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February 15, 2011

TO: The CRE Finance Council

FROM: Scott A. Sinder
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RE: Certain Credit Rating-Related Disclosure Obligations Under SEC Rules

Overview

This memorandum describes disclosure obligations imposed by the Securities and Exchange Commission (“SEC”) in connection with its framework to facilitate credit rating by “non-hired” Nationally Recognized Statistical Rating Organizations (“NRSROs”).¹ The Commission’s framework establishes obligations for “arrangers” (i.e., the issuer, sponsor, or underwriter) of structured finance transactions that hire an NRSRO to conduct initial ratings or surveillance of a transaction, as well as obligations for the hired NRSRO, and for those that seek to use the framework to perform their own rating (“non-hired” NRSROs).

The framework applies where an NRSRO issues or maintains a credit rating for a security or money market instrument issued by an asset pool as part of any asset-backed or mortgage-backed securities transaction, that was paid for by the arranger of the security or money market instrument. And the disclosure obligations are as follows: the hired NRSRO is required to establish and maintain, for the use of non-hired NRSROs, a website describing each structured finance product it has been hired to rate, and directing the site’s viewers to a website that is maintained by the arranger and that collects and discloses all information the arranger has provided to the hired NRSRO as part of the rating process. The NRSRO is required to obtain representations from the arranger that the arranger will fulfill its duties to set up and maintain a website as required by the Rule, and that the arranger will provide access to non-hired NRSROs as required (although the hired NRSRO is not responsible for enforcing an arranger’s compliance with the Rule). A non-hired NRSRO seeking to access the websites under this framework is required to submit an annual certification to the SEC (with copies to hired NRSROs and arrangers as appropriate) that the NRSRO seeks access only for purposes of determining or monitoring credit ratings, that it will treat the information it accesses as confidential in accordance with its internal policies on use of material nonpublic information, and

¹ See 17 CFR 240.17g-5 (a)(3) (the “Rule”).

that it will undertake to perform credit ratings for a certain percentage of the securities or instruments for which it accesses information if it accesses such information for ten or more issued securities or instruments in the calendar year covered by the certification.

The stated purpose of the Rule is to encourage more ratings of structured finance deals by non-hired NRSROs, thereby mitigating the effects of any conflict of interest that may be associated with a rating obtained under the arranger-paid framework, and discouraging “ratings shopping.” It is unclear, however, whether, or to what extent, the Rule has led to an increase in unsolicited NRSRO ratings.

By necessity, the Rule has led to more formality in the communication of information between structured finance arrangers and the NRSROs they hire to do ratings, because the information conveyed between the parties to facilitate the rating process must be recorded in some fashion and posted on the arranger’s website. While the Rule does not require such information to be recorded in writing, the SEC anticipated that increased formalization would result in written submission of information that in the past, may have been communicated orally. Since each NRSRO and arranger is free to agree to implement whatever practice they believe will work most efficiently for them in compliance with the rule, it is not possible to confirm whether the Rule has resulted in the widespread adoption of use of electronic mail to record communications between NRSROs and arrangers for purposes of compliance with the Rule, although it is clear that parties are widely being advised by counsel to implement procedures that rely on some form of written communication.

NRSROs were required to begin complying with the Rule on June 2, 2010. However, a lack of clarity about application of the Rule where a non-U.S. arranger has hired a NRSRO to rate a non-U.S. transaction led the Commission to delay the compliance start date for such cases.

The Rule’s requirements are described in more detail below.

Covered Transactions

The Rule applies to 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.”² The SEC has indicated that this language is intended to cover the full range of structured finance products transactions, and not just transactions covered by Regulation AB.³ Thus, the Rule covers both registered and non-registered securities and money market instruments. To illustrate, the SEC has listed the following structured finance products as being covered by the Rule, noting that this list is not necessarily exhaustive:

- Securities collateralized by static and actively managed pools of loans or receivables (*e.g.*, commercial and residential mortgages, corporate loans, auto loans, education loans, credit card receivables, and leases);
- Collateralized debt obligations;
- Collateralized loan obligations;

² See *id.* § 240.17 (b)(9).

³ See 74 *Fed. Reg.* 63844 (December 4, 2009).

