

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 240 and 249b**

**[Release No. 34-59342; File No. S7-13-08]**

**RIN 3235-AK14**

**Amendments to Rules for Nationally Recognized Statistical Rating Organizations**

**AGENCY:** Securities and Exchange Commission (“Commission”).

**ACTION:** Final rule.

**SUMMARY:** The Commission is adopting rule amendments that 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.

**DATES:** Effective Date: April 10, 2009

Compliance Date: April 10, 2009, except that the compliance date for the amendment to § 240.17g-2(d) is August 10, 2009.

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**SUPPLEMENTARY INFORMATION:**

## I. BACKGROUND

On June 16, 2008, the Commission, in the first of three related actions, proposed a series of amendments to its existing rules governing the conduct of NRSROs.<sup>1</sup> The proposed amendments were designed to address concerns about the integrity of the process by which NRSROs rate structured finance products, particularly mortgage related securities.<sup>2</sup> Today, the Commission is adopting, with revisions, a majority of the rule amendments proposed in the first action.<sup>3</sup> These new requirements are designed to address practices identified, in part, by the Commission staff during its examination of the three largest NRSROs.<sup>4</sup> In particular, the requirements are intended to increase the transparency of the NRSROs' rating methodologies, strengthen the NRSROs' disclosure

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<sup>1</sup> Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57967 (June 16, 2008), 73 FR 36212 (June 25, 2008) (“June 16, 2008 Proposing Release”). The existing NRSRO rules were adopted by the Commission in 2007. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55857 (June 5, 2007), 72 FR 33564 (June 18, 2007) (“June 5, 2007 Adopting Release”). The second action taken by the Commission (also on June 16, 2008) was to propose a new rule that would require NRSROs to distinguish their ratings for structured finance products from other classes of credit ratings by publishing a report with the rating or using a different rating symbol. See June 16, 2008 Proposing Release. The third action taken by the Commission was to propose a series of amendments to rules under the Exchange Act, Securities Act of 1933 (“Securities Act”), and Investment Company Act of 1940 (“Investment Company Act”) that would end the use of NRSRO credit ratings in the rules. See References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (July 1, 2008), 73 FR 40088 (July 11, 2008); Securities Ratings, Securities Act Release No. 8940 (July 1, 2008), 73 FR 40106 (July 11, 2008); References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28327 (July 1, 2008), 73 FR 40124 (July 11, 2008). The second and third actions are not being finalized in this release.

<sup>2</sup> 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 such as residential mortgage-backed securities (“RMBS”) and to other types of structured debt instruments such as collateralized debt obligations (“CDOs”), including synthetic and hybrid CDOs.

<sup>3</sup> The June 16, 2008 Proposing Release included amendments to paragraphs (a) and (b) of Rule 17g-5 that are not being adopted today. Instead, in part, in response to the many comments received on these proposed amendments identifying substantial issues as to how they would operate in practice, the Commission today is re-proposing these amendments in a separate release. In addition, the Commission is also proposing potential additional requirements to the final amendment to paragraph (d) of Rule 17g-2 being adopted today.

<sup>4</sup> See June 16, 2008 Proposing Release, 73 FR at 36213; Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies (July 2008). The report can be accessed at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>

of ratings performance, prohibit the NRSROs from engaging in certain practices that create conflicts of interest, and enhance the NRSROs' recordkeeping and reporting obligations to assist the Commission in performing its regulatory and oversight functions.<sup>5</sup> The Commission received 61 comment letters on the amendments as proposed.<sup>6</sup> Many commenters expressed general support for the proposals and the ends

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<sup>5</sup> The June 16, 2008 Proposing Release contains a detailed discussion of concerns the final rules are intended to address, particularly with respect to the NRSROs' role in the credit market turmoil. See June 16, 2008 Proposing Release, 73 FR at 36213-36218.

