Date: June 24, 2008

To: Interested Persons

Re: SEC Proposes New Rating Agency Rules

On June 11, 2008 the Securities and Exchange Commission proposed a series of rules and rule changes designed to address what was, in the SEC's view, the role of credit rating agencies in precipitating the ongoing credit crisis.[1] The proposals would significantly alter the roles and responsibilities of participants in the market for structured products (defined by the SEC as a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction), and could have an impact on institutions that hold structured products. Beyond the structured products market, aspects of the proposals could affect all companies that issue rated securities.

Congress gave the SEC regulatory authority over the credit rating industry with the enactment of the Credit Rating Agency Reform Act of 2006, which the SEC implemented through a regulatory regime finalized in June 2007. The Credit Rating Agency Reform Act, codified principally as Section 15E of the Securities Exchange Act of 1934, created a voluntary system of regulation under which a credit rating agency electing to be treated as a "nationally recognized statistical rating organization," or "NRSRO," could file a registration form with the SEC and opt-in to SEC regulation. Credit rating agencies that do not seek NRSRO treatment are not required to register and are not subject to the oversight regime.

Standard and Poor's Rating Services, Moody's Investors Service and Fitch Ratings, Inc. were among the handful of credit rating agencies that elected to register as NRSROs after the SEC's regulatory program went into effect. Each of these rating agencies had, however, previously been known as an NRSRO. Even though rating agencies were not subject to formal SEC oversight until 2007, the NRSRO concept has played an important role in the SEC's regulatory architecture since 1975. The net capital rule, which regulates the amount of capital that a broker-dealer must hold to conduct business, currently assigns "haircuts" to broker-dealer assets based on NRSRO ratings. Eligibility to use Form S-3 for a public debt offering depends today, for some issuers, on whether the debt being offered is rated investment grade by an NRSRO. Money market funds are, at present, generally required to hold assets carrying specified NRSRO ratings.

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[1] See *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, Securities Exchange Act of 1934 Release No. 57967 (June 16, 2008); available at http://www.sec.gov/rules/proposed/2008/34-57967.pdf

Before the Credit Rating Agency Reform Act, the SEC staff followed an informal practice of recognizing certain credit rating agencies as NRSROs for regulatory purposes through the issuance of no-action letters. This led to criticism that the SEC staff had effectively granted a monopoly to a handful of powerful rating agencies, as it was argued that without the benefit of a staff no-action letter, it was not possible for a small rating agency or a new entrant to gain the market following necessary to be considered "nationally recognized." At the same time, the SEC's inability to regulate NRSROs became a source of Congressional frustration after the Enron debacle, partial blame for which was directed at the major rating agencies for having suddenly slashed their ratings of Enron's debt long after, it was maintained, they should have been aware of Enron's perilous financial condition.

Now comes another crisis, and a search for the underlying causes is well underway. The SEC has decided that NRSROs bear partial responsibility for the ongoing credit crunch because of overly optimistic ratings assigned in recent years to structured products, specifically residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) linked to subprime loans. The SEC cited concerns that these rating decisions were impaired by conflicts of interest in the industry and has determined, therefore, that more rules are in order.

The proposals include:

- A broad public disclosure requirement covering all information provided to an NRSRO by issuers, underwriters, sponsors and others involved in offering a structured product, if that information is used by the NRSRO in formulating the product's credit rating or thereafter in monitoring the credit rating. (Proposed Rule 17g-5(a)(3))

- A prohibition on rating a security (whether or not a structured product) if the NRSRO (or its associated persons) made "recommendations" to the issuer, underwriter or sponsor of the security about the corporate or legal structure, assets, liabilities or activities of the issuer of the security. (Proposed Rule 17g-5(c)(5))

- A requirement, in effect, that NRSROs change their ratings symbols for structured products. (Proposed Rule 17g-7)

Each of these proposals raises serious concerns; however the SEC has set a short public comment period (ending July 25), and has announced that on June 25 it will issue additional proposals to scale back reliance on NRSRO ratings in the SEC's own rules. In responding aggressively to the credit crisis, the SEC may be moving quickly to adopt rules whose long-term costs and consequences are difficult to predict.

