

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 249b

[Release No. 34-57967; File No. S7-13-08]

RIN 3235-AK14

Proposed Rules for Nationally Recognized Statistical Rating Organizations

AGENCY: Securities and Exchange Commission ("Commission").

ACTION: Proposed rule.

SUMMARY: In the first of three related actions the Commission is proposing rule amendments that would impose additional requirements on nationally recognized statistical rating organizations ("NRSROs") in order to address concerns about the integrity of their credit rating procedures and methodologies in the light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages. Second, the Commission also makes a proposal related to structured finance products rating symbology. And third, in the near future, the Commission intends to propose rule amendments that would be intended to reduce undue reliance in the Commission's rules on NRSRO ratings.

DATES: Comments should be received on or before July 25, 2008.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-13-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-13-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also

available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT:

Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Assistant Director, at (202) 551-5521; Randall W. Roy, Branch Chief, at (202) 551-5522; Joseph I. Levinson, Attorney, at (202) 551-5598; Carrie A. O'Brien, Attorney, at (202) 551-5640; Sheila D. Swartz, Special Counsel, at (202) 551-5545; Rose Russo Wells, Special Counsel, at (202) 551-5527; Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-6628 or, with respect to questions involving the proposed amendments as they implicate the Securities Act of 1933, Kathy Hsu, Special Counsel, at (202) 551-3306 or Eduardo Aleman, Special Counsel, at (202) 551-3646; Division of Corporation Finance, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION:

I. Background

A. Introduction

Beginning in the early 2000s, originators started to increasingly make residential mortgage loans based on lower underwriting standards ("subprime loans").¹ For the first few years there did not appear to be any negative repercussions from this lending practice. However, beginning in mid-2006, home values leveled off and soon began to decline, which, in turn, led to a corresponding increase in delinquencies and, ultimately, defaults in subprime loans.² This marked

¹ There is no standard definition of a subprime loan. However, such a loan can broadly be described as a mortgage loan that does not conform to the underwriting standards required for sale to the government sponsored enterprises (non-conforming loans) and are made to borrowers who: (1) Have weakened credit histories such as payment delinquencies, charge-offs, judgments, and bankruptcies; (2) have reduced repayment capacity as measured by credit scores (e.g., FICO), debt-to-income ratios, loan-to-value ratios, or other criteria; (3) have not provided documentation to verify all or some of the information, particularly financial information, in their loan applications; or (4) have any combination of these factors. Non-conforming loans made to less risky borrowers fall into two other classifications: jumbo and Alt-A.

² See e.g., Testimony of John C. Dugan, Comptroller of the Currency, before the U.S. Senate

increase in subprime loan delinquencies and, ultimately, in defaults has had substantial adverse effects on the markets for, and market values and liquidity of, residential mortgage-backed securities ("RMBS") backed by subprime loans and on collateralized debt obligations ("CDOs") linked to such loans (collectively "subprime RMBS and CDOs").³

Moreover, the impacts from the troubles experienced by subprime loans extended beyond subprime RMBS and CDOs to the broader credit markets and the economy as a whole.⁴ As a result, the parties that participated in various parts of the process of making subprime loans, packaging them into subprime RMBS and CDOs, and selling these debt instruments, including mortgage brokers, loan originators, securities sponsors and underwriters, and NRSROs have come under intense scrutiny. Today, the Commission is proposing a series of new requirements that are designed to address concerns that have been raised about NRSROs in light of the role they played in this process. Additionally, two weeks from today, the Commission will complete its proposal of this series of rule changes. These changes would be intended to reduce undue reliance in the Commission's rules on NRSRO ratings, thereby promoting increased investor due diligence.

B. The Credit Rating Agency Reform Act of 2006

The purpose of the Credit Rating Agency Reform Act of 2006 (the "Rating Agency Act"), enacted on September 29, 2006, is to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."⁵ The operative provisions of the Rating Agency Act became applicable upon the Commission's

Committee on Banking, Housing, and Urban Affairs (March 4, 2008) ("Dugan March 4, 2008 Senate Testimony"), pp. 8-12; Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, before U.S. Senate Committee on Banking, Housing, and Urban Affairs (March 4, 2008) ("Bair March 4, 2008 Senate Statement"), pp. 5-6.

³ See e.g., Dugan March 4, 2008 Senate Testimony, pp. 12-14; Bair March 4, 2008 Senate Statement, pp. 6-7.

⁴ See e.g., Statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (February 28, 2008) ("Bernanke February 28, 2008 Senate Statement"), pp. 1-3; Dugan March 4, 2008 Senate Testimony, pp. 12-15.

⁵ *Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006*, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006) ("Senate Report"), p. 1.

adoption in June 2007 of a series of rules implementing a registration and oversight program for credit rating agencies that register as NRSROs.⁶

To date, a total of nine credit rating agencies have been granted registration with the Commission as NRSROs pursuant to the Rating Agency Act and the rules thereunder.⁷ These registrants include the credit rating agencies most active in rating subprime RMBS and CDOs: Fitch Ratings, Inc. ("Fitch"), Moody's Investors Service ("Moody's"), and Standard and Poor's Rating Services ("S&P").⁸ In the fall of 2007, the Commission, exercising the new authority conferred by the Rating Agency Act, began a staff examination of the NRSROs' activities in rating subprime RMBS and CDOs in order to review whether they adhered to their stated and documented procedures and methodologies for rating these debt instruments and the extent, if any, to

which their ratings may have been impaired by conflicts of interest.⁹

In addition to the examination, the Commission has worked closely with other regulators and supervisors of the financial markets in analyzing the credit market turmoil and in developing recommendations and principles for market participants, including NRSROs.¹⁰ For example, the President's Working Group on Financial Markets issued a *Policy Statement on Financial Market Developments* in March 2008.¹¹ Further, as a member of the International Organization of Securities Commissions ("IOSCO"), the Commission played a substantial role in drafting *The Role of Credit Rating Agencies in Structured Finance Markets*, which was issued for consultation by IOSCO in March 2008.¹² Also, the Commission, as part of its participation in the Financial Stability Forum, worked with its counterparts in the U.S. and abroad on *The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* released in April 2008, which discussed credit rating agencies.¹³

These and other efforts have assisted the Commission in identifying a number of areas in which its current NRSRO rules could be augmented to address concerns about the role NRSROs played in the credit market turmoil.¹⁴ As a result, the Commission is proposing amendments to its existing NRSRO rules and a new rule with the goal of improving the quality of credit ratings determined by NRSROs generally and, in particular, for structured finance products such as RMBS and CDOs.¹⁵ These proposals and the proposals to be considered in two weeks are designed to:

- Enhance the disclosure and comparability of credit ratings performance statistics;

- Increase the disclosure of information about structured finance products;

- Require more information about the procedures and methodologies used to determine credit ratings for structured finance products;

- Strengthen internal control processes through reporting requirements; and

- Address conflicts of interest arising from the process of rating structured finance products; and

- Reduce undue reliance in the Commission's rules on NRSRO ratings, thereby promoting increased investor due diligence.

The Commission believes these proposals would further the purpose of the Rating Agency Act to improve the quality of NRSRO credit ratings by fostering accountability, transparency, and competition in the credit rating industry.¹⁶

C. The Role of Credit Ratings in the Credit Market Turmoil

The growth in the origination of subprime loans began in the early 2000s.¹⁷ For example, Moody's reports that subprime loans amounted to \$421 billion of the \$3.038 trillion in mortgages originated in 2002 (14%) and \$640 billion of the \$2.886 trillion in mortgages originated in 2006 (22%).¹⁸ This growth was facilitated by steadily rising home values and a low interest rate environment.¹⁹ In addition, increases in the breadth of the credit risk transfer markets as a result of new investors willing to purchase credit based structured finance products provided an opportunity for lenders to originate subprime loans and then move them off their balance sheets by packaging and selling them through the securitization process to investors as subprime RMBS and CDOs.²⁰ The investors in subprime RMBS and CDOs included domestic and foreign mutual funds, pension funds, hedge funds, banks, insurance companies, special investment vehicles, and state government operated funds.

This "originate to distribute" business model created demand for residential

⁶ See *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations*, Securities Exchange Act of 1934 ("Exchange Act") Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007) ("Adopting Release"). The rules adopted by the Commission prescribe: how a credit rating agency must apply to the Commission for registration as an NRSRO (Rule 17g-1 (17 CFR 240.17g-1)); the form of the application and the information that must be provided in the application (Form NRSRO and the Instructions to Form NRSRO (17 CFR 240.249b.300)); the records an NRSRO must make and maintain (Rule 17g-2 (17 CFR 240.17g-2)); the reports an NRSRO must furnish to the Commission annually (Rule 17g-3 (17 CFR 240.17g-3)); the areas that must be addressed in an NRSRO's procedures to prevent the misuse of material nonpublic information (Rule 17g-4 (17 CFR 240.17g-4)); the types of conflicts of interest an NRSRO must disclose and manage or is prohibited from having (Rule 17g-5 (17 CFR 240.17g-5)); and certain unfair, coercive, or abusive practices an NRSRO is prohibited from engaging in (Rule 17g-6 (17 CFR 240.17g-6)).

⁷ See Commission Orders granting registration of A.M. Best Company, Inc. (34-56507, September 24, 2007), DBRS Ltd. (34-56508, September 24, 2007), Fitch, Inc. (34-56509, September 24, 2007), Japan Credit Rating Agency, Ltd. (34-56510, September 24, 2007), Moody's Investor Services, Inc. (34-56511, September 24, 2007), Rating and Investment Information, Inc. (34-56512, September 24, 2007), Standard & Poor's Rating Services (34-56513, September 24, 2007), Egan-Jones Rating Company (34-57031, December 21, 2007) and LACE Financial Corp. (34-57300, February 11, 2008).

⁸ According to their most recent Annual Certifications on Form NRSRO, S&P rates 197,700 issuers of asset-backed securities, the category that includes RMBS, Moody's rates 110,000 such issuers, and Fitch rates 75,278 such issuers. No other registered NRSRO reports rating more than 1,000 issuers of asset-backed securities. See Standard & Poor's 2007 Annual Certification on Form NRSRO, available at <http://www.standardandpoors.com>; Moody's Investor Services 2007 Annual Certification on Form NRSRO, available at <http://www.moody.com>; Fitch, Inc. 2007 Annual Certification on Form NRSRO, available at <http://www.fitchratings.com>.

⁹ See Testimony of Christopher Cox, Chairman, Commission, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (April 22, 2008) ("Cox April 22, 2008 Senate Testimony"), pp. 2-3.

¹⁰ See *Id.*, p. 4.

¹¹ A copy of the policy statement is available at: <http://www.ustreas.gov>.

¹² A copy of the report is available at: <http://www.iosco.org>.

¹³ A copy of the report is available at: <http://www.fsforum.org>.

¹⁴ See Cox April 22, 2008 Senate Testimony, pp. 6-8.

¹⁵ The term "structured finance product" as used throughout this release refers broadly to any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This broad category of financial instrument includes, but is not limited to, asset-backed securities ("ABS") such as RMBS and to other types of structured debt instruments such as CDOs, including synthetic and hybrid CDOs.

¹⁶ See Senate Report, p. 2.

¹⁷ See e.g., Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, before U.S. Senate Committee on Banking, Housing, and Urban Affairs (January 31, 2008) ("Bair January 31, 2008 Senate Statement"), p. 4.

¹⁸ According to Moody's, subprime mortgage loans represented \$421 billion of \$3.038 trillion total mortgage origination in 2002 and \$640 billion of \$2.886 trillion total mortgage origination in 2006. See *A Short Guide to Subprime*, Moody's, March 25, 2008, p. 1.

¹⁹ See e.g., Dugan March 4, 2008 Senate Testimony, pp. 8-11.

²⁰ *Id.*

mortgage loans, including subprime loans. For example, according to Moody's, of the approximately \$2.5 trillion worth of mortgage loans originated in 2006, \$1.9 trillion were securitized into RMBS and approximately 25%, or \$520 billion worth, of these loans were categorized as subprime.²¹ The demands of the loan securitization markets encouraged lenders to lower underwriting standards to maintain a steady volume of loans and to use less traditional products such as adjustable rate, negative amortization, and closed-end second lien mortgages.²²

1. The Creation of Subprime RMBS and CDOs

The creation of an RMBS begins by packaging a pool of mortgage loans, usually numbering in the thousands, and transferring them to a bankruptcy remote trust. The trust purchases the loan pool and becomes entitled to the interest and principal payments made by the borrowers. The trust finances the purchase of the loan pool through the issuance of RMBS. The monthly interest and principal payments from the loan pool are used to make monthly interest and principal payments to the investors in the RMBS.

The trust typically issues different classes of RMBS (known as "tranches") offering a sliding scale of coupon rates based on the level of credit protection afforded to the security. Credit protection is designed to shield the tranche securities from loss of interest and principal arising from defaults of the loans backing the RMBS. The degree of credit protection afforded a tranche security is known as its "credit enhancement" and is provided through several means. The primary source of credit enhancement is subordination, which creates a hierarchy of loss absorption among the tranche securities. For example, if a trust issued securities in 10 different tranches of securities, the first (or senior) tranche would have nine subordinate tranches, the next highest tranche would have eight subordinate tranches and so on down the capital structure. Losses of interest and principal experienced by the trust from delinquencies and defaults among loans in the pool are allocated first to the lowest tranche until its principal amount is exhausted and then to the next lowest tranche and so on up the capital structure. Consequently, the senior tranche would not incur any loss

until the principal amounts from all the lower tranches have been exhausted through the absorption of losses from the underlying loans.

A second form of credit enhancement is over-collateralization, which is the amount that the principal balance of the mortgage pool underlying the trust exceeds the principal balance of the tranche securities issued by the trust. This excess principal creates an additional "equity" tranche below the lowest tranche security to absorb losses. In the example above, the equity tranche would sit below the 10th tranche security and protect it from the first losses experienced as a result of defaulting loans.

A third form of credit enhancement is excess spread, which consists of the amount by which the interest derived from the underlying loans in the aggregate exceeds interest payments due to investors in the tranche securities in the aggregate plus the administrative expenses of the trust such as fees due the loan servicer as well as premiums due on derivatives contracts and bond insurance. In other words, the excess spread is the amount that the monthly interest income from the pool of loans exceeds the weighted average interest due to the RMBS bondholders. This excess spread can be used to build up loss reserves or pay off delinquent interest payments due to a tranche security.

A fourth form of credit enhancement sometimes employed is bond insurance. When used, bond insurance is typically purchased only for the senior RMBS tranche.

The creation of a typical CDO is similar to that of an RMBS. A bankruptcy remote trust is created to hold the CDO's assets and issue its securities. The underlying assets, however, are generally debt securities rather than mortgage loans. The CDO trust uses the interest and principal payments from the approximately 200 underlying debt securities to make interest and principal payments to investors in the securities issued by the trust. The trust is structured to provide differing levels of credit enhancement to the securities it issues. Similar to RMBS, credit enhancement is provided through subordination, over-collateralization, excess spread, and bond insurance. In addition to the underlying assets, one significant difference between a CDO and an RMBS is that the CDO may be actively managed such that its underlying assets change over time, whereas the mortgage loan pool underlying an RMBS remains static for the most part.

In recent years, CDOs have been some of the largest purchasers of subprime RMBS and the drivers of demand for those securities. For example, according to Fitch, the average percentage of subprime RMBS in the collateral pools of CDOs it rated grew from 43.3% in 2003 to 71.3% in 2006.²³ Generally, the CDOs holding subprime RMBS issued fell into one of two categories: High grade and mezzanine. High grade CDOs are generally defined as those that hold RMBS tranches with AAA, AA, or A credit ratings, whereas mezzanine CDOs are those that hold RMBS tranches rated predominantly BBB. Securities issued by mezzanine CDOs pay higher yields than those issued by high grade CDOs since the BBB-rated RMBS underlying the mezzanine CDOs pay higher yields than the AAA to A rated RMBS underlying high grade CDOs. In addition to CDOs holding subprime RMBS, a market for CDOs holding other CDOs that held subprime RMBS developed in recent years. These debt instruments are known as "CDOs-squared."

As the market for mortgage related CDOs grew, CDO issuers began to use credit default swaps to replicate the performance of subprime RMBS and CDOs. In this case, rather than purchasing subprime RMBS or CDOs, the CDO entered into credit default swaps referencing subprime RMBS or CDOs, or indexes on RMBS. These CDOs, in some cases, are composed entirely of credit default swaps ("synthetic CDOs") or a combination of credit default swaps and cash RMBS ("hybrid CDOs"). The use of credit default swaps allowed the CDO securities to be issued more quickly, since the issuer did not have to wait to accumulate actual RMBS for the underlying collateral pool.

2. Determining Credit Ratings for Subprime RMBS and CDOs

A key step in the process of creating and ultimately selling a subprime RMBS and CDO is the issuance of a credit rating for each of the tranches issued by the trust (with the exception of the most junior "equity" tranche). The credit rating for each rated tranche indicated the credit rating agency's view as to the creditworthiness of the debt instrument in terms of the likelihood that the issuer would default on its obligations to make interest and principal payments on the debt instrument.²⁴ To varying degrees,

²¹ *Subprime Residential Mortgage Securitizations: Frequently Asked Questions*, Moody's, April 19, 2007, p. 1.

²² See e.g., Bernanke February 28, 2008 Senate Testimony, p. 1; Dugan March 4, 2008 Senate Testimony, pp. 8-10.

²³ *Rating Stability of Fitch-Rated Global Cash Mezzanine Structured Finance CDOs with Exposure to U.S. Subprime RMBS*, Fitch, April 2, 2007, p. 1.

²⁴ See, e.g., *Inside the Ratings: What Credit Ratings Mean*, Fitch, August 2007 ("Inside the Ratings"), p. 2; Testimony of Michael Kanef, Group

many investors rely on credit ratings in making the decision to purchase subprime RMBS or CDOs, particularly with respect to the senior AAA rated tranches. Some investors use the credit ratings to assess the risk of the debt instruments. In part, this may be due to the large number of debt instruments in the market and their complexity. Other investors use credit ratings to satisfy client investment mandates regarding the types of securities they can invest in or to satisfy regulatory requirements based on certain levels of credit ratings, or a combination of these conditions. Moreover, investors typically only have looked to ratings issued by Fitch, Moody's, and S&P, which causes the arrangers²⁵ of the subprime RMBS and CDOs to use these three NRSROs to obtain credit ratings for the tranche securities they brought to market.

The procedures followed by these three NRSROs in developing ratings for subprime RMBS are generally similar. The arranger of the RMBS initiates the rating process by sending the credit rating agency a range of data on each of the subprime loans to be held by the trust (e.g., principal amount, geographic location of the property, credit history and FICO score of the borrower, ratio of the loan amount to the value of the property, and type of loan: First lien, second lien, primary residence, secondary residence), the proposed capital structure of the trust, and the proposed levels of credit enhancement to be provided to each RMBS tranche issued by the trust. Upon receipt of the information, the NRSRO assigns a lead analyst who is responsible for analyzing the loan pool, proposed capital structure, and proposed credit enhancement levels and, ultimately, for formulating a ratings recommendation for a rating committee composed of analysts and/or senior-level personnel not involved in the analytic process.

The next step in the ratings process is the development of predictions, based

on a quantitative expected loss model and other qualitative factors, as to how many of the loans in the collateral pool would default under stresses of varying severity. This analysis also includes assumptions as to how much principal would be recovered after a defaulted loan is foreclosed. Each NRSRO generally uses between 40 and 60 specific credit characteristics to analyze each loan in the collateral pool of an RMBS in order to assess the potential future performance of the loan under various possible scenarios. These characteristics include the loan information described above as well as the amount of equity that the borrowers have in their homes, the amount of documentation provided by borrowers to verify their assets and/or income levels, and whether the borrowers intend to rent or occupy the homes.²⁶

The purpose of this loss analysis is to determine how much credit enhancement a given tranche security would need for a particular category of credit rating. The severest stress test (i.e., the one that would result in the greatest number of defaults among the underlying loans) is run to determine the amount of credit enhancement required for an RMBS tranche issued by the trust to receive an AAA rating. For example, this test might result in an output that predicted that under the "worst case" scenario, 40 percent of the loans in the underlying pool would default and that after default the trust would recover only 50 percent of the principal amount of each loan in foreclosure. Consequently, to get an AAA rating, an RMBS tranche security issued by the trust would need credit enhancement sufficient to cover at least 20 percent of the principal amount of all the RMBS tranches issued by the trust. In other words, absent other forms of credit enhancement such as excess spread, at least 20 percent of the principal amount of the RMBS tranches issued by the trust, including the equity tranche, would have to be subordinate to the senior tranche and, therefore, obligated to absorb the losses resulting from 40% of the underlying loans defaulting.²⁷ The next severest stress test is run to determine the amount of credit enhancement required of the AA tranche and so on down the capital structure. The lowest rated tranche (typically BB or B) is analyzed under a more benign market scenario.

Consequently, its required level of credit enhancement—typically provided primarily or exclusively by a subordinate equity tranche—is based on the number of loans expected to default in the normal course given the lowest possible level of macroeconomic stress.

Following the determination of the level of credit enhancement required for each credit rating category, the next step in the ratings process is to check the proposed capital structure of the RMBS against these requirements. For example, if the proposed structure would create a senior RMBS tranche that had 18 percent of the capital structure subordinate to it (the other RMBS tranches, including, as applicable, an equity tranche), the analyst reviewing the transaction might conclude that based on the output of the loss model the senior tranche should be rated AA since it would need 20 percent subordination to receive an AAA credit rating. Additionally, the analyst could take other factors into consideration such as the quality of the loan servicer or the actual performance of similar pools of loans underlying other RMBS trusts to determine that in this case 18 percent subordination would be sufficient to support an AAA rating (to the extent these factors were not covered by the model).

Typically, if the analyst concludes that the capital structure of the RMBS did not support the desired ratings—in the example above, if it determined that 18 percent credit enhancement is insufficient for the desired AAA rating—this preliminary conclusion would be conveyed to the arranger. The arranger could accept that determination and have the trust issue the securities with the proposed capital structure and the lower rating or adjust the structure to provide the requisite credit enhancement for the senior tranche to get the desired AAA rating (e.g., shift 2 percent of the principal amount of the senior tranche to a lower tranche or add or remove certain mortgages from the proposed asset pool). Generally, arrangers aim for the largest possible senior tranche, i.e., to provide the least amount of credit enhancement possible, since the senior tranche—as the highest rated tranche—pays the lowest coupon rate of the RMBS' tranches and, therefore, costs the arranger the least to fund.

The next step in the process is a cash flow analysis on the interest and principal expected to be received by the trust from the pool of subprime loans to determine whether it will be sufficient to pay the interest and principal due on each RMBS tranche issued by the trust. The NRSROs use quantitative cash flow

Managing Director, Moody's Investors Service, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007) ("Kanef September 26, 2007 Senate Testimony"), p. 2; *Principles-Based Rating Methodology For Global Structured Finance Securities*, S&P, May 29, 2007, p. 3. Since credit ratings are issued for tranches of RMBS and CDOs individually, rather than for the issuers of those tranches, the NRSRO credit ratings are estimates of the probability of default of each RMBS or CDO tranche as an independent instrument.

²⁵ As bankruptcy remote stand-alone legal entities, RMBS and CDO trusts had no employees. Consequently, they relied on third-parties to create and manage them. The term "arranger" is used herein to refer to the party that oversees the creation of the RMBS and CDO, which would include the process of obtaining credit ratings for the various tranches. Frequently, the arranger also served as the underwriter of the securities.

²⁶ See, e.g., Kanef September 26, 2007, Senate Testimony, p. 7.

²⁷ To the extent that the RMBS included other forms of credit enhancement besides the subordination and over-collateralization provided in this example, e.g., excess spread, this 20 percent subordination figure would be reduced accordingly.

models that analyze the amount of principal and interest payments expected to be generated from the loan pool each month over the terms of the RMBS tranche securities under various stress scenarios. The outputs of this model are compared against the priority of payments (the “waterfall”) to the RMBS tranches specified in the trust legal documents. The waterfall documentation could specify over-collateralization and excess spread triggers that, if breached, would reallocate principal and interest payments from lower tranches to higher tranches until the minimum levels of over-collateralization and excess spread were reestablished. Ultimately, the monthly principal and interest payments derived from the loan pool need to be enough to satisfy the monthly payments of principal and interest due by the trust to the investors in the RMBS tranches as well as to cover the administrative expenses of the trust.

In addition to expected loss and cash flow analysis, the analysts review the legal documentation of the trust to evaluate whether it is bankruptcy remote, *i.e.*, isolated from the effects of any potential bankruptcy or insolvency of the arranger. They also review operational and administrative risk associated with the trust, using the results of periodic examinations of the principal parties involved in the issuance of the security, including the mortgage originators, the issuer of the security, the servicer of the mortgages in the loan pool, and the trustee.²⁸ In assessing the servicer, for example, an NRSRO might review its past performance with respect to loan collection, billing, recordkeeping, and the treatment of delinquent loans.

Following these steps, the analyst develops a rating recommendation for each RMBS tranche, which then is presented to a rating committee composed of analysts and/or senior-level personnel not involved in the analytic process. The rating committee votes on the ratings for each tranche and usually approaches the arranger privately to notify it of the ratings decisions. In most cases, an arranger can appeal a rating decision, although the appeal is not always granted (and, if granted, may not necessarily result in any change in the rating decision). Final ratings decisions are published and subsequently monitored through surveillance processes. The NRSRO

typically is paid only if the credit rating is issued, though sometimes it receives a breakup fee for the analytic work undertaken even if the credit rating is not issued.

The process for assigning ratings to subprime CDOs also involves a review of the creditworthiness of each tranche of the CDO. As with RMBS, the process centers on an examination of the pool of assets held by the trust and analysis of how they would perform individually and in correlation during various stress scenarios. However, this analysis is based primarily on the credit rating of each RMBS or CDO in the underlying pool or referenced through a credit default swap entered into by the CDO. In other words, the credit rating is the primary characteristic of the underlying debt instruments that the NRSROs take into consideration when performing their loss analysis. Hence, this review of the debt instruments in the collateral pool and the potential correlations among those securities does not “look through” those securities to their underlying asset pools. The analysis, consequently, generally only goes one level down to the credit ratings of the underlying instruments or reference securities.

CDOs collateralized by RMBS or by other CDOs often are actively managed. Consequently, there can be frequent changes to the composition of the cash assets (RMBS or CDOs), synthetic assets (credit default swaps), or combinations of cash and synthetic assets in the underlying pool. As a result, NRSRO ratings for managed CDOs are based not on the closing date composition of the pool but instead on covenanted limits for each potential type of asset that could be put in the pool. Typically, following a post-closing period in which no adjustments can be made to a CDO’s collateral pool, the CDO’s manager has a predetermined period of several years in which to adjust that asset pool through various sales and purchases pursuant to covenants set forth in the CDO’s indenture. These covenants set limitations and requirements for the collateral pools of CDOs, often by establishing minimum and maximum concentrations for certain types of securities or certain ratings.

NRSROs use a CDO’s indenture guidelines to run “worst-case” scenarios based on the various permutations of collateral permitted under the indenture. For example, an indenture might specify that a CDO’s collateral pool must include between 10 and 20 percent AAA-rated subprime RMBS, with the remaining 80 to 90 percent composed of investment-grade, but not AAA, subprime RMBS. In preparing a

rating for that CDO, an NRSRO will run its models based on all possible collateral pools permissible under the indenture guidelines, placing the most weight on the results from the weakest potential pools (*i.e.*, the minimum permissible amount, 10 percent, of AAA-rated securities and the lowest-rated investment grade securities for the remaining 90 percent). As with RMBS ratings, the model results are then compared against the capital structure of the proposed CDO to confirm that the level of subordination, over-collateralization and excess spread available to each tranche provides the necessary amount of credit enhancement to sustain a particular rating.