<sup>6</sup> Letter dated June 10, 2008 from Deborah A. Cunningham and Boyce I. Greer, Co-Chairs Company, Co-Chairs, SIFMA Credit Rating Agency Task Force ("First SIFMA Letter"); letter dated June 12, 2008 from G. Brooks Euler ("Euler Letter"); letter dated June 19, 2008 from Rupert Schoder, Financial Engineer, Socit Gnrale, France ("SGF Letter"); letter dated July 8, 2008 from William Morris, Principal, The Morris Group ("Morris Letter"); letter dated July 8, 2008 from Elaine Wieche ("Wieche Letter"); letter dated July 13, 2008 from Walter C. Hamscher, Member, XBRL International Board of Directors ("Hamscher Letter"); letter dated July 14, 2008 from Robert Dobilas, President, CEO, Realpoint LLC ("Realpoint Letter"); letter dated July 21, 2008 from Dottie Cunningham, Chief Executive Officer, Commercial Mortgage Securities Association ("CMSA Letter"); letter dated July 21, 2008 from Bruce Goldstein, SunTrust Robinson Humphrey ("STRH Letter"); letter dated July 21, 2008 from Raymond E. Petersen, President, Inland Mortgage Capital Corporation ("Inland Letter"); letter dated July 21, 2008 from Leonard W. Cotton, Vice Chairman, Centerline Capital Group ("Centerline Letter"); letter dated July 21, 2008 from Gregg Rademacher, Chief Executive Officer, Los Angeles County Employees Retirement Association ("LACERA Letter"); letter dated July 22, 2008 from Kevin Kohler, VP - Levered Finance, Capmark Investments LP ("Capmark Letter"); letter dated July 22, 2008 from Richard Metcalf, Director, Corporate Affairs Department, Laborers' International Union of North America ("LIUNA Letter"); letter dated July 22, 2008 from Mary A. Downing, Director -Surveillance and Due Diligence, Hillenbrand Partners ("Hillenbrand Letter"); letter dated July 23, 2008 from Kent Wideman, Group Managing Director, Policy & Rating Committee and Mary Keogh, Managing Director, Policy & Regulatory Affairs, DBRS ("DBRS Letter"); letter dated July 24, 2008 from Takefumi Emori, Managing Director, Japan Credit Rating Agency, Ltd. ("JCR Letter"); letter dated July 24, 2008 from J. Douglas Adamson, Executive Vice President, Technical Services, American Bankers Association ("ABA Letter"); letter dated July 24, 2008 from Amy Borrus, Deputy Director, Council of Institutional Investors ("Council Letter"); letter dated July 24, 2008 from Joseph A. Hall and Michael Kaplan, Davis Polk, and Wardwell ("DPW Letter"); letter dated July 24, 2008 from Vickie A. Tillman, Executive Vice President, Standard & Poor's Ratings Services ("S&P Letter"); letter dated July 24, 2008 from Deborah A. Cunningham and Boyce I. Greer, Co-Chairs Company, Co-Chairs, SIFMA Credit Rating Agency Task Force ("Second SIFMA Letter"); letter dated July 24, 2008 from Alex J. Pollock, Resident Fellow, American Enterprise Institute ("Pollock Letter"); letter dated July 25, 2008 from Sally Scutt, Managing Director, and Pierre de Lauzun, Chairman, Financial Markets Working Group, International Banking Federation ("IBFED Letter"); letter dated July 25, 2008 from Eric Sanitas, President, Association federative internationale des porteurs d'emprunts russe ("AFIPER Letter"); letter dated July 25, 2008 from Denise L. Nappier, Treasurer, State of Connecticut ("Nappier Letter"); letter dated July 25, 2008 from Suzanne C. Hutchinson, Mortgage Insurance Companies of America ("MICA Letter"); letter dated July 25, 2008 from Kieran P. Quinn, Chairman, Mortgage Bankers Association ("MBA Letter"); letter dated July 25, 2008 from Sean J. Egan, President, Egan-Jones Ratings Co. ("Egan-Jones Letter"); letter dated July 25, 2008 from Frank Chin, Chairman, Municipal Securities Rulemaking Board ("MSRB Letter"); letter dated July 25, 2008

they were designed to achieve.<sup>7</sup> At the same time, commenters raised concerns about the practicality and costs of the proposals.<sup>8</sup> The rules being adopted today incorporate many aspects of the rules as proposed, but also include significant revisions based on the