Disclosure requirements for structured products offerings

Proposed Rule 17g-5(a)(3) would require that all information provided to an NRSRO by an issuer, underwriter, sponsor, depositor or trustee be publicly disclosed if it is used by the NRSRO in determining the credit rating for a structured product – regardless of whether the security is issued in a public offering, a private placement, or an offshore transaction. The rule does not say who is required to make the disclosure, but the SEC made clear that the NRSRO has no safe harbor available to it if another party to the transaction agrees but then fails to make the required disclosure. According to the SEC, the "intent behind this disclosure is to create the opportunity for other NRSROs to use the information to rate the instrument as well. Any resulting 'unsolicited ratings' could be used by market participants to evaluate the ratings issued by the NRSRO hired to rate the product and, in turn, potentially expose an NRSRO whose ratings were influenced by the desire to gain favor with the arranger in order to obtain more business." The proposal underscores the SEC's discomfort with the "issuer-pays" business model that currently prevails in the structured products market and elsewhere in the credit rating industry, and tilts the playing field towards credit rating agencies, including those not registered as NRSROs, that operate on a "subscriber-pays" business model.

In the context of an offering registered under the Securities Act of 1933, the SEC said that the disclosable information would constitute "written communications," and that, as a result, the issuer, underwriter and other offering participants would have to comply with Securities Act rules regarding the disclosure of written communications, which would be subject to the civil liability and antifraud provisions of the Securities Act. In a registered offering, the information would need to be publicly disclosed "on the date the underwriter and the issuer or depositor set the offering price of the securities being rated." Although the SEC seems to believe that this information is potentially material to an investment decision (otherwise the antifraud provisions would be irrelevant), the SEC gave no indication as to how long the information needed to be in the market and available to investors before an underwriter could safely confirm sales.

In the context of an offering not registered under the Securities Act, including Rule 144A offerings, Regulation D private placements and offshore transactions that benefit from the Regulation S exemption, the SEC observed that public disclosure of the information could constitute a general solicitation or directed selling efforts that would render the intended Securities Act registration exemption unavailable. Facing this conundrum, the SEC proposed that the information be made available only to "investors" and "credit rating agencies" (including those not registered as NRSROs) on the pricing date, and then to the general public on the business day after the closing date of the transaction. The SEC seems not to have considered that an unregistered transaction could still be in distribution after the closing date such that the rules against advertising and directed selling efforts would continue to apply. The SEC did however realize that not all credit rating agencies would qualify as accredited investors, and that the mandated pricing date disclosure could therefore inadvertently result in a public offering under well-established learning. To address this problem, the SEC announced that it was prepared to make a limited exception to its previous interpretations on what constitutes a general solicitation or advertising – but explicitly cautioned that this guidance "is applicable only if the proposed amendments are adopted." Left unaddressed was how the NRSRO would know who the relevant investors are, or even who the other credit rating agencies are.

After the offering is completed, the rule would require that any information provided to the NRSRO for purposes of monitoring the rating also be simultaneously disclosed to the public. In other words, for structured products, the Regulation FD exemption that permits issuers to communicate in confidence with rating agencies would be impliedly repealed.

Proposed Rule 17g-5(a)(3) is noteworthy for a number of reasons. As a practical matter, the rule would severely constrain communications between rating analysts and structured product sponsors, because virtually any information requested by the analyst during the iterative process of formulating a rating would need to be treated as having been "used" by the NRSRO in the process and therefore disclosed. Because an NRSRO would need to capture and disclose all information that it receives and "uses" in the analytic process, it is unlikely that NRSROs would be comfortable permitting their analysts to engage in much verbal communication with sponsors, and it is likely that the ratings process itself would migrate entirely to email and, with the looming threat of antifraud liability, become highly formalized and stylized, with lengthy disclaimers and boilerplate of the sort found in the fine print of equity analyst reports.