3. The Downgrades in Credit Ratings of Subprime RMBS and CDOs

As noted above, the development of the credit risk transfer markets gave rise to an “originate to distribute” model whereby mortgage loans are originated with the intent to securitize them. Under this model, arrangers earn fees from originating, structuring, and underwriting RMBS and servicing the loans underlying the RMBS, as well as frequently a third set of fees from structuring, underwriting, and managing CDOs composed of RMBS. Moreover, the yields offered by subprime RMBS and CDO tranches (as compared to other types of similarly rated debt instruments) led to increased investor demand for these debt instruments. The originate to distribute model creates incentives for originating high volumes of mortgage loans while simultaneously reducing the incentives to maintain high underwriting standards for making such loans. The continued growth of the housing market through 2006, which led to increased competition among lenders, also contributed to looser subprime loan underwriting standards.²⁹

By mid-2006, however, the steady rise in home prices that had fueled this growth in subprime lending came to an end as prices began to decline.³⁰ Moreover, widespread areas of the country began to experience declines whereas, in the past, poor housing markets generally had been confined to distinct geographic areas.³¹ The downturn in the housing market has been accompanied by a marked increase

²⁹ See *e.g.*, Dugan March 4, 2008 Senate Testimony, p. 10; Bernanke February 28, 2008 Senate Testimony, p. 1.

³⁰ See *e.g.*, *Id.*; Bair March 4, 2008 Senate Statement, pp. 5–8; Bair January 31, 2008 Senate Statement, p. 3.

³¹ See *e.g.*, Bair January 31, 2008 Senate Statement, p. 3.

²⁸ Principal parties are not rated *de novo* in each RMBS transaction; rather, each NRSRO has its own procedures and schedules for reviewing those parties on a periodic basis in order to incorporate its assessment of those entities into the rating process.

in delinquencies and defaults of subprime loans.³²

The increases in delinquency and default rates have been concentrated in loans made in 2006 and 2007, which indicates that borrowers have been falling behind within months of the loans being made.³³ For example, by the fourth quarter of 2006, the percentage of subprime loans underlying RMBS rated by Moody's that were in default within six months of the loans being made stood at 3.54 percent, nearly four times the average six month default rate of 0.90 percent between the first quarter of 2002 and the second quarter of 2005. Similarly, default rates for subprime loans within 12 months of the loans being made rose to 7.39 percent as compared to 2.00 percent for the period from the first quarter of 2002 through the second quarter of 2005.³⁴ Figures released by S&P show similar deterioration in the performance of recent subprime loans.³⁵ According to S&P, the serious delinquency rate³⁶ for subprime loans underlying RMBS rated by S&P within twelve months of the initial rating was 4.97 percent of the current aggregate pool balance for subprime RMBS issued in 2005, 10.55 percent for subprime RMBS issued in 2006, and 15.19 percent for subprime RMBS issued in 2007.³⁷

Along with the deterioration in the performance of subprime loans, there has been an increase in the losses incurred after the loans are foreclosed. According to S&P, the actual realized losses on loans underlying 2007 subprime RMBS after 12 months of seasoning were 65 percent higher than the losses recorded for RMBS issued in 2006 at the same level of seasoning.³⁸

The rising delinquencies and defaults in subprime loans backing the RMBS rated by the NRSROs has exceeded the projections on which they based their initial ratings. Furthermore, the defaults and foreclosures on subprime loans have resulted in realizable losses to the lower RMBS tranches backed by the loans and, correspondingly, to the lower CDO tranches backed by those RMBS.

As discussed above, the reduction in the amount of monthly principal and interest payments coming from the underlying pool of subprime loans or, in the case of a CDO, RMBS tranches or other CDO tranches is allocated to the tranches in ascending order. In addition to directly impairing the affected tranche, the losses—by reducing the principal amount of these tranches—decreased the level of subordination protecting the more senior tranches. In other words, losses suffered by the junior tranches of an RMBS or CDO directly reduced the level of credit enhancement—the primary factor considered by NRSROs in rating tranchised securities—protecting the senior tranches of the instrument. These factors have caused the NRSROs to reevaluate, and in many cases downgrade, their ratings for these instruments.

- As of February 2008, Moody's had downgraded at least one tranche of 94.2 percent of the subprime RMBS deals it rated in 2006 (including 100 percent of 2006 RMBS deals backed by subprime second-lien mortgage loans) and 76.9 percent of all subprime RMBS deals it rated in 2007. Overall, 53.7 percent and 39.2 percent of 2006 and 2007 tranches, respectively, had been downgraded by that time. RMBS tranches backed by first lien loans issued in 2006 were downgraded an average of 6.0 notches from their original ratings, while RMBS tranches backed by second-lien loans issued that year were downgraded 9.7 notches on average. The respective figures for 2007 first- and second-lien backed tranches were 5.6 and 7.8 notches.³⁹

- As of March 2008, S&P had downgraded 44.3 percent of the subprime RMBS tranches it had rated between the first quarter of 2005 and the third quarter of 2007, including 87.2 percent of second-lien backed securities. Downgrades to subprime RMBS issued in 2005 averaged four to six notches, while the average for those issued in 2006 and 2007 was 6.0 to 11 notches.⁴⁰

- As of December 7, 2007, Fitch had issued downgrades to 1,229 of the 3,666 tranches of subprime RMBS issued in 2006 and the first quarter of 2007, representing a par value of \$23.8 billion out of a total of \$193 billion.⁴¹ Subsequently, on February 1, 2008, Fitch placed all subprime first-lien

RMBS issued in 2006 and the first half of 2007, representing a total outstanding balance of approximately \$139 billion, on Rating Watch Negative.⁴²

The extensive use of subprime RMBS in the collateral pools of CDOs has led to similar levels of downgrade rates for those securities as well. Moreover, the use of subprime RMBS as reference securities for synthetic CDOs magnified the effect of RMBS downgrades on CDO ratings. Surveillance of CDO credit ratings has been complicated by the fact that the methodologies used by the NRSROs to rate them relied heavily on the credit rating of the underlying RMBS or CDOs. Consequently, to adjust the CDO rating, the NRSROs first have needed to complete their reviews of the ratings for the underlying RMBS or adjust their methodologies to sufficiently account for the anticipated poor performance of the RMBS.⁴³ Ultimately, the NRSROs have downgraded a substantial number of CDO ratings.

- Over the course of 2007, Moody's issued 1,655 discrete downgrade actions (including multiple rating actions on the same tranche), which constituted roughly ten times the number of downgrade actions in 2006 and twice as many as in 2002, previously the most volatile year for CDOs. Further, the magnitude of the downgrades (number of notches) was striking. The average downgrade was roughly seven notches as compared to a previous average of three to four notches prior to 2007. In the words of a March 2008 report by Moody's, "[T]he scope and degree of CDO downgrades in 2007 was unprecedented."⁴⁴

- As of April 1, 2008, S&P had downgraded 3,068 tranches from 705 CDO transactions, totaling \$321.9 billion in issuance, and placed 443 ratings from 119 transactions, with a value of \$33.8 billion, on CreditWatch negative, "as a result of stress in the

³² *Id.*

³³ See e.g., Bair March 24, 2008 Senate Statement, p. 6 ("Serious delinquency rates on subprime mortgages securitized in 2006 are significantly higher than those for any of the previous three years.").

³⁴ *Early Defaults Rise in Mortgage Securitizations: Updated Data Show Continued Deterioration*, Moody's, September 19, 2007, pp. 3–4.

³⁵ *U.S. Subprime RMBS Performance Update: January 2008 Distribution Date*, S&P, February 25, 2008, p. 1.

³⁶ Defined as 90-plus day delinquencies, foreclosures, and real estate owned. *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *U.S. Subprime RMBS 2005–2007 Vintage Rating Actions Update: January 2008*, Moody's, February 1, 2008, pp. 2–4.

⁴⁰ *Transition Study: Structured Finance Rating Transition And Default Update as of March 21, 2008*, S&P, March 28, 2008, pp. 2–3.

⁴¹ *U.S. RMBS Update*, Fitch, February 20, 2008 p. 5.

⁴² *Update on U.S. Subprime and Alt-A: Performance And Rating Reviews*, Fitch, March 20, 2008, p. 13.

⁴³ For example, in November 2007, Fitch announced that in rating CDOs with asset pools which included subprime RMBS, it would adjust all subprime RMBS securities on Rating Watch Negative downwards by three categories—or notches—(six in the case of 2007 subprime RMBS rated BBB+ or lower) before factoring them into a re-assessment of the CDO's rating. See *Global Criteria for the Review of Structured Finance CDOs With Exposure to U.S. Subprime RMBS*, Fitch, November 15, 2007, p. 4.

⁴⁴ *2008 U.S. CDO Outlook and 2007 Review*, Moody's, March 3, 2008, p. 6.

U.S. residential mortgage market and credit deterioration of U.S. RMBS.”⁴⁵

• By mid-December, 2007, Fitch had issued downgrades to 158 of the 431 CDOs it had rated with exposure to RMBS.⁴⁶ Among the 30 CDOs with exposure to the subprime RMBS which “suffered the greatest extent and magnitude of negative rating migration,” all but \$82.7 million of the \$20.7 billion in balance was downgraded.⁴⁷

The scope and magnitude of these downgrades has caused a loss of confidence among investors in the reliability of RMBS and CDO credit ratings issued by the NRSROs.⁴⁸ This lack of confidence in the accuracy of NRSRO ratings has been a factor in the broader dislocation in the credit markets.⁴⁹ For example, the complexity of assessing the risk of structured finance products and the lack of commonly accepted methods for measuring the risk has caused investors to leave the market, including the market for AAA instruments, particularly investors that had relied primarily on NRSRO credit ratings in assessing whether to purchase these instruments.⁵⁰ This has had a significant impact on the liquidity of the market for these instruments.⁵¹

In the wake of these events, the NRSROs that rated subprime RMBS and CDOs have come under intense criticism and scrutiny. It has been suggested that changes may be needed to address the conflicts of interest inherent in the process of rating RMBS and CDOs.⁵² The NRSROs that have been the primary ratings providers for subprime RMBS and related CDOs each operate under an “issuer-pays” model in which they are paid by the arranger to rate a proposed RMBS or CDO. The arranger has an economic interest in obtaining the highest credit rating possible for each security issued by the trust and the NRSRO has an economic interest in having the arranger select it to rate the next RMBS or CDO brought by the arranger to market. Observers

have questioned whether, given the incentives created by this arrangement, the NRSROs are able to issue unbiased ratings, particularly as the volume of deals brought by certain arrangers increased in the mid-2000s.⁵³ The above concerns are compounded by the arrangers’ ability to “ratings shop.” Ratings shopping is the process by which an arranger will bring its proposed RMBS and CDO transaction to multiple NRSROs and choose, on a deal-wide or tranche-by-tranche basis, which two (or in some cases one) to use based on the preliminary ratings of the NRSROs.

In addition, the interaction between the NRSRO and the arranger during the RMBS and CDO rating process has raised concerns that the NRSROs are rating products they designed (*i.e.*, evaluating their own work).⁵⁴ A corporate issuer is more constrained in how it can adjust in response to an NRSRO to improve its creditworthiness in order to obtain a higher rating. In the context of structured finance products, the arranger has much more flexibility to make adjustments to obtain a desired credit rating by, for example, changing the composition of the assets in the pool held by the trust or the subordination levels of the tranche securities issued by the trust. In fact, an arranger frequently will inform the NRSRO of the rating it wishes to obtain for each tranche and will choose an asset pool, trust structure, and credit enhancement levels based on its understanding of the NRSRO’s quantitative and qualitative models. The credit analyst will use the expected loss and cash flow models to, in effect, check whether the proposed assets, trust structure and credit enhancement levels are sufficient to support the credit ratings desired by the arranger.

The NRSRO rules adopted by the Commission in June of 2007 preceded the full emergence of the credit market turmoil. The Commission, in light of its experience since the final rules became effective, is proposing amendments to those rules and a new rule with the goal of further enhancing the utility of NRSRO disclosure to investors, strengthening the integrity of the ratings process, and more effectively addressing the potential for conflicts of interest

inherent in the ratings process for structured finance products.

II. Proposed Amendments

A. Amendments to Rule 17g-5

The Commission adopted Rule 17g-5, in part, pursuant to authority “to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by an [NRSRO].”⁵⁵ The rule identifies a series of conflicts arising from the business of determining credit ratings. Under the rule, some of these conflicts must be disclosed and managed, while other specified conflicts are prohibited outright.

Paragraph (a) of Rule 17g-5 prohibits an NRSRO from having a conflict identified in paragraph (b) of the rule unless the NRSRO discloses the type of conflict on Form NRSRO and establishes, maintains, and enforces procedures to manage it.⁵⁶ Paragraph (b) identifies eight types of conflicts, which include being paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite⁵⁷ or being paid by persons for subscriptions to receive or access credit ratings where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating.⁵⁸

Paragraph (c) of Rule 17g-5 prohibits outright four types of conflicts of interest. Consequently, an NRSRO would violate the rule if it has the type of conflict described in paragraph (c) even if it disclosed the conflict and established procedures to manage it. In the Adopting Release, the Commission explained that these conflicts were prohibited because they would be difficult to manage given their potential to cause undue influence.⁵⁹

The Commission is proposing to amend Rule 17g-5 to require the disclosure and establishment of procedures to manage an additional conflict and to prohibit certain other conflicts outright, as described below.

⁴⁵ *86 Ratings Lowered On 20 U.S. CDOs Of ABS Deals; \$9.107 Billion In Issuance Affected*, S&P, April 1, 2008, p. 1.

⁴⁶ *Summary of Global Structured Finance CDO Rating Actions*, Fitch, December 14, 2007, p. 1.

⁴⁷ *Id.*, p. 6.

⁴⁸ *See, e.g.*, Dugan March 4, 2008 Senate Testimony, p. 13.

⁴⁹ *Id.*, Bair March 4, 2008 Senate Statement, p. 7.

⁵⁰ *Id.*, Bernanke February 28, 2008 Senate Testimony, p. 3.

⁵¹ *See, e.g.*, Dugan March 4, 2008 Senate Testimony, p. 13; Bair January 31, 2008 Senate Testimony, pp. 3-4.

⁵² *See, e.g.*, Opening Statement of Senator Richard C. Shelby for the Hearing of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), pp. 1-2.

⁵³ *See, e.g.*, Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), pp. 4-5.

⁵⁴ *See, e.g.*, Opening Statement of Senator Jack Reed for the Hearing of the U.S. Senate Committee on Banking, Housing, and Urban Affairs (September 26, 2007), pp. 1-2.

⁵⁵ *See* Section 15E(h)(2) of the Exchange Act (15 U.S.C. 78o-7(h)(2)).

⁵⁶ 17 CFR 240.17g-5(a).

⁵⁷ 17 CFR 240.17g-5(b)(1).

⁵⁸ 17 CFR 240.17g-5(b)(5).

⁵⁹ Adopting Release, 72 FR at 33598.

1. Addressing the Particular Conflict Arising From Rating Structured Finance Products by Enhancing the Disclosure of Information Used in the Rating Process

a. The Proposed Amendment

The Commission is proposing to amend Rule 17g-5⁶⁰ to add to the list of conflicts that must be disclosed and managed the additional conflict of repeatedly being paid by certain arrangers to rate structured finance products. This conflict is a subset of the broader conflict already identified in paragraph (b)(1) of Rule 17g-5; namely, “being paid by issuers and underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.”⁶¹ In the case of structured finance products, the Commission preliminarily believes this “issuer/underwriter-pay” conflict is particularly acute because certain arrangers of structured finance products repeatedly bring ratings business to the NRSROs.⁶² As sources of constant deal based revenue, some arrangers have the potential to exert greater undue influence on an NRSRO than, for example, a corporate issuer that may bring far less ratings business to the NRSRO.⁶³ Consequently, the Commission is proposing amendments to Rule 17g-5 that would require additional measures to address this particular type of “issuer/underwriter-pay” conflict.

Specifically, the proposed amendment would re-designate paragraph (b)(9) of Rule 17g-5 as paragraph (b)(10) and in new paragraph (b)(9) identify the following conflict: issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument. To address this conflict, proposed new paragraph (a)(3) would require that as a condition to the NRSRO rating a structured finance product the information provided to the

NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed through a means designed to provide reasonably broad dissemination of the information.⁶⁴ 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.⁶⁵

The proposed amendment would require the disclosure of information provided to an NRSRO by the “issuer, underwriter, sponsor, depositor, or trustee.” The Commission preliminarily believes that, taken together, these are the parties that provide all relevant information to the NRSRO to be used in the initial rating and rating monitoring processes. The Commission is not proposing to specify the party—NRSRO, arranger, issuer, depositor, or trustee—that would need to disclose the information. It may be that the issuer through the arranger and trustee would be in the best positions to disclose the information. In this case, in contracting with these parties to provide a rating for a structured finance product, the NRSRO could require a representation from them that the necessary information would be disclosed as required by the proposed rule. The Commission notes, however, that the proposed rule does not provide a safe harbor for an NRSRO arising from such a representation. Consequently, an NRSRO would violate the proposed rule if it issued a credit rating for a structured finance product where the information is not disclosed notwithstanding any representations from the arranger.

The goal of this proposed amendment is to promote the effective management of this conflict of interest, increase the transparency of the process for rating structured finance products, and foster competition by making it feasible for more market participants, in particular NRSROs that are not contracted by the

arranger to issue a rating but still wish to do so, to perform credit analysis on the instrument and to monitor the instrument’s creditworthiness. As noted above, by providing the opportunity for more NRSROs to determine credit ratings for structured finance products, this proposal is designed to increase the number of ratings extant for a given instrument and, in particular, promote the issuance of ratings by NRSROs that are not hired by the arranger. The goal would be to expose an NRSRO that was unduly influenced by the “arranger-pay” conflict into issuing higher than warranted ratings.⁶⁶ An ancillary benefit would be that the proposal could make it easier for users of credit ratings to identify potentially inaccurate credit ratings and incompetent NRSROs. The proposal also is designed to make it more difficult for arrangers to exert influence on the NRSROs that they hire to determine ratings for structured finance products. Specifically, by opening up the rating process to greater scrutiny, the proposal is designed to make it easier for the hired NRSRO to resist pressure from the arranger by increasing the likelihood that any steps taken to inappropriately favor the arranger could be exposed to the market. Further, as noted above, an ancillary benefit of the proposal is that it could operate as a check on inaccuracy and incompetence.

To further these goals, the proposal would require the disclosure of the following information:

- All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used in determining the initial credit rating for the security or money market instrument, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument;⁶⁷
- All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used by the nationally recognized statistical rating organization in undertaking credit rating surveillance on the security or money market

⁶⁰ 17 CFR 240.17g-5.

⁶¹ 17 CFR 240.17g-5(b)(1). As the Commission noted when adopting Rule 17g-5, the concern with conflict identified in paragraph (b)(1) “is that an NRSRO may be influenced to issue a more favorable credit rating than warranted in order to obtain or retain the business of the issuer or underwriter.” Adopting Release, 72 FR at 33595.

⁶² See e.g., Testimony of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (April 22, 2008) (“Coffee April 22, 2008 Senate Testimony”), pp. 4–6.

⁶³ *Id.*

⁶⁴ This proposed requirement would be in addition to the current requirements of paragraph (a) that an NRSRO disclose the type of conflict of interest in Exhibit 6 to Form NRSRO; and establish, maintain and enforce written policies and procedures to address and manage the conflict of interest. 17 CFR 240.17g-5(a)(1) and (2).

⁶⁵ As used herein, an “unsolicited rating” is one that is determined without the consent and/or payment of the obligor being rated or issuer, underwriter, or arranger of the securities being rated.

⁶⁶ The Commission notes that “unsolicited” ratings could be used to obtain business with arrangers by creating a track record of favorable ratings. The Commission believes the potential to expose such conduct would be equal to that of exposing an NRSRO influenced by the “arranger-pay” conflict inasmuch as the paid for ratings (usually at least two) would be consistently lower than the “unsolicited” ratings.

⁶⁷ See proposed paragraph (a)(3)(i)(A) and (B) of Rule 17g-5.

instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument.⁶⁸

For the purposes of the proposed amendment, the Commission would consider only information that is taken into account in generating the credit rating or in performing surveillance to be “used” by the NRSRO in those contexts. This would exclude information about collateral pools (*i.e.*, “loan tapes”) provided by the arranger containing a mix of assets that is different than the composition of the final collateral pool upon which the credit rating is based. The proposed rule also would exclude from disclosure most, if not all, communications between the NRSRO and the issuer, underwriter, sponsor, depositor, or trustee to the extent the communications do not contain information necessary for the NRSRO to determine an initial credit rating or perform surveillance on an existing credit rating.

The Commission recognizes that the NRSRO would define the information that it uses for purposes of generating credit ratings and, likely, would obtain representations from the arranger that the information is being disclosed as required under the rule. There is a potential that an NRSRO that uses relatively little information to generate credit ratings would be favored by arrangers to minimize the amount of information subject to the disclosure requirement. The Commission preliminarily believes that there is some degree of standardization as to the information used by NRSROs to rate structured finance products (*e.g.*, loan level information, payment priorities among the issued tranches, and legal structure of the issuer). An NRSRO that requires less than the standard level of information would need to convince users of credit ratings, most notably investors, that its ratings process was credible. Otherwise, arrangers ultimately would not use the NRSRO since it would be more difficult to sell the structured finance products if they carried ratings that were not accepted by the marketplace. Nonetheless, the Commission, if this proposal is adopted, intends to monitor whether it results in a significant reduction in the information provided to NRSROs.

The timing and scope of the disclosures of the first set information described above—information used in

determining the initial credit rating—would depend on the nature of the offering: public, private, or offshore.⁶⁹ In an offering registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), the information would need to be disclosed on the date the underwriter and the issuer or depositor set the offering price of the securities being rated (the “pricing date”).⁷⁰ In offerings that are not registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), the information would need to be disclosed to investors in the offering and entities meeting the definition of “credit rating agency” in Section 3(a)(61) of the Exchange Act (which would include credit rating agencies registered, and not registered, as NRSROs)⁷¹ and on the pricing date and disclosed publicly on the first business day after the transaction closes.

The Commission is proposing the pricing date as the time of the first disclosures because it preliminarily believes that this is the earliest date upon which the asset pool and legal structure of the trust are settled on. Thus, the information that would be disclosed would reflect the actual characteristics of the securities to be issued and not, for example, preliminary assets pools with different compositions of loans. At the same time, the disclosure of the information before the securities are sold is designed to provide the opportunity for other credit rating agencies to use the information to develop “unsolicited ratings” for the tranche securities before they are purchased by investors. To the extent unsolicited ratings are issued, they would provide investors with a greater range of credit assessments and, in particular, assessments from credit rating agencies that are not subject to the “arranger-pay” conflict.

The Commission anticipates that the information that would need to be disclosed (*i.e.*, the information used by the hired NRSRO to determine the initial rating) generally would include the characteristics of the assets in the pool underlying the structured finance product and the legal documentation setting forth the capital structure of the trust, payment priorities with respect to the tranche securities issued by the trust (the waterfall), and all applicable covenants regarding the activities of the trust. For example, for an initial rating for an RMBS, this information generally

would include the “loan tape” (frequently a spreadsheet) that identifies each loan in the pool and its characteristics such as type of loan, principal amount, loan-to-value ratio, borrower’s FICO score, and geographic location of the property. In addition, the disclosed information also would include a description of the structure of the trust, the credit enhancement levels for the tranche securities to be issued by the trust, and the waterfall cash flow priorities. With respect to the loan pool information, the Commission does not intend that the proposed disclosure would include any personal identifying information on individual borrowers or properties (such as names, phone numbers, addresses or tax identification numbers).

After the disclosure of the information used by the NRSRO to perform the initial rating, the proposed amendment would require the disclosure of information about the underlying assets that is provided to, and used by, the NRSRO to perform any ratings surveillance.⁷² The Commission anticipates that generally this information would consist of reports from the trustee describing how the assets in the pool underlying the structured finance product are performing. For an RMBS credit rating, this information likely would include the “trustee report” customarily generated to reflect the performance of the loans constituting the collateral pool. For example, an RMBS trustee may generate reports describing the percentage of loans that are 30, 60, and 90 days in arrears, the percentage that have defaulted, the recovery of principal from defaulted loans, and information regarding any modifications to the loans in the asset pool. The disclosure of this information would allow NRSROs that were not hired to rate the deal, including ones that determined unsolicited initial ratings, to monitor on a continuing basis the creditworthiness of the tranche securities issued by the trust. The proposed amendment provides that this information would need to be disclosed at the time it is provided to the NRSRO. This is designed to put other NRSROs and other interested parties on an equal footing with the NRSRO hired by the arranger inasmuch as they would all obtain the information at the same time. Consequently, they all could begin any surveillance processes simultaneously.

The goal of this aspect of the proposal again would be to expose an NRSRO that was allowing business considerations to impact its judgment.

⁶⁹ See Sections II.A.1.b.i–iii below for a broader discussion of the scope of the disclosures that would be required under the proposed amendments.

⁷⁰ See proposed paragraph (a)(3)(i)(A) of Rule 17g–5.

⁷¹ 15 U.S.C. 78c(a)(61).

⁷² Proposed paragraph (a)(3)(ii) of Rule 17g–5.

⁶⁸ See proposed paragraph (a)(3)(ii) of Rule 17g–5.

For example, in order to maintain favor with a particular arranger, an NRSRO may be reluctant to downgrade a credit rating for a structured finance product to its appropriate category even where a downgrade is implied by its surveillance procedures and methodologies. Increasing the number of credit ratings extant for the instrument, including ratings not paid for by the arranger, would make it more difficult to conceal the fact that a particular NRSRO was being unduly influenced by an arranger as to its surveillance process.

As discussed below, the manner and breadth of the disclosures, including how widely the information could be disseminated, would depend on the nature of the offering for the rated structured finance product: public, private, or offshore. The proposed amendment's requirement that the information be "disclosed through a means designed to provide reasonably broad dissemination" would be interpreted by the Commission to mean in the manner described in sections II.A.1.b.i—iii below that discuss the proposed amendment in the context of public, private, and offshore offerings.

The Commission is proposing these amendments to Rule 17g–5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.⁷³ The provisions in this section of the statute provide the Commission with authority to prohibit, or require the management and disclosure of, any potential conflict of interest relating to the issuance of credit ratings by an NRSRO.⁷⁴ The Commission preliminarily believes the proposed amendments are necessary and appropriate in the public interest and for the protection of investors because they are designed to address conflicts of interest and improve the quality of credit ratings for structured finance products by: (1) Increasing the transparency of the ratings process and thereby making it more apparent when an NRSRO may be allowing business considerations to impair its objectivity and (2) enhancing competition by creating the opportunity for NRSROs that are not hired to rate structured products to nonetheless determine credit ratings and establish track records for rating these products.

The Commission preliminarily believes that it is appropriate to require an NRSRO to address and manage the conflict of interest raised by the NRSRO's recurring relationships with structured finance product arrangers by making the rating process more

transparent in terms of the information used to determine the ratings. This would create an opportunity for other NRSROs (including subscriber based NRSROs), unregistered credit rating agencies, and other interested parties to assess the creditworthiness of these products and issue their own credit ratings or credit assessments.⁷⁵ Market participants and observers would be able to compare the ratings of the NRSROs hired by the arrangers against the ratings of NRSROs and others not hired by the arrangers. As discussed above, the Commission preliminarily believes that this would enhance the integrity of the ratings process by making it easier for users of credit ratings to compare NRSROs and evaluate whether an NRSRO's objectivity had been compromised by the undue influence of an arranger. It also could make it easier for the NRSROs hired to determine credit ratings for structured finance products to resist pressure from arrangers insofar as the parties would be aware that the potential for exposing a compromised NRSRO had been increased through the proposed amendment's disclosure requirements.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Would the information proposed to be required to be disclosed sufficient to permit the determination of an unsolicited credit rating? Conversely, would the proposed amendment require the disclosure of more information than would be necessary to permit the determination of an unsolicited credit rating? Commenters believing more information should be disclosed should specifically describe the additional information and the practicality of requiring its disclosure, while commenters believing that less information should be disclosed should specifically describe what information would be unnecessary and explain why it would be unnecessary to disclose.

- The proposed amendment would require the disclosure of information provided to an NRSRO by the "issuer, underwriter, sponsor, depositor, or trustee" based on the Commission's

preliminary belief that these would be the parties relevant to an NRSRO's performance of the ratings process, *i.e.*, that taken together, these are the parties that would provide all relevant information to the NRSRO. Are there other entities that should be included in this category?

