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TO: CMSA

FROM: Scott A. Sinder
Rhonda M. Bolton

RE: Administration's Legislative Proposals on Credit Rating Agencies ("CRAs") and Executive Compensation

You have asked us to provide an overview of the legislative proposals recently released by the U.S. Treasury Department to implement the Obama Administration's financial regulatory reform plans concerning credit rating agencies and executive compensation. The proposals are part of the Administration's "blueprint" to completely overhaul regulation of the nation's financial system, upon which we have previously reported (with a particular focus on changes proposed for securitization markets), and which is available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

Overview

The stated purpose of the CRA legislation is to increase transparency, tighten oversight, and reduce investor reliance on the agencies' ratings. In terms of specifics, the legislation focuses on new transparency, conflict of interest, and registration requirements for CRAs. Most notably, the transparency requirements include a provision directing CRAs to use differentiated

rating symbols for structured finance products, a concept that CMSA has opposed, and which was previously rejected by the SEC in 2008.

With respect to executive compensation, the Administration has focused its proposal on non-binding shareholder “say-on-pay” for executive compensation and golden parachutes, and on the independence of board compensation committees. We note that House Financial Services Committee Chairman Barney Frank also circulated a discussion draft of a bill this week which is described as being based on the Administration’s proposals, although the Frank bill would go farther by giving bank regulators the ability to prohibit “financial institutions” (and potentially, other types of public entities) from engaging in compensation practices deemed to be too risky, and requiring disclosure of incentive-based compensation structures. These latter two proposals from Chairman Frank, in particular, warrant close and continued monitoring because of the open question regarding the types of entities they might be applied to.

Following are additional details on each of the Administration proposals and Chairman Frank’s executive compensation proposal.

Credit Rating Agencies

The Administration’s CRA legislation covers five basic areas –

1. **Transparency and Disclosure:** The legislation imposes numerous new disclosure obligations concerning ratings. Of primary interest to CMSA is a requirement that CRAs use different symbols for structured finance products as an indication of what the Administration terms “disparate risks” for these products. Other notable requirements include disclosure by issuers of any preliminary ratings obtained from CRAs, which is intended to discourage ratings shopping, and a requirement that CRAs issue a report in conjunction with each rating that contains an assessment of data reliability, the probability of default, the estimated severity of loss in the event of default, and the sensitivity of a rating to changes in assumptions;
2. **New Conflict of Interest Rules:** These provisions mostly consist of additional disclosure and management requirements (e.g., of conflicts that might arise due to affiliations, business relationships, or payment structures, and a separate fee payment disclosure requirement), although there also is an outright prohibition on

3. Registration Requirements: SEC registration of all CRAs would be mandatory, rather than the voluntary system now in place;
4. Enhanced SEC Oversight: The SEC is directed to promulgate rules to implement all of the legislation's directives, and would also be authorized to examine the internal controls, due diligence, and implementation of methodologies for all CRAs. A dedicated office within the agency would be established to supervise CRAs; and
5. Reduced Reliance on Ratings: In furtherance of a proposal made by the SEC last year, the government would continue to explore ways to reduce investor reliance on ratings, and the GAO would be directed to study and report on reliance in federal and state regulations.

Executive Compensation

Preliminarily, we note that the current Administration proposal is similar to the executive compensation restrictions it has imposed on companies receiving government assistance under the Troubled Assets Relief Program. Both the Administration proposal and the one being circulated by Chairman Frank have the following components:

1. Say-on-Pay: all public companies would be required to give shareholders an annual non-binding vote on executive compensation, and a non-binding vote on any pay for "principal" executives associated with a merger or similar transaction (i.e., golden parachutes) (this aspect is similar to say-on-pay legislation that passed the House in 2007);
2. Independent Compensation Committee Requirement: all public companies with compensation committees must have only independent directors on those committees. "Independent" means the directors may not accept consulting, advisory, or compensatory fees from the company (other than for serving as board members), and may not be affiliated with the company. Moreover, any compensation consultant or other advisor hired by a compensation committee must be independent, in accordance with standards that will be developed by the SEC. And compensation committees will be given the responsibility and the resources to hire their own consultants and "independent counsel." If a compensation committee does not follow its consultant's recommendation, the committee must provide a justification to shareholders for such a decision. We note that the SEC is directed to promulgate rules to effect the say-on-pay and

In addition to the above, the Frank discussion draft (but not the Treasury proposal) contains the following:

- Incentive Based Compensation Disclosure Requirements: “Financial institutions” (which specifically includes banks, bank holding companies, broker-dealers, credit unions & investment advisors) must disclose compensation structures for officers and employees (not just senior executives) that include any incentive-based elements, such that regulators can determine whether the structures “properly measure and reward performance, is structured to account for the time horizon of risks, and is aligned with sound risk management,” in addition to other factors regulators may deem appropriate. Note that this requirement may be imposed on other types of institutions in a joint rulemaking by the relevant Federal financial regulators; and,
- Compensation Standards for Financial Institutions: Federal regulators are directed to jointly develop restrictions on compensation structures or incentive-based payment arrangements for financial institutions that “could have serious adverse effects on economic conditions or financial stability, or could threaten the safety and soundness of the covered financial institution.” A summary of Chairman Frank’s discussion draft states that such restrictions would be imposed “as part of solvency regulation.” Note that like the compensation disclosure requirements, these compensation restrictions may be imposed on institutions other than “financial institutions” if regulators deem it to be appropriate.

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We will continue to monitor developments concerning legislative proposals affecting CRAs and executive compensation.