
This memorandum is for general information purposes only and is not intended to advertise our services, solicit clients or represent our legal advice as to any particular set of facts, nor does this memorandum represent any undertaking to keep recipients advised as to all relevant legal developments.

SEC Proposes Rules to Increase Transparency in Credit Rating Agencies

On June 11, 2008, the Securities and Exchange Commission (the “Commission” or “SEC”) proposed comprehensive reforms to increase transparency, accountability and competition in the credit rating process by nationally recognized statistical rating organizations (“NRSROs”).¹ The Commission was given statutory authority to oversee NRSROs under the Credit Rating Agency Reform Act of 2006 (the “Act”).² As a result of the subprime mortgage crisis, the Commission decided to supplement the initial rules promulgated under the Act.³ Comments on the proposed rules are due within 30 days of publication in the Federal Register.

The proposed rulemaking will be in three parts.

The first part of the Commission’s rule proposal, as stated in the SEC’s press release, would:

- Prohibit a credit rating agency from issuing a rating on a structured product unless information on assets underlying the product was available.
- Prohibit credit rating agencies from structuring the same products that they rate.

¹ Release No. 2008-110, *SEC Proposes Comprehensive Reforms to Bring Increased Transparency to Credit Rating Process* (June 11, 2008) available at <http://www.sec.gov/news/press/2008/2008-110.htm>. The Commission released the full text of the proposed rules on June 16, 2008. Release No. 34-57967; File No. S7-13-08, *Proposed Rules for Nationally Recognized Statistical Rating Organizations* (June 16, 2008) available at <http://www.sec.gov/rules/proposed/2008/34-57967.pdf>.

² Credit Rating Agency Reform Act of 2006 (Public Law No. 109-291).

³ Rule 17g-1 through 17g-6, promulgated under the Securities Exchange Act of 1934, require registration of credit rating agencies as NRSROs and certain disclosure. The rules also prohibit certain unfair practices.

- Require credit rating agencies to make all of their ratings and subsequent rating actions publicly available. This data would be required to be provided in a way that will facilitate comparisons of each credit rating agency's performance.
- Attack the practice of buying favorable ratings by prohibiting anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it.
- Prohibit gifts from those who receive ratings to those who rate them, in any amount over \$25.
- Require credit rating agencies to publish performance statistics for 1, 3, and 10 years within each rating category, in a way that facilitates comparison with their competitors in the industry.
- Require disclosure by the rating agencies of the way they rely on the due diligence of others to verify the assets underlying a structured product.
- Require disclosure of 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.
- Require credit rating agencies to make an annual report of the number of ratings actions they took in each ratings class, and require the maintenance of an XBRL database of all rating actions on the rating agency's Web site.
- Require the public disclosure of the information a credit rating agency uses to determine a rating on a structured product, including information on the underlying assets.
- Require documentation of the rationale for any significant out-of-model adjustments.

The second part of the Commission's proposal, in recognition of the substantial differences between the rating of structured products and corporate debt, would require credit rating agencies to differentiate the ratings they issue on structured products from those they issue on corporate debt. This could be done through the use of different symbols, such as attaching an identifier to the rating, or by issuing a report disclosing the differences between ratings of structured products and other securities.

The final set of recommendations for the Commission's proposal, to be considered by the SEC on June 25, is the revision of rules that make explicit reference to credit ratings, to reduce undue reliance in the Commission's rules on NRSRO ratings, thereby promoting increased investor due diligence.

* * *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jon Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com.