- Should the Commission provide a "safe harbor" so that an NRSRO that obtained a representation from one or more parties to a transaction to disclose the required information would not be held in violation of the rule if the party did not fulfill its disclosure obligations under the representation?

- Should the Commission also require the disclosure of information about the steps, if any, that were taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by the security or money market instrument, or, if no such steps were taken, a disclosure of that fact?

- Would the disclosure of the initial information on the pricing date provide enough time for other NRSROs to determine unsolicited ratings before the securities were sold to investors? If not, would it be appropriate to require that this information be disclosed prior to the pricing date? Alternatively, would it be more appropriate to require NRSROs hired by the arranger to wait a period of calendar or business days (*e.g.*, 2, 4, 10 days) after the asset pool is settled upon by the arranger before issuing the initial credit rating in order to provide other NRSROs with sufficient time to determine an unsolicited rating?

- Should the Commission also require the disclosure of the results of any steps taken by the NRSRO, issuer, underwriter, sponsor, depositor, or trustee to verify information about the assets underlying or referenced by a structured finance product? Alternatively, should the Commission require a general disclosure of whether any steps were taken to verify the information and, if so, a description of those steps?

- Do NRSROs obtain information about the underlying assets of structured products—particularly in the surveillance process—from third-parties such as vendors rather than from issuers, underwriters, sponsors, or trustees? If so, would it be necessary to require the disclosure of this information as proposed or can the goals of the proposed amendments in promoting unsolicited ratings be achieved under current practices insofar as the information necessary for surveillance can be obtained from third-party vendors, albeit for a fee?

⁷³ 15 U.S.C. 78o–7(h)(2).

⁷⁴ *Id.*

⁷⁵ As discussed below, for private offerings and offshore offerings, this information would not be disclosed publicly before the offering closes but instead would be provided via a password-protected Internet Web site to credit rating agencies and accredited investors. After the offering closes, the information would be required to be disclosed publicly and, therefore, made available to market observers such as academics.

• Does the information provided to NRSROs by issuers, underwriters, sponsors, depositors, or trustees about assets underlying structured products (e.g., mortgage loans, home equity loans, consumer loans, credit card receivables) commonly include personal identifying information about individuals such as names, social security numbers, addresses, and telephone numbers? If so, are there practical ways to ensure that this information is not disclosed?

• Does any of the information provided to NRSROs by issuers, underwriters, sponsors, depositors, or trustees about assets underlying structured products contain proprietary information? Commenters that believe this is the case should specifically identify any such information.

b. Proposed Guidance for Compliance With Provisions of the Securities Act of 1933

As noted above, the proposed amendments to Rule 17g-5 that would require the disclosure of information about the underlying assets of a structured finance product implicate the Securities Act.⁷⁶ As explained below, the means by which information would be disclosed for the purposes of the proposed amendments to Rule 17g-5 would be governed by the nature of the offering. The Securities Act restricts the types of offering communications that issuers or other parties subject to the Securities Act's provisions (such as underwriters) may use during a registered public offering and, for private offerings, restricts the methods by which communications may be made so as to avoid general solicitation or general advertising of the private offering to potential purchasers. Communications that may be considered offers⁷⁷ are subject to these restrictions.⁷⁸ Likewise, with respect to

unregistered offshore offerings that are intended to comply with the safe harbor provisions of Regulation S, communications that are deemed to be offers in the United States or directed selling efforts in the United States are prohibited. Information about securities that are the subject of an offering that has been provided to NRSROs and is required to be disclosed pursuant to the proposed rules would be considered offers or directed selling efforts and therefore subject to these restrictions relating to offering communications.⁷⁹

In the following three sections, the Commission provides guidance on how the information that would be required to be disclosed under proposed new paragraph (a)(3) of Rule 17g-5 ("Paragraph (a)(3) Information") would need to be disclosed under the proposed amendment and consistent with the Securities Act. As discussed below, the manner and breadth of the disclosures under the proposed amendment would depend on whether the structured finance product was issued under a public, private, or offshore offering.

i. Public Offerings

With respect to registered offerings at the time the Paragraph (a)(3) Information would be required to be disclosed (the pricing date), the information would be written communications and the issuer, underwriter, or other offering participant also would have to comply with the Securities Act with regard to the disclosure of such written communications.⁸⁰ In addition, such written communications would be

limited to a "statutory prospectus" that conforms to the information requirements of Securities Act Section 10. See Securities Act Section 5(b)(1) (15 U.S.C. 77e(b)(1)) and Securities Act Section 10 (15 U.S.C. 77j). After the registration statement is declared effective, offering participants may make written offers only through a statutory prospectus, except that they may use additional offering materials if a final prospectus that meets the requirements of Securities Act Section 10(a) is sent or given prior to or with those materials. See Securities Act Section 2(a)(10) (15 U.S.C. 77b(a)(10)) and Section 5(b)(1).

⁷⁹ This may be the case even if the information relates to pools backing prior issuances. In an offering of securities backed by the same class of assets, the information provided for surveillance and required to be disclosed pursuant to proposed Rule 17g-5(a)(3)(iii) may be static pool data as described in Item 1105 of Regulation AB (17 CFR 229.1105).

⁸⁰ See *Securities Offering Reform*, Securities Act Release 33-8591 (July 19, 2005), 70 FR 44722 (August 3, 2005) (the "Securities Offering Reform Release") for a discussion of the definition of written communications and rules relating to permitted communications in registered offerings. See also *Asset-Backed Securities*, Securities Act Release No. 8518 (December 22, 2004) 70 FR 1506 (January 7, 2005) (the "Asset-Backed Securities Release") for rules applicable to offerings of asset-backed securities.

subject to the civil liability and antifraud provisions of the Securities Act.⁸¹

As discussed in the Commission's Securities Offering Reform Release adopting several reforms to the securities offering process,⁸² issuers of structured finance products have potentially two sets of rules under the Securities Act on which they may rely in using written offering materials. If the offering is registered on Securities Act Form S-3,⁸³ then the written materials may constitute ABS informational and computational materials, as defined in Item 1101 of Regulation AB,⁸⁴ and

⁸¹ Under the Securities Act, purchasers of an issuer's securities in a registered offering have private rights of action for materially deficient disclosure in registration statements under Section 11 and in prospectuses and oral communications under Section 12(a)(2). Under Securities Act Section 12(a)(2) and Securities Act Rule 159, the liability determination as to an oral communication, prospectus, or statement, as the case may be, does not take into account information conveyed to a purchaser only after the time of sale (including the contract of sale), including information contained in a final prospectus, prospectus supplement, or Exchange Act filing that is filed or delivered subsequent to the time of sale (including the contract of sale) where the information is not otherwise conveyed at or prior to that time. The time of sale under the Securities Act includes the time of the contract of sale—the time at which an investor has taken the action the investor must take to become committed to purchase the securities and therefore entered into a contract of sale.

⁸² See Section III.D.3.b.iii(C)(3)(a)(iii) of the Securities Offering Reform Release, 70 FR 44722, 44751.

⁸³ 17 CFR 239.13. An ABS issuer is eligible to use Form S-3 if the conditions of General Instruction V are met.

⁸⁴ 17 CFR 229.1101. Item 1101 of Regulation AB provides the following definition:

(a) *ABS informational and computational material* means a written communication consisting solely of one or some combination of the following:

(1) Factual information regarding the asset-backed securities being offered and the structure and basic parameters of the securities, such as the number of classes, seniority, payment priorities, terms of payment, the tax, Employment Retirement Income Security Act of 1974, as amended, (29 U.S.C. 1001 *et seq.*) ("ERISA") or other legal conclusions of counsel, and descriptive information relating to each class (e.g., principal amount, coupon, minimum denomination, anticipated price, yield, weighted average life, credit enhancements, anticipated ratings, and other similar information relating to the proposed structure of the offering);

(2) Factual information regarding the pool assets underlying the asset-backed securities, including origination, acquisition and pool selection criteria, information regarding any prefunding or revolving period applicable to the offering, information regarding significant obligors, data regarding the contractual and related characteristics of the underlying pool assets (e.g., weighted average coupon, weighted average maturity, delinquency and loss information and geographic distribution) and other factual information concerning the parameters of the asset pool appropriate to the nature of the underlying assets, such as the type of assets comprising the pool and the programs under which the loans were originated;

(3) Identification of key parties to the transaction, such as servicers, trustees, depositors, sponsors,

⁷⁶ 15 U.S.C. 77a *et seq.*

⁷⁷ Securities Act Section 2(a)(3) (15 U.S.C. 77b(a)(3)) defines an "offer" as any attempt to offer to dispose of, or solicitation of any offer to buy, a security or interest in a security for value. The term "offer" has been interpreted broadly and goes beyond the common law concept of an offer. See *Diskin v. Lomasney & Co.*, 452 F. 2d 871 (2d Cir. 1971); *SEC v. Cavanaugh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998). The Commission has explained that "the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer in its securities constitutes an offer * * *." *Guidelines for the Release of Information by Issuers Whose Securities are in Registration*, Securities Act Release No. 5180 (August 16, 1971), 36 FR 16506.

⁷⁸ Before the registration statement is filed, all offers, in whatever form, are prohibited. See Securities Act Section 5(c) (15 U.S.C. 77e(c)). Between the filing of the registration statement and its effectiveness, offers made in writing (including by e-mail or Internet), by radio, or by television are

should be filed on Exchange Act Form 8-K⁸⁵ in accordance with Rules 167 and 426 of the Securities Act.⁸⁶ The written materials may constitute a free writing prospectus, as defined in Rule 405 of the Securities Act.⁸⁷ In that case, the information that is disclosed must be filed in accordance with Rules 164 and 433 of the Securities Act.⁸⁸ Given that the Paragraph (a)(3) Information could constitute offering materials, the Commission believes it is important to explain how the rules under the Securities Act may be relied upon when Paragraph (a)(3) Information is made publicly available.⁸⁹

originators and providers of credit enhancement or other support, including a brief description of each such party's roles, responsibilities, background and experience;

(4) Static pool data, as referenced in Item 1105 of this Regulation AB, such as for the sponsor's and/or servicer's portfolio, prior transactions or the asset pool itself;

(5) Statistical information displaying for a particular class of asset-backed securities the yield, average life, expected maturity, interest rate sensitivity, cash flow characteristics, total rate of return, option adjusted spread or other financial or statistical information relating to the class or classes under specified prepayment, interest rate, loss or other hypothetical scenarios. Examples of such information under the definition include:

(i) Statistical results of interest rate sensitivity analyses regarding the impact on yield or other financial characteristics of a class of securities from changes in interest rates at one or more assumed prepayment speeds;

(ii) Statistical information showing the cash flows that would be associated with a particular class of asset-backed securities at a specified prepayment speed; and

(iii) Statistical information reflecting the financial impact of losses based on a variety of loss or default experience, prepayment, interest rate and related assumptions.

(6) The names of underwriters participating in the offering of the securities, and their additional roles, if any, within the underwriting syndicate;

(7) The anticipated schedule for the offering (including the approximate date upon which the proposed sale to the public will begin) and a description of marketing events (including the dates, times, locations, and procedures for attending or otherwise accessing them); and

(8) A description of the procedures by which the underwriters will conduct the offering and the procedures for transactions in connection with the offering with an underwriter or participating dealer (including procedures regarding account-opening and submitting indications of interest and conditional offers to buy). The Commission confirmed in the Asset-Backed Securities Release that loan level information could be included in ABS information and computational materials.

⁸⁵ 17 CFR 249.308.

⁸⁶ 17 CFR 230.167 and 17 CFR 230.426.

⁸⁷ 17 CFR 230.405. The contents of free writing prospectuses are not limited to ABS informational and computational materials.

⁸⁸ 17 CFR 230.164 and 17 CFR 230.433. Rule 433 also provides that a free writing prospectus or portion thereof required to be filed under Rule 433 containing only ABS informational and computational materials may be filed under Rule 433 but within the time frame required for satisfaction of the conditions of Rule 426, and that such filing will satisfy the conditions of Rule 433.

⁸⁹ Depending on whether the materials constitute a free writing prospectus or ABS informational and

Most elements of the Paragraph (a)(3) Information would need to be filed in accordance with the rules governing free writing prospectuses or ABS informational and computational materials pursuant to Rules 433 and 426.⁹⁰ Currently, the timing or filing requirements under these rules is tied to when the information is provided to specific investors. However, unlike other free writing prospectuses and ABS informational and computational materials that may be provided to specific investors, in a public offering, the Paragraph (a)(3) Information would be required to be disclosed publicly. Therefore, the Commission believes that it is appropriate to clarify when the materials should be filed with the Commission.

Under Rule 426, ABS informational and computational materials are required to be filed by the later of the due date for filing the final prospectus under Rule 424(b) or two days after the date of first use. Under Rule 433, a free writing prospectus must be filed with the Commission no later than the date of first use. However, in order to conform certain asset-backed free writing prospectuses with the filing requirements for ABS informational and computational materials in Rule 426, Rule 433(d)(6) provides that a free writing prospectus containing only ABS information and computational materials may be filed in the time provided by Rule 426(b). Thus, under both rules the information must be filed by the later of the due date for filing the final prospectus under Rule 424(b) or two days after the date of first use.

In addition, Rule 433 requires filing by issuers of free writing prospectuses prepared by or on behalf of, or used or referred to by, issuers or, depositors, sponsors, servicers, or affiliated depositors, whether or not the issuer, but not by underwriters or dealers, unless they contain issuer information or are distributed in a manner reasonably designed to lead to its broad dissemination. The Paragraph (a)(3) Information that would be required to

computational materials, the liability provisions governing the disclosure may differ. Free writing prospectuses are subject to liability under Section 12(a)(2) and Section 17(a) of the Securities Act. 15 U.S.C. 77j(a)(2) and 15 U.S.C. 77q(a). A free writing prospectus will not be part of a registration statement subject to liability under Securities Act Section 11 unless the issuer elects to file it as part of the registration statement. See also Asset-Backed Securities Release at footnote 335. On the other hand, ABS informational and computational materials also are subject to Section 12(a)(2) and Section 17(a) liability, but they must be filed on Form 8-K and therefore, by virtue of incorporation by reference into a registration statement, are subject to Section 11 liability.

⁹⁰ 17 CFR 230.433 and 17 CFR 230.426.

be disclosed would not be considered underwriter or dealer information, even if prepared by the underwriter or dealer, given the broad dissemination and thus would need to be filed.

Rules 164 and 167 provide the exemption from Section 5(b)(1) of the Securities Act for the use of free writing prospectuses and ABS informational and computational materials, respectively. For the most part, Rule 164 should be available for the use of the Paragraph (a)(3) Information, even where the issuer is an ineligible issuer,⁹¹ given that the rule provides that ineligible issuers that are asset-backed issuers may use a free writing prospectus as long as the free writing prospectus contains only specified information.⁹² Much of the Paragraph

⁹¹ An "ineligible issuer," as the term is defined in Rule 405 of the Securities Act, includes, in the case of asset-backed issuers, the depositor or any issuing entities previously established, directly or indirectly by the depositor, who are not current in their Exchange Act reports and other materials required to be filed during the prior 12 months (or such shorter period that the issuer was required to file such reports and materials), other than reports on Form 8-K required solely pursuant to an item specified in General Instruction I.A.4 of Form S-3.

⁹² In asset-backed offerings by ineligible issuers, free writing prospectuses used by ineligible issuers are limited to the following information:

(1) Factual information regarding the asset-backed securities being offered and the structure and basic parameters of the securities, such as the number of classes, seniority, payment priorities, terms of payment, the tax, ERISA or other legal conclusions of counsel, and descriptive information relating to each class (e.g., principal amount, coupon, minimum denomination, anticipated price, yield, weighted average life, credit enhancements, anticipated ratings, and other similar information relating to the proposed structure of the offering);

(2) factual information regarding the pool assets underlying the asset-backed securities, including origination, acquisition and pool selection criteria, information regarding any prefunding or revolving period applicable to the offering, information regarding significant obligors, data regarding the contractual and related characteristics of the underlying pool assets (e.g., weighted average coupon, weighted average maturity, delinquency and loss information and geographic distribution) and other factual information concerning the parameters of the asset pool appropriate to the nature of the underlying assets, such as the type of assets comprising the pool and the programs under which the loans were originated;

(3) identification of key parties to the transaction, such as servicers, trustees, depositors, sponsors, originators and providers of credit enhancement or other support, including a brief description of each such party's roles, responsibilities, background and experience;

(4) static pool data;

(5) the names of underwriters participating in the offering of the securities, and their additional roles, if any, within the underwriting syndicate;

(6) the anticipated schedule for the offering (including the approximate date upon which the proposed sale to the public will begin) and a description of marketing events (including the dates, times, locations, and procedures for attending or otherwise accessing them); and

(7) a description of the procedures by which the underwriters will conduct the offering and the

(a)(3) Information should contain information that can be included in a free writing prospectus used by an asset-backed issuer pursuant to Rule 164. To the extent that Rule 167 is not available because the offering is registered on Form S-1 rather than Form S-3, and Rule 164 is not available, the information should be filed in an amendment to the registration statement.

In addition, the Commission understands that currently at least some of the information that would constitute Paragraph (a)(3) Information, if not included in a free writing prospectus, is often included as a schedule to pooling and servicing agreements. Those agreements, along with their schedules and exhibits, should be filed by the time of the offering of securities. Therefore they should be filed at the time of the takedown as exhibits to a Form 8-K incorporating them by reference into the Form S-3 registration statement.⁹³

The Commission generally requests comment on all aspects of this proposed guidance. In addition, the Commission requests comment on the following questions related to the proposal.

- Do we need to give more guidance on the relationship between the proposed disclosure requirements regarding information about the underlying assets provided to, and used by, the NRSRO to perform ratings surveillance and the requirements of Regulation FD? ⁹⁴ If commenters believe that the proposed requirements are not consistent with Regulation FD, they should provide a detailed explanation as to why not.

- The proposed disclosure requirements regarding information about the underlying assets provided to, and used by, the NRSRO to perform ratings surveillance may be the same as the information required to be disclosed on Form 10-D for so long as the issuer has an Exchange Act reporting obligation. Given that the Form 10-D reporting obligation is typically suspended for most asset-backed issuers after the first year of reporting, does the proposed disclosure requirement raise any issues regarding Exchange Act reporting?

- ABS informational and computation materials, as defined in Item 1101 of Regulation AB, can

include, among other things, factual information regarding the pool assets underlying the asset-backed securities, including origination, acquisition and pool selection criteria, information regarding any prefunding or revolving period applicable to the offering, information regarding significant obligors, data regarding the contractual and related characteristics of the underlying pool assets (e.g., weighted average coupon, weighted average maturity, delinquency and loss information and geographic distribution) and other factual information concerning the parameters of the asset pool appropriate to the nature of the underlying assets, such as the type of assets comprising the pool and the programs under which the loans were originated.⁹⁵ As noted above, the Commission believes that at least some of the proposed Paragraph (a)(3) Information could fall within this category and therefore constitute ABS informational and computational materials. Since there may be a wide variety of information that is provided to an NRSRO, it is not clear that all information provided would fit within the definition of ABS informational and computation materials, or in the various categories of free writing prospectus. Should the Commission provide additional interpretation regarding what types of material that could be provided and would be required to be disclosed to fit within this category? Is there information that is likely to be provided and disclosed that does not appear to fit within these definitions? Should the Commission instead revise the definitions to specifically include the information required to be disclosed?

- Is there any need for the Commission to revise Securities Act Rules 426 or 433 to clarify when the materials need to be filed?

- Are there any additional requirements in Regulation AB or under the Securities Act that are implicated by the proposed amendments? Is there any information that would typically need to be disclosed under this proposed amendment that is not already generally disclosed in filings with the Commission?

- Should the Commission amend Regulation AB to require that the Paragraph (a)(3) Information be disclosed?

ii. Private Offerings

The proposed amendments also would implicate the Securities Act restrictions affecting private offerings. Offerings of securities made in reliance

on an exemption from registration contained in Securities Act Section 4(2),⁹⁶ the rules promulgated thereunder or pursuant to Regulation D,⁹⁷ are offerings that are not made to the public. As a result, general solicitation or advertising is prohibited in these offerings under Securities Act Section 4(2) and the applicable Securities Act rules.⁹⁸ As a result of the application of the general solicitation and advertising restrictions, public disclosure of offering or security information pursuant to the proposed rules could cause the private offering exemptions to be unavailable to securities offerings to which the proposed rules apply.

As discussed above, the Commission believes it is likely that much of the information that would need to be disclosed under the proposed amendment would contain extensive loan level data, and thus anticipates that a common medium for disclosure of this information would be an Internet Web site. The Commission has indicated that the placement of private offering materials on an Internet Web site, without sufficient procedures to limit access only to accredited investors, is inconsistent with the prohibition against general solicitation or advertising in Securities Act Rule 502(c).⁹⁹ However, as discussed above, the Commission also believes that to address the conflict of interest inherent in the structured finance product arranger-pay business model it would be beneficial to make this information available to investors and entities meeting the definition of "credit rating agency" in Section 3(a)(61) of the Exchange Act (which would include NRSROs)¹⁰⁰ on the date the placement agent and the issuer or depositor set the offering price of the securities being

⁹⁶ 15 U.S.C. 77d(2).

⁹⁷ 17 CFR 230.501 through 230.508.

⁹⁸ See Securities Act Section 4(2) (15 U.S.C. 77d(2)) and Securities Act Rules 504, 505 and 506 of Regulation D (17 CFR 230.504, 230.505 and 230.506). An exception to the prohibition against general solicitation applies to some limited offerings under Rule 504(b)(1) (17 CFR 230.504(b)(1)) when an issuer has satisfied state securities laws of specified types. See *Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption*, Securities Act Release No. 7644 (February 25, 1999), 64 FR 11090. The restriction on general solicitation or advertising applies to all methods by which the communication can be made, including electronic, paper, mail, radio, television, or in newspapers or magazines.

⁹⁹ See *Use of Electronic Media*, Securities Act Release No. 7856 (April 28, 2000), 65 FR 25843 (the "Electronic Media Release"). The Commission noted in the Electronic Media Release that the federal securities laws apply equally to information contained on an issuer's Web site as they do to other communications made by or attributed to the issuer.

¹⁰⁰ 15 U.S.C. 78c(a)(61).

procedures for transactions in connection with the offering with an underwriter or participating dealer (including procedures regarding account opening and submitting indications of interest and conditional offers to buy).

⁹³ See Form S-3 (17 CFR 239.13), Form 8-K (17 CFR 249.308) and Item 601(b)(4) of Regulation S-K (17 CFR 229.601).

⁹⁴ 17 CFR 243.100 to 103.

⁹⁵ See Asset-Backed Securities Release.

rated, and to the general public on the first business day after the offering closes.

The Commission believes, therefore, that in a private offering, Paragraph (a)(3) Information would need to be provided to investors, NRSROs, and credit rating agencies by posting the information on a password-protected Internet Web site.¹⁰¹ On the first business day after the offering closes, however, the Paragraph (a)(3) Information would need to be disclosed publicly. The Commission believes that removing the password protection from the Internet Web site where the Paragraph (a)(3) Information is posted after the offering closes is consistent with the Securities Act restrictions on private offerings while satisfying the requirements of proposed Rule 17g-5(a)(3).

As discussed above, the Commission believes it would be appropriate to allow early access to credit rating agencies other than those hired to issue a rating to provide them with an opportunity to perform independent assessments of the validity of ratings and identify flaws, opportunities for improvement, or compromised procedures in the hired NRSRO's approach. While permitting access to this information to credit rating agencies in addition to accredited investors extends beyond the Commission's previous interpretations on what constitutes a general solicitation or advertising, the Commission believes it balances those issues with the benefits of having other credit rating agencies able to assess the quality of, or provide additional, ratings.¹⁰² This approach is designed to promote competition among NRSROs by providing credit rating agencies that were not paid by the issuer to rate the issuer's products with information they need to issue unsolicited ratings and allowing other market participants to also have access to the information to allow them to evaluate the ratings. In a private offering, disclosure of this information is undertaken in two steps in order to avoid issues of general solicitation. The Commission is providing the above guidance only in the context of the proposed amendments. Moreover, the guidance expressed in this release is

applicable only if the proposed amendments are adopted.

The Commission generally requests comment on all aspects of this proposed guidance. In addition, the Commission requests comment on the following questions related to the proposal.

- Are there other parties besides credit rating agencies and investors that should be eligible to access Paragraph (a)(3) Information in the context of a private offering without raising issues of general solicitation?
- Should any of the foregoing guidance regarding the use of Paragraph (a)(3) Information be codified?
- Is expanding the categories of parties who can access the information that would be contained in the proposed Paragraph (a)(3) Information consistent with the purposes of the Securities Act?
- Is there any Paragraph (a)(3) Information that should remain accessible only to credit rating agencies and investors, rather than, as proposed, disclosed to the public on the business day after the offering has closed?
- Should the requirement to publicly disclose the Paragraph (a)(3) Information on the first business day after the offering has closed also permit the NRSRO, depositor, etc. to omit deal-specific information relating to the transaction such that only "generic" information is provided to the public?
- Does disclosure of information provided for purposes of credit rating surveillance raise issues of general solicitation in the context of subsequent offerings of the same asset class? If so, does this vary by asset class?

iii. Offshore Offerings

Similar to private offerings, the proposed amendments would implicate restrictions under Regulation S. Under the General Statement of Regulation S,¹⁰³ the provisions of Section 5 of the Securities Act apply to offers and sales of securities that occur in the United States and do not apply to those that occur outside the United States. Regulation S contains various safe harbor procedures that issuers, offering participants and others can follow for unregistered offerings outside the United States. These procedures include restrictions against offers being made to persons in the United States¹⁰⁴ and restrictions against directed selling efforts in the United States by the issuer, distributor, any of their respective affiliates, or persons acting on their behalf.¹⁰⁵

As noted above, the Commission believes that it is likely that much of the information that would be required to be disclosed would contain extensive loan level data and thus anticipates that a common medium for disclosure of this information would be an Internet Web site. The Commission has provided guidance with respect to the use of Internet Web sites for securities offerings outside the United States.¹⁰⁶ This guidance sets out a general approach that when adequate measures are implemented to prevent U.S. persons from participating in an offshore offer, the Commission would not view the offer as occurring in the United States for registration purposes. The Commission believes that this guidance can be equally applied to the proposed disclosure of the proposed Paragraph (a)(3) Information.

Under this guidance, what constitutes adequate measures would depend on all of the facts and circumstances of a particular transaction. As the Commission noted previously:

"We generally would not consider an offshore Internet offer made by a non-U.S. offeror as targeted at the United States, however, if: (1) the Web site contains a prominent disclaimer making it clear that the offer is directed only to countries other than the United States; * * * and (2) the Web site offeror implements procedures that are reasonably designed to guard against sales to U.S. persons in the offshore offering."¹⁰⁷

These procedures are not exclusive.

The Commission's prior guidance distinguishes among foreign issuers and U.S. issuers each conducting offshore offerings under Regulation S and U.S. offerings conducted on an exempt basis. The Commission believes it is appropriate to continue this treatment with respect to the proposed disclosure of the Paragraph (a)(3) Information. Under this guidance, a foreign issuer making an offshore offering with no concurrent U.S. private offering is not required to password-protect Internet-based offering communications so long as adequate measures are put in place. Thus, credit rating agencies and other market participants should be able to have ready access to any Paragraph (a)(3) Information that is posted by a foreign issuer. A foreign issuer making an offshore offering concurrently with private offerings in the United States could implement additional other procedures to prevent its offshore Internet communications from being

¹⁰¹ A password-protected Web site would meet the requirements of an amended Rule 17g-5 in the context of private offerings.

¹⁰² The Commission noted in *Interpretative Release on Regulation D*, Securities Act Release No. 6455 (March 3, 1983), 17 CFR 231, that Rule 502(c) relates to the nature of the offering, not the nature of the offerees.

¹⁰³ Rule 901 of Regulation S, 17 CFR 230.901.

¹⁰⁴ Rule 903(a)(1).

¹⁰⁵ Rule 903(a)(2).

¹⁰⁶ See *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore*, Securities Act Release No. 7516 (March 23, 1998).

