative or quantitative inputs used).

Form and Certifications to Accompany Credit Ratings

Section 15E also requires the SEC to adopt rules to require NRSROs upon taking credit ratings action to publish (1) a form and (2) certification from any third-party provider of due diligence services received by the NRSRO that relates to the credit ratings.

As proposed, the form must include information about the credit rating resulting from or subject to the rating action and disclose:

- information relating to the assumptions underlying the credit rating procedures and methodologies;
- the data that was relied on to determine the credit ratings; and
- any information that can be used by investors and other users of credit ratings to enhance their understanding of the credit ratings in each class of credit ratings issued by the NRSRO.

The form and certifications must be published by the NRSRO in the same medium and made available to the same persons who can receive or access the credit rating.

Upgrading Standards of Training, Experience, and Competence

In the Release, the SEC adopted proposed rules, that seek to implement Section 936 of Dodd-Frank,⁷ setting forth a heightened standard of training for credit analysts involved in producing ratings for NRSROs.

Pursuant to new rule 17g-9, an NRSRO will be required to:

- establish standards of training, experience, and competence for credit analysts and to determine credit ratings that are reasonably designed to achieve the objective that such individuals produce accurate credit ratings in the classes and subclasses of credit ratings for which the NRSRO is registered;
- consider certain factors when establishing such standards (e.g., the complexity of the securities that will be rated by the analyst);
- periodically test its credit analysts on the credit rating procedures and methodologies such credit analysts have been employed by the NRSRO to determine; and
- require that at least one individual with three or more years of experience in performing credit analysis participates in determining a credit rating.

New Rule 17g-9 will also be subject to the record retention and production requirements set forth in Rule 17g-2.

Universal Rating Symbols.

The SEC further proposed rules to implement Section 938 of Dodd-Frank that require each NRSRO to have policies and procedures that are reasonably designed to:

- assess the probability that an issuer of a security or money market instrument will default;
- clearly define each symbol in the NRSRO's rating scale; and
- apply any such symbol in a consistent manner.

The SEC proposed new Rule 17g-8(b) and amendments to Rule 17g-2, which mirror the statutory text of Dodd-Frank.

New Electronic Filings Requirements for Form NRSRO and Annual Reports

Currently, the SEC rules permit an NRSRO to submit a Form NRSRO and annual report in paper form. Under the proposed rule amendments, however, an NRSRO would be required to use EDGAR to electronically submit annual reports, Form NRSRO, and the information and documents contained in Exhibits 1-9 of Form NRSRO, if such submission is made to update an NRSRO registration, submit the annual certification, or withdraw from registration.

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¹ SEC Speech, Mary L. Schapiro, *Opening Statement at SEC Open Meeting* (May 18, 2011). In the same Release, the SEC also adopted proposed rules that require disclosure of third-party due diligence reports relating to asset-backed securities and used by NRSROs, issuers, or underwriters. A summary of these proposed rules are the subject of an Alston & Bird advisory entitled "*SEC Proposes Rules Regarding Third-Party Due Diligence Reports and Certifications for Asset-Backed Securities.*"

² See Release at 25.

³ Release at 32.

⁴ Release at 39-40.

⁵ Release at 72.

⁶ Exhibit 1 to Form NRSRO is part of the registration application a credit rating agency must submit to the SEC to become an NRSRO. After a credit rating agency becomes an NRSRO, it must file with the SEC on Exhibit 1 any updates to its registration application. Instruction H requires an applicant to

provide, among other items of disclosure, performance measurement statistics for credit ratings of the applicant or NRSRO.

⁷ Section 936 of Dodd-Frank requires the SEC to issue rules that are reasonably designed to ensure that any person employed by an NRSRO to perform ratings (1) meets certain standards of training, experience, and competence necessary to produce ratings for the categories of issuers whose securities such person rates, and (2) is tested for knowledge of the credit rating process.