CLEARY GOTTLIEB Alert Memo

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SEC Takes Action on Credit Rating Agency Rules

At its open meeting on September 17, 2009, the SEC voted to adopt a number of previously-proposed rules regulating nationally recognized statistical rating organizations (NRSROs) and to re-open the comment period for, or propose for initial comments, other ratings-related rules. The rules adopted on September 17 were originally proposed in June 2008 and re-proposed in February 2009 after initial comments were received. The two most significant final rules just adopted by the SEC (the first two described below) were specifically noted as being "strongly supported" by the Obama Administration when the Treasury Department released its proposed legislation concerning rating agencies in July of this year. The SEC's new final rules and rule proposals are as follows:

Disclosure of Structured Product Data—Final Rule Adopted. The final rule that is likely to prove most significant to many market participants requires that information provided to an NRSRO to enable it to rate a structured product must also be made available to competing NRSROs so that they may issue unsolicited ratings on that product. While the SEC release setting out the new rule is not yet available, it appears that this rule is being adopted substantially as it was re-proposed in February of this year:

- The NRSRO whose rating is sought would disclose that fact to other NRSROs, and would be required to obtain an undertaking from the transaction's issuer, sponsor or underwriter to make available to any other NRSRO all information that is provided to the NRSRO whose rating it has requested.

- Other NRSROs would be restricted to using that information only to issue their own ratings on the product, and a related amendment to Regulation FD would permit issuers to make the required non-public information available to them.

- In order to qualify for access to such information, an NRSRO would be required to issue unsolicited ratings on a certain percentage of the structured products for which it sought data, and would certify this annually to the SEC.

Commissioner Casey voiced her view that the proposal as adopted did not go far enough, and urged that the SEC require this information to be disclosed to investors generally rather

than just to other NRSRO's—which was the proposal as initially put forth by the SEC last year. That aspect of the original proposal met with widespread opposition from commenters who were concerned with the liability implications of such disclosures and with how disclosure of proprietary information could be handled.

NRSRO Ratings Histories—Final Rule Adopted. In February, the SEC adopted a requirement that NRSROs make public (with a six-month lag) a random sample of 10% of their issuer-paid ratings for each class of ratings in which they had issued 500 or more ratings. At the same time, the SEC requested further comment on requiring public rating histories for all issuer-paid ratings and for subscriber-paid ratings. In their recent action, the SEC revised the existing rule to require disclosure of 100% of issuer-paid ratings histories (with a one-year lag) and 100% of subscriber-paid ratings (with a two-year lag).

Removal of Ratings References from SEC Rules. In 2008, the SEC proposed a series of amendments that were intended to remove virtually all references to NRSRO ratings from the SEC's rules and forms, on the grounds that relying on ratings for regulatory purposes represented an official imprimatur that was not appropriate. The SEC received extensive comments on those proposed amendments, and until this meeting had not taken any further action on them. The July Treasury Department press release states that Treasury will work with the SEC and the President's Working Group on Financial Markets to determine where rating agency references can be removed from regulations, and the new SEC actions reflect that cautious approach to this controversial initiative. In their September 17 meeting, the SEC adopted only a few of the more technical amendments it had previously proposed, and opted to re-open the comment period on the most controversial measures rather than finalizing them. In his comments, Commissioner Aguilar noted that each time the SEC has requested comment on removing credit rating references from its rules, the comments have been "overwhelmingly in support" of retaining those references as they are. Commissioner Paredes similar cautioned that some references to NRSRO ratings in the rules may still be useful. Commissioner Casey, on the other hand, urged the SEC to eliminate all ratings references from its rules and forms.

The adopted amendments are:

- *Exchange Act Rule 3a1-1, Regulation ATS and related forms*. These rules and forms relate to "alternative trading systems," and currently differentiate between alternative systems for trading investment-grade corporate debt securities and those for non-investment grade corporate debt securities. The SEC's revisions collapse those two categories into a single category of corporate debt securities.

- *Investment Company Act Rule 5b-3*. This rule prescribes the conditions under which a mutual fund may treat a refunded bond (*i.e.*, a debt security as to which all remaining payments have been defeased with escrowed U.S. Government securities) as equivalent to the underlying government

securities. The amendment removes a provision that permitted the mutual fund to rely on an NRSRO rating rather than requiring a CPA's certification that the escrowed securities are sufficient.

- *Investment Company Act Rule 10f-3*. This rule permits a mutual fund to purchase municipal securities underwritten by an affiliate of the fund if the securities have specified NRSRO ratings. The amendment substitutes liquidity and credit risk standards for the rating requirement.

The amendments for which <u>further comments are sought</u> include changes to:

- *Regulation M*. Currently, nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities are exempt from Regulation M (the SEC's anti-market manipulation rule) if they are rated investment grade by at least one NRSRO. As a result, issuers, selling securityholders and distribution participants such as underwriters may continue ordinary market activities during a public distribution of those securities. The SEC's proposed change would modify the exemption to apply to securities of well-known seasoned issuers and asset-backed securities that are registered on Form S-3 (in each case, whether or not rated investment grade).