- Collateralized mortgage obligations;
- Structured investment vehicles;
- Synthetic collateralized debt obligations that reference debt securities or indexes; and,
- Hybrid collateralized debt obligations.

Hired NRSRO Obligations

An NRSRO hired to rate or monitor a covered transaction has two primary obligations under the Rule:

1) *Website Maintenance* – First, the NRSRO must maintain a password-protected website listing each structured finance product for which it is in the process of determining an initial⁴ credit rating. The list must be in chronological order and identify the type of structured finance product, the name of the issuer, the date the rating process was initiated, and an Internet web address where the arranger (either the issuer, sponsor, or underwriter) of the structured finance transaction maintains information that has been provided to the hired NRSRO about the transaction, as required by the Rule. The Rule does not specify a deadline by which this information must be posted.

Any non-hired NRSRO has a right to free and unlimited access to the hired NRSRO’s website, provided that the non-hired NRSRO provides an annual certification to the SEC (with a copy to the arranger and the hired NRSRO) reflecting that the non-hired NRSRO has complied with the Rule (discussed in more detail below).

2) *Obtaining Assurances from Arrangers* – Second, NRSRO(s) hired by an arranger of structured finance products to issue an initial credit rating must obtain from the arranger a written representation that can reasonably be relied upon that the arranger:

- Will maintain an identified password-protected Internet website that includes all information an arranger provides to the hired NRSRO, or contracts with a third party to provide, for the purpose of determining the initial credit rating and for undertaking credit rating surveillance for the structured finance product, in each case at the same time the information is provided to the hired NRSRO; and
- Will provide access to the website to any NRSRO that has submitted the appropriate certification of compliance with the Rule (described below) to the SEC.

Hired NRSROs are not held responsible for enforcing compliance by an arranger with these requirements. However, if an NRSRO has knowledge that an arranger has not complied with its

⁴ The SEC notes that the Rule requires posting to the hired NRSRO’s website where the NRSRO is in the process of determining an “initial” credit rating, and that the Commission does not intend the Rule to require that NRSROs continue posting information about securities or money market instruments for which the NRSRO has already published an initial rating and is monitoring the rating. Consequently, the Commission advises, “upon publication of the initial rating, the NRSRO can remove the information about the security or money market instrument from the list it maintains on the Internet Web site. The Commission notes that the information on the arranger’s Web site would remain available. If, however, the arranger decides to terminate the rating process before the hired NRSRO published an initial rating, the NRSRO would be permitted to remove the information from the list.” *Id.* at 63845, n.139.

representations, the NRSRO would be on notice that future reliance on the arranger might be unreasonable. Thus, the SEC has expressed its expectation that the required representations from arrangers will become part of the standard contracts entered into between NRSROs and arrangers, and that arrangers who fail to comply with their representations risk having the hired NRSRO withdraw the credit ratings paid for by that arranger and being denied the ability to obtain credit ratings from the hired NRSRO in the future, since the hired NRSRO may be unable to reasonably rely on the arrangers' representations.⁵

Arranger Obligations

As is apparent from the above discussion, an arranger is responsible for maintaining a password-protected website that includes all information the arranger provides to the hired NRSRO, either directly or indirectly, for the purpose of determining the initial credit rating or for ratings surveillance. The website may be maintained by either the issuer, sponsor, or underwriter of the transaction (collectively referred to in the Rule as "arrangers"). The requirement includes "information about the characteristics or performance of the assets underlying or referenced by the security or money market instrument, and the legal structure of the security or money market instrument," but does not specify additional details concerning the required information beyond this description.⁶

The information must be posted to the website "at the same time" the information is provided to the hired NRSRO. The Rule provides no further specification as to how posting is to be accomplished "at the same time." And as information is added to the website, the arranger must tag the information in a manner that indicates the most recent information given the hired-NRSRO, to enable non-hired NRSROs to discern which information is the most current. The Commission further advised that it expects arrangers to provide all information "in the same format," for example, "if the arranger provides information to the hired NRSRO in downloadable and/or searchable format, the Commission expects the arranger to provide the same information in the same format on its Internet Web site."⁷

The arranger must provide access to the website to any non-hired NRSRO that provides it with a copy of a certification to the SEC (described below) that the non-hired NRSRO is in compliance with the Rule. Although the Rule does not specify that the arranger is to provide "free and unlimited" access to its website, as is the case in the provision governing hired NRSRO obligations, there is no indication in the Rule or its preamble that the Commission intends to permit arrangers to charge an access fee to non-hired NRSROs.

