



SEC Proposes New Rules and Amendments to Implement: *Dodd-Frank Provisions Concerning Nationally Recognized Statistical Rating Organizations*

On May 18, 2011, the Securities and Exchange Commission (the “SEC”) proposed new rules and amendments intended to increase transparency and improve the integrity of credit ratings.¹ The proposed rules would implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act² (the “Act”) and enhance the SEC’s existing rules governing credit ratings and Nationally Recognized Statistical Rating Organizations (“NRSROs”).

Under the SEC’s proposal, NRSROs would be required to report on internal controls, guard against conflicts of interest, establish professional standards for analysts and enhance public disclosure about credit ratings, including the methodologies used to establish them and their performance.

The SEC’s proposal also requires disclosure concerning reports and analyses delivered by third-party reviewers (“due diligence providers”) often used to evaluate assets in connection with the offering of asset-backed securities.

The Proposed Rules

The following is a summary of some of the key provisions of the proposed rules, some of which would expand upon provisions in the Act that are self-executing, while others are the result of provisions in the Act that require SEC rulemaking.

Internal Controls

Section 932(a)(2)(B) of the Act added paragraph (3) to Section 15E(c) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).³ This requires that each NRSRO have an effective internal control structure governing the way in which the NRSRO determines credit ratings.

The Act also requires each NRSRO to submit an annual report to the SEC about its internal controls. Therefore, the SEC has proposed amending Rule 17g-3 under the Exchange Act⁴ to require each NRSRO to file a report with the SEC containing a description of management’s responsibility in establishing the internal control structure and an assessment of the effectiveness of those internal controls.

¹ SEC Release No. 34-64514; File No. S7-18-11 (May 18, 2011). Available at: <http://www.sec.gov/rules/proposed/2011/34-64514.pdf>.

² Pub. L. No. 111-203, 124 Stat. 1376, H.R. 4173 (July 21, 2010).

³ Dodd-Frank Act, supra note 2, § 932(a)(2)(B) and 15 U.S.C. § 78a(15)(E)(c)(3).

⁴ 17 C.F.R. 240.17g-3. Note that the SEC has also proposed amending Rule 17g-2 (17 C.F.R. 240.17g-2(c), (d), (e), and (f)) to require NRSROs to maintain the necessary records regarding their internal controls.

Conflicts of Interest

Section 932(a)(4) of the Dodd-Frank Act added new paragraph (3) to Section 15E(h) of the Exchange Act.⁵ It forbids an NRSRO from taking into account “sales and marketing” considerations when establishing credit ratings.

The SEC proposes to implement these changes by amending Exchange Act Rule 17g-5.⁶ Under the proposed rule amendments, an NRSRO must ensure that its employees do not serve in the dual functions of (i) participating in the sales or marketing of a product or service of the NRSRO and (ii) determining or monitoring a credit rating or developing or approving procedures used for determining a credit rating. The proposal would establish a mechanism by which small NRSROs could seek an exemption from this provision.

The SEC would have the power to suspend or revoke the registration of an NRSRO or impose other penalties if it finds that the NRSRO has committed a violation of a conflict of interest rule that affected a rating.

“Look-Back” Review

Section 932(a)(4) of the Act amended Section 15E(h) of the Exchange Act to add a new paragraph (4).⁷ This section of the Act requires NRSROs to establish policies regarding former employees who participated in determining a credit rating, and who were subsequently employed (within one year) by an entity subject to that credit rating – or by the issuer, underwriter, or sponsor of a product subject to that credit rating. In such cases, the NRSRO must conduct a “look-back” review to determine whether any conflicts of interest influenced the credit rating and take action to revise the rating, if appropriate, “in accordance with the such rules as the [SEC] shall provide.”⁸

In order to implement the required change, the SEC has proposed amending Rule 17g-2⁹ to impose certain record-keeping requirements on NRSROs and has also proposed new Rule 17g-8. Under the new proposed rule, if the NRSRO “look-back” review determined that a conflict influenced a rating, the NRSRO would be required to, at a minimum:

- immediately place the credit rating on a credit watch and include an explanation that the reason for the action is that the rating was influenced by a conflict of interest;
- promptly determine whether the credit rating must be revised so it no longer is influenced by a conflict of interest; and
- promptly publish a revised credit rating or an affirmation of the credit rating, if appropriate.

Disclosure of Information about Performance

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new subsection (q).¹⁰ This section of the Act requires NRSROs to publicly disclose information on their initial credit ratings – and subsequent changes to such ratings – so users can evaluate the ratings and compare the performance of different rating agencies.

⁵ Dodd-Frank Act, supra note 2, § 932(a)(4) and 15 U.S.C. 78o-7(h)(3).

⁶ 17 C.F.R. 240.17g-5.

⁷ Dodd-Frank Act, supra note 2, § 932(a)(4) and 15 U.S.C. 78o-7(h)(4).

⁸ Dodd-Frank Act, supra note 2, § 932(a)(4).

⁹ 17 C.F.R. 240.17g-2.

¹⁰ Dodd-Frank Act, supra note 2, § 932(a)(8) and 15 U.S.C. 78o-7(q).