By putting a public disclosure burden on an NRSRO in the context of a securities offering, the rule risks expanding the group of those subject to offering liabilities beyond the offering participants and the other parties identified in Section 11 of the Securities Act. In other words, while the SEC did not say that the rule's public disclosure obligation would create liability to investors under Section 10(b) of the Exchange Act and Rule 10b-5, in view of the proposal's statements about Securities Act antifraud civil liability, it is possible that a creative plaintiffs' lawyer might someday make the argument that Exchange Act antifraud liabilities apply to this disclosure. This is in some tension with the Congressional intent, expressed in the Credit Rating Agency Reform Act, that there be no private right of action under that Act. Faced with this potential liability, perhaps credit rating agencies will ask what benefits they gain from voluntarily registering as NRSROs, particularly if the SEC succeeds in lessening its rulebook's reliance on their ratings.

By applying the rule to both registered and unregistered offerings, the SEC would, for the first time, create specific disclosure obligations for private placements directed exclusively at sophisticated institutional investors.[2] And by declining to exempt Regulation S transactions from the rule's broad reach, the SEC would, for the first time, create specific disclosure obligations for offerings outside the United States involving no U.S. offering participants or investors whatsoever.[3] Therefore, if a non-U.S. issuer requests an NRSRO to rate a structured product that it intends to sell exclusively to non-U.S. investors, the proposed rule will trigger a U.S. disclosure obligation. Both results raise the question of whether the SEC has observed the limitation on its authority under the Credit Rating Agency Reform Act that the rules and regulations it prescribes "be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations." Indeed the proposing release made scant effort to show that the proposals were "narrowly tailored" to address the SEC's concerns.

Ban on "recommendations"

Proposed Rule 17g-5(c)(5) would ban an NRSRO from issuing or maintaining a credit rating with respect to an obligor or security if the NRSRO, or a person associated with the NRSRO, made "recommendations" to the obligor or the issuer, underwriter or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. Although this proposal seems rooted in the SEC's concerns over structured products, the ban would apparently apply equally to "recommendations" made by the NRSRO to corporate issuers, among others, because of the SEC's belief that "it would be very difficult for an NRSRO to remain objective when assessing the creditworthiness of an obligor or debt security where the NRSRO or person associated with the NRSRO made recommendations about steps the obligor or issuer of the security could take to obtain a desired credit rating."

While the SEC helpfully noted that the proposal "is not intended to prohibit all interaction between the NRSRO and the obligor, issuer, underwriter, or sponsor during the rating process," the proposing release does not give much guidance as to when discussions between a ratings analyst and an issuer cross the line into prohibited conduct. And while the SEC acknowledges that in the course of formulating a rating for a particular security, a credit analyst and a sponsor will engage in discussions about ratings criteria, the SEC cautioned that "if the feedback process turns into recommendations by the NRSRO about changes the

[2] Rule 144A under the Securities Act, a non-exclusive registration safe harbor for resales of securities to qualified institutional buyers, requires that limited financial and business information about certain types of issuers be made available on request to holders and prospective purchasers.

[3] Regulation S under the Securities Act, a non-exclusive registration safe harbor for offers and sales of securities that occur outside of the United States, contains limited notification requirements designed to ensure that the parties understand that the transaction is being conducted pursuant to the safe harbor. In transactions with no U.S. nexus and no U.S. participants, it is unlikely that the participants would feel any such notification was needed.

[sponsor] could make to the structure or asset pool that would result in a desired credit rating, the NRSRO's role would transition from an objective credit analyst to subjective consultant."

The interpretive questions raised by the proposed ban are complex, and if the SEC declines to clarify exactly what the ban prohibits, there is a significant risk that the ban will inhibit communications between rating agencies and issuers of rated securities to the point where issuers have difficulty understanding what criteria they are being measured against. For example, if a ratings analyst tells a corporate issuer that the issuer's long-term debt rating is under review because of its exposure to a given line of business, would the SEC consider this a prohibited "recommendation" about the "activities" of the issuer? If an analyst told a financial institution that it was unlikely to maintain its current ratings without a significant infusion of equity capital, would this be a prohibited "recommendation" about the issuer's corporate structure, assets or liabilities?