The Rule does not require that non-hired NRSROs accessing an arranger's website enter a confidentiality agreement with the arranger. But the SEC advises that arrangers can establish "a

⁵ *See id.* at 63847.

⁶ *See id.* at 63846. The Commission did, however, agree with one commentator's observation that trustee, servicer, and special servicer information would be relevant to rating surveillance, and therefore, included the requirement in the Rule that an arranger post information given to the hired NRSRO by a third party, as well as information directly given by the arranger to the hired NRSRO. *See id.* at 63848.

⁷ *Id.* at 63846, n.152.

simple process requiring non-hired NRSROs to agree to keep the information they obtain from the arranger confidential, provided that such a process does not operate to preclude, discourage, or significantly impede non-hired NRSROs' access to the information, or their ability to issue a credit rating based on the information."⁸

Non-Hired NRSRO Obligations

In order to access websites maintained by hired NRSROs and arrangers pertaining to structured finance products, a non-hired NRSRO must submit a certification to the SEC, for each calendar year for which the non-hired NRSRO seeks a password to access the websites, stating that the NRSRO:

- Will access the website(s) solely for purposes of determining or monitoring credit ratings;
- Will keep the information it accesses confidential and treat it as material non-public information subject to its internal policies governing treatment of such information; and,
- Will determine and maintain credit ratings for at least 10% of the issued structured finance products for which it accesses information, if it accesses information for 10 or more issued structured finance products in the calendar year covered by the certification.⁹

The non-hired NRSRO's certification must also disclose the number of issuances in the prior calendar year for which it accessed information under the Rule, the number of ratings it determined or maintained for such securities, or whether it accessed information fewer than 10 times in the most recently ended calendar year.

The Rule specifies that hired NRSROs and arrangers need only provide access to a non-hired NRSRO whose certification indicates that the non-hired NRSRO has either: (1) determined and maintained credit ratings for at least 10% of the issued securities and money market instruments for which it accessed information pursuant to the Rule in the calendar year prior to the year covered by the certification, if it accessed such information for 10 or more issued securities or money market instruments; or (2) has not accessed information pursuant to the Rule 10 or more times in the most recently ended calendar year.¹⁰

⁸ *Id.* at 63849.

⁹ 17 CFR 240.17g-5(e).

¹⁰ *Id.* at 63846, 63848. The Commission has clarified, however, that this requirement does not mean that a non-hired NRSRO would be precluded from accessing the hired-NRSRO's website if at some point prior to the most recently ended calendar year, the NRSRO accessed the web site 10 or more times. As an illustration, the Commission states: "[f]or example, if a non-hired NRSRO accessed the Web site 10 or more times in year 1, but did not access the Web site in year 2, the non-hired NRSRO would then be permitted to access the Internet Web site in year 3." See *id.* at 63846.

It appears, however, that the Commission is willing to entertain requests to allow non-hired NRSROs to have continued access to hired NRSRO websites even when a non-hired NRSRO has not fulfilled the requirement to determine or maintain credit ratings for 10% of the securities for which it accessed information in the prior calendar year. Specifically, the Commission advises that it “recognizes that there may be legitimate reasons why an NRSRO does not meet the 10% threshold in a given year, and NRSROs may request appropriate relief in such cases. For example, an NRSRO may access the information for a new type of financial instrument which it believed it was capable of rating but, upon reviewing the information posted by the arranger, determined that it did not have the resources or capacity to do so. In such a case, it would not be in the public interest for the non-hired NRSRO to produce a rating; nor, however, would it be desirable to penalize that NRSRO for its good-faith re-evaluation of its ability to produce the rating.”¹¹

General Considerations

The SEC has acknowledged that the Rule’s requirements will lead to a more formalized process of information exchange between arrangers and hired NRSROs for structured finance products. While the Rule does not require such information to be recorded in writing, the SEC anticipated that increased formalization would result in written submission of information that in the past, may have been communicated orally.¹² Given that NRSROs and arrangers are free to implement whatever practice they agree will work most efficiently for them in compliance with the rule, it is not possible to confirm whether the Rule has resulted in the widespread adoption of electronic mail to record communications between NRSROs and arrangers for purposes of compliance with the Rule. It is clear, however, that parties are widely being advised to implement procedures that rely on some form of written communication.