¹⁰⁷ *Id.*

used to solicit participants for its U.S.-based exempt offering, and U.S. issuers conducting an offshore offering should implement procedures similar to those for private placements, such as password-type procedures, under which only non-U.S. persons can obtain access to the materials. Consistent with the procedures for private offerings, there could be pricing date disclosure to credit rating agencies that are not purchasers in the offering through a password-protected Internet Web site. As a result, when a foreign issuer is conducting a U.S. private offering under Section 4(2), and when a U.S. issuer is conducting an offshore offering under Regulation S or a private offering under Section 4(2), it would follow the procedures outlined in Section II.A.1.b.ii above with respect to private offerings, including procedures calling for public disclosure of Paragraph (a)(3) Information on the business day after the closing date.

The Commission generally requests comment on all aspects of this proposed guidance. In addition, the Commission requests comment on the following questions related to the proposal.

- Are there other parties besides credit rating agencies that should be eligible to access Paragraph (a)(3) Information in the context of an offshore offering without raising issues of directed selling efforts or offers of securities in the United States?

- Should any of the foregoing guidance regarding the use of Paragraph (a)(3) Information be codified?

- Is expanding the categories of parties who can access the information that would be contained in the proposed Paragraph (a)(3) Information consistent with the purposes of the Securities Act?

- Is there any Paragraph (a)(3) Information that should remain accessible only to credit rating agencies and investors, rather than, as proposed, be disclosed to the public on the business day after the offering has closed?

- Should the requirement to publicly disclose the Paragraph (a)(3) Information on the first business day after the offering has closed also permit the NRSRO, depositor, etc. to omit deal-specific information relating to the transaction such that only "generic" information is provided to the public?

2. Rule 17g-5 Prohibition on Conflict of Interest Related to Rating an Obligor or Debt Security Where Obligor or Issuer Received Ratings Recommendations From the NRSRO or Person Associated With the NRSRO

The Commission is proposing to amend Rule 17g-5(c) to add a new

paragraph (5) that would prohibit an NRSRO from issuing a credit rating with respect to an obligor or security where the NRSRO or a person associated with the NRSRO, as defined in Section 3(a)(63) of the Exchange Act,¹⁰⁸ made recommendations to the obligor or the issuer, underwriter, or sponsor of the security (that is, the parties responsible for structuring the security) about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. This proposal would prohibit the NRSRO and, in particular, its credit analysts from making recommendations to obligors, issuers, underwriters, and sponsors such as arrangers of structured finance products about how to obtain a desired credit rating during the rating process. It also would prohibit an NRSRO from issuing a credit rating where a person associated with the NRSRO, such as an affiliate, made such recommendations.

The Commission is proposing this amendment to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.¹⁰⁹ The provisions of this section of the statute provide the Commission with authority to prohibit, or require the management and disclosure of, any potential conflict of interest relating to the issuance of credit ratings by an NRSRO.¹¹⁰ The Commission preliminarily believes the proposed amendment is necessary and appropriate in the public interest and for the protection of investors because it would address a potential practice that could impair the objectivity, and, correspondingly, the quality, of a credit rating. It has been suggested that during the process of rating structured finance products the NRSROs have recommended to arrangers how to structure a trust or complete an asset pool to receive a desired credit rating and then rated the securities issued by the trust—in effect, rating their own work.¹¹¹ This proposal would prohibit this conduct based on the Commission's preliminary belief that it creates a conflict that cannot be effectively managed inasmuch as 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.

¹⁰⁸ 15 U.S.C. 78c(a)(63).

¹⁰⁹ 15 U.S.C. 78o-7(h)(2).

¹¹⁰ *Id.*

¹¹¹ See e.g., Coffee April 22, 2008 Senate Testimony, pp. 2-3.

The proposal is not intended to prohibit all interaction between the NRSRO and the obligor, issuer, underwriter, or sponsor during the rating process. The Commission preliminarily believes that the transparency of an NRSRO's procedures and methodologies for determining credit ratings is enhanced when the NRSRO explains to obligors and issuers the bases, assumptions, and rationales behind rating decisions. For example, the Commission understands that in the structured finance area, NRSROs may provide information to arrangers about the output of expected loss and cash flow models. The information provided by the NRSRO during the rating process allows the arranger to better understand the relationship between model outputs and the NRSRO's decisions with respect to necessary credit enhancement levels to support a particular rating. The arranger then can consider the feedback and determine independently the steps it will take, if any, to adjust the structure, credit enhancement levels, or asset pool. However, if the feedback process turns into recommendations by the NRSRO about changes the arranger 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. In this case, the Commission believes it would be difficult for the NRSRO to remain impartial since the expectation would be that the changes suggested by the NRSRO would result in the credit ratings sought by the arranger.

The prohibition would extend to recommendations by persons associated with the NRSRO to address affiliates. For example, an NRSRO's holding company could establish an affiliate to provide consulting services to issuers about how to obtain desired credit ratings from the NRSRO subsidiary. The Commission believes it would be difficult for the NRSRO to remain objective in this situation since the financial success of the affiliate would depend on issuers getting the ratings they desired after taking any steps recommended by the affiliate. This would create undue pressure on the NRSRO's credit analysts to determine credit ratings that favored the affiliate.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Is this type of conflict one that could be addressed through disclosure and procedures to manage it instead of prohibiting it? Should the Commission,

rather than prohibiting it, add this type of conflict to the list of conflicts in paragraph (b) of Rule 17g-5, which, under paragraph (a) of the rule, must be addressed through disclosure and procedures to manage them?

- Would there be practical difficulties for an NRSRO that is part of a large conglomerate in monitoring the business activities of persons associated with the NRSRO such as affiliates located in other countries to comply with the proposed requirement? If so, given the greater separation between the NRSRO and these types of persons associated with the NRSRO, should the Commission require instead that, for these types of persons associated with the NRSRO only, the NRSRO disclose this conflict and manage it through information barriers rather than prohibit it?

- The Commission recognizes that the line between providing feedback during the rating process and making recommendations about how to obtain a desired rating may be hard to draw in some cases. Consequently, should the Commission specify the type of interactions between an NRSRO and the person seeking the rating that would and would not constitute recommendations for the purposes of this rule? Commenters that believe the Commission should provide more guidance on this issue should provide suggested definitions.

3. Rule 17g-5 Prohibition on Conflict of Interest Related to the Participation of Certain Personnel in Fee Discussions

The Commission is proposing to amend Rule 17g-5¹¹² by adding a new paragraph (c)(6) of Rule 17g-5 to address the conflict of interest that arises when a fee paid for a rating is discussed or arranged by a person within the NRSRO who has responsibility for participating in determining credit ratings (including analysts and rating committee members) or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models.

The Commission is proposing this amendment to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.¹¹³ The provisions of this section of the statute provide the Commission with authority to prohibit, or require the management and disclosure of, any potential conflict of interest relating to the issuance of credit ratings by an NRSRO.¹¹⁴ The

Commission preliminarily believes the proposed amendment is necessary and appropriate in the public interest or for the protection of investors because it would address a potential practice that could impair the objectivity, and, correspondingly, the quality, of a credit rating. This amendment is designed to effectuate the separation within the NRSRO of persons involved in fee discussions from persons involved in the credit rating analytical process. While the incentives of the persons discussing fees could be based primarily on generating revenues for the NRSRO; the incentives of the persons involved in the analytical process should be based on determining accurate credit ratings. There is a significant potential for these distinct incentive structures to conflict with one another where persons within the NRSRO are engaged in both activities.

The potential consequences are that a credit analyst or person responsible for approving credit ratings or credit rating methodologies could, in the context of negotiating fees, let business considerations undermine the objectivity of rating process. For example, an individual involved in a fee negotiation with an issuer might not be impartial when it comes to rating the issuer's securities. In addition, persons involved in approving the methodologies and processes used to determine credit ratings could be reluctant to adjust a model to make it more conservative if doing so would make it more difficult to negotiate fees with issuers. For these reasons, the Commission preliminarily believes that this conflict should be prohibited.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following items related to the proposal.

- Should the proposed prohibition also be extended to cover participation in fee negotiations by NRSRO personnel with supervisory authority over the NRSRO personnel participating in determining credit ratings or developing or approving procedures or methodologies used for determining credit ratings?

- Instead of prohibiting this conflict outright, would disclosure and procedures to manage the conflict adequately address the conflict? If so, what specific disclosures should be required? What other measures should be required in addition to disclosures?

- Would there be practical difficulties in separating analytic and fee discussions for a small NRSRO, including one that has limited staff, that are significant enough that the

Commission should consider a different mechanism to address the conflict? If so, what sort of mechanism and with what conditions? Should the Commission adopt an exemption from the prohibition for small NRSROs and, instead, require them to disclose the conflict and establish procedures to manage it? For example, the exemption could apply to NRSROs that have less than 10, 20, or 50 associated persons. Commenters that endorse an exemption for small NRSROs should provide specific details as to how the Commission should define an NRSRO as "small" for purposes of the exemption. For example, for purposes of the Final Regulatory Flexibility Analysis for the Adopting Release the Commission concluded that an NRSRO with total assets of \$5 million or less was a "small" entity for purposes of the Regulatory Flexibility Act.¹¹⁵ Would that be an appropriate way to define a small NRSRO for purposes of this exemption?

4. Rule 17g-5 Prohibition of Conflict of Interest Related to Receipt of Gifts

The Commission is proposing to amend Rule 17g-5¹¹⁶ by adding a new paragraph (c)(7) that would prohibit an NRSRO from having a conflict of interest relating to the issuance or maintenance of a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating, received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than \$25. Thus, this proposed prohibition would prohibit any gifts to credit analysts and persons on credit rating committees from the obligors, issuers, underwriters, or sponsors with respect to whom they had determined, monitored or approved credit ratings. It also would create an exception for items provided during normal business activities such as meetings to the extent they do not in the aggregate exceed \$25 per meeting. For example, the provision of pens, notepads, or minor refreshments, such as soft drinks or coffee, generally are incidental to meetings and other normal course business interactions and not treated as gifts *per se*. The proposed \$25 exception is designed to be high enough

¹¹² 17 CFR 240.17g-5.

¹¹³ 15 U.S.C. 78o-7(h)(2).

¹¹⁴ *Id.*

¹¹⁵ See Adopting Release, 72 FR at 33618.

¹¹⁶ 17 CFR 240.17g-5.

to permit these types of exchanges without implicating the prohibition.

The Commission is proposing these amendments to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.¹¹⁷ The provisions in this section of the statute provide the Commission with authority to prohibit, or require the management and disclosure of, any potential conflict of interest relating to the issuance of credit ratings by an NRSRO as the Commission deems necessary or appropriate in the public interest or for the protection of investors.¹¹⁸ The Commission preliminarily believes the proposed amendment is necessary and appropriate in the public interest or for the protection of investors because it would address a potential practice that could impair the objectivity, and, correspondingly, the quality, of a credit rating.

Persons seeking credit ratings for an obligor or debt security could use gifts to gain favor with the analyst responsible for determining the credit ratings and cause the analyst to be less objective during the rating process. In the case of a substantial gift, the potential to impact the analyst's objectivity could be immediate. With smaller gifts, the danger is that over time the cumulative effect of repeated gifts can impact the analyst's objectivity. Therefore, the proposal would establish an absolute prohibition on gifts with the exception of minor incidentals provided in business meetings.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission request comment on the following questions related to the proposal.

- Instead of prohibiting this conflict outright, should the Commission require that NRSROs disclose it and establish procedures to manage it? If so, what specific disclosures should be required?

- Instead of prohibiting gifts outright, should the Commission establish a yearly limit on the aggregate value of gifts that would be permitted under the prohibition? For example, the Commission could provide in the rule that the prohibition would not be triggered until the aggregate value of all gifts received from a particular person in a twelve month period exceeded \$100, \$500 or \$1,000 or some other amount.

- Is the proposed \$25 aggregate value an appropriate threshold for incidentals provided at meetings, or should a higher or lower threshold be applied?

- Should the Commission adopt a recordkeeping requirement with respect to the receipt of gifts by analysts and persons responsible for approving credit ratings in addition to the prohibition? For example, the Commission could require an NRSRO to document for each gift the identity of the person providing the gift, the recipient, and the nature of the gift.

B. Amendments to Rule 17g-2

The Commission adopted Rule 17g-2, in part, pursuant to authority in Section 17(a)(1) of the Exchange Act requiring NRSROs to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act.¹¹⁹ Rule 17g-2 requires an NRSRO to make and retain certain records relating to its business and to retain certain other business records made in the normal course of business operations. The rule also prescribes the time periods and manner in which all these records are required to be retained. The Commission is proposing to amend this rule to require NRSROs to make and retain certain additional records and to require that some of these proposed new records be made publicly available.

1. A Record of Rating Actions and the Requirement That They Be Made Publicly Available

The Commission is proposing to amend Exchange Act Rule 17g-2¹²⁰ to add a new paragraph (8) to Rule 17g-2 that would require a registered NRSRO to make and retain a record showing all rating actions (initial rating, upgrades, downgrades, and placements on watch for upgrade or downgrade) and the date of such actions identified by the name of the security or obligor and, if applicable, the CUSIP for the rated security or the Central Index Key (CIK) number for the rated obligor. Furthermore, the Commission is proposing to amend Rule 17g-2(d) to require that this record be made publicly available on the NRSRO's corporate Internet Web site in an interactive data file that uses a machine-readable computer code that presents information in eXtensible Business Reporting Language ("XBRL") in electronic format ("XBRL Interactive Data File"). The purpose of this disclosure is to provide users of credit ratings, investors, and other market

participants and observers the raw data with which to compare how the NRSROs initially rated an obligor or security and, subsequently, adjusted those ratings, including the timing of the adjustments. In order to expedite the establishment of a pool of data sufficient to provide a useful basis of comparison, this requirement would apply to all currently rated securities or obligors as well as to all future credit ratings.

The goal of this proposal is to foster greater accountability of the NRSROs with respect to their credit ratings as well as competition among the NRSROs by making it easier for persons to analyze the actual performance of the credit ratings the NRSROs issue in terms of accuracy in assessing creditworthiness. The disclosure of this information on the history of each credit rating would create the opportunity for the marketplace to use the information to develop performance measurement statistics that would supplement those required to be published by the NRSROs themselves in Exhibit 1 to Form NRSRO. The intent is to tap into the expertise and flexibility of credit market observers and participants to create better and more useful means to compare credit ratings. This goal is to make NRSROs more accountable for their ratings by enhancing the transparency of the results of their rating processes for particular securities and obligors and classes of securities and obligors and encourage competition within the industry by making it easier for users of credit ratings to judge the output of the NRSROs.

As noted above, the proposed amendments would require that the record be made publicly available on the NRSRO's corporate Internet Web site in an XBRL Interactive Data File that uses a machine-readable computer code that presents information in XBRL. The Commission is proposing to require that an NRSRO use this format to publicly disclose the ratings action data because it would allow users to dynamically search and analyze the information, thereby facilitating the comparison of information across different NRSROs. In addition, an XBRL Interactive Data File would enable investors, analysts, and the Commission staff to capture and analyze the ratings action data more quickly and at less of a cost than is possible using another format. The Commission further believes that the XBRL Interactive Data File would be compatible with a wide range of open source and proprietary XBRL software applications and that as the ratings action data becomes more widely available, advances in interactive data software, online viewers, search

¹¹⁷ 15 U.S.C. 78o-7(h)(2).

¹¹⁸ *Id.*

¹¹⁹ See Section 5 of the Rating Agency Act and 15 U.S.C. 78q(a)(1).

¹²⁰ 17 CFR 240.17g-2.

engines, and other Web-based tools may further enhance the accessibility and usability of the data.

The Commission's experience in having certain issuers use XBRL for EDGAR filings has demonstrated the benefits of this format to investors, filers, and Commission staff.¹²¹ Expanding its use to NRSRO ratings history data would be consistent with Commission policy to utilize this format where practical.

The proposed amendment to Rule 17g-2(d) also would provide that the records be made publicly available no later than six months after the date of the rating action. The Commission anticipates that the record required under this amendment would need to be updated frequently as new credit ratings are issued and existing credit ratings are upgraded, downgraded and put on ratings watch. For purposes of the internal record, the NRSRO would need to keep the record current to reflect the complete ratings history of each extant credit rating. However, for purposes of the requirement to make the record publicly available, the NRSRO would be permitted to disclose the record on its Internet Web site six months after the record is updated to reflect a new ratings action. The proposed six-month time lag for publicly disclosing the updated record is designed to accommodate NRSROs that operate using the subscriber-pay model because they are paid for access to their current credit ratings. It also is designed to preserve the revenues that NRSROs operating using the issuer-pay model derive from selling download access to their current credit ratings.¹²² The Commission preliminarily believes the six-month time lag would not have any negative effect on the goal of this proposed amendment because the information on credit ratings actions that would be disclosed—perhaps many years' worth for some credit ratings—should be sufficient to develop meaningful performance metrics for comparing NRSROs.

Finally, the proposed amendments also would amend the instructions to Exhibit 1 to Form NRSRO to require the disclosure of the Web address where the XBRL Interactive Data File could be accessed. This is designed to inform

persons who use credit ratings where the ratings histories can be obtained.

The Commission is proposing these amendments, in part, under authority to require NRSROs to make and keep for prescribed periods such records as the Commission prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.¹²³ The Commission preliminarily believes the proposed new recordkeeping and disclosure requirements are necessary and appropriate in the public interest and for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Specifically, by proposing to require NRSROs to make ratings actions publicly available in an XBRL Interactive Data File, market participants would be able to create their own performance measurement metrics, including default and transition matrices, by which to judge the accuracy of NRSRO ratings. In addition, users of credit ratings would be able to compare side-by-side how each NRSRO initially rated a particular security, when the NRSRO took actions to adjust the rating upward or downward, and the degree of those adjustments.

Furthermore, users of credit ratings, academics and information vendors could use the raw data to perform analyses comparing how the NRSROs differ in their initial ratings and their monitoring for different types of asset classes. This could identify an NRSRO that is an outlier in terms of issuing high or low credit ratings or consistently reassesses ratings on a delayed basis for some or all asset classes when compared to other NRSROs. It also could help identify NRSROs that are consistently more or less accurate than others. This information also may identify NRSROs whose objectivity may be impaired because of conflicts of interest.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Is the six-month delay before publicly disclosing a rating action sufficiently long to address the business concerns of the subscriber-based NRSROs and the issuer-paid NRSROs? Should the delay be for a longer period such as one or two years or even longer? Alternatively, is six months too long and should it be a shorter period of time such as three months or even shorter?

- Should the rule require that a notice be published along with the XBRL Interactive Data File warning that because of the permitted delay in updating the record some of the credit ratings in the record may no longer reflect the NRSRO's current assessment of the creditworthiness of the obligor or debt security? For example, the notice could explain that the information in the record is six months old and state that the credit ratings contained in record may not be up-to-date.

- Are there ways in which the NRSROs should be required to sort the credit ratings contained on the record such as by asset class or type of ratings?

- What mechanisms are appropriate for identifying rated securities? Are there other identifiers in addition, or as an alternative, to CUSIP or CIK number that could be used in the rule?

- Should the Commission allow the ratings action data to be provided in a format other than XBRL, such as pipe delimited text data ("PDTD") or eXtensible Markup Language ("XML")? Is there another format that is more widely used or would be more appropriate than XBRL for NRSRO data? What are the advantages/disadvantages of requiring the XBRL format?

- Should the Commission require that the information on the assets underlying a structured finance products discussed in Section II.A.1.a above be provided in a specific format such as PDTD, XML, or XBRL? Again, is there another format that is more widely used or would be more appropriate for such data? What are the advantages/disadvantages of requiring a specific format?

- Should the Commission take the lead in creating the new tags that are needed for the XBRL format or should it allow the tags to be created by another group and then review the tags? How long would it take to create new tags?

- The Commission anticipates that the data provided by NRSROs would be simple and repetitive (*i.e.*, the data would be name, CUSIP, date, rating, date, rating, etc.). Is there a need for more detailed categories of data?

- What would be the costs to an NRSRO to provide data in the XBRL format? Would there be a cost burden on smaller NRSROs? Is there another format that would cost less but still allow investors and analysts to easily download and analyze the data?

- Should the Commission institute a test phase for providing this information in an XBRL format (such as a voluntary pilot program, similar to what it is currently doing for EDGAR filings)? How long should this test phase last?

- Where is the best place to store the data provided by NRSROs? Currently,

¹²¹ See *Extension of Interactive Data Voluntarily Reporting Program in the EDGAR System to Include Mutual Fund Risk/Return Summary Information*, Securities Act Release No. 8823 (August 20, 2007).

¹²² The accommodation of subscriber-pay models acknowledges the Rating Agency Act's intent to encourage the subscriber-pays model (*see* Senate Report, p. 7) while simultaneously ensuring equal treatment for NRSROs operating under an issuer-pays model.

¹²³ See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

information that needs to be made publicly available is stored on each NRSRO's Web site. Should the Commission create a central database to store the information? If so, should it use the EDGAR database or should it create a new database?

2. A Record of Material Deviation From Model Output

The Commission is proposing to amend paragraph (a)(2) of Rule 17g-2 to add an additional record that would be required to be made for each current credit rating, namely, if a quantitative model is a substantial component in the process of determining the credit rating, a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued. The NRSRO issuing the rating would be responsible for making the determination of what constituted a "substantial component" of the rating process as well as what constituted a "material" difference between the rating issued and the rating implied by the model.¹²⁴ This proposal is designed to enhance the recordkeeping processes of the NRSROs so that Commission examiners (and any internal auditors of the NRSRO) could reconstruct the analytical process by which a credit rating was determined. This would facilitate their review of whether the NRSRO followed its disclosed and internally documented procedures for determining credit ratings.

The requirement to make the record would be triggered in cases where a quantitative model is a substantial component of the credit ratings process for the type of obligor or security being rated and the output of the model would result in a materially different conclusion if the NRSRO relied on it without making an out-of-model adjustment. For example, the Commission preliminarily believes the expected loss and cash flow models used by the NRSROs to rate RMBS and CDOs are substantial components of the rating process. The following hypothetical scenario is intended as an illustrative example of an instance when an out-of-model adjustment would be material to the RMBS rating process thereby triggering the requirement to document the rationale for the adjustment under the proposed rule. A credit analyst uses the NRSRO's expected loss model to analyze a \$1 billion (aggregate principal amount)

loan pool received from an arranger that is proposed to collateralize an RMBS. The results of the model imply that the senior RMBS tranche would need to have at least 20% subordination in order to receive an AAA rating. However, the NRSRO's methodologies and procedures for rating RMBS allow for the subordination level suggested by the model output to be adjusted based on certain qualitative factors such as the experience and competence of the loan servicer or the recent performance of similar loan pools. Based on the superior competence of the loan servicer, the analyst concludes that the senior tranche only needs 19% subordination and, ultimately, the ratings committee agrees. Consequently, the RMBS is issued with a senior tranche having 19% subordination and receiving an AAA rating from the NRSRO. In this case, under the proposed amendment, the NRSRO would be required to make a record that identified the rationale—the servicer's superior competence—for determining a credit rating that was different from the rating implied by the model.

As the above scenario demonstrates, the failure to make such a record could hamper the ability of the Commission to review whether an NRSRO was following its stated procedures for determining credit ratings. In the above scenario, the analyst could adjust the rating requirements implied by the model by applying qualitative factors with respect to the loan servicer or the performance of similar pools. A record indicating which rationale was applied would make it easier for the Commission to review whether the procedures were followed.

The Commission is proposing this amendment, in part, under authority to require NRSROs to make and keep for prescribed periods such records as the Commission prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.¹²⁵ The Commission preliminarily believes this proposed new recordkeeping requirement is necessary and appropriate in the public interest and for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Specifically, as explained above, the Commission preliminarily believes that maintaining records identifying the rationale for material divergences from the ratings implied by qualitative models used as a substantial component in the ratings process would assist the

Commission in evaluating whether an NRSRO is adhering to its disclosed procedures for determining ratings. Further, as the Commission noted in the Adopting Release, "books and records rules have proven integral to the Commission's investor protection function because the preserved records are the primary means of monitoring compliance with applicable securities laws." In the absence of such a recordkeeping requirement, there may be no way to determine whether an analyst modified the requirements for obtaining a certain category of credit rating (e.g. AAA) as indicated by the model results by applying appropriate qualitative factors permitted under the NRSRO's documented procedures or because of undue influence from the person seeking the credit rating or other inappropriate reasons such as those prohibited by Rule 17g-6.¹²⁶

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Would this proposal have the impermissible effect of regulating the substance of credit ratings in any way?
- Should the Commission define in the rule when the use of a model would be a "substantial component" in the process of determining a credit rating? Commenters endorsing the adoption of such a definition should provide specific proposals.
- Are there certain types of rated products (e.g., corporate debt, municipal bonds) which generally employ a quantitative model as a substantial component of the ratings process? Commenters should identify the types of bonds and a general description of the models used to rate them.
- Should the Commission define in the rule when the divergence from a model would be "material"? Commenters endorsing the adoption of such a definition should provide specific proposals.
- Is the hypothetical scenario of the RMBS rating process used to illustrate when a divergence would be material for purposes of the proposed amendment reasonable? For example, is the adjustment of the subordination level from 20% to 19% for a \$1 billion loan pool a material divergence? Would

¹²⁴ The Commission notes that it would consider the RMBS and CDO rating process described above in Section I.C.2 as using a quantitative model as a substantial component in the ratings process.

¹²⁵ See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

¹²⁶ 17 CFR 240.17g-6. Rule 17g-6 prohibits an NRSRO from engaging in certain unfair, abusive or coercive practices such as issuing a credit rating that is not determined in accordance with the NRSRO's established procedures and methodologies for determining credit ratings based on whether the rated person will purchase the credit rating. See 17 CFR 240.17g-6(a)(2).

a lesser adjustment of the subordination level (e.g., 20% to 19.5%) also be material?

- Are there alternative types of records that may be created or retained by an NRSRO that would allow the Commission to understand when and why an NRSRO's final rating differed materially from the rating implied by the model?
- Should the Commission require that the information about material deviations from the rating implied by the model be publicly disclosed by the NRSRO in the presale report or when the rating is issued?

3. Records Concerning Third-Party Analyst Complaints

The Commission is proposing an amendment to Exchange Act Rule 17g-2¹²⁷ to add a requirement that an NRSRO retain records of any complaints regarding the performance of a credit analyst in determining credit ratings. Specifically, the proposed amendment would add a new paragraph (b)(8) to Rule 17g-2 to require an NRSRO to retain any communications that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

The Commission is proposing these amendments, in part, under authority to require NRSROs to make and keep for prescribed periods such records as the Commission prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in the furtherance of the Exchange Act.¹²⁸ The Commission preliminarily believes the proposed new recordkeeping requirements are necessary and appropriate in the public interest and for the protection of investors, or otherwise in furtherance of the Exchange Act, because they would assist the Commission in reviewing how NRSROs address conflicts of interest that could impair the integrity of their credit rating processes. For example, an NRSRO might respond to complaints from issuers that an analyst is too conservative by removing the analyst from the responsibility of rating the securities of those issuers and assigning a new analyst that is more willing to determine credit ratings desired by the issuers. As discussed above with respect to the proposed amendments to Rule 17g-5, the potential for this type of response to complaints about analysts is particularly acute in the structured finance area given that certain arrangers

of structured finance products repeatedly bring ratings business to the NRSROs.¹²⁹ The pressure to maintain the business relationship with these arrangers could cause an NRSRO to remove an analyst responsible for rating the structured finance products these arrangers bring to market if they complained about how the analyst was determining credit ratings and implied that they might take their business to other NRSROs.

The records proposed under these amendments would allow the Commission, in evaluating the integrity of the NRSRO's ratings process, to better assess whether analyst reassignments or terminations were for reasons unconnected to a conflict of interest (e.g., the analyst's poor performance) or as a result of the "arranger-pay" conflict of interest described above. For example, the examiners could review the complaint file that would be established by this proposed amendment and follow-up with the relevant persons within the NRSRO as to how the complaint was addressed. The potential for such a review by Commission examiners could reduce the willingness of an NRSRO to reassign or terminate a credit analyst for inappropriate business considerations.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- In addition to the proposed recordkeeping requirement, should the Commission require the NRSROs to publicly disclose when an analyst has been re-assigned from the responsibility to rate an obligor or the securities of an issuer, underwriter, or sponsor?