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from Charles D. Brown, General Counsel, Fitch Ratings (“Fitch Letter”); letter dated July 25, 2008 from Bill Lockyer, State Treasurer, California (“Lockyer Letter”); letter dated July 25, 2008 from Jeremy Reifsnnyder and Richard Johns, Co-Chairs, American Securitization Forum Credit Rating Agency Task Force (“ASF Letter”); letter dated July 25, 2008 from Annemarie G. DiCola, Chief Executive Officer, Trepp, LLC (“Trepp Letter”); letter dated July 25, 2008 from Francisco Paez, Metropolitan Life Insurance Company (“MetLife Letter”); letter dated July 25, 2008 from Cate Long, Multiple-Markets (“Multiple-Markets Letter”); letter dated July 25, 2008 from Kurt N. Schacht, Executive Director and Linda L. Rittenhouse, Senior Policy Analyst, CFA Institute Centre for Financial Market Integrity (“CFA Institute Letter”); letter dated July 25, 2008 from Lawrence J. White, Professor of Economics, Stern School of Business, New York University (“White Letter”); letter dated July 25, 2008 from Jack Davis, Head of Fixed Income Research, Schroder Investment Management North America Inc. (“Schroders Letter”); letter dated July 25, 2008 from Karrie McMillan, General Counsel, Investment Company Institute (“ICI Letter”); letter dated July 25, 2008 from Michael Decker, Co-Chief Executive Officer and Mike Nicholas, Co-Chief Executive Officer, Regional Bond Dealers Association (“RBDA Letter”); letter dated July 25, 2008 from Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable (“Roundtable Letter”); letter dated July 25, 2008 from James H. Gellert, Chairman and CEO and Dr. Patrick J. Caragata, Founder and Executive Vice Chairman, Rapid Ratings International Inc. (“Rapid Ratings Letter”); letter dated July 25, 2008 from Alan P. Kress, Counsel, Principal Global Investors, LLC (“Principal Global Letter”); letter dated July 25, 2008 from James A. Kaitz, President and CEO, Association for Financial Professionals (“AFP Letter”); letter dated July 25, 2008 from Gregory W. Smith, General Counsel, Colorado Public Employees’ Retirement Association (“Colorado PERA Letter”); letter dated July 25, 2008 from Cleary Gottlieb Steen & Hamilton LLP, “CGSH Letter”); letter dated July 25, 2008 from Keith A. Styrcula, Chairman, Structured Products Association (“SPA Letter”); letter dated July 25, 2008 from Yasuhiro Harada, Chairman and Co-CEO, Rating and Investment Information, Inc. (“R&I Letter”); letter dated July 28, 2008 from Michel Madelain, Chief Operating Officer, Moody’s Investors Service (“Moody’s Letter”); letter dated July 28, 2008 from Keith F. Higgins, Chair, Committee on Federal Regulation of Securities and Vicki O. Tucker, Chair, Committee on Securitization and Structured Finance, American Bar Association (“ABA Business Law Committees Letter”); letter dated July 28, 2008 from Morris C. Foutch (“Foutch Letter”); letter dated July 29, 2008 from Glenn Reynolds, CEO and Peter Petas, President CreditSights, Inc. (“CreditSights Letter”); letter dated July 31, 2008 from Robert S. Khuzami Managing Director and General Counsel, Deutsche Bank Americas (“DBA Letter”); letter dated August 5, 2008 from John Taylor, President and CEO, National Community Reinvestment Coalition (“NCRC Letter”); letter dated August 8, 2008 from Jeffrey A. Perlowitz, Managing Director and Co-Head of Global Securitized Markets, and Myongsu Kong, Director and Counsel, Citigroup Global Markets Inc. (“Citi Letter”); letter dated August 12, 2008 from John J. Niebuhr, Managing Director, Lehman Brothers, Inc. (“Lehman Letter”); letter dated August 15, 2008 from Steve Linehan, Executive Vice-President and Treasurer, Capital One Financial Corporation (“Capital One Letter”); letter dated August 17, 2008 from Olivier Raingeard, Ph.D (“Raingeard Letter”); letter dated August 22, 2008 from Robert Dobilas, CEO and President, Realpoint LLC (“Second Realpoint Letter”); letter dated August 27, 2008 from Larry G. Mayewski, Executive Vice President & Chief Rating Officer, A.M. Best Company (“A.M. Best Letter”).

<sup>7</sup> See, e.g., LACERA Letter; LIUNA Letter; Council Letter; Second SIFMA Letter; Nappier Letter; RBDA Letter; Colorado PERA Letter; CGSH Letter; SPA Letter; R&I Letter; Moody’s Letter; CreditSights Letter; DBA Letter; NCRC Letter; Lehman Letter; Capital One Letter.