Overall, the SEC intends these requirements to alert non-hired NRSROs to new transactions and direct them to the arranger’s website to obtain information that would enable them to rate and monitor structured finance products on an unsolicited basis. As mentioned, however, it is presently unclear whether non-hired NRSROs are taking advantage of the Rule to perform unsolicited ratings.

Finally, it is important to be aware that there is a lack of clarity about application of the Rule where a non-U.S. arranger has hired an NRSRO to rate a non-U.S. transaction. In response to questions from foreign regulators and others about the authority and effect of the Rule in these circumstances, the Commission created an exemption that delays the compliance date until December 2, 2011 for transactions in which: (1) the issuer of the structured finance product is a non-U.S. person; and (2) the NRSRO has a reasonable basis to conclude that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will only effect transactions of the structured finance outside the United States.¹³ Even if a transaction met these two criteria, questions remain as to whether the exemption would

¹¹ *Id.* at 63849.

¹² *See id.* at 63847.

¹³ *See* Release No. 34-62120, Order Granting Temporary Conditional Exemption (dated May 19, 2010), extended in Release No. 34-63363 (dated Nov. 23, 2010). This has led at least one NRSRO to require arrangers who believe their transactions are within the scope of this exemption to provide a representation to that effect. *See* discussion of Fitch’s “Required Representations for Exempt Structured Finance Transactions” at <http://www.businesswire.com/news/home/20100524006839/en/Fitch-Updates-Plan-Address-SEC-Rule-17g-5>.

apply when the transaction, nevertheless, targets U.S. investors. And it is also unclear what the Commission would require of NRSROs and of non-U.S. arrangers if the Commission decides to end the exemption (for example, what would be accomplished by requiring an NRSRO to list the offshore transaction on its website if the non-U.S. arranger cannot be compelled to set up and maintain a website under the Rule?). Such questions remain unanswered by the Commission. It follows that until the SEC resolves the remaining issues regarding the status of exempt transactions, NRSROs should continue to monitor SEC proceedings on this matter

Summary of Steps for Compliance

The following presents a summary of steps NRSROs should take in seeking to comply with the Rule:

1. If the NRSRO expects to be hired to rate structured finance transactions, establish a website designed to meet the NRSRO obligations in the Rule (e.g., password protected, capable of listing all applicable deals the NRSRO is in the process of rating, etc.).
2. Once hired, determine if the transaction in question is a “covered” structured finance transaction within the meaning of the Rule.
3. Determine whether the transaction falls under the “temporary exemption” for non-U.S. products. If the arranger believes the transaction is exempt, obtain representations from the arranger to support this position. Take care, however, to ensure that the transaction does not target U.S. investors, notwithstanding that it involves a non-U.S. arranger and is an offshore transaction. If U.S. investors are targeted, a careful determination should be made as to whether to treat the transaction as exempt. Until the SEC resolves the remaining issues regarding the status of exempt transactions, NRSROs should continue to monitor SEC proceedings on this matter.
4. If the transaction is not exempt, the NRSRO must obtain representations from the arranger as required by the Rule (e.g., that the arranger will establish and maintain its own website as required by the Rule).
5. The NRSRO and the arranger must also agree on and implement a means of communication of information pertinent to the rating process that can be posted on the website by the arranger.
6. Once the website is operating and the NRSRO is rating a transaction that is subject to the Rule, the NRSRO must be prepared to accommodate access to non-hired NRSROs that seek access, such as by having internal systems in place to record the fact that a non-hired NRSRO has provided a copy of a valid, current certification.
7. If the NRSRO expects to conduct unsolicited ratings taking advantage of information available under the Rule, prepare and submit to the SEC the certification required under the Rule to access hired NRSRO and arranger websites.