The SEC proposes to implement these requirements by amending the instructions to Form NRSRO as they relate to Exhibit 1 and amending Rule 17g-1, Rule 17g-2, and Rule 17g-7 under the Exchange Act.¹¹ The SEC proposals would standardize the way an NRSRO calculates and presents aggregate information about how its ratings change over time and how often a rated entity or product subsequently defaulted, and require the NRSRO to publicly display this information on an “easily accessible” portion of its website.

The proposals would also enhance the “100% Rule,” which requires an NRSRO to publish information concerning its rating actions for credit ratings that the NRSRO initially determined on or after June 26, 2007.¹² The disclosure must be made within 12 months after determination for ratings that are issuer-paid and within 24 months after determination for ratings that are not issuer-paid.

The proposed enhancements would require that the disclosures include any credit ratings that were outstanding as of June 26, 2007, and any subsequent rating actions taken with respect to those ratings, increase the number and scope of the data fields that must be disclosed about a rating action and provide that an NRSRO may stop disclosing a rating history no earlier than 20 years after the withdrawal of the credit rating.

Rating Methodologies

Section 932(a)(8) of the Dodd-Frank Act amends Section 15E of the Exchange Act to add new subsection (r).¹³ Under this section of the Act, the SEC must adopt rules requiring an NRSRO to have policies and procedures governing the way the NRSRO determines credit ratings. Under the proposed rule (section (a) of new Rule 17g-8 under the Exchange Act), those policies and procedures would have to be reasonably designed to ensure, among other things, that:

- the board of directors approves them;
- material changes 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.

Third-Party Due Diligence for Asset-Backed Securities

Section 932(a)(8) of the Dodd-Frank Act amended Section 15E of the Exchange Act to add new paragraph (s).¹⁴ Consistent with the requirements of that section, the SEC has proposed a new rule (new Rule 15Ga-2) that would require that due diligence providers for asset-backed securities must provide a written certification to any NRSRO that rates the securities.

The certification would be made on a new form – Form ABS Due Diligence-15E – which would describe the due diligence undertaken and the findings and conclusions resulting from the due diligence. This information would be required to be made public by the NRSRO, or if the NRSRO does not do so, by the issuer or underwriter of the securities.

¹¹ 17 C.F.R. 240.17g-1, 17 C.F.R. 240.17g-2 and 17 C.F.R. 240.17g-7.

¹² 17 C.F.R. 240.17-2(d)(3).

¹³ Dodd-Frank Act, supra note 2, § 932(a)(8) and 15 U.S.C. 78o-7(r).

¹⁴ Dodd-Frank Act, supra note 2, § 932(a)(8) and 15 U.S.C. 78o-7(s).

Disclosure of Information about Credit Ratings

Section 932 of the Act requires the SEC to issue rules to require NRSROs to publish a form with each credit rating. Under the proposed rule, the NRSRO would be required to include in the form information about the credit rating, such as information relating to the assumptions underlying the methodology used to determine the credit rating as well as any certification of due diligence providers described above.

The form and certifications would have to be published in the same medium and made available to the same persons who can receive or access the credit rating. The NRSRO would need to disclose in the form substantial qualitative and quantitative information about the credit rating and methodologies used to determine the credit rating.

Training, Experience and Competence

The SEC proposes to implement Section 936 by proposing new Rule 17g-9 under the Exchange Act. The proposed rule would require NRSROs to establish standards of training, experience and competence for credit analysts and to consider certain factors when establishing the standards, such as the complexity of the securities to be rated. The NRSRO would also be required to periodically test its credit analysts on the credit rating procedures and methodologies it uses, and require that at least one individual with three or more years of experience in performing credit analysis participates in determining a credit rating.

Rating Symbols

Section 938(a) of the Act¹⁵ provides that the SEC shall establish rules requiring each NRSRO to establish, maintain, and enforce written policies and procedures that:

- (1) assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument;
- (2) clearly define and disclose the meaning of any symbol used by the NRSRO to denote a credit rating; and
- (3) apply any symbol described in item (2) in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.

The SEC proposes to implement these requirements in new paragraph (b) of new Rule 17g-8.

Electronic Filings of Form NRSRO and the Annual Reports

Section 932(a)(5) of the Act amended Section 15E(j) of the Exchange Act.¹⁶ Under the proposed rule amendments, each NRSRO would be required to use the SEC's EDGAR system to electronically submit Form NRSRO to update an NRSRO registration, submit the annual certification or withdraw from registration. The proposal also would require NRSROs to use EDGAR to file their annual reports.

NRSRO Compliance Officer Reports

Section 932 of the Act also requires the designated compliance officer of an NRSRO to submit to the NRSRO an annual report on the rating agency's compliance with the securities laws and its policies and procedures that must be filed together with the report that NRSROs must submit to the SEC annually.

¹⁵ Dodd-Frank Act, *supra* note 2, § 938(a).

¹⁶ Dodd-Frank Act, *supra* note 2, § 932(a)(5) and 15 U.S.C. 78o-7(j).

Request for Comments

The SEC's proposal seeks public comments that should be received within 60 days of its publication in the Federal Register.

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