<sup>8</sup> See, e.g., White Letter; Roundtable Letter; Rapid Ratings Letter; ABA Business Law Committees Letter; Raingeard Letter.

comments received.<sup>9</sup> The revisions seek to address practical impediments identified by commenters while at the same time continuing to promote the substantive goals of the proposed rules (increasing transparency and disclosure, diminishing conflicts, and strengthening oversight) and of the Credit Rating Agency Reform Act of 2006 (“Rating Agency Act”).<sup>10</sup>

In summary, the rule amendments 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;<sup>11</sup> (2) an NRSRO to make, keep and preserve additional records under Rule 17g-2;<sup>12</sup> (3) an NRSRO to make publicly available on its Internet Web site in XBRL format a random sample of 10% of the ratings histories of credit ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated (“issuer-paid credit ratings”) in each class of credit ratings for which it is registered and has issued 500 or more issuer-paid credit ratings, with each new ratings action to be reflected in such histories no later than six months after they are taken;<sup>13</sup> and (4) an NRSRO to furnish the Commission with an additional annual report.<sup>14</sup>

## **II. THE FINAL RULE AMENDMENTS**

### **A. Amendments to the Instructions for Form NRSRO**

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<sup>9</sup> These comments are available on the Commission’s Internet Web site, located at <http://www.sec.gov/comments/s7-13-08/s71308.shtml>, and in the Commission’s Public Reference Room in its Washington DC headquarters.

<sup>10</sup> See 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. 2.

<sup>11</sup> See amendments to Form NRSRO.

<sup>12</sup> 17 CFR 240.17g-2.

<sup>13</sup> See Rule 17g-2(a)(8) and (d).

<sup>14</sup> See Rule 17g-3(a)(6).

Form NRSRO contains 8 line items and requires 13 Exhibits. The line items elicit information about the applicant credit rating agency or NRSRO such as: its address; corporate form; credit rating affiliates that would be, or are, a part of its registration; the classes of credit ratings for which it is seeking, or is, registered as an NRSRO; the number of credit ratings it has issued in each class and the date it began issuing credit ratings in each class; and whether it or a person associated with it has committed or omitted any act, been convicted of any crime, or is subject to any order identified in Section 15(d) of the Exchange Act. The 13 Exhibits to Form NRSRO elicit the information required under Sections 15E(a)(1)(B)(i) through (ix) of the Exchange Act and additional information the Commission prescribed under authority in Section 15E(a)(1)(B)(x) of the Exchange Act.<sup>15</sup>

The Commission proposed amending the instructions to Form NRSRO to enhance the disclosures NRSROs make in Exhibits 1 and 2. As discussed below, the Commission is adopting the changes with certain modifications that respond, in part, to points raised by commenters.

### **1. Enhanced Ratings Performance Measurement Statistics on Form NRSRO**

Exhibit 1 to Form NRSRO elicits the information required by Section 15E(a)(1)(B)(i) of the Exchange Act: credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable) of the credit rating agency.<sup>16</sup> The instructions for the Exhibit provide that an applicant and NRSRO must include in the Exhibit definitions of the credit ratings (i.e., an explanation of each

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<sup>15</sup> 15 U.S.C. 78o-7(a)(1)(B)(i) – (x).

<sup>16</sup> 15 U.S.C. 78o-7(a)(1)(B)(i).

category and notch) and explanations of the performance measurement statistics, including the metrics used to derive the statistics.

The first proposed amendment to the Exhibit 1 instructions would enhance the disclosure by requiring separate sets of default and transition statistics for different classes of credit ratings. Specifically, as proposed, the instructions would require separate sets of statistics for each class of credit rating for which an applicant is seeking registration as an NRSRO or an NRSRO is registered as well as for any other broad class of credit ratings issued by the NRSRO.