- Should the Commission require NRSROs to retain any communications containing a request from an obligor, issuer, underwriter, or sponsor that the NRSRO assign a specific analyst to a transaction in addition to the proposed requirement to retain complaints about analysts?

4. Clarifying Amendment to Rule 17g-2(b)(7)

Paragraph (b)(7) of Rule 17g-2 currently requires an NRSRO to retain all internal and external communications that relate to "initiating, determining, maintaining, changing, or withdrawing a credit rating." The Commission is proposing to add the word "monitoring" to this list. The intent is to clarify that NRSRO

recordkeeping rules extend to all aspects of the credit rating surveillance process as well as the initial rating process. This was the intent when the Commission originally adopted the rule as indicated by the use of the term "maintaining." The Commission believes that adding the term "monitoring"—a term of art in the credit rating industry—would better clarify this requirement.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following question related to the proposal.

- Should the Commission delete the term "maintaining" from paragraph (b)(7) and proposed new paragraph (b)(8) of Rule 17g-2 as it has the same meaning as "monitoring?"

C. Amendments to the Instructions for Form NRSRO

Form NRSRO is the means by which credit rating agencies apply to be registered with the Commission and registered NRSROs update information they must publicly disclose. Much of the information elicited in Form NRSRO is required to be submitted to the Commission pursuant to the statutory requirements of Section 15E(a)(1)(B) of the Exchange Act.¹³⁰ The Commission added certain additional information to be submitted in the Form.¹³¹ As discussed below, the Commission, in part, under its authority pursuant to Section 15E(a)(1)(B)(x), is now proposing to amend Form NRSRO to further enhance the quality and usefulness of the information to be furnished and disclosed by registered NRSROs by requiring specified information in addition to that which is statutorily defined in the Section 15E of the Exchange Act.

1. Enhanced Ratings Performance Measurement Statistics on Form NRSRO

As discussed above, the Commission is proposing to require the disclosure of the historical rating actions relating to each current credit rating of an NRSRO through amendments to Rule 17g-2. The intent is to make available the raw data necessary for the marketplace to develop and apply credit ratings performance metrics. At the same time, the Commission is proposing to amend the instructions to Exhibit 1 to Form NRSRO to enhance the comparability of the performance measurement statistics the NRSROs are required to publicly disclose in the Form. Currently, the

¹²⁷ 17 CFR 240.17g-2.

¹²⁸ See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

¹²⁹ See e.g., Coffee April 22, 2008 Senate Testimony, pp. 4-6.

¹³⁰ 15 U.S.C. 78o-7(a)(1)(B).

¹³¹ 15 U.S.C. 78o-7(a)(1)(B)(x).

instructions require the disclosure of “performance measurement statistics of the credit ratings of the Applicant/NRSRO over short-term, mid-term, and long-term periods (as applicable) through the most recent calendar year-end.” The Commission, in adopting this requirement, did not require disclosure of performance statistics in Form NRSRO beyond those specified in Section 15E(a)(1)(B)(i) of the Exchange Act.¹³² In the Adopting Release, the Commission explained that it was not prepared to prescribe standard metrics at that time in light of the varying approaches suggested by some commenters and the opposition of other commenters to having the Commission impose any standards.¹³³ The Commission also stated that it would continue to consider the issue to determine the feasibility, as well as the potential benefits and limitations, of devising measurements that would allow reliable comparisons of the accuracy of the NRSROs’ credit ratings.¹³⁴

The Commission, with the benefit of further consideration of the issue, now preliminarily believes that the instructions to Exhibit 1 can prescribe greater specificity about how the performance statistics must be generated without intruding into the processes and methodologies by which NRSROs determine credit ratings. For example, through the examination process, the Commission has become more familiar with the procedures and methodologies used by the NRSROs to determine credit ratings. Through this experience, the Commission preliminarily believes it can prescribe generic requirements for the performance statistics that would accommodate the different procedures and methodologies used by the NRSROs.

The first proposed amendment would augment the instructions to Exhibit 1 by requiring the disclosure of separate sets of default and transition statistics for each asset class of credit rating for which an applicant is seeking registration as an NRSRO or an NRSRO is registered and any other broad class of credit ratings issued by the NRSRO. This would result in the generation of performance statistics that are specific to each class of credit ratings for which the NRSRO is registered (or an applicant is seeking registration). This proposal is designed to make it easier for users of credit ratings to compare the accuracy of NRSRO credit ratings on a class-by-class basis.

The proposed amendment also would require an NRSRO registered in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Rating Agency Act¹³⁵ (or an applicant seeking registration in that class) when generating the performance statistics for that class to include credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This is designed to ensure the inclusion of ratings actions for credit ratings of structured finance products that do not meet the narrower statutory definition of “issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of Federal Regulations).”¹³⁶

The second proposed amendment would require that these class-by-class disclosures be broken out over 1, 3 and 10-year periods. Section 15E(a)(1)(B)(i) of the Exchange Act requires that the performance statistics be over short, mid, and long-term periods.¹³⁷ The proposed amendment would define those statutorily prescribed periods in specific years so that the performance statistics generated by the NRSROs cover comparable time periods. The Commission preliminarily believes that 1, 3, and 10 year periods are reasonable definitions of the terms “short-term, mid-term, and long-term periods” as used in Section 15E(a)(1)(B)(i) of the Exchange Act.¹³⁸ For example, the 1 year period would provide users with information about how the credit ratings are currently performing. In effect, it could serve as an early warning mechanism if a problem developed in an NRSRO’s rating processes due to flaws or conflicts. Similarly, the 3 year period would provide information about the how the ratings were currently performing but, by including more historical data, smooth out spikes in the 1 year statistics to give a better sense of how the ratings perform over time. The 3 year statistics also would serve as a bridge to the longer term 10 year statistics. The 10 year statistics would show users how the ratings in a particular class of securities perform over the long range.

The third proposed amendment would modify what ratings actions are required to be included in these performance measurement statistics by replacing the term “down-grade and default rates” with “ratings transition and default rates.” The proposed switch

to “ratings transition” rates from “downgrade” rates is designed to clarify that upgrades (as well as downgrades) should be included in the statistics. The fact that an NRSRO upgrades a substantial amount of credit ratings may be just as indicative of a flaw in the initial rating as a large number of downgrades. For example, an NRSRO could try to manipulate its performance statistics by issuing overly conservative ratings.

The final proposed amendment would specify that the default statistics required under the exhibit must show defaults relative to the initial rating and incorporate defaults that occur after a credit rating is withdrawn. This amendment is designed to prevent an NRSRO from manipulating the performance statistics by not including defaults when generating statistics for a category of credit ratings (e.g., AA) because the defaults occur after the rating is downgraded to a lower category (e.g., CC) or withdrawn.

The Commission is proposing these amendments, in part, under authority to require such additional information in the application as it finds necessary or appropriate in the public interest or for the protection of investors.¹³⁹ The Commission preliminarily believes the proposed new disclosure requirements for Exhibit 1 are necessary and appropriate and in the public interest or for the protection of investors. Specifically, the information that would be required under the proposed amendments would aid investors by allowing them to evaluate how the credit ratings of an NRSRO perform (*i.e.*, the percentage of credit ratings that migrate to another category of credit rating and the percentage of rated obligors and securities that default) on a class-by-class basis. This would provide better information on how an NRSRO’s ratings have performed within the field of financial products relevant to any given user of credit ratings and investor. For example, an investor contemplating the purchase of a highly-rated subprime RMBS would be able to consider the performance of an NRSRO’s ratings of structured finance products, which would be more useful than the NRSRO’s general performance statistics across all classes of credit ratings. Specifically, an NRSRO may be much better at assessing the creditworthiness of corporate debt securities than of structured finance products. Consequently, performance statistics of such an NRSRO that incorporate all classes of credit ratings

¹³² See 15 U.S.C. 78o–7(a)(1)(B)(i).

¹³³ See Adopting Release, 72 FR at 33574.

¹³⁴ *Id.*

¹³⁵ 15 U.S.C. 78c(a)(62)(B)(iv).

¹³⁶ *See Id.*

¹³⁷ 15 U.S.C. 78o–7(a)(1)(B)(i).

¹³⁸ 15 U.S.C. 78o–7(a)(1)(B)(i).

¹³⁹ See Section 15E(a)(1)(B)(x) of the Exchange Act (15 U.S.C. 78o–7(a)(1)(B)(x)).

(e.g., corporate debt and structured finance products) would be less precise in terms of evaluating the performance of the NRSRO's credit ratings for structured finance products.

Furthermore, by defining "short-term, mid-term, and long-term" periods as 1, 3, and 10-year timeframes, the proposed amendment would provide a better basis for comparing the performance of different NRSROs as the statistics for each NRSRO would cover the same periods. Finally, the replacement of the "down-grade" requirement with a "ratings transition" requirement and the clarification of what default statistics would need to be incorporated into the ratings performance statistics would further enhance investor understanding of NRSRO performance by requiring that similar information be captured in the NRSROs' performance rating statistics and eliminating certain ways that could be used to "pad" statistics.

The Commission generally requests comment on all aspects of these proposed amendments. In addition, the Commission requests comment on the following questions related to the proposals.

- Should the Commission prescribe specific standards for the performance statistics, such as requiring an NRSRO to disclose how its credit ratings performed relative to metrics such as credit spreads? Commenters endorsing such an approach should provide specific details as to how it could be implemented; taking into consideration factors such as the issues related to the difficulty of obtaining timely and consistent pricing information for many debt instruments and the volatility of credit spreads.

- Should the Commission require performance statistics in a more granular form than by class of credit ratings? For example, should the Commission require for structured finance products statistics by more narrowly defined asset classes such as CDOs and RMBS or types of asset-backed securities such as those backed by home loans, credit cards, or commercial real estate? Commenters endorsing greater granularity should provide specific details, including definitions of the credit rating classes.

- Should the Commission prescribe different time periods for the short, medium, and long term statistics than 1, 3, and 10 years, respectively. For example, should the periods be 6 months, 2 years and 7 years or 2, 5, and 15 years or some other set of time periods?

2. Enhanced Disclosure of Ratings Methodologies

The Commission is proposing to amend the instructions for Exhibit 2 to Form NRSRO to require enhanced disclosures about the procedures and methodologies an NRSRO uses to determine credit ratings. Section 15E(a)(1)(B)(ii) of the Exchange Act requires that an application for registration as an NRSRO contain information regarding the procedures and methodologies used by the firm to determine credit ratings.¹⁴⁰ The Commission implemented this requirement by prescribing through the instructions to Form NRSRO that an applicant and NRSRO must provide general descriptions of their procedures and methodologies for determining credit ratings and that the descriptions must be sufficiently detailed to provide users of credit ratings with an understanding of the procedures and methodologies. The instructions also identified various areas that are required to be addressed in Exhibit 2, including, as applicable, descriptions of the NRSRO's policies for determining whether to initiate a credit rating; the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; and the quantitative and qualitative models and metrics used to determine credit ratings.

The Commission is proposing to add three additional areas that an applicant and a registered NRSRO would be required to address in the descriptions of its procedures and methodologies in Exhibit 2. The inclusion of these would serve to better disclose the actions an applicant and NRSRO is, or is not taking, in determining credit ratings. The additional areas required to be addressed in the exhibit would be:

- Whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings;
- Whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction play a part in the determination of credit ratings; and

- How frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings.

The Commission is proposing these amendments, in part, under authority to require such additional information in the application as it finds necessary or appropriate in the public interest or for the protection of investors.¹⁴¹ The Commission preliminarily believes the proposed new disclosure requirements for Exhibit 2 are necessary and appropriate and in the public interest or for the protection of investors. Specifically, they are designed to provide greater clarity around three areas of the NRSROs' rating processes, particularly for structured finance products, where questions have been raised in the context of the credit market turmoil: Namely, the verification performed on information provided in loan documents; the quality of loan originators; and the surveillance of existing ratings and how changes to models are applied to existing ratings. The amendments are designed to enhance the disclosures NRSROs make in these areas and, thereby, allow users of credit ratings to better evaluate the quality of their ratings processes.

The first proposed amendment would require an NRSRO to disclose whether it considers in its rating process for structured finance product steps taken to verify information about the assets in the pool backing the structured finance product. Underwriters and sponsors of structured finance products frequently take some steps to verify information provided by borrowers in loan documentation. Generally, they have been reluctant to provide this information to NRSROs for proprietary reasons. The proposed amendment would not require that the NRSROs incorporate verification (or the lack of verification) into their ratings processes. Rather, it would require an NRSRO to disclose whether and, if so, how information about verification performed on the assets is relied on in determining credit ratings for structured finance products. For example, an NRSRO would need to disclose, as applicable: If it does not consider steps taken to verify the information; if it

¹⁴⁰ 15 U.S.C. 78o-7(a)(1)(B)(ii).

¹⁴¹ See Section 15E(a)(1)(B)(x) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(B)(x)).

requires some minimum level of verification to be performed before it will determine a credit rating for a structured finance product; and how it incorporates the level of verification performed into its procedures and methodologies for determining credit ratings (e.g., if it compensates for the lack of verification by requiring greater levels of credit enhancement for the tranche securities).

The Commission preliminarily believes this disclosure would benefit users of credit ratings by providing information about the potential accuracy of an NRSRO's credit ratings. As noted above, the NRSROs determine credit ratings for structured finance products based on assumptions in their models as to how the assets underlying the instruments will perform under varying levels of stress. These assumptions are based on the characteristics of the assets (e.g., value of the property, income of the borrower) as reported by the arranger of the structured finance product. If this information is inaccurate, the capacity of the model to predict the potential future performance of the assets may be significantly impaired. Consequently, information about whether an NRSRO requires that some level of verification be performed or takes other steps to account for the lack of verification or a low level of verification would be useful to users of credit ratings in assessing the potential for an NRSRO's credit ratings to be adversely impacted by bad information about the assets underlying a rated structured finance product.

The second proposed amendment would require an NRSRO to disclose whether it considers qualitative assessments of the originator of assets underlying a structured finance product in the rating process for such products. Certain qualities of an asset originator, such as its experience and underwriting standards, may impact the quality of the loans it originates and the accuracy of the associated loan documentation. This, in turn, could influence how the assets ultimately perform and the ability of the NRSRO's models to predict their performance. Consequently, the failure to perform any assessment of the loan originators could increase the risk that an NRSRO's credit ratings may not be accurate. Therefore, disclosures as to whether the NRSRO performs any qualitative assessments of the originators would be useful in comparing the efficacy of the NRSRO's procedures and methodologies.

The third proposed amendment would require an NRSRO to disclose the frequency of its surveillance efforts and how changes to its quantitative and

qualitative ratings models are incorporated into the surveillance process. The Commission believes that users of credit ratings would find information about these matters useful in comparing the ratings methodologies of different NRSROs. For example, how often and with what models an NRSRO monitors its credit ratings would be relevant to assessing the accuracy of the ratings inasmuch as ratings based on stale information and outdated models may not be as accurate as ratings of like products determined using newer data and models. Moreover, with respect to new types of rated obligors and debt securities, the NRSROs refine their models as more information about the performance of these obligors and debt securities is observed and incorporated into their assumptions. Consequently, as the models evolve based on more robust performance data, credit ratings of obligors or debt securities determined using older models may be at greater risk for being inaccurate than the newer ratings. Therefore, whether the NRSRO verifies the older ratings using the newer methodologies would be useful to users of credit ratings in assessing the accuracy of the credit ratings.

The Commission generally requests comment on all aspects of the proposed amendments. In addition, the Commission requests comment on the following question related to the proposals.

- Are there other areas of the ratings process where enhanced disclosure on Form NRSRO would benefit investors and other users of credit ratings? Commenters endorsing further disclosures should specifically identify them.

D. Amendment to Rule 17g-3 (Report of Credit Rating Actions)

The Commission adopted Rule 17g-3 pursuant to authority in Section 15E(k) ¹⁴² of the Exchange Act, which requires an NRSRO to furnish to the Commission, on a confidential basis ¹⁴³ and at intervals determined by the Commission, such financial statements and information concerning its financial condition as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. The statute also provides that the Commission may, by rule, require that the financial statements be certified by an independent public accountant. ¹⁴⁴ In

addition, Section 17(a)(1) of the Exchange Act ¹⁴⁵ requires an NRSRO to make and keep such records, and make and disseminate such reports, as the Commission prescribes by rule as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the Exchange Act. ¹⁴⁶

Rule 17g-3 requires an NRSRO to furnish the Commission on an annual basis the following reports: Audited financial statements; unaudited consolidated financial statements of the parent of the NRSRO, if applicable; an unaudited report concerning revenue categories of the NRSRO; an unaudited report concerning compensation of the NRSRO's credit analysts; and an unaudited report listing the largest customers of the NRSRO. The rule further requires an NRSRO to furnish the Commission these reports within 90 days of the end of its fiscal year.

The Commission is proposing to amend Rule 17g-3 to require an NRSRO to furnish the Commission with an additional annual report of the number of credit rating actions during the fiscal year in each class of security for which the NRSRO is registered. Specifically, the amendment would add a new paragraph (a)(6) to Rule 17g-3, which would require an NRSRO to provide the Commission with a report of the number of credit rating actions (upgrades, downgrades, and placements on watch for an upgrade or downgrade) during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission. A note to paragraph (a)(6) would clarify that for the purposes of reporting credit rating actions in the asset-backed security class of credit ratings described in Section 3(a)(62)(B)(iv) of the Rating Agency Act ¹⁴⁷ an NRSRO would need to include credit rating actions on *any* security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction. This is designed to ensure the inclusion of information about ratings actions for credit ratings of structured finance products that do not meet the narrower statutory definition of "issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of Federal Regulations)." ¹⁴⁸

The Commission is proposing this amendment, in part, under authority to require an NRSRO to "make and

¹⁴² 15 U.S.C. 78o-7(k).

¹⁴³ An applicant can request that the Commission keep this information confidential. See Section 24 of the Exchange Act (15 U.S.C. 78x), 17 CFR 240.24b-2, 17 CFR 200.80 and 17 CFR 200.83.

¹⁴⁴ *Id.*

¹⁴⁵ 15 U.S.C. 78q(a)(1).

¹⁴⁶ See Section 5 of the Rating Agency Act and 15 U.S.C. 78q(a)(1).

¹⁴⁷ 15 U.S.C. 78c(a)(62)(B)(iv).

¹⁴⁸ See *Id.*

disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act].”¹⁴⁹ The Commission preliminarily believes this proposed amendment is necessary and appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act because it would assist the Commission in its examination function of NRSROs. Large spikes in ratings actions within a class of credit ratings could indicate the processes for determining the ratings may be compromised by inappropriate factors. For example, a substantial increase in the number of downgrades in a particular class of credit ratings may be indicative of the fact that the initial ratings were higher than the NRSRO’s procedures and methodologies would have implied because the NRSRO sought to gain favor with issuers and underwriters by issuing higher ratings. A substantial increase in upgrades also could be the result of the NRSRO attempting to gain favor with issuers and underwriters.

The Commission recognizes that an increase in the number of ratings actions in a particular class of credit ratings may be the result of macroeconomic factors broadly impacting the rated obligors or securities. In this case, the ratings actions would be the result of appropriate credit analysis and not inappropriate extraneous factors. On the other hand, large numbers of actions could be a signal that the process for rating and monitoring ratings in the impacted class has been compromised by improper practices such as failing to adhere to disclosed and internally documented ratings procedures and methodologies, having prohibited conflicts, failing to establish reasonable procedures to manage conflicts, or engaging in unfair, coercive, or abusive conduct. Consequently, the report would be a valuable tool to improve the focus of examination resources.

The Commission generally requests comment on all aspects of this proposed amendment. In addition, the Commission requests comment on the following questions related to the proposal.

- Could the performance statistics currently required in Exhibit 1 to Form NRSRO, as well as the proposed enhancements to those statistics, be used to target potential problem areas in an NRSRO’s credit rating processes in

the same manner as this proposed report thereby making the report redundant?

- Should the Commission also require NRSROs to furnish an “early warning” report to the Commission when the number of downgrades in a class of credit ratings passes a certain percentage threshold (e.g., 5%, 10%, 15%, or 20%) within a number of calendar or business days (e.g., 2, 5, 10, or 15 days) after the threshold is passed, similar to the broker-dealer notification rule (See 17 CFR 240.17a–11)?

III. Proposed New Rule 17g–7 (Special Reporting or Use of Symbols to Differentiate Credit Ratings for Structured Finance Products)

The Commission is proposing a new rule, Rule 17g–7, 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. This proposal also is designed to address concerns that some investors may not have performed internal risk analysis on structured finance products before purchasing them, although at least one survey indicates that many institutional investors asserted that this was not a widespread problem.¹⁵⁰ Specifically, under proposed Rule 17g–7, each time an NRSRO published a credit rating for a structured finance product it also would be required to publish a report describing how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments such as corporate and municipal debt securities. The objective of this proposal is to alert investors that there are different rating methodologies and risk characteristics associated with structured finance products. As an alternative to publishing the report, an NRSRO would be allowed to use ratings symbols for structured finance products that differentiated them from the credit ratings for other types of debt securities.

More specifically, paragraph (a) of proposed Rule 17g–7 would require an NRSRO to publish a report accompanying every credit rating it publishes for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that describes the rating methodology used to determine the credit rating and how it differs from a rating for any other

type of obligor or debt security and how the risks associated with a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction are different from other types of rated obligors and debt securities. A possible risk associated with this approach is that investors would come to view such reports as “boilerplate” and therefore would not review them.

However, the Commission preliminarily believes that requiring an NRSRO to publish such a report along with each publication of a credit rating for a structured finance product likely would provide certain investors with useful information about structured finance products. The goal of the proposal is to spur investors to perform more rigorous internal risk analysis on structured finance products so that they do not overly rely on NRSRO credit ratings in making investment decisions. A possible ancillary benefit of such reports is that they could cause certain investors to seek to better understand risks that are not necessarily addressed in credit ratings of structured products, such as market and liquidity risk.

Because the goal of the rule is to foster greater independent analysis by investors, the Commission preliminarily believes that permitting an NRSRO to comply with the rule by differentiating its structured finance product rating symbols would be an equally effective alternative. The differentiated symbol would alert investors that a structured product was being rated and, therefore, raise the question of how it differs from other types of debt instruments.

The Commission is not proposing to require that specific rating symbols be used to distinguish credit ratings for structured finance products. An NRSRO would be permitted to choose the appropriate symbol. The Commission preliminarily believes that methods for identifying credit ratings for structured finance products could include using a different rating symbol altogether, such as a numerical symbol, or appending identifying characters to existing ratings scales, e.g., “AAA.sf” or “AAA_{sf}.”

The Commission is proposing these amendments under authority to require an NRSRO to “make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of [the Exchange Act].”¹⁵¹ The Commission preliminarily believes these proposed amendments are

¹⁴⁹ See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

¹⁵⁰ See *Introducing Assumption Volatility Scores and Loss Sensitivities for Structured Finance Securities*, Moody’s, May 14, 2007, p. 3.

¹⁵¹ See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

necessary and appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act because they are designed to encourage investors to perform greater levels of internal risk assessment of structured finance products by putting them on notice that these products have different characteristics than other types of rated debt instruments. The Commission does acknowledge the risks related to these proposals as outlined above.

The Commission generally requests comment on all aspects of this proposed rule. In addition, the Commission requests comment on the following questions related to the proposal.

- Would the use of different rating symbols for structured products impact automated securities trading, routing, settlement, clearance, trade confirmation, reporting, processing, and risk management systems and any other systems that are programmed to use standard credit rating symbols across all product classes? Commenters should describe how these systems may be impacted and associated costs to address the impacts on the firm such as costs to change or update the systems. Commenters also should describe how the impacts to these systems could impact trading activity in the markets for structured finance products.

- Is the proposed rule sufficiently clear about the types of securities and money market instruments to which it applies? Are there securities to which the proposal applies that should not be subject to the requirement of a report or a differentiated symbol?

- Would the use of different rating symbols have consequences for investment guidelines and covenants in legal documents that use credit ratings to distinguish finance instruments? Commenters should describe the potential consequences and associated costs to market participants and to the finance markets more broadly.

- Would the use of different rating symbols or reports dissuade purchases of structured finance products?

- Would the reports or differentiated symbols achieve the Commission's stated goal of encouraging investors to perform more internal risk assessments of structured finance products? Could the reports cause investors to ignore other relevant disclosures or lead to confusion?

- Should the rule be expanded to require reports or different ratings symbols for each class of credit ratings identified in Section 3(a)(62)(B) of the Exchange Act (15 U.S.C. 78c(a)(62)(B)); namely: (1) Financial institutions, brokers, or dealers; (2) insurance

companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities or securities issued by a foreign government? Alternatively, should the rule be expanded to require reports or different ratings symbols for only certain of these classes or subclasses such as for municipal securities?

- Should the rule prohibit an NRSRO from using a common set of symbols (e.g., AAA, AA, A, BBB, BB, B, CCC, CC, C) to rate different types of obligors and debt securities (e.g., corporate debt and municipal debt) where the NRSRO uses different methodologies for determining such ratings? Would such a proposal raise any questions relating to the scope of the Commission's legal authority in this area?

- Should the rule allow the use of a common set of symbols only if the NRSRO determines additional types of ratings to distinguish the different risk characteristics of the different types of obligors and debt securities? For example, the rule could require the determination of ratings to distinguish the potential volatility of the credit ratings of different classes of obligors and debt securities or the differing levels of market and liquidity risk associated with different classes of debt securities. Would such disclosures raise any concerns regarding liability if they were found to be deficient?

IV. Paperwork Reduction Act

Certain provisions of the proposed rule amendments contain a "collection of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").¹⁵² The Commission is submitting these proposed amendments and proposed rule to the Office of Management and Budget ("OMB") for review in accordance with the PRA. An agency may not conduct or sponsor, and a person is not required to comply with, a collection of information unless it displays a currently valid control number. The titles for the collections of information are:

(1) Rule 17g-1, Application for registration as a nationally recognized statistical rating agency; Form NRSRO and the Instructions for Form NRSRO (OMB Control Number 3235-0625);

(2) Rule 17g-2, Records to be made and retained by nationally recognized statistical rating organizations (OMB Control Number 3235-0628);

(3) Rule 17g-3, Annual reports to be furnished by nationally recognized statistical rating organizations (OMB Control Number 3235-0626);

(4) Rule 17g-5, Conflicts of interest (a proposed new collection of information); and

(5) Rule 17g-7, Credit rating reports to be furnished by nationally recognized statistical rating organizations (a proposed new collection of information).

A. Collections of Information Under the Proposed Amendments

The Commission is proposing for comment rule amendments to prescribe additional requirements for NRSROs to address concerns that have arisen with respect to their role in the credit market turmoil. These proposed amendments would modify rules the Commission adopted in 2007 to implement registration, recordkeeping, financial reporting, and oversight rules under the Rating Agency Act. Additionally, the Commission is proposing a new rule under authority provided in the Rating Agency Act.¹⁵³ Certain of the proposed amendments and the proposed new rule would contain recordkeeping and disclosure requirements that would be subject to the PRA. The collection of information obligations imposed by the proposed amendments and proposed new rule would be mandatory. The proposed amendments and proposed new rule, however, would apply only to credit rating agencies that are registered with the Commission as NRSROs. Such registration is voluntary.¹⁵⁴

In summary, the proposed rule amendments and proposed new rule would require: (1) An NRSRO to provide enhanced disclosure of performance measurements statistics and the procedures and methodologies used by the NRSRO in determining credit ratings for structured finance products and other debt securities on Form NRSRO; (2) an NRSRO to make, keep and preserve additional records under Rule 17g-2;¹⁵⁵ (3) an NRSRO to make its rating actions and the date of such actions from the initial credit rating to the current credit rating publicly available in an XBRL Interactive Data File no later than six months after the date of the rating action;¹⁵⁶ (4) an NRSRO to furnish the Commission with an additional annual report;¹⁵⁷ (5) disclosure of certain information about securities being rated beginning on the date the issuer or depositor sets the offering price of the securities being rated;¹⁵⁸ and (6) an

¹⁵³ Proposed Rule 17g-7.

¹⁵⁴ See section 15E of the Exchange Act (15 U.S.C. 78o-7).