Many companies are aware of the practical difficulties created by the regulation of their communications with third party professionals such as accountants. This proposal, if adopted, could inject similar uncertainty into their communications with rating agencies.

Ratings symbols for structured products

By a two-thirds vote, the SEC proposed new Rule 17g-7, which would have the likely effect of causing rating agencies to change their ratings symbols for structured products. For example, the highest rating for a structured product could read "AAA.sf" rather than "AAA." The purpose of this change is to communicate to investors that the rating for a structured product does not mean the same thing as a rating for some other class of security, and "to address concerns that certain investors assumed the risk characteristics for structured finance products, particularly highly rated instruments, were the same as for other types of similarly rated instruments."

As a technical matter, the SEC has not actually proposed this as a new requirement. Instead, the SEC proposed a cumbersome requirement to publish, each time a structured product rating is published, a description of how structured product ratings differ from other ratings. Understanding that a publication requirement would be difficult or unworkable, the SEC offered to exempt NRSROs from it as long as they change their rating symbols for structured products. The SEC plainly acknowledged that the rule would cause rating agencies to change their symbols; in the mandatory cost-benefit analysis of the proposal the SEC said that it "believes . . . that most, if not all, NRSROs would opt to differentiate their ratings . . . rather than publish a report. . . . The Commission believes that an NRSRO would choose to employ this symbology approach because it would be more efficient and less burdensome than ensuring that the appropriate report was published along with the credit rating." This rule-writing technique appears designed to avoid crossing the mandate of the Credit

Rating Agency Reform Act that the SEC may not "regulate the substance of credit ratings." The SEC may be concerned that if it directly required a rating agency to change its symbols in order to alter the information content of a credit rating, it would be regulating the credit rating's substance.

If this proposal were adopted (and then survived the court challenge), a number of issues would be presented for structured product investors. Most obviously, institutional investors would need to examine their investment guidelines to determine whether or not they are permitted to hold assets that carry the new ratings. Institutional investors would also need to consider their own disclosures, and the consequences of reporting to their boards, owners and investors that they do, or do not, invest in assets that carry the presumably riskier rating. The broader impact may be to further chill the market for structured products.

Other proposals

The June 11, 2008 proposals contain a number of elements in addition to those discussed above. The proposed rules would also:

- Require NRSROs using quantitative models to document the rationale for any significant out-of-model adjustments. (Proposed Rule 17g-2(a)(2)(iii))

- Require NRSROs to make all of their ratings and subsequent rating actions publicly available. This data would be required to be made available in XBRL format in order to facilitate comparisons of NRSRO performance. (Proposed Rules 17g-2(a)(8); 17g-2(d); 17g-3(a)(6))

- Require NRSROs to maintain records of complaints about the performance of a credit analyst. (Proposed Rule 17g-2(b)(8))

- Prohibit anyone who participates in determining an NRSRO credit rating from negotiating the fee paid for it. (Proposed Rule 17g-5(c)(6))

- Prohibit gifts from those who receive NRSRO ratings to those who rate them, in any amount over $25. (Proposed Rule 17g-5(c)(7))

- Require NRSROs to publish performance statistics for one, three and 10 years within each rating category, in a way that facilitates comparison with their competitors in the industry. (Proposed Item 9, Exhibit 1 to Form NRSRO)

- Require NRSROs to disclose the way they rely on the due diligence of others to verify the assets underlying a structured product. (Proposed Item 9, Exhibit 2 to Form NRSRO)

- Require NRSROs to disclose how frequently credit ratings are reviewed; whether different models are used for ratings surveillance than for initial ratings; and whether changes made to models are applied retroactively to existing ratings. (Proposed Item 9, Exhibit 2 to Form NRSRO)

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If you have any questions about this memorandum, please call your regular Davis Polk contact.

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