The Commission received eight comment letters on this amendment.<sup>17</sup> One commenter noted that separating performance measurements by classes of credit ratings would help market participants make informed decisions.<sup>18</sup> Commenters suggested that the Commission refine the classes of credit ratings and raised concerns about how to interpret the catchall phrase in the rule “any other broad class of credit rating.” For example, one commenter argued that such a category “would capture a variety of operational and qualitative scales, such as servicer and bank support ratings, for which default and/or transition studies are of limited or no value.”<sup>19</sup> The same commenter suggested that the single category encompassing government securities, municipal securities and foreign government securities be divided into three separate classes (sovereigns, United States public finance, and international public finance) to account for the different types of investors each such class of securities attracts as well as the potential for the much greater amount of data on public finance issuance in the United

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<sup>17</sup> See Second SIFMA Letter; Fitch Letter; Lockyer Letter; Multiple-Markets Letter; ICI Letter; AFP Letter; ABA Business Law Committees Letter; Raingard Letter.

<sup>18</sup> See AFP Letter.

<sup>19</sup> See Fitch Letter.

States to overwhelm the sovereign and international public finance data, thus making the statistics less useful to investors.<sup>20</sup>

In response to commenters' concerns, the Commission is adopting the proposed amendments to the instructions but not adopting the "catchall" requirement to which commenters objected. Eliminating the catchall will remove ambiguity in the rule. In addition, the Commission is adding language to the instructions as amended that divide government securities into three classes: sovereigns, United States public finance, and international public finance. This will make the performance statistics for these classes of credit ratings more meaningful, since the types of rated obligors and instruments in each class will be more similar.

As proposed, the first amendment to the Exhibit 1 instructions also would require an NRSRO registered in the class of credit ratings described in Section 3(a)(62)(B)(iv) of the Rating Agency Act<sup>21</sup> (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 was designed to include 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)."<sup>22</sup> The Commission received no comment on this aspect of the amendment and is adopting it as proposed.

This first amendment to the Exhibit 1 instructions, modified as described above, will result in the generation of performance statistics that will make it easier for users of

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<sup>20</sup>

<sup>21</sup> Id.  
15 U.S.C. 78c(a)(62)(B)(iv).

<sup>22</sup> See id.



credit ratings to compare the accuracy of NRSRO credit ratings on a class-by-class basis. For the reasons discussed, the Commission is adopting the amendment to the instructions with the modifications described above.

As proposed, the second amendment to the Exhibit 1 instructions would require that the 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, which is also the language currently used in Form NRSRO.<sup>23</sup> The purpose of this amendment was to prescribe periods in specific years so that the performance statistics generated by the NRSROs are more easily comparable.

The Commission received 12 comments on the amendment.<sup>24</sup> Most of the commenters supported the amendment, including the 1, 3, and 10 year time frames. These comments supported the Commission's view 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.<sup>25</sup> Commenters believed the proposed statistics would provide investors additional information to make informed investment decisions.<sup>26</sup> Several commenters asked that the Commission clarify whether the default rates were for the most recent 1, 3, and 10 year periods or the average over multiple 1, 3, and 10 year periods.<sup>27</sup> The Commission intended the default statistics to be for the most recent 1, 3, and 10 year periods. The Commission is adopting the amendment to the instructions as proposed.

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<sup>23</sup> 15 U.S.C. 78o-7(a)(1)(B)(i).

<sup>24</sup> See LIUNA Letter; JCR Letter; Council Letter; S&P Letter; Second SIFMA Letter; Fitch Letter; Multiple-Markets Letter; AFP Letter; Colorado PERA Letter; ABA Business Law Committees Letter; NCRC Letter; Rainguard Letter.

<sup>25</sup> 15 U.S.C. 78o-7(a)(1)(B)(i).

<sup>26</sup> See LIUNA Letter; AFP Letter.

<sup>27</sup> See JCR Letter; S&P Letter.

As proposed, the third amendment to the Exhibit 1 instructions would clarify the type of ratings actions that are required to be included in these performance measurement statistics. Specifically, it would change the instruction requiring that the performance statistics show “down-grade and default rates” with an instruction that they show “ratings transition and default rates.” The switch to “ratings transition” rates from “downgrade” rates was designed to clarify that upgrades (as well as downgrades) should be included when generating the statistics. The Commission did not receive any comments on this amendment to the instructions and is adopting it as proposed.

Finally, the Commission proposed an amendment to the instructions of Exhibit 1 that 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. The proposed amendment was 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.