¹⁵⁵ 17 CFR 240.17g-2.

¹⁵⁶ See proposed Rule 17g-2(a)(2)(iv) and (d).

¹⁵⁷ See proposed Rule 17g-3(a)(6).

¹⁵⁸ See proposed Rule 17g-5(a)(3) and (b)(9).

¹⁵² 44 U.S.C. 3501 *et seq.*; 5 CFR 1320.11.

NRSRO to attach a report to its credit ratings for structured finance products describing the rating methodology used and how it differs from the determination of ratings for other types of securities or use a symbol that identifies the rated security as a structured finance product.¹⁵⁹

B. Proposed Use of Information

The proposed amendments and new rule would enhance the framework for Commission oversight of NRSROs in response to the recent credit market turmoil.¹⁶⁰ The collections of information in the proposed amendments and new rule are designed to assist the Commission in effectively monitoring, through its examination function, whether an NRSRO is conducting its activities in accordance with section 15E of the Exchange Act¹⁶¹ and the rules thereunder. In addition, these proposed amendments and the new rule are designed to assist users of credit ratings by proposing to require the disclosure of additional information with respect to an NRSRO that could be used to compare the credit ratings quality of different NRSROs, particularly with respect to structured finance products. The Commission believes that the information that NRSROs would have to make public as a result of the proposed amendments would advance one of the primary objectives of the Rating Agency Act, as noted in the accompanying Senate Report, to "facilitate informed decisions by giving investors the opportunity to compare ratings quality of different firms."¹⁶²

C. Respondents

In adopting the final rules under the Rating Agency Act, the Commission estimated that approximately 30 credit rating agencies would be registered as NRSROs.¹⁶³ The Commission believes that this estimate continues to be appropriate for identifying the number of respondents for purposes of the proposed amendments and for proposed new Rule 17g-7. Since the initial set of rules under the Rating Agency Act became effective in June 2007, nine credit rating agencies have registered with the Commission as NRSROs.¹⁶⁴ The registration program has been in

effect for less than a year; consequently, the Commission expects additional entities will register. While 20 more entities may not ultimately register, the Commission believes the estimate is within reasonable bounds and appropriate given that it adds an element of conservatism as it increases paperwork burden estimates as well as cost estimates.

In addition, proposed Rule 17g-5(a)(3)¹⁶⁵ would require the disclosure of certain information provided to, and used by, an NRSRO in determining an initial rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction and for monitoring those ratings. The rule would not specify which party would disclose such information: The NRSRO, sponsor, issuer, depositor, trustee or some other person. The Commission believes that the most likely persons to disclose this information would be structured finance product arrangers, managers, or trustees as they are the entities that generate the information and provide it to the NRSROs. For purposes of the PRA estimate for proposed Rule 17g-5(a)(3), based on staff information gained from the NRSRO examination process, the Commission estimates that there would be approximately 200 respondents. As noted throughout the release, the number of arrangers bringing structured finance products to market is small relative to the number of deals.

The Commission generally requests comment on all aspects of these proposed estimates for the number of respondents. In addition, the Commission requests specific comment on the following items related to these estimates.

- Should the Commission use the number of credit rating agencies currently registered as NRSROs rather than the estimated number of 30 ultimate registrants? Alternatively, is there a basis to estimate a different number of likely registrants?
- Is the Commission correct in believing that structured product arrangers, managers, and trustees would be the entities that disclose the information required under the proposed amendments to Rule 17g-5(a)?
- Are there sources that could provide credible information that could be used to determine the number of credit rating agencies and other NRSROs that would be subject to the proposed paperwork burdens? Commenters should identify any such sources and explain how a given source could be

used to either support the Commission's estimate or arrive at a different estimate.

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

D. Total Annual Recordkeeping and Reporting Burden

As discussed in further detail below, the Commission estimates the total recordkeeping burden resulting from the proposed amendments and proposed new rule would be approximately 1,434,690 hours on an annual basis¹⁶⁶ and 64,500 hours on a one-time basis.¹⁶⁷

The total annual and one-time hour burden estimates described below are averages across all types of NRSROs expected to be affected by the proposed amendment and new rule. The size and complexity of NRSROs range from small entities to entities that are part of complex global organizations employing thousands of credit analysts. Consequently, the burden hour estimates represent the average time across all NRSROs. The Commission further notes that, given the significant variance in size between the largest NRSROs and the smallest NRSROs, the burden estimates, as averages across all NRSROs, are skewed higher because the largest firms currently predominate in the industry.

1. Amendments to Form NRSRO

The proposed amendments to Form NRSRO would change the instructions for the Form to require that NRSROs provide more detailed credit ratings performance statistics in Exhibit 1 and disclose with greater specificity information about the procedures and methodologies used to determine structured finance and other credit ratings in Exhibit 2.¹⁶⁸ The Commission expects these proposed amendments would not have a material effect on the respondents' hour burden. The Commission believes that the total annual burden hours of 2,100 currently approved by OMB would not change for Rule 17g-1 and Form NRSRO materially because the additional disclosures would be included within the overall preparation of the initial Form NRSRO for new applicants. Additionally, the Commission believes that the nine currently registered NRSROs could be

¹⁵⁹ See proposed Rule 17g-7.

¹⁶⁰ See 17 CFR 17g-1 through 17g-6, and Form NRSRO.

¹⁶¹ 15 U.S.C. 78o-7.

¹⁶² See Senate Report, p. 8.

¹⁶³ See Adopting Release, 72 FR at 33606-33607.

¹⁶⁴ A.M. Best Company, Inc.; DBRS Ltd.; Fitch.; Japan Credit Rating Agency, Ltd.; Moody's; Rating and Investment Information, Inc.; S&P; LACE Financial Corp.; and Egan-Jones Rating Company.

¹⁶⁵ See proposed Rule 17g-5(a)(3)(i) and (iii).

¹⁶⁶ This total is derived from the total annual hours set forth in the order that the totals appear in the text: 390 + 300 + 4,000 + 150,000 + 1,280,000 = 1,434,690.

¹⁶⁷ This total is derived from the total one-time hours set forth in the order that the totals appear in the text: 900 + 900 + 60,000 + 1,500 + 300 + 900 = 64,500.

¹⁶⁸ 17 CFR 240.17g-1 and Form NRSRO.

required to prepare and furnish an amended Form NRSRO to update their registration applications if the Commission were to adopt the proposed amendments (*i.e.*, nine amended Form NRSROs). However, the Commission believes these potential nine furnishings of Form NRSRO are accounted for in the currently approved PRA collection for Rule 17g-1, which includes an estimate that each NRSRO would file two amendments to Form NRSRO per year.¹⁶⁹

The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-1 and Form NRSRO, proposed to be amended. In addition, the Commission requests specific comment on the following items related to these estimates:

- Would the proposed additional disclosure requirements increase the burden hours from the amount currently budgeted for Rule 17g-1 and Form NRSRO? Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

2. Amendments to Rule 17g-2

Rule 17g-2 requires an NRSRO to make and keep current certain records relating to its business and requires an NRSRO to preserve those and other records for certain prescribed time periods.¹⁷⁰ The Commission's current estimate for the average one-time burden of implementing a recordkeeping system to comply with Rule 17g-2 is 300 hours.¹⁷¹ Additionally, the total annual burden currently approved by OMB for Rule 17g-2 is 7,620 hours, which represents the average annual amount of time an NRSRO will spend to make and maintain these records (254 hours per year) multiplied by 30 respondents.¹⁷²

The proposed amendments to Rule 17g-2 would require an NRSRO to make and retain two additional records and retain a third type of record. The records to be made and retained would be: (1) A record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of

determining a credit rating;¹⁷³ and (2) a record showing the history and dates of all previous rating actions with respect to each current credit rating.¹⁷⁴ The proposed amendments to Rule 17g-2 would require an NRSRO to make the second set of records—rating actions related to current ratings—publicly available in an XBRL Interactive Data File.¹⁷⁵ In addition, the proposed amendments would require an NRSRO to retain communications that contain any complaints by an obligor, issuer, underwriter, or sponsor about the performance of a credit analyst.¹⁷⁶

With respect to the proposed amendments to Rule 17g-2, the Commission estimates, based on staff information gained from the NRSRO examination process, that the total one-time and annual record recordkeeping burdens would increase approximately 10% and 5%, respectively.¹⁷⁷ Thus, the Commission estimates that the one-time burden that each NRSRO would spend implementing a recordkeeping system to comply with Rule 17g-2 as proposed to be amended would be approximately 330 hours,¹⁷⁸ for a total one-time burden of 9,900 hours for 30 NRSROs.¹⁷⁹ The Commission estimates that an NRSRO would spend an average of 267 hours per year¹⁸⁰ to make and retain records under Rule 17g-2 as proposed to be amended, for a total annual hour burden under Rule 17g-2 of 8,010 hours.¹⁸¹ This estimate would result in an increase in the currently approved PRA burden under Rule 17g-2 of 390 annual burden hours.¹⁸² As discussed above, the increase in annual burden hours would result from the increase in the number of records an NRSRO would be required to make and retain under the proposed amendments to Rule 17g-2.

In addition, the proposed amendments to Rule 17g-2 would

require an NRSRO to make the records of its rating actions publicly available in an XBRL Interactive Data File.¹⁸³

The Commission believes that an NRSRO would choose to make this information available through its Internet Web site and that each NRSRO already has, or would have, an Internet Web site. Therefore, based on staff information gained from the NRSRO examination process, the Commission estimates that, on average, an NRSRO would spend approximately 30 hours to publicly disclose the history of its rating actions for each credit rating in an XBRL Interactive Data File and, thereafter, 10 hours per year to update this information.¹⁸⁴ Accordingly, the total aggregate one-time burden to the industry to make the history of rating actions publicly available in an XBRL Interactive Data File would be 900 hours,¹⁸⁵ and the total aggregate annual burden hours would be 300 hours.¹⁸⁶

Under the currently approved PRA collection for Rule 17g-2, the Commission estimated that an NRSRO may need to purchase recordkeeping system software to establish a recordkeeping system in conformance with Rule 17g-2.¹⁸⁷ The Commission estimated that the cost of the software would vary based on the size and complexity of the NRSRO. Also, the Commission estimated that some NRSROs would not need such software because they already have adequate recordkeeping systems or, given their small size, such software would not be necessary. Based on these estimates, the Commission estimated that the average cost for recordkeeping software across all NRSROs would be approximately \$1,000 per firm, with an aggregate one-time cost to the industry of \$30,000. The Commission estimates that the proposed amendments to Rule 17g-2 would not alter this estimate or that any increases in the cost would be *de minimis*.

The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-2. In addition, the Commission requests specific comment on the following items related to these burden estimates:

- Are there publicly available reports or other data sources the Commission

¹⁷³ Proposed paragraph (a)(2)(iii) of Rule 17g-2.

¹⁷⁴ Proposed paragraph (a)(8) of Rule 17g-2.

¹⁷⁵ Proposed amendment to Rule 17g-2(d).

¹⁷⁶ Proposed paragraph (b)(8) of Rule 17g-2.

¹⁷⁷ The Commission believes that the one-time burden to set up and/or modify a recordkeeping system to comply with the proposed amendments would be greater than the ongoing annual burden. Once an NRSRO has set up or modified its recordkeeping system to comply with the proposed amendments, its annual hour burden would be increased only to the extent it would be required to make and retain additional records.

¹⁷⁸ $300 \text{ hours} \times 1.10 = 330 \text{ hours}$. This would result in an increase of approximately 30 hours per NRSRO for the one-time hour burden.

¹⁷⁹ $330 \text{ hours} \times 30 \text{ respondents} = 9,900 \text{ hours}$. The proposed amendments would result in an increase of 900 total one-time burden hours.

¹⁸⁰ $254 \text{ hours} \times 1.05 = 267 \text{ hours}$. The proposed amendments would result in an increase of approximately 13 annual burden hours per NRSRO for Rule 17g-2.

¹⁸¹ $267 \text{ hours} \times 30 \text{ respondents} = 8,010 \text{ hours}$.

¹⁸² $8,010 \text{ hours} - 7,620 \text{ hours} = 390 \text{ hours}$.

¹⁸³ See proposed amendment to Rule 17g-2(d).

¹⁸⁴ The Commission also bases this estimate on the current one-time and annual burden hours for an NRSRO to publicly disclose its Form NRSRO. No alternatives to these estimates as proposed were suggested by commenters. See Adopting Release, 72 FR at 33609.

¹⁸⁵ $30 \text{ hours} \times 30 \text{ NRSROs} = 900 \text{ hours}$.

¹⁸⁶ $10 \text{ hours} \times 30 \text{ NRSROs} = 300 \text{ hours}$.

¹⁸⁷ See Adopting Release, 72 FR at 33609, 33610.

¹⁶⁹ See Adopting Release, 72 FR at 33609. To date, only one of the seven NRSROs that have been registered with the Commission since September 2007 has furnished the Commission with an amended Form NRSRO since registering with the Commission.

¹⁷⁰ 17 CFR 240.17g-2.

¹⁷¹ See Adopting Release, 72 FR at 33608.

¹⁷² See Adopting Release, 72 FR at 33610.

should consider in arriving at these burden estimates?

- Are the estimates that these amendments would result in an increase to the current total one-time and annual recordkeeping burdens of approximately 10% and 5% accurate? If not, should they be higher or lower?

- Are the estimates that the requirement to make records of rating actions publicly available in an XBRL Interactive Data File would result in an increased one-time burden for each NRSRO of approximately 30 hours to publicly disclose the history of its rating actions for each credit rating in an XBRL Interactive Data File and, thereafter, 10 hours per year to update this information accurate? If not, should they be higher or lower?

- Is the estimate that the NRSROs would incur no additional costs (or that any additional costs would be *de minimis*) to update recordkeeping systems to comply with the proposed new recordkeeping requirements accurate? If not, what would the additional costs be?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

3. Proposed Amendment to Rule 17g-3

Rule 17g-3 requires an NRSRO to furnish certain financial reports to the Commission on an annual basis, including audited financial statements as well as other financial reports.¹⁸⁸ The Commission is proposing to amend Rule 17g-3 to require an NRSRO to furnish the Commission with an additional report: an unaudited report of the number of credit ratings that were changed during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission.¹⁸⁹

The total annual burden currently approved by OMB for Rule 17g-3 is 6,000 hours, based on the fact that it would take an NRSRO, on average, approximately 200 hours to prepare for and file the annual reports.¹⁹⁰ In addition, the total annual cost burden currently approved by OMB is \$450,000 to engage the services of an independent public accountant to conduct the annual audit as part of the preparation of the first report required by Rule 17g-3.¹⁹¹

This estimate is based on 30 NRSROs hiring an independent public accountant on an annual basis for an average of \$15,000.¹⁹²

The Commission believes that the proposed amendment to Rule 17g-3 that would require a report on an NRSRO's rating changes during a fiscal year would have a *de minimis* effect on the annual hour burden for the current PRA collection for Rule 17g-3. The Commission preliminarily believes that an NRSRO already would have this information with respect to each class of credit ratings for which it is registered. In addition, the proposed amendment does not prescribe a format for the report. Consequently, the Commission estimates that proposed Rule 17g-3(a)(6) would not have a significant effect on the total annual hour burden currently approved for the PRA for Rule 17g-3.

The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-3. In addition, the Commission requests specific comment on the following items related to these burden estimates:

- Are there publicly available reports or other data sources the Commission should consider in arriving at these burden estimates?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

4. Amendments to Rule 17g-5

Rules 17g-5 requires an NRSRO to manage and disclose certain conflicts of interest.¹⁹³ The rule also prohibits specific types of conflicts of interest.¹⁹⁴ The proposed amendments to Rule 17g-5 would add an additional conflict to paragraph (b) of Rule 17g-5. This proposed conflict of interest would be issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of an asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument.¹⁹⁵ Under the proposal, an NRSRO would be prohibited from issuing a credit rating for a structured finance product, unless certain information about the transaction and the assets underlying the structured finance product are disclosed.¹⁹⁶ Specifically, the following information

would need to be made publicly available beginning on the date the underwriter, issuer or depositor set the offering price of the securities being rated: (1) All information provided to the NRSRO that is used in determining the initial credit rating, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure; and (2) all information provided to the NRSRO by the issuer, underwriter, sponsor, depositor or trustee that is used by the NRSRO in undertaking credit rating surveillance on the security or money market instrument.¹⁹⁷ In a private offering, the above information would need to be made available on the date the underwriter and the issuer or depositor set the offering price of the securities being rated only to credit rating agencies and investors; it would need to be made publicly available, however, no later than one business day after the offering closes.

The proposed rule would not specify which party would disclose the information: the NRSRO, sponsor, issuer, depositor or trustee. The Commission preliminarily believes that in order to avoid conflicts with Securities Act prohibitions on general solicitations as well as to avoid making the NRSRO liable for the accuracy of information that would originally be supplied by the arrangers and trustees of structured products, this information would likely be disclosed by those arrangers and trustees. The Commission estimates that there would be approximately 200 such entities. For purposes of this PRA, the Commission estimates that it would take a respondent approximately 300 hours to develop a system, as well as policies and procedures, for the disclosures required by the proposed rule. This estimate is based on the Commission's experience with, and burden estimates for, the recordkeeping requirements for NRSROs.¹⁹⁸ Accordingly, the Commission believes, based on staff experience, that a respondent would take approximately 300 hours on a one-time basis to implement a disclosure system to comply with the proposal in that a respondent would need a set of policies and procedures for disclosing the information, as well as a system for making the information publicly available. This would result in a total one-time hour burden of 60,000 hours for 200 respondents.¹⁹⁹

¹⁸⁸ 17 CFR 240.17g-3.

¹⁸⁹ See proposed Rule 17g-3(a)(6).

¹⁹⁰ 200 hours × 30 NRSROs = 6,000 hours. See Adopting Release, 72 FR at 33610.

¹⁹¹ Rule 17g-3 currently requires five reports. Only the first report—financial statements—need be audited. The two new reports proposed to be required by the amendments would not need to be audited.

¹⁹² \$15,000 × 30 NRSROs = \$450,000. See Adopting Release, 72 FR at 33610.

¹⁹³ 17 CFR 240.17g-5.

¹⁹⁴ 17 CFR 240.17g-5(c).

¹⁹⁵ See proposed Rule 17g-5(b)(9). The current paragraph (b)(9) would be renumbered as (b)(10).

¹⁹⁶ See proposed Rule 17g-5(a)(3).

¹⁹⁷ See proposed Rule 17g-5(a)(3)(i)-(iii).

¹⁹⁸ See Adopting Release, 72 FR at 33609.

¹⁹⁹ 300 hours × 200 respondents = 60,000 hours.

In addition to the one-time hour burden, disclosure would also be required under the proposed rule on a transaction by transaction basis when an initial rating is determined. Based on staff experience, the Commission estimates that each respondent would disclose information with respect to approximately 20 new transactions per year and that it would take approximately 1 hour per transaction to make the information publicly available. This estimate is based on the Commission's expectation that the respondent will have already implemented the system and policies and procedures for disclosure. The Commission estimates that a large NRSRO would have rated approximately 2,000 new RMBS and CDO transactions in a given year. The Commission is basing this estimate on the number of new RMBS and CDO deals rated in 2006 by two of the largest NRSROs which rated structured finance transactions. The Commission adjusted this number to approximately 4,000 transactions in order to include other types of structured finance products, including commercial MBS and other consumer assets. Therefore, the Commission estimates for purposes of the PRA that each respondent would arrange approximately 20 new transactions per year: 4,000 new transactions/200 arrangers = 20 new transactions. The Commission notes that the number of new transactions arranged per year would vary by the size of arranger and that this estimate would be an average across all respondents. Larger respondents may arrange in excess of 20 new deals per year, while a smaller entity may only arrange one or two new deals on an annual basis. Based on this analysis, the Commission estimates that it would take a respondent approximately 20 hours²⁰⁰ to disclose this information under the proposed rule, on an annual basis, for a total aggregate annual hour burden of 4,000 hours.²⁰¹

In addition, proposed Rule 17g-5(a)(ii) would require disclosure of information provided to an NRSRO that is used by an NRSRO in undertaking credit rating surveillance on a security or money market instrument. Because surveillance would cover more than just initial ratings, the Commission estimates based on staff information gained from the NRSRO examination process that monthly disclosure would be required with respect to approximately 125 transactions on an ongoing basis. Also based on staff

information gained from the NRSRO examination process, the Commission estimates that it would take a respondent approximately 0.5 hours per transaction to disclose the information. Therefore, the Commission estimates that each respondent would spend approximately 750 hours²⁰² on an annual basis disclosing information under proposed Rule 17g-5, for a total aggregate annual burden hours of 150,000 hours.²⁰³

The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-5. In addition, the Commission requests specific comment on the following items related to these estimates:

- Are there publicly available reports or other data sources the Commission should consider in arriving at these burden estimates?
- Are the estimates of the one-time and recurring burdens of the proposed additional disclosures accurate? If not, should they be higher or lower? Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

5. Proposed Rule 17g-7

The Commission is proposing a new rule—Rule 17g-7—which would address concerns that investors believe that the risk characteristics for a structured finance product are the same as for other types of obligors or debt securities. Proposed Rule 17g-7 would require an NRSRO to attach a report each time it publishes a credit rating for a structured finance product describing how the ratings procedures and methodologies differ from those for other types of obligors or debt securities.²⁰⁴ Proposed Rule 17g-7 would include an exemption to this requirement, however, if the NRSRO used credit rating symbols for structured finance products that identify the product as such as distinct from any other type of obligor or debt security. The Commission believes that proposed Rule 17g-7²⁰⁵ would provide users of credit ratings with useful information either through the report or the differentiated symbol upon which to base their investment decisions.

The Commission expects that most NRSROs already have documented their methodologies and procedures in place to determine credit ratings for

structured finance products and corporate debt securities, and have disclosed such policies and procedures if they have registered with the Commission as an NRSRO. The Commission expects, however, that an NRSRO would have to compile and/or modify these documents to comply with the specific reporting requirements that would be mandated by the proposed rule. Based on staff information gained from the NRSRO examination process, the Commission estimates that it would take an NRSRO approximately 50 hours²⁰⁶ to draft the report required under the proposed rule for a total one-time hour burden of 1,500 hours.²⁰⁷

The Commission also estimates that it would take an NRSRO additional time to publish the report each time a credit rating for a structured finance product is published and to monitor the publications of structured finance credit ratings to ensure compliance with the proposed rule. Based on the average number of credit ratings of asset-backed securities outstanding as of the latest fiscal year of the three largest NRSROs, the Commission estimates that an NRSRO would publish approximately 128,000 asset-backed credit ratings per year.²⁰⁸ The Commission notes that this number may not include all structured finance ratings, since some may not fit within the statutory definition of asset-backed security. However, the Commission also notes that the issuance of RMBS has dropped dramatically off recent highs. Accordingly, the Commission believes the number of asset-backed ratings reported in Form NRSRO is a reasonable proxy for the number of structured finance ratings. The Commission also notes that, as discussed below, the burden estimate identifies 30 respondents. However, most of the structured finance ratings are concentrated in the largest 3 or 4 NRSROs. Accordingly, the average number of structured finance ratings issued per NRSRO each year may be considerably lower than 128,000. For these reasons, the Commission believes the estimate is fairly conservative.

The Commission estimates that an NRSRO would publish a rating action

²⁰⁶ The Commission based this estimate on the estimated number of hours it would take an NRSRO to comply with Rule 17g-4 to develop policies and procedures to prevent the misuse of material nonpublic information. See Adopting Release, 72 FR at 33611.

²⁰⁷ 50 hours × 30 NRSROs = 1,500 hours.

²⁰⁸ This estimate uses the average of the approximate number of credit ratings for asset-backed securities as defined in 17 CFR 229.1101(c) that S&P, Moody's and Fitch had outstanding as of the most recent calendar year end as reported in their annual certifications. (S&P: 197,700; Moody's: 110,000; and Fitch: 75,278).

²⁰² 125 transactions × 30 minutes × 12 months = 45,000 minutes/60 minutes = 750 hours.

²⁰³ 750 hours × 200 respondents = 150,000 hours.

²⁰⁴ See proposed Rule 17g-7.

²⁰⁵ See proposed Rule 17g-7.

²⁰⁰ 20 transactions × 1 hour = 20 hours.

²⁰¹ 20 hours × 200 respondents = 4,000 hours.

with respect to a particular structured finance rating approximately 4 times per year for a total of 512,000 publications.²⁰⁹ The Commission notes that this estimate would include publication of an initial rating, upgrades, downgrades and any affirmations published in a given year. Based on staff experience, the Commission estimates that an NRSRO would spend approximately 5 minutes ensuring that the required report was published along with the credit rating, for a total of 42,667 annual burden hours²¹⁰ per respondent, and a total of 1,280,000 hours²¹¹ across 30 NRSROs. Finally, the Commission estimates, based on staff experience, that it would take an NRSRO approximately 10 hours per year to review and update the report to ensure that the disclosure was accurate and up-to-date for a total aggregate annual hour burden to the industry of 300 hours.²¹² The Commission believes, therefore, that the aggregate one-time and annual burden hours under proposed Rule 17g-7(a) would be 1,280,000 and 1,800 hours,²¹³ respectively.

The Commission believes, however, that most, if not all, NRSROs would opt to differentiate their ratings under paragraph (b) of proposed Rule 17g-7,²¹⁴ rather than publish a report. The Commission believes that an NRSRO would likely choose to use a specific credit rating symbol to indicate that the particular credit rating relates to structured product as distinct from a credit rating for any other category of security or issuer. 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. The Commission believes that the implementation of a different rating symbol would entail a one-time burden of approximately 30 hours to develop the symbol for a total aggregate one-time burden to the industry of 900 hours.²¹⁵

Because the Commission believes that NRSROs will choose to differentiate their ratings under paragraph (b) of proposed Rule 17g-7 rather than

publish a report under paragraph (a) of the proposed new rule, the Commission believes that the appropriate estimate for the aggregate one-time burden to the industry under proposed Rule 17g-7 is 900 hours. The Commission generally requests comment on all aspects of these proposed burden estimates for Rule 17g-7. In addition, the Commission requests specific comment on the following items related to these burden estimates:

- Is the Commission incorrect in its belief that NRSROs would opt to use a different rating symbol rather than to publish a report with each structured product rating? If so, what percentage of NRSROs would be likely to opt to publish a report?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

E. Collection of Information Is Mandatory

The recordkeeping and notice requirements for the proposed amendment and the proposed new rule would be mandatory.

F. Confidentiality

The disclosures proposed to be required under the amendments to Rule 17g-1 and Form NRSRO would be made publicly available on Form NRSRO. The books and records information proposed to be collected under the proposed amendments to Rule 17g-2 would be stored by the NRSRO and made available to the Commission and its representatives as required in connection with examinations, investigations, and enforcement proceedings. However, an NRSRO would be required to make the record of rating actions under proposed Rule 17g-2(a)(8) publicly available in an XBRL Interactive Data File no later than six months after the date of the rating action.²¹⁶ The information proposed to be collected under the proposed amendment to Rule 17g-3 would be generated from the internal records of the NRSRO and would be furnished to the Commission on a confidential basis, to the extent permitted by law.²¹⁷ The information under Rule 17g-5(a)(3) would be made publicly available or available to certain permitted persons. The information proposed to be required under proposed new Rule 17g-7 would be made publicly available.

G. Record Retention Period

The records required under the proposed amendments to Rule 17g-1 and Form NRSRO, Rule 17g-2, and 17g-3 would need to be retained by the NRSRO for at least three years.²¹⁸

H. Request for Comment

The Commission requests comment on the proposed collections of information in order to: (1) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (2) evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information; (3) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; (4) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and (5) evaluate whether the proposed rules would have any effects on any other collection of information not previously identified in this section.

Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090, and refer to File No. S7-13-08. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this document in the **Federal Register**; therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-13-08, and be submitted to the Securities and Exchange Commission, Records Management Office, 100 F Street, NE., Washington, DC 20549-1110.

V. Costs and Benefits of the Proposed Rules

The Commission is sensitive to the costs and benefits that result from its rules. The Commission has identified

²⁰⁹ $128,000 \times 4 = 512,000$ ratings publications.

²¹⁰ $512,000 \times 5$ minutes per report = 2,560,000 minutes/60 minutes per hour = 42,667 hours.