- *Net Capital Rule*. Currently, the SEC's net capital rule for securities broker-dealers (Exchange Act Rule 15c3-1) prescribes lower "haircuts" for certain investment-grade securities than for other securities. The SEC proposes to replace the rating standard with subjective standards for credit and liquidity risk, permitting a lower net capital charge if the broker-dealer determines that the security:

    - is subject to no greater than "moderate" credit risk and can be sold at or near its carrying value in a reasonably short period of time, in the case of nonconvertible debt securities and preferred stock; or

    - is subject to "minimal" credit risk and can be sold at or near carrying value almost immediately, in the case of commercial paper.

- *Securities Act Rule 415 and Form S-3*. Currently, Rule 415 permits shelf offerings of highly-rated mortgage-related securities, and Form S-3 permits short-form registration to be used for offerings of investment grade asset-backed securities. The SEC has proposed to modify both standards to permit the more favorable treatment only for offerings that are limited to "qualified institutional buyers" under Rule 144A in minimum denominations of at least $250,000, effectively making these registration options unavailable for retail asset-backed transactions.

- *Investment Company Act Rule 3a-7.* Rule 3a-7 provides an exemption from Investment Company Act registration for structured finance transactions that meet certain conditions, including that only investment-grade securities may be sold to retail investors by entities relying on the rule. The SEC's proposal is to eliminate this portion of the exemption entirely, making it impossible for entities relying on Rule 3a-7 to offer any of their securities to retail investors and limiting them instead to institutional accredited investors and qualified institutional buyers.

- *Exchange Act Rule 10b-10.* The SEC proposes deleting the section of this rule that requires broker-dealer confirmations of trades involving corporate debt securities that are not rated by any NRSRO to include a statement to that effect.

- *Investment Company Act Rule 5b-3.* This rule permits a mutual fund to treat a repurchase agreement for securities with certain NRSRO ratings as equivalent to a purchase of the securities themselves; the proposed revision substitutes the determination of the fund's board of directors that the securities present minimum credit risks and are highly liquid.

- *Investment Advisers Act Rule 206(3)-3T.* This rule concerns the requirements for notice to, and consent by, an advisory client before an investment adviser may engage in a principal transaction with the client. The rule currently provides an alternative means of satisfying that requirement under certain circumstances if the securities being traded are non-convertible investment-grade debt.

Required Disclosures of Ratings by Issuers—Newly Proposed Rule. Currently, there is no requirement that issuers disclose ratings of securities they sell in public offerings. The SEC has proposed to require disclosure of such ratings and related information, including what the rating covers and any "material limitations" on its scope; who paid for the rating; and whether a "preliminary rating" was obtained from an NRSRO that was not then asked to issue a final rating. The proposal also includes a requirement that issuers keep their ratings disclosure current by reporting changes on Form 8-K.

Liability of NRSROs—Concept Release. The SEC also announced it will issue a "concept release" seeking comment on a proposal to impose "expert" liability on rating agencies for the disclosure concerning their ratings that appears in a registration statement. Currently, a specific rule shields NRSROs whose ratings are included in a registration statement from being liable for that disclosure as "experts" (as auditors are liable for audited financial statements, for example). The SEC is requesting comment on whether it should repeal this exemption, stating that NRSROs would then be required to consent to being named as "experts" (presumably with respect to the ratings disclosure described above -- meaning that

simply omitting the ratings information will not be an option) and accept the resulting liability under the Securities Act.

Under Section 11 of the Securities Act, an expert is generally liable for the portions of the registration statement it has "expertized" unless the expert can show that after reasonable investigation, it had reasonable grounds to believe the contested statements were true and contained no material omission—the same "due diligence defense" available to underwriters. Underwriters and other persons with potential registration statement liability (other than issuers) are not liable for "expertized" portions of a registration statement as long as they had no reasonable grounds to believe, and did not believe, that those portions were untrue or contained a material omission.

Commissioner Casey pointed out that rating agencies are already subject to anti-fraud liability, and stated that in her view imposing expert liability on rating agencies will not advance investor protection but merely expose rating agencies to costly litigation. The other Commissioners generally didn't express a view except to say that they look forward to seeing the comments.

Disclosures of NRSRO Revenue Sources—Newly Proposed Rule. The SEC also decided to propose for comment new rules that would require each NRSRO to disclose on their Web sites at the end of fiscal year:

- With respect to each client who paid it for a credit rating during the year, the percentage of the NRSRO's net revenue for providing non-rating services to that client and where that client ranks as a source of the NRSRO's net revenue for the year (top 10%, top 25%, top 50%, bottom 50% or bottom 25%); and

- The percentage of the NRSRO's net revenue attributable to its 20 largest credit rating customers (in the aggregate) and the percentage of its net revenue attributable to non-rating services and products.

Compliance Reports—Newly Proposed Rule. The SEC also voted to propose for comment a rule that would require NRSROs to provide the SEC with an annual report concerning their compliance system and issues.

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Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Structured Finance or Capital Markets in the "Practices" section of our web site (http://www.clearygottlieb.com) if you have any questions.

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