Commenters raised a number of concerns about how this proposal would operate in practice.<sup>28</sup> Several commenters expressed concern that the requirement to include defaults occurring after a rating is withdrawn could obligate an NRSRO to monitor ratings for an indefinite period of time after the NRSRO stops rating such instruments, and that an NRSRO may not be able to provide such statistics after a rating is withdrawn.<sup>29</sup> Two NRSROs noted that the ability to monitor ratings depends on the ability of the NRSRO to obtain information that an event of default has occurred and that

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<sup>28</sup> See DBRS Letter; S&P Letter; Fitch Letter; Moody’s Letter.

<sup>29</sup> See DBRS Letter; S&P Letter.

this may be impractical given limited access to information once a rating is withdrawn.<sup>30</sup>

Another NRSRO believed that the proposal was overbroad and outside the scope of the Commission's authority, asserting that it intrudes upon the substance of the NRSRO's rating procedures.<sup>31</sup> The Commission agrees that, given the limited information available to NRSROs following the withdrawal of a rating, requiring the inclusion in these statistics of defaults occurring after a rating is withdrawn may be problematic. Therefore, the Commission is not adopting this provision at this time. While the instructions to Exhibit 1 will continue to require default statistics that are relative to initial rating on a class-by-class basis, for the reasons discussed above, the amendment as adopted does not require the inclusion of defaults that occur after a credit rating is withdrawn in those statistics. As an alternative means of achieving the Commission's goals in proposing this amendment, the Commission notes that, as discussed below, ratings withdrawals must be included among the ratings actions to be disclosed under the Commission's amendment to Rule 17g-3,<sup>32</sup> which requires an annual report of all ratings actions taken during the year within a class of credit ratings. This information will be useful in determining whether the number of ratings actions in a given class is unusually large and, if so, the need for a review of the causes of any significant changes to that number – including, potentially, a disproportionate amount of ratings withdrawals.

## **2. Enhanced Disclosure of Ratings Methodologies**

Exhibit 2 to Form NRSRO elicits the information required by Section 15E(a)(1)(B)(ii) of the Exchange Act: information regarding the procedures and

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<sup>30</sup> See S&P Letter; Fitch Letter.

<sup>31</sup> See Moody's Letter.

<sup>32</sup> 17 CFR 240.17g-3.

methodologies used by the credit rating agency to determine credit ratings.<sup>33</sup> The instructions for the Exhibit require a description of the procedures and methodologies (not the submission and disclosure of each actual procedure and methodology). The instructions further provide that the description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes the applicant or NRSRO employs to determine credit ratings. The instructions also identify a number of areas that must be addressed in the description to the extent they are applicable.<sup>34</sup>

The Commission proposed amending the instructions to Exhibit 2 to add three additional areas that an applicant and a registered NRSRO would need to address in the descriptions of its procedures and methodologies in Exhibit 2 to the extent they are applicable. The three proposed areas that would need to be addressed by an applicant and NRSRO were:

- 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;

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<sup>33</sup> 15 U.S.C. 78o-7(a)(1)(B)(ii).

<sup>34</sup> Specifically, the instructions require an NRSRO to provide descriptions of the following areas (as applicable): “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; the quantitative and qualitative models and metrics used to determine 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; and procedures to withdraw, or suspend the maintenance of, a credit rating.” See Form NRSRO Instructions for Exhibit 2.

- 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 comments submitted on the first proposed amendment to the instructions to Exhibit 2 were supportive of the proposal.<sup>35</sup> Commenters generally supported the second proposed amendment as well.<sup>36</sup> Likewise, commenters were supportive of the third proposed amendment. They stated that it would be particularly helpful to retail investors and that all investors would benefit from knowing what ratings have undergone surveillance by the NRSRO.<sup>37</sup>

The Commission is adopting the first amendment to the instructions to Exhibit 2 as proposed. This amendment requires 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. The Commission believes this disclosure will benefit users of credit ratings by providing information about the potential accuracy of an

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<sup>35</sup> See NCRC Letter; Second SIFMA Letter; MICA Letter; ASF Letter.

<sup>36</sup> See Second SIFMA Letter; ASF Letter.

<sup>37</sup> See ASF Letter; Multiple-Markets Letter; NCRC Letter.

NRSRO's credit ratings. 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 will be useful to users of credit ratings in assessing the potential for an NRSRO's credit ratings to be adversely impacted by inaccurate information about the assets underlying a rated structured finance product.