²¹¹ $42,667 \text{ hours} \times 30 \text{ NRSROs} = 1,280,000 \text{ hours}$.

²¹² This estimate is based on the number of hours it would take an NRSRO to complete an annual certification on Form NRSRO. See Adopting Release, 72 FR at 33609. $10 \text{ hours} \times 30 \text{ NRSROs} = 300 \text{ hours}$.

²¹³ $1,500 + 300 \text{ hours}$.

²¹⁴ See proposed Rule 17g-7(b).

²¹⁵ $30 \text{ hours} \times 30 \text{ NRSROs}$.

²¹⁶ See proposed Rule 17g-2(a)(8) and (d).

²¹⁷ 15 U.S.C. 78o-7(k).

²¹⁸ 17 CFR 240.17g-2(c).

certain costs and benefits of the proposed amendments and the proposed new rule and requests comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis.²¹⁹ The Commission seeks comment and data on the value of the benefits identified. The Commission also welcomes comments on the accuracy of its cost estimates in each section of this cost-benefit analysis, and requests those commenters to provide data so the Commission can improve the cost estimates, including identification of statistics relied on by commenters to reach conclusions on cost estimates. Finally, the Commission seeks estimates and views regarding these costs and benefits for particular types of market participants, as well as any other costs or benefits that may result from the adoption of these proposed rule amendments.

A. Benefits

The purposes of the Rating Agency Act, as stated in the accompanying Senate Report, are to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.²²⁰ As the Senate Report states, the Rating Agency Act establishes “fundamental reform and improvement of the designation process” to further the belief that “eliminating the artificial barrier to entry will enhance competition and provide investors with more choices, higher quality ratings, and lower costs.”²²¹

The proposed amendments and new rule would be issued pursuant to specific grants of rulemaking authority in the Rating Agency Act as well as the

Commission’s authority under the Exchange Act. The amendments are designed to further the goals of the Rating Agency Act and to enhance the Commission’s oversight of NRSROs, in light of the recent credit market turmoil. Since the adoption of the final rules implementing the Rating Agency Act in 2007,²²² and in response to the recent concerns about the role of credit rating agencies in the credit market turmoil, the Commission has identified a number of areas where it would be appropriate to enhance the current regulatory program for NRSROs.

Consequently, the Commission is proposing amendments and a new rule that are designed to address concerns raised about the role NRSROs played in the credit turmoil by proposing to enhance the disclosure of credit ratings performance measurement statistics; increase the disclosure of information about the assets underlying structured finance products; require more information about the procedures and methodologies used to determine structured finance ratings; and address conflicts of interest arising from the structured finance rating process. As discussed below, the Commission believes that these proposed amendments and proposed new rule would further the purpose of the Rating Agency Act to improve the quality of credit ratings by fostering accountability, transparency, and competition in the credit rating industry, particularly with respect to credit ratings for structured finance products.²²³

Rule 17g-1 prescribes a process for a credit rating agency to register with the Commission as an NRSRO using Form NRSRO,²²⁴ and requires that a credit rating agency provide information required under Section 15E(a)(1)(B) of the Exchange Act and certain additional information.²²⁵ Form NRSRO is also the means by which NRSROs update the information they must publicly disclose. The proposed amendments to the instructions to Exhibit 1 to Form NRSRO would require NRSROs to provide more detailed performance statistics and, thereby, make it easier for users of credit ratings to compare the ratings performance of the NRSROs.²²⁶ In addition, these proposed amendments could make it easier for an NRSRO to demonstrate that it has a

superior ratings methodology or competence and, thereby, attract clients.

The proposed amendments to the instructions to Exhibit 2 of Form NRSRO are designed to provide greater clarity around three areas of the NRSROs’ rating processes for structured finance products that have raised concerns in the context of the recent credit market turmoil: the level of verification performed on information provided in loan documents; the quality of loan originators; and the on-going surveillance of existing ratings and how changes made to a model used for initial ratings are applied to existing ratings. The additional information provided by the proposed amendments would assist users of credit ratings in making more informed decisions about the quality of an NRSRO’s ratings processes, particularly with regard to structured finance products.

The Commission preliminarily believes that these proposed enhanced disclosures in the Exhibits to Form NRSRO could make it easier for market participants to select the NRSROs that are performing best and have the highest quality processes for determining credit ratings. The potential result could be increased competition and the promotion of capital formation through a restoration of confidence in credit ratings.

The proposed amendments to Rule 17g-2 are designed to assist the Commission in its examination function and provide greater information to users of credit ratings about the performance of an NRSRO’s credit ratings. The additional records would be: (1) A record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining a credit rating;²²⁷ (2) a record showing the history and dates of all previous rating actions with respect to each current credit rating;²²⁸ and (3) any complaints regarding the performance of a credit analyst in determining credit ratings.²²⁹ These proposed records would assist the Commission in monitoring whether an NRSRO is complying with provisions of Section 15E of the Exchange Act and the rules thereunder. This would include monitoring whether an NRSRO is operating consistently with the methodologies and procedures it establishes (and discloses) to determine credit ratings and its policies and procedures designed to ensure the

²¹⁹ For the purposes of this cost/benefit analysis, the Commission is using salary data from the Securities Industry and Financial Markets Association (“SIFMA”) Report on Management and Professional Earnings in the Securities Industry 2007, which provides base salary and bonus information for middle-management and professional positions within the securities industry. The Commission believes that the salaries for these securities industry positions would be comparable to the salaries of similar positions in the credit rating industry. Finally, the salary costs derived from the report and referenced in this cost benefit section, are modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The Commission used comparable assumptions in adopting the final rules implementing the Rating Agency Act in 2007, requested comments on such assumptions, and received no comments in response to its request. See Adopting Release, 72 FR at 33611, note 576. Hereinafter, references to data derived from the report as modified in the manner described above will be cited as “SIFMA 2007 Report as Modified.”

²²⁰ Senate Report, p. 2.

²²¹ *Id.*, p. 7.

²²² See Adopting Release.

²²³ See Senate Report, p. 2.

²²⁴ See Rule 17g-1.

²²⁵ See Section 15E(a)(1)(B) of the Exchange Act. 15 U.S.C. 78o-7(a)(1)(B).

²²⁶ 17 CFR 240.17g-1 and Form NRSRO.

²²⁷ Proposed paragraph (a)(2)(iii) of Rule 17g-2.

²²⁸ Proposed paragraph (a)(8) of Rule 17g-2.

²²⁹ Proposed paragraph (b)(8) of Rule 17g-2.

impartiality of its credit ratings, including its ratings of structured finance products.

In addition, the proposed amendments to Rule 17g-2, which would require an NRSRO to make its rating actions history publicly available in an XBRL Interactive Data File, would allow the marketplace to develop performance measurement statistics that would supplement those already required to be published by NRSROs in Exhibit 1 to Form NRSRO. This proposed amendment is designed to leverage the expertise of the marketplace and, thereby, provide users of credit ratings with innovative and potentially more useful metrics with which to compare NRSROs. This could make NRSROs more accountable for their ratings by enhancing the transparency of their ratings performance. By proposing to require an XBRL Interactive Data File the Commission also believes the proposed amendment would allow investors, analysts, and the Commission staff to capture and analyze the ratings action data more quickly and at less of a cost than is possible using another format.

The Commission preliminarily believes that the proposed amendments to Rule 17g-2 would enhance the Commission's oversight of NRSROs and, with respect to the public disclosure of ratings history, provide the marketplace with the raw materials to develop metrics for comparing the ratings performance of NRSROs. This could, in turn, help in restoring confidence in credit ratings and, thereby, promote capital formation. Increased disclosure of ratings history could make the ratings performance of the NRSROs more transparent to the marketplace and, thereby, highlight those firms that do a better job analyzing credit risk. This could benefit smaller NRSROs to the extent they have performed better than others by alerting the market to their superior competence.

The proposed amendment to Rule 17g-3 would require an NRSRO to furnish an additional annual report to the Commission: An unaudited report of the number of credit ratings that were changed during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission.²³⁰ The proposed new report is designed to enhance the Commission's oversight of NRSROs by providing the Commission with additional information to assist in the monitoring of NRSROs for compliance with their stated policies and procedures. For example, the proposed

new report would allow examiners to target potential problem areas in an NRSRO's rating processes by highlighting spikes in rating actions within a particular class of credit rating.

The proposed amendments to Rule 17g-5 would prohibit an NRSRO from issuing a rating for a structured product unless information about the assets underlying the rated security is made available to certain persons.²³¹ These proposed rule amendments would prohibit an NRSRO from issuing or maintaining a credit rating where the NRSRO or an affiliate provided recommendations on the structure of the transaction being rated; a credit analyst or person involved in the ratings process participated in fee negotiations; or a credit analyst or a person responsible for approving a credit rating received gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than \$25.²³² The Commission believes that the proposed amendments to Rule 17g-5 would promote the disclosure and management of conflicts of interest and mitigate potential undue influences on an NRSRO's credit rating process, particularly with respect to credit ratings for structured finance products.²³³ This would in turn increase confidence in the integrity of NRSRO ratings and, thereby, promote capital formation. In addition, the proposed disclosure of additional information regarding the assets underlying a structured finance transaction²³⁴ would allow for unsolicited ratings that could help address ratings shopping by exposing an NRSRO whose ratings methodologies are less conservative in order to gain business. It also could mitigate the impact of rating shopping, since NRSROs not hired to rate a deal could nonetheless issue a credit rating. These potential impacts of the rule proposal could help to restore confidence in credit ratings and, thereby, promote capital formation. Also, by creating a mechanism for determining unsolicited ratings, they could increase competition by allowing smaller NRSROs to demonstrate proficiency in rating structured products.

Proposed Rule 17g-7 would address concerns that investors may believe that the risk characteristics for a structured finance product are the same as for

other types of obligors or debt securities by requiring an NRSRO to attach a report each time it publishes a credit rating for a structured finance product describing how the ratings procedures and methodologies differ from those ratings for other types of obligors or debt securities.²³⁵ Alternatively, an NRSRO would be permitted to use rating symbols for structured finance products that differentiate them from its other credit ratings. The Commission believes this proposed rule would address potential confusion by investors as to the different characteristics of structured finance products when compared to other types of obligors or debt securities and help them in assessing the risks involved with different types of securities and promote better informed investment decisions.

The Commission generally requests comment on all aspects of these proposed benefits. In addition, the Commission requests specific comment on the following items related to these benefits.

- Are there metrics available to quantify these benefits and any other benefits the commenter may identify, including the identification of sources of empirical data that could be used for such metrics.

Commenters should provide specific data and analysis to support any comments they submit with respect to these benefit estimates.

B. Costs

The cost of compliance with the proposed amendments and new rule to a given NRSRO would depend on its size and the complexity of its business activities. The size and complexity of NRSROs vary significantly. Therefore, the cost could vary significantly across NRSROs. Instead, the Commission is providing estimates of the average cost per NRSRO, as a result of the proposed amendments, taking into consideration the range in size and complexity of NRSROs and the fact that many already may have established policies, procedures and recordkeeping systems and processes that would comply substantially with the proposed amendments. Additionally, the Commission notes that nine credit rating agencies are currently registered with the Commission as NRSROs and subject to the Act and its implementing regulations. The cost of compliance would also vary depending on which classes of credit ratings an NRSRO issues. NRSROs which issue credit ratings for structured finance products would incur higher compliance costs

²³¹ See proposed Rule 17g-5(a)(3) and (b)(9).

²³² See proposed Rule 17 CFR 240.17g-5(c)(5)-(7).

²³³ See 15 U.S.C. 78o-7(a)(1)(B)(vi) and (h).

²³⁴ See proposed Rule 17 CFR 240.17g-5(a)(3).

²³⁵ See proposed Rule 17g-7.

²³⁰ See proposed Rule 17g-3(a)(6).

than those NRSROs which do not issue such credit ratings or issue very few credit ratings in that class.

For these reasons, the cost estimates represent the average cost across all NRSROs and take into account that some firms would only need to augment existing policies, procedures and recordkeeping systems and processes to come into compliance with the proposed amendments.

1. Proposed Amendments to Form NRSRO

As discussed above, the Commission is proposing to amend the instructions to Exhibit 1 to Form NRSRO to provide more detailed performance statistics. Currently, the instructions require the disclosure of performance measurement statistics of the credit ratings of the "Applicant/NRSRO over the short-term, mid-term and long-term periods (as applicable) through the most recent calendar year end." The proposed amendments would augment these instructions to require the disclosure of separate sets of default and transition statistics for each class of credit ratings. In addition, the class-by-class disclosures would need to be broken out over 1, 3 and 10 year periods.²³⁶

The proposed amendments would also amend the instructions to Exhibit 2 to Form NRSRO to require enhanced disclosures about the procedures and methodologies an NRSRO uses to determine credit ratings, including whether and, if so, how information about verification performed on assets underlying a structured finance transaction is relied on in determining credit ratings; whether and, if so, how assessments of the quality of originators of assets underlying a structured finance transaction factor into the determination of credit ratings; and how frequently credit ratings are reviewed, whether different models are used for ratings surveillance than for determining credit ratings, and whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings. As discussed above, the Commission estimates that for PRA purposes the total one-time and annual hour burdens and the cost would have a neutral effect, resulting in no overall change in hours or cost for the currently approved PRA collection.

The Commission preliminarily believes, however, NRSROs may incur a cost of compliance in updating their performance metric statistics to conform to the new requirements set forth in the proposed rule amendments. Under the

current instructions to Exhibit 1 to Form NRSRO, an NRSRO must disclose its performance metrics over short, mid, and long-term periods. Thus, the current Form NRSRO instructions to Exhibit 1 allow an NRSRO to use its own definitions of "short, mid, and long-term periods" and to include all credit ratings, regardless of class of rating, in one set of metrics. Under the proposed amendments, an NRSRO would be required to break out on a class-by-class basis performance statistics over 1, 3 and 10-year periods. The Commission believes that existing NRSROs would incur costs to conform their current performance statistics with the requirements of this proposed amendment to Exhibit 1.

The Commission estimates that it would take each NRSRO currently registered with the Commission approximately 50 hours to review its performance measurement statistics and to develop and implement any changes necessary to comply with the proposed amendment. The Commission is basing this estimate on the amount of time the Commission estimated that it would take an NRSRO to establish procedures in conformance with Rule 17g-4 and on information gained from the NRSRO examination process.²³⁷ For these reasons, the Commission estimates that the average one-time cost to an NRSRO would be \$12,740²³⁸ and the total aggregate cost to the currently registered NRSROs would be \$114,660.²³⁹

The Commission generally requests comment on all aspects of these proposed cost estimates for the proposed amendments to Form NRSRO. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would these proposals impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

²³⁷ See 17 CFR 240.17g-4; Adopting Release, 72 FR at 33616.

²³⁸ The Commission estimates that a Compliance Attorney (40 hours) and a Programmer Analyst (10 hours) would perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly rates for a Compliance Attorney and a Programmer Analyst are \$270 and \$194 per hour, respectively. Therefore, the average one-time cost to an NRSRO would be \$12,740 [(40 hours × \$270) + (10 hours × \$194)].

²³⁹ \$12,740 × 9 NRSROs = \$114,660.

2. Proposed Amendments to Rule 17g-2

Rule 17g-2 requires an NRSRO to make and preserve specified records related to its credit rating business.²⁴⁰ As discussed above, the proposed amendments to Rule 17g-2 would require an NRSRO to make and retain two additional records and retain a third type of record. The records to be made and retained would be: (1) A record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining a credit rating;²⁴¹ and (2) a record showing the history and dates of all previous rating actions with respect to each current credit rating.²⁴² The proposed amendments to Rule 17g-2 would require an NRSRO to make the second record-rating actions related to current ratings publicly available in an XBRL Interactive Data File.²⁴³ In addition, the proposed amendments would require an NRSRO to retain communications that contain any complaints by an obligor, issuer, underwriter, or sponsor about the performance of a credit analyst.²⁴⁴

As discussed with respect to the PRA, the Commission estimates that, based on staff experience, the total one-time and annual recordkeeping burdens would increase approximately 10% and 5%, respectively. Thus, the Commission estimates that the one-time hour burden that each NRSRO would spend implementing a recordkeeping system to comply with Rule 17g-2 would be approximately 330 hours (an increase of 30 hours)²⁴⁵ for a total one-time burden of 9,900 hours (an increase of 900 hours).²⁴⁶

The Commission estimates that an NRSRO would spend an average of 267 hours per year (an increase of 13 hours)²⁴⁷ to make and maintain records under Rule 17g-2, for a total annual hour burden of 8,010 hours.²⁴⁸ This estimate would increase the currently approved PRA burden under Rule 17g-2 by 390 hours.²⁴⁹ For these reasons, the Commission estimates that an NRSRO would incur an average one-time cost of \$7,350 and the average annual cost of \$3,185, as a result of the proposed

²⁴⁰ 17 CFR 240.17g-2.

²⁴¹ Proposed paragraph (a)(2)(iii) of Rule 17g-2.

²⁴² Proposed paragraph (a)(8) of Rule 17g-2.

²⁴³ Proposed amendment to Rule 17g-2(d).

²⁴⁴ Proposed paragraph (b)(8) of Rule 17g-2.

²⁴⁵ 300 hours × 1.10 = 330 hours.

²⁴⁶ 330 hours × 30 respondents = 9,900 hours.

²⁴⁷ 254 hours × 1.05 = 267 hours.

²⁴⁸ 267 hours × 30 respondents = 8,010 hours.

²⁴⁹ 8,010 hours – 7,620 hours = 390 hours.

²³⁶ See proposed instructions to Exhibit 1, Form NRSRO.

amendments.²⁵⁰ Consequently, the total aggregate one-time cost attributable to the proposed amendments would be \$220,500²⁵¹ and the total aggregate annual cost to the industry would be \$95,550.²⁵²

In addition, the proposed amendments to Rule 17g-2 would require an NRSRO to make the records of its rating actions publicly available in an XBRL Interactive Data File.²⁵³ As discussed with respect to the PRA, the Commission estimates that, on average, an NRSRO would spend approximately 30 hours to publicly disclose this ratings history information in an XBRL Interactive Data File and, thereafter, 10 hours per year to update its rating action history.²⁵⁴ Accordingly, the total aggregate one-time burden to the industry to make the history of its rating actions publicly available in an XBRL Interactive Data File would be 900 hours²⁵⁵ and the total aggregate annual burden hours would be 300 hours.²⁵⁶ Furthermore, as discussed in the PRA the Commission estimates there will be 30 NRSROs. For these reasons, the Commission estimates that an NRSRO would incur an average one-time cost of \$8,670 and an average annual cost of \$2,890, as a result of the proposed amendment.²⁵⁷ Consequently, the total aggregate one-time cost to the industry would be \$260,100²⁵⁸ and the total aggregate annual cost to the industry would be \$86,700.²⁵⁹

As discussed with respect to the PRA, the Commission estimated that an NRSRO may have to purchase recordkeeping software to establish a recordkeeping system in conformance with Rule 17g-2. The Commission estimated that the cost of the software

will vary based on the size and complexity of the NRSRO. Also, the Commission estimated that some NRSROs would not need such software because they already have adequate recordkeeping systems or, given their small size, such software would not be necessary. Based on these estimates, the Commission estimated that the average cost for recordkeeping software across all NRSROs would be approximately \$1,000 per firm. Therefore, the estimated one-time cost to the industry would be \$30,000. The Commission estimates that the proposed amendments to Rule 17g-2 would not alter this estimate or that any increases in the cost would be *de minimis*.

Finally, proposed paragraph (a)(8) to Rule 17g-2 would require an NRSRO to create and maintain a record showing all rating actions and the date of such actions from the initial rating to the current rating identified by the name or rated security or obligor, and, if applicable, the CUSIP of the rated security or the Central Index Key (CIK) number of the rated obligor.²⁶⁰ The Commission estimates that an NRSRO could be required to purchase a license from the CUSIP Service Bureau in order to access CUSIP numbers for the securities it rates. The CUSIP Service Bureau's operations are covered by fees paid by issuers and licensees of the CUSIP Service Bureau's data. Issuers pay a one-time fee for each new CUSIP assigned, and licensees pay a renewable subscription or a license fee for access and use of the CUSIP Service Bureau's various database services. The CUSIP Service Bureau's license fees vary based on usage, *i.e.*, how many securities or by type of security or business line.²⁶¹ The Commission estimates that the license fees incurred by an NRSRO would vary depending on the size of the NRSRO and the number of credit ratings it issues. For purposes of this cost estimate, the Commission estimates that

an NRSRO would incur a fee of \$100,000 to obtain access to the CUSIP numbers for the securities it rates. Consequently, the estimated total one-time cost to the industry would be \$3,000,000.²⁶²

The Commission generally requests comment on all aspects of these cost estimates for the proposed amendments to Rule 17g-2. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would these proposals impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs? Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

3. Proposed Amendment to Rule 17g-3

Rule 17g-3 requires an NRSRO to furnish audited annual financial statements to the Commission, including certain specified schedules.²⁶³ The proposed amendment to Rule 17g-3 would require an NRSRO to furnish the Commission with an additional annual report: An unaudited report of the number of credit ratings that were changed during the fiscal year in each class of credit ratings for which the NRSRO is registered with the Commission. The Commission believes that the annual costs to NRSROs to comply with the proposed amendment to Rule 17g-3 would be *de minimis*, as the Commission preliminarily believes that a credit rating agency already would have this information with respect to each class of credit ratings for which it is registered. In addition, the proposed amendment does not prescribe a format for the report. Consequently, the Commission estimates that proposed Rule 17g-3(a)(6) would not have a significant effect on the total average annual cost burden currently estimated for Rule 17g-3.

The Commission generally requests comment on all aspects of these cost estimates for the proposed amendment to Rule 17g-3. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would this proposal impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory

²⁵⁰ The Commission estimates that an NRSRO will have a Compliance Manager perform these responsibilities. Based on the average hourly rate for a Compliance Manager of \$245, the average one time cost will be \$7,350 (30 hours × \$245 per hour) and the average annual cost will be \$3,185 (13 hours × \$245 per hour).

²⁵¹ $7,350 \times 30 \text{ NRSROs} = \$220,500$.

²⁵² $3,185 \times 30 \text{ NRSROs} = \$95,550$.

²⁵³ See proposed amendment to Rule 17g-2(d).

²⁵⁴ The Commission also bases this estimate on the estimated one-time and annual burden hours it would take an NRSRO to publicly disclose its Form NRSRO on its Web site. No comments were received on these estimates in the final rule release. See Adopting Release, 72 FR at 33609.

²⁵⁵ $30 \text{ hours} \times 30 \text{ NRSROs} = 900 \text{ hours}$.

²⁵⁶ $10 \text{ hours} \times 30 \text{ NRSROs} = 300 \text{ hours}$.

²⁵⁷ The Commission estimates that an NRSRO would have a Senior Programmer perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Senior Programmer is \$289. Therefore, the average one-time cost would be \$8,670 [(30 hours) × (\$289 per hour)] and the average annual cost would be \$2,890 [(10 hours per year) × (\$289 per hour)].

²⁵⁸ $900 \text{ hours} \times \289 per hour .

²⁵⁹ $300 \text{ hours} \times \289 per hour .

²⁶⁰ See proposed Rule 17g-2(a)(8). The Central Index Key (CIK) is used on the Commission's computer systems to identify corporations and individual people who have filed disclosure with the Commission. Anyone may search <http://www.edgarcompany.sec.gov> for a company, fund, or individual CIK. There is no fee for this service. CUSIP stands for Committee on Uniform Securities Identification Procedures. A CUSIP number identifies most securities, including: Stocks of all registered U.S. and Canadian companies, U.S. government and municipal bonds, as well as structured finance issuances. The CUSIP system—owned by the American Bankers Association and operated by Standard & Poor's—facilitates the clearing and settlement process of securities. The CUSIP number consists of nine characters (including letters and numbers) that uniquely identify a company or issuer and the type of security.

²⁶¹ See https://www.cusip.com/static/html/webpage/service_fees.html#lic_fees.

²⁶² $\$100,000 \times 30 \text{ NRSROs} = \$3,000,000$.

²⁶³ 17 CFR 240.17g-3.

purposes, and persons who purchase services and products from NRSROs?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

4. Proposed Amendments to Rule 17g-5

Rule 17g-5 requires an NRSRO to manage and disclose certain conflicts of interest.²⁶⁴ The proposed amendments would add an additional conflict to paragraph (b) of Rule 17g-5. This proposed conflict of interest would be issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of an asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument.²⁶⁵ Unlike the other conflicts of interest in paragraph (b) of Rule 17g-5, NRSROs would be prohibited from issuing a rating, unless certain information about the transaction and the assets underlying the structured product being rated were disclosed, pursuant to proposed Rule 17g-5(a)(3)(i) and (ii).²⁶⁶

Specifically, proposed Rule 17g-5(a)(3)(i) and (ii) would require the disclosure of certain information about the assets underlying a structured product that is provided to an NRSRO and used in determining an initial rating and monitoring the rating. While the proposed rule would require disclosure of certain information, the rule would not specify which party would disclose the information. For purposes of this PRA, the Commission estimates that it would take a respondent approximately 300 hours to develop a system, as well as policies and procedures to disclose the information as required under the proposed rule. This would result in a total one-time hour burden of 60,000 hours for 200 respondents.²⁶⁷ For these reasons, the Commission estimates that the average one-time cost to each respondent would be \$65,850²⁶⁸ and

the total aggregate one-time cost to the industry would be \$13,116,000.²⁶⁹

As discussed with respect to the PRA, in addition to the one-time hour burden, respondents also would be required to disclose the required information under proposed Rule 17g-5(a)(3)(i) on a transaction by transaction basis. Based on staff information gained from the NRSRO examination process, the Commission estimates that the proposed amendments would require each respondent to disclose information with respect to approximately 20 new transactions per year and that it would take approximately 1 hour per transaction to make the information publicly available.²⁷⁰ Therefore, as discussed with respect to the PRA, the Commission estimates that it would take a respondent approximately 20 hours²⁷¹ to disclose this information under proposed Rule 17g-5(a)(i) and (ii), on an annual basis, for a total aggregate annual hour burden of 4,000.²⁷² For these reasons, the Commission estimates that the average annual cost to a respondent would be \$4,100²⁷³ and the total annual cost to the industry would be \$820,000.²⁷⁴

Proposed Rule 17g-5(a)(ii) would require respondents to disclose information provided to an NRSRO that is used by an NRSRO in undertaking credit rating surveillance on a structured product. Because surveillance would cover more than just initial ratings, the Commission estimates that a respondent would be required to disclose information with respect to approximately 125 transactions on an ongoing basis and that the information would be provided to the NRSRO on a monthly basis. As discussed with respect to the PRA, the Commission estimates that each respondent would spend approximately 750 hours²⁷⁵ on an annual basis

disclosing the information for a total aggregate annual burden hours of 150,000 hours.²⁷⁶ For these reasons, the Commission estimates that the average annual cost to a respondent would be \$153,750²⁷⁷ and the total annual cost to the industry would be \$30,750,000.²⁷⁸

The Commission is also proposing to amend paragraph (c) to Rule 17g-5 to add three additional prohibited conflicts of interest.²⁷⁹ The Commission estimates that the amendments to paragraph (c) to Rule 17g-5 generally would impose *de minimis* costs on an NRSRO. However, the Commission recognizes that an NRSRO may incur costs related to training employees about the requirements with respect to these proposed amendments. It also is possible that the proposed amendments could require some NRSROs to restructure their business models or activities, in particular with respect to their consulting services.

The Commission generally requests comment on all aspects of these cost estimates for the proposed amendments to Rule 17g-5. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would the proposals for additional disclosure impose costs on issuers, underwriters, sponsors, depositors, or trustees?
- Would these proposals impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory purposes, and persons who purchase services and products from NRSROs?
- Would there be costs in addition to those identified above, such as costs arising from systems changes and restructuring business practices to account for the new reporting requirement?
- Would the proposed amendments to paragraph (c) of Rule 17g-5 impose training and restructuring costs?
- Would the proposed amendments to paragraph (c) of Rule 17g-5 impose personnel costs?
- Would the proposed amendments to paragraph (c) of Rule 17g-5 impose any additional costs on an NRSRO that is part of a large conglomerate related to monitoring the business activities of persons associated with the NRSRO, such as affiliates located in other

²⁶⁴ 17 CFR 240.17g-5.

²⁶⁵ See proposed Rule 17g-5(b)(9). The current paragraph (b)(9) would be renumbered as (b)(10).

²⁶⁶ See proposed Rule 17g-5(a)(3).

²⁶⁷ 300 hours × 200 respondents = 60,000 hours.

²⁶⁸ The Commission estimates an NRSRO would have a Compliance Manager and a Programmer Analyst perform these responsibilities, and that each would spend 50% of the estimated hours performing these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Compliance Manager is \$245 and the average hourly cost for a Programmer Analyst is 194. Therefore, the average one-time cost to an NRSRO would be $[(150 \text{ hours} \times \$245) + (150 \text{ hours} \times \$194)] = \$65,850$.

²⁶⁹ $\$65,850 \times 200 \text{ respondents} = \$13,116,000$.

²⁷⁰ This estimate assumes the respondent has already implemented the system and policies and procedures for disclosure. The Commission cannot estimate the number of initial transactions per year with certainty. The Commission believes that the number of deals that each respondent will disclose information on will vary widely based on the size of the entity. In addition, the Commission preliminarily believes that the number of asset-backed or mortgage-backed issuances being rated by NRSROs in the next few years would be difficult to predict given the recent credit market turmoil.

²⁷¹ 20 transactions × 1 hour = 20 hours.

²⁷² 20 hours × 200 respondents = 4,000 hours.

²⁷³ The Commission estimates an NRSRO would have a Webmaster perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Webmaster is \$205. Therefore, the average one-time cost to a respondent would be 20 hours × \$205 = \$4,100.

²⁷⁴ $\$4,100 \times 200 \text{ respondents} = \$820,000$.

²⁷⁵ 125 transactions × 30 minutes × 12 months = 45,000 minutes/60 minutes = 750 hours.

²⁷⁶ 750 hours × 200 respondents = 150,000 hours.

²⁷⁷ The Commission estimates an NRSRO would have a Webmaster perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Webmaster is \$205. Therefore, the average one-time cost to a respondent would be 750 hours × 205 = \$153,750.

²⁷⁸ $\$153,750 \times 200 \text{ respondents} = \$30,750,000$.

²⁷⁹ See proposed Rule 17g-5(c)(5)-(7).

countries, to comply with the proposed requirement?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

5. Proposed Rule 17g–7

The Commission is proposing a new rule—proposed Rule 17g–7—which would require an NRSRO to attach a report each time it publishes a credit rating for a structured finance product describing how the ratings procedures and methodologies differ from those for corporate debt.²⁸⁰ Alternatively, an NRSRO would be permitted to use rating symbols for structured finance products that differentiate them from its other credit ratings. The Commission expects that most NRSROs already have methodologies in place to determine credit ratings for structured finance products and corporate debt securities, and disclosed such policies and procedures if they have registered as an NRSRO. The Commission expects, however, that an NRSRO would have to conform these disclosures into a report to comply with the specific requirements in the proposed rule. As discussed above with respect to PRA, the Commission estimates that it would take approximately 50 hours for an NRSRO to compile and write disclosures to comply with the proposed rule and that there would be 30 NRSROs. For these reasons, the Commission estimates that the average one-time cost to an NRSRO would be \$12,250²⁸¹ and the total aggregate one-time cost to the industry would be \$367,500.²⁸²

As discussed above with respect to the PRA, the Commission also estimates that it would take an NRSRO additional time to attach the report to each credit rating for a structured finance product and to monitor the report on an ongoing basis to ensure that the disclosure was accurate. Based on staff experience staff information gained from the NRSRO examination process, the Commission estimates that an NRSRO would spend approximately 5 minutes to attach each proposed report to the estimated 128,000 asset-backed credit ratings per NRSRO, four times per year, as discussed above, for a total of 42,667

annual burden hours²⁸³ per respondent, and a total of 1,280,010 annual burden hours²⁸⁴ for 30 NRSROs. For these reasons, the Commission estimates that the average annual cost to an NRSRO would be \$4,373,265²⁸⁵ and the total aggregate annual cost to the industry would be \$131,197,950.²⁸⁶

Finally, as discussed with respect to the PRA, the Commission estimates, based on staff experience, that it would take an NRSRO approximately 10 hours per year to review and update the report to ensure the disclosure was accurate and up-to-date for a total aggregate annual hour burden to the industry of 300 hours.²⁸⁷ For these reasons, the Commission estimates that the average annual cost to an NRSRO would be \$2,700²⁸⁸ and the total aggregate annual cost to the industry would be \$81,000.²⁸⁹

The Commission generally requests comment on all aspects of these cost estimates for the proposed amendments to Rule 17g–7. In addition, the Commission requests specific comment on the following items related to these cost estimates:

- Would the use of different rating symbols for structured products impact automated securities trading, routing, settlement, clearance, trade confirmation, reporting, processing, and risk management systems and any other systems that are programmed to use standard credit rating symbols across all product classes?
- Would the use of different rating symbols have consequences for investment guidelines and covenants in legal documents that use credit ratings to distinguish finance instruments?
- Would these proposals impose costs on other market participants, including persons who use credit ratings to make investment decisions or for regulatory

²⁸³ $128,000 \times 4 = 512,000$ reports $\times 5$ minutes per report = 2,560,000 minutes/60 minutes per hour = 42,667 hours.

²⁸⁴ $42,667 \text{ hours} \times 30 \text{ NRSROs} = 1,280,010 \text{ hours}$.

²⁸⁵ The Commission estimates an NRSRO would have a Webmaster perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Webmaster is \$205. Therefore, the average one-time cost to an NRSRO would be \$4,373,265 ($21,333 \text{ hours} \times \205).

²⁸⁶ $\$4,373,265 \times 30 \text{ NRSROs} = \$131,197,950$.

²⁸⁷ This estimate is based on the number of hours it would take an NRSRO to complete an annual certification on Form NRSRO. See Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564, 33609 (June 18, 2007). $10 \text{ hours} \times 30 \text{ NRSROs} = 300 \text{ hours}$.

²⁸⁸ The Commission estimates an NRSRO would have a Compliance Attorney perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Compliance Attorney is \$270. Therefore, the average one-time cost to an NRSRO would be \$2,700 ($10 \text{ hours} \times \270).

²⁸⁹ $\$2,700 \times 30 \text{ NRSROs} = \$81,000$.

purposes, and persons who purchase services and products from NRSROs?

- Would there be costs in addition to those identified above, such as costs arising from systems changes and restructuring business practices to account for the new reporting requirement?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

C. Total Estimated Costs and Benefits of This Rulemaking

As discussed above, the proposed amendments and new rules are expected to have both benefits and costs for investors and the credit rating industry as a whole. The Commission believes the benefits to investors and other users of credit ratings, especially with respect to investments in structured finance products would be quite substantial, but are difficult to quantify. Similarly difficult to quantify are the expected benefits to the Commission's oversight over NRSROs due to the enhanced recordkeeping, disclosure and reporting requirements. Moreover, not all the costs the Commission anticipates would result from this rulemaking are quantifiable. Based on the figures discussed above, however, the Commission estimates that the first year quantifiable costs related to this proposed rulemaking would be approximately \$180,175,810.²⁹⁰

VI. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Under Section 3(f) of the Exchange Act,²⁹¹ the Commission shall, when engaging in rulemaking that requires the Commission to consider or determine if an action is necessary or appropriate in the public interest, consider whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act²⁹² requires the Commission to consider the anticompetitive effects of any rules the Commission adopts under the Exchange Act. Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. As discussed below, the Commission's preliminary view is that the proposed amendments and new

²⁹⁰ $\$17,078,760$ (total one-time costs) + $\$163,097,810$ (total annual costs) = $\$180,175,810$.

²⁹¹ 15 U.S.C. 78c(f).

²⁹² 15 U.S.C. 78w(a)(2).

²⁸⁰ See proposed Rule 17g–3A.

²⁸¹ The Commission estimates an NRSRO would have a Compliance Manager perform these responsibilities. The SIFMA 2007 Report as Modified indicates that the average hourly cost for a Compliance Manager is \$245. Therefore, the average one-time cost to an NRSRO would be \$12,250 ($50 \text{ hours} \times \245).

²⁸² $30 \text{ NRSROs} \times \$12,250 = \$367,500$.

rules should promote efficiency, competition, and capital formation.

The proposed amendments to the Instructions to Exhibit 1 to Form NRSRO would require NRSROs to make more comparable disclosures about the performance of their credit ratings. These could make it easier for an NRSRO to demonstrate that it has a superior ratings methodology or competence and, thereby, attract clients. In addition, the proposed amendments to the instructions to Exhibit 2 are designed to enhance the disclosures NRSROs make with respect to their methodologies for determining credit ratings. The Commission believes these enhanced disclosures would make it easier for users of credit ratings to compare the quality of the NRSRO's procedures and methodologies for determining credit ratings. The greater transparency that would result from all these enhanced disclosures could make it easier for market participants to select the NRSROs that are performing best and have the highest quality processes for determining credit ratings. This could increase competition and promote capital formation by restoring confidence in the credit ratings, which are an integral part of the capital formation process.

The proposed amendments to Rule 17g-2 are designed to enhance the Commission's oversight of NRSROs and, with respect to the public disclosure of ratings history, provide the marketplace with the raw materials to develop metrics for comparing the ratings performance of NRSROs. Enhancing the Commission's oversight could help in restoring confidence in credit ratings and, thereby, promote capital formation. Increased disclosure of ratings history could make the ratings performance of the NRSROs more transparent to the marketplace and, thereby, highlight those firms that do a better job analyzing credit risk. This could benefit smaller NRSROs to the extent they have performed better than others by alerting the market to their superior competence.

The proposed amendment to Rule 17g-3 is designed to enhance the Commission's oversight of NRSROs. Enhancing the Commission's oversight could help in restoring confidence in credit ratings and, thereby, promote capital formation.

The proposed amendments to paragraphs (a) and (b) of Rule 17g-5 would enhance the disclosures made about assets underlying structured finance products. The goal of these proposals is to provide a mechanism for NRSROs to determine unsolicited credit ratings and other market participants and observers to independently assess

the creditworthiness of structured finance products. This could expose NRSROs whose procedures and methodologies for determining credit ratings are less conservative in order to gain business. It also could mitigate the impact of rating shopping, since NRSROs not hired to rate a deal could nonetheless issue a credit rating. These potential impacts of the rule proposal could help to restore confidence in credit ratings and, thereby, promote capital formation. Also, by creating a mechanism for determining unsolicited ratings, they could increase competition by allowing smaller NRSROs to demonstrate proficiency in rating structured products.

The proposed amendments to paragraph (c) of Rule 17g-5 would prohibit NRSROs and their affiliates from providing consulting or advisory services, prohibit analysts from participating in fee negotiations, and prohibit credit analysts or persons responsible for approving a credit rating receiving gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than \$25. These proposals could increase confidence in the integrity of NRSROs and the credit ratings they issue. This could help to restore confidence in credit ratings and, thereby, promote capital formation.

Proposed new Rule 17g-7 would provide users of credit ratings with useful information about structured product ratings. This could help them in assessing the risk of securities and promote better informed investment decisions. This could increase the efficiency of the capital markets by making structured finance ratings more transparent.

The Commission generally requests comment on all aspects of this analysis of the burden on competition and promotion of efficiency, competition, and capital formation. In addition, the Commission requests specific comment on the following items related to this analysis:

- Would the proposed amendments have an adverse effect on efficiency, competition, and capital formation that is neither necessary nor appropriate in furtherance of the purposes of the Exchange Act?

Commenters should provide specific data and analysis to support any comments they submit with respect to these burden estimates.

VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"²⁹³ the Commission must advise OMB whether a proposed regulation constitutes a major rule. Under SBREFA, a rule is "major" if it has resulted in, or is likely to result in:

- An annual effect on the economy of \$100 million or more;
- A major increase in costs or prices for consumers or individual industries;
- or
- A significant adverse effect on competition, investment, or innovation.

If a rule is "major," its effectiveness will generally be delayed for 60 days pending Congressional review. The Commission requests comment on the potential impact of each of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

VIII. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis ("IRFA"), in accordance with the provisions of the Regulatory Flexibility Act,²⁹⁴ regarding proposed amendments to Form NRSRO, Rule 17g-2, Rule 17g-3, and Rule 17g-5 and regarding proposed Rule 17g-7 under the Exchange Act.

The Commission encourages comments with respect to any aspect of this IRFA, including comments with respect to the number of small entities that may be affected by the proposed amendments. Comments should specify the costs of compliance with the proposed amendments and suggest alternatives that would accomplish the goals of the amendments. Comments will be considered in determining whether a Final Regulatory Flexibility Analysis is required and will be placed in the same public file as comments on the proposed amendments. Comments should be submitted to the Commission at the addresses previously indicated.

A. Reasons for the Proposed Action

The proposed amendments would prescribe additional requirements for NRSROs to address concerns raised about the role of credit rating agencies in the recent credit market turmoil. The proposed amendments are designed to enhance and strengthen the rules the

²⁹³ Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

²⁹⁴ 5 U.S.C. 603.

Commission adopted in 2007 to implement specific provisions of the Rating Agency Act.²⁹⁵ The Rating Agency Act defines the term “nationally recognized statistical rating organization” as a credit rating agency registered with the Commission, provides authority for the Commission to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered NRSROs.

B. Objectives

The proposed amendments and new rules would enhance and strengthen the rules the Commission adopted in 2007 to implement specific provisions of the Rating Agency Act. The objectives of the Rating Agency Act are “to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.”²⁹⁶ The proposed amendments and new rules are designed to further enhance these objectives and assist the Commission in monitoring whether an NRSRO complies with the provisions of the Rating Agency Act and rules thereunder, consistent with the Commission’s statutory mandate to adopt rules to implement the NRSRO regulatory program, and provide information regarding NRSROs to the public and to users of credit ratings. These proposed amendments would also prescribe additional requirements for NRSROs to address concerns raised about the role of credit rating agencies in the recent credit market turmoil, including concerns with respect to the determination of credit ratings for structured finance products.

C. Legal Basis

Pursuant to the Sections 3(b), 15E, 17(a), 23(a) and 36 of the Exchange Act.²⁹⁷

D. Small Entities Subject to the Rule

Paragraph (a) of Rule 0–10 provides that for purposes of the Regulatory Flexibility Act, a small entity “[w]hen used with reference to an ‘issuer’ or a ‘person’ other than an investment company” means “an ‘issuer’ or ‘person’ that, on the last day of its most recent fiscal year, had total assets of \$5 million or less.”²⁹⁸ The Commission believes that an NRSRO with total assets of \$5 million or less would qualify as a

“small” entity for purposes of the Regulatory Flexibility Act.

As noted in the Adopting Release,²⁹⁹ the Commission believes that approximately 30 credit rating agencies ultimately would be registered as an NRSRO. Of the approximately 30 credit rating agencies estimated to be registered with the Commission, the Commission estimates that approximately 20 may be “small” entities for purposes of the Regulatory Flexibility Act.³⁰⁰

E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposals would amend Form NRSRO to elicit certain additional information regarding the performance data for the credit ratings and the methods used by a credit rating agency for issuing credit ratings.³⁰¹

The proposals would amend Rule 17g–2 to establish additional recordkeeping requirements.³⁰² The proposed amendments would require an NRSRO to make and retain two additional records and retain a third type of record. The records would be: (1) A record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued, if a quantitative model is a substantial component in the process of determining a credit rating;³⁰³ (2) a record showing the history and dates of all previous rating actions with respect to each current credit rating;³⁰⁴ and (3) any complaints about the performance of a credit analyst.³⁰⁵ These records would assist the Commission, through its examination process, in monitoring whether the NRSRO continues to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity (as required under the Rating Agency Act) and whether the NRSRO was complying with the provisions of the Exchange Act including the provisions of the Rating Agency Act, the rules adopted thereunder, and the NRSRO’s disclosed policies and procedures.

The proposals would amend Rule 17g–3 to require an NRSRO to furnish the Commission with an additional annual report: the number of downgrades in each class of credit ratings for which it is registered and the description of the findings from an

independent review.³⁰⁶ This requirement is designed to assist the Commission in its examination function and to require an NRSRO to assess the integrity of its rating process. It also is designed to assist the Commission in monitoring whether the NRSRO is complying with provisions of the Rating Agency Act and the rules adopted thereunder.

The proposals would amend paragraphs (a) and (b) of Rule 17g–5 to prohibit an NRSRO from issuing a credit rating for a structured product unless certain information about the assets underlying the product are disclosed. The proposals would amend paragraph (c) of Rule 17g–5 to prohibit NRSROs and their affiliates from providing consulting or advisory services, prohibit analysts from participating in fee negotiations, and prohibit credit analysts or persons responsible for approving a credit rating received gifts from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than \$25.³⁰⁷

The proposals would amend Rule 17g–7 to require an NRSRO to attach a report each time it publishes a credit rating for a structured finance product describing how the ratings procedures and methodologies and credit risk characteristics for structured products differ from those for other types of obligors and debt securities. An NRSRO could avoid having to attach the report if it used ratings symbols for structured products that differentiate them from its other types of credit ratings.³⁰⁸

F. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the proposed amendments or new rule.

G. Significant Alternatives

Pursuant to Section 3(a) of the RFA,³⁰⁹ the Commission must consider certain types of alternatives, including: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (3) the use of

²⁹⁵ Pub. L. 109–291 (2006); see also Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564, 33609 (June 18, 2007).

²⁹⁶ See Senate Report.

²⁹⁷ 15 U.S.C. 78c(b), 78o–7, 78q(a), and 78w.

²⁹⁸ 17 CFR 240.0–10(a).

²⁹⁹ Adopting Release, 72 FR at 33618.

³⁰⁰ See 17 CFR 240.0–10(a).

³⁰¹ See proposed amendments to Form NRSRO.

³⁰² See proposed amendments to Rule 17g–2.

³⁰³ Proposed paragraph (a)(2)(iii) of Rule 17g–2.

³⁰⁴ Proposed paragraph (a)(8) of Rule 17g–2.

³⁰⁵ Proposed paragraph (b)(8) of Rule 17g–2.

³⁰⁶ See proposed amendment to Rule 17g–3.

³⁰⁷ See proposed amendment to Rule 17g–5.

³⁰⁸ See proposed Rule 17g–7.

³⁰⁹ 5 U.S.C. 603(c).

performance rather than design standards; and (4) an exemption from coverage of the rule, or any part of the rule, for small entities.

The Commission is considering whether it is necessary or appropriate to establish different compliance or reporting requirements or timetables; or clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities. Because the proposed amendments and proposed new rule are designed to improve the overall quality of ratings and enhance the Commission's oversight, the Commission is not proposing to exempt small entities from coverage of the rule, or any part of the rule. The proposed amendments and new rules allow NRSROs the flexibility to develop procedures tailored to their specific organizational structure and business models. The Commission also does not believe that it is necessary at this time to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments as the amendments already propose performance standards and do not dictate for entities of any size any particular design standards that must be employed to achieve the Act's objectives.

H. Request for Comments

The Commission encourages the submission of comments to any aspect of this portion of the IRFA. Comments should specify costs of compliance with the proposed amendments and suggest alternatives that would accomplish the objective of the proposed amendments.

IX. Statutory Authority

The Commission is proposing amendments to Form NRSRO and Rules 17g-2, 17g-3, and 17g-5 and is proposing new rule 17g-7 pursuant to the authority conferred by the Exchange Act, including Sections 3(b), 15E, 17, 23(a) and 36.³¹⁰

Text of Proposed Rules

List of Subjects in 17 CFR Parts 240 and 249b

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations as follows.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.17g-2 is amended by:

- a. Removing paragraph (a)(2)(iv);
- b. Redesignating paragraph (a)(2)(iii) as paragraph (a)(2)(iv);
- c. In newly redesignated paragraph (a)(2)(iv), removing “; and” and in its place adding a period;
- d. Adding new paragraph (a)(2)(iii);
- e. Adding paragraph (a)(8);
- f. In paragraph (b)(7), revising the phrase “maintaining, changing,” to read “maintaining, monitoring, changing.”;
- g. Redesignating paragraphs (b)(8), (b)(9), and (b)(10) as paragraphs (b)(9), (b)(10), and (b)(11), respectively;
- h. Adding new paragraph (b)(8); and
- i. In paragraph (d), adding a sentence to the end of the paragraph.

The additions read as follows:

§ 240.17g-2 Records to be made and retained by nationally recognized statistical rating organizations.

(a) * * *

(2) * * *

(iii) If a quantitative model was a substantial component in the process of determining the credit rating, a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued; and

* * * * *

(8) A record showing all rating actions and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key (CIK) number of the rated obligor.

(b) * * *

(8) Any communications that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

* * * * *

(d) * * * In addition, the records required to be retained pursuant to paragraph (a)(8) of this section must be made publicly available on the corporate Web site of the NRSRO in an XBRL Interactive Data File that uses a

machine-readable computer code that presents information in eXtensible Business Reporting Language in electronic format no later than six months after the date of the rating action.

* * * * *

3. Section 240.17g-3 is amended by:

- a. Adding paragraph (a)(6); and
- b. Revising paragraph (b).

The additions and revision read as follows:

§ 240.17g-3 Annual financial reports to be furnished by nationally recognized statistical rating organizations.

(a) * * *

(6) The number of credit ratings actions taken during the fiscal year in each class of credit ratings identified in section 3(a)(62)(B) of the Act (15 U.S.C. 78c(a)(62)(B)) for which the nationally recognized statistical rating organization is registered with the Commission.

Note to paragraph (a)(6): A nationally recognized statistical rating organization registered in the class of credit ratings described in section 3(a)(62)(B)(iv) of the Act (15 U.S.C. 78c(a)(62)(B)(iv)) must include credit ratings actions taken on credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction for purposes of reporting the number of credit ratings actions in this class.

(b) The nationally recognized statistical rating organization must attach to the financial reports furnished pursuant to paragraphs (a)(1) through (a)(6) of this section a signed statement by a duly authorized person associated with the nationally recognized statistical rating organization stating that the person has responsibility for the financial reports and, to the best knowledge of the person, the financial reports fairly present, in all material respects, the financial condition, results of operations, cash flows, revenues, analyst compensation, and credit rating actions of the nationally recognized statistical rating organization for the period presented.

* * * * *

4. Section 240.17g-5 is amended by:

- a. Removing the word “and” at the end of paragraph (a)(1);
- b. Removing the period at the end of paragraph (a)(2) and in its place adding “; and”;
- c. Adding paragraph (a)(3);
- d. Redesignating paragraph (b)(9) as paragraph (b)(10);
- e. Adding new paragraph (b)(9);
- f. Removing the word “or” at the end of paragraph (c)(3);
- g. Removing the period at the end of paragraph (c)(4) and in its place adding a semi-colon; and

³¹⁰ 15 U.S.C. 78c(b), 78o-7, 78q, 78w, and 78mm.

h. Adding paragraphs (c)(5), (c)(6), and (c)(7).

The additions read as follows:

§ 240.17g-5 Conflicts of interest.

(a) * * *

(3) In the case of the conflict of interest identified in paragraph (b)(9) of this section, the following information is disclosed through a means designed to provide reasonably broad dissemination:

(i) (A) All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used in determining the initial credit rating for the security or money market instrument, including information about the characteristics of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument, with such information to be disclosed publicly in an offering registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) on the date the underwriter and the issuer or depositor set the offering price of the securities being rated;

(B) In offerings that are not registered under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*), the information in paragraph (a)(3)(i)(A) of this section must be disclosed to investors and credit rating agencies on the date the underwriter and the issuer or depositor set the offering price of the securities being rated, and disclosed publicly on the first business day after the transaction closes; and

(ii) All information provided to the nationally recognized statistical rating organization by the issuer, underwriter, sponsor, depositor, or trustee that is used by the nationally recognized statistical rating organization in undertaking credit rating surveillance on the security or money market instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument, with such information to be disclosed publicly at the time such information is provided to the nationally recognized statistical rating organization.

(b) * * *

(9) Issuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument.

* * * * *

(c) * * *

(5) The nationally recognized statistical rating organization issues or maintains a credit rating with respect to an obligor or security where the nationally recognized statistical rating organization or a person associated with the nationally recognized statistical rating organization 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;

(6) The nationally recognized statistical rating organization issues or maintains a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the nationally recognized statistical rating organization who has responsibility for participating in determining credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models; or

(7) The nationally recognized statistical rating organization issues or maintains a credit rating where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than \$25.

* * * * *

5. Section 240.17g-7 is added to read as follows:

§ 240.17g-7 Credit rating reports to be furnished by nationally recognized statistical rating organizations.

(a) A nationally recognized statistical rating organization must attach a report each time it publishes a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction that describes the rating methodology used to determine such credit rating and how it differs from the determination of ratings for any other type of obligor or debt security and how the credit risk characteristics associated with a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction differ from those of any other type of obligor or debt security.

(b) *Exemption from attaching report.* A nationally recognized statistical rating organization is not required to attach the

report each time it publishes a credit rating as prescribed by paragraph (a) of this section if the credit rating symbol used by the nationally recognized statistical rating organization to indicate the credit rating identifies the credit rating as relating to a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction as distinct from a credit rating for any other type of obligor or debt security.

PART 249b—FURTHER FORMS, SECURITIES EXCHANGE ACT OF 1934

6. The authority citation for part 249b continues to read in part as follows:

Authority: 15 U.S.C. 78a *et seq.*, unless otherwise noted;

* * * * *

7. Form NRSRO (referenced in § 249b.300) is amended by revising Exhibits 1 and 2 in section H, Item 9 of the Form NRSRO Instructions to read as follows:

Note: The text of Form NRSRO and this amendment does not appear in the Code of Federal Regulations.

Form NRSRO

* * * * *

Form NRSRO Instructions

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H. Instructions for Specific Line Items

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Item 9. Exhibits. * * *

Exhibit 1. Provide in this Exhibit performance measurement statistics of the credit ratings of the Applicant/NRSRO, including performance measurement statistics of the credit ratings separately for each class of credit rating for which the Applicant/NRSRO is seeking registration or is registered (as indicated in Item 6 and/or 7 of Form NRSRO) and any other broad class of credit rating issued by the Applicant/NRSRO. For the purposes of this Exhibit, an Applicant/NRSRO registered in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Act (15 U.S.C. 78c(a)(62)(B)(iv)) must include credit ratings of any security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction for purposes of reporting the performance measurement statistics for this class. The performance measurement statistics must at a minimum show the performance of credit ratings in each class over 1 year, 3 year, and 10 year periods (as applicable) through the most recent calendar year-end, including, as applicable: historical ratings transition

and default rates within each of the credit rating categories, notches, grades, or rankings used by the Applicant/NRSRO as an indicator of the assessment of the creditworthiness of an obligor, security, or money market instrument in each class of credit rating. The default statistics must include defaults relative to the initial rating and must incorporate defaults that occur after a credit rating is withdrawn. As part of this Exhibit, define the credit rating categories, notches, grades, and rankings used by the Applicant/NRSRO and explain the performance measurement statistics, including the inputs, time horizons, and metrics used to determine the statistics. Also provide in this Exhibit the Web site address where the records of credit rating actions required under 17 CFR 240.17g–2(a)(8) are, or will be, made publicly available in an XBRL Interactive Data File pursuant to the requirements of 17 CFR 240.17g–2(d).

Exhibit 2. Provide in this Exhibit a general description of the procedures and methodologies used by the Applicant/NRSRO to determine credit ratings, including unsolicited credit ratings within the classes of credit ratings for which the Applicant/NRSRO is seeking registration or is registered. The description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed by the Applicant/

NRSRO in determining credit ratings, including, as applicable, descriptions of: policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings; the quantitative and qualitative models and metrics used to determine credit ratings, including whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction factor into the determination of credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting

process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings, including how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings; and procedures to withdraw, or suspend the maintenance of, a credit rating. An Applicant/NRSRO may provide in Exhibit 2 the location on its Web site where additional information about the procedures and methodologies is located.

* * * * *

Dated: June 16, 2008.

By the Commission.

Jill M. Peterson,

Assistant Secretary.

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