The Commission is adopting the second amendment to the instructions to Exhibit 2 as proposed. This amendment requires 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. The Commission believes that 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 NRSROs' procedures and methodologies.

The Commission is adopting the third amendment to the instructions to Exhibit 2 as proposed. This amendment requires 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 will 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 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 notes that, unlike the prior two changes, this new instruction applies to all classes of credit ratings for which the NRSRO determines credit ratings (not solely to structured products). For the reasons noted above, the Commission is adopting this amendment as proposed.

The Commission is adopting these amendments to the instructions to Exhibit 2 to Form NRSRO, 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.<sup>38</sup> The Commission believes the new disclosure requirements 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 where questions have been raised, particularly for structured finance products, 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.

**B. Amendments to Rule 17g-2**

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.<sup>39</sup> The rule also prescribes the time periods and manner in which these records are required to be retained. The Commission is adopting amendments to Rule 17g-2 to require NRSROs to make and retain certain additional records and to require that a portion of these new records be made publicly available.

**1. A Record of Rating Actions and the Requirement that they be made Publicly Available**

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<sup>38</sup> See Section 15E(a)(1)(B)(x) of the Exchange Act (15 U.S.C. 78o-7(a)(1)(B)(x)).

<sup>39</sup> See 17 CFR 240.17g-2.



The Commission proposed an amendment that would require an NRSRO to make and retain a record of the ratings history of each outstanding credit rating as well as an amendment that would require the NRSRO to make the ratings histories contained in the record publicly available on its corporate Web site in eXtensible Business Reporting Language (“XBRL”) electronic format, with each new ratings action to be made public no later than six months after the date of the rating action. The Commission is adopting the amendment with substantial changes in part to address concerns raised by commenters.

As adopted, paragraph (a)(8) to Rule 17g-2 requires an NRSRO to make and retain a record for each outstanding credit rating it maintains showing all rating actions (initial rating, upgrades, downgrades, placements on watch for upgrade or downgrade, and withdrawals) and the date of such actions identified by the name of the security or obligor rated and, if applicable, the CUSIP for the rated security or the Central Index Key (CIK) number for the rated obligor. This full record of credit rating histories will be maintained by the NRSRO as part of its internal records that are available to Commission staff.

In addition, paragraph (d) to Rule 17g-2, as amended, requires that an NRSRO make publicly available, on a six-month delayed basis, a random sample of 10% of the issuer-paid credit ratings and their histories documented pursuant to paragraph (a)(8) for each class of credit rating for which the NRSRO is registered and has issued 500 or more ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated. Consequently, the final rule only requires the disclosure of ratings histories for a limited number of outstanding credit ratings and only if they are issuer-

paid credit ratings. Generally, NRSROs make their issuer-paid credit ratings publicly available for free.

NRSROs also obtain revenues by selling subscriptions to their credit ratings. Certain NRSROs derive their credit rating revenues solely or predominantly from selling subscriptions to their credit ratings. These NRSROs determine credit ratings that are not paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated (“subscriber-paid credit ratings”). Generally, NRSROs do not make their subscriber-paid credit ratings publicly available for free.

The Commission believes it is appropriate at this time to adopt a rule that will accomplish much of what the Commission sought to achieve in the proposal, mindful of the many comments about the proposal’s potential impact. In addition, in a companion release<sup>40</sup>, the Commission is proposing additional means of accomplishing even more of the Commission’s objective of providing information to the marketplace in order to gauge the accuracy of ratings over time. Both the rule adopted today and the re-proposal are designed to foster accountability and comparability – and hence, competition – among NRSROs.

As noted above, NRSROs generally make their issuer-paid credit ratings publicly available for free. Currently, while these rating actions are made public free of charge, it may be difficult to compile the actions and compare them across NRSROs. Therefore, the Commission expects that making this information more accessible will advance the Commission’s goal of fostering accountability and comparability among NRSROs with respect to their issuer-paid credit ratings. Furthermore, the Commission notes that issuer-

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<sup>40</sup> See Re-proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59343 (January 30, 2009) (“Companion Proposing Release”).

paid credit ratings account for over 98% of the outstanding credit ratings issued by NRSROs, according to information furnished by NRSROs in Form NRSRO. Moreover, seven of the ten registered NRSROs currently maintain 500 or more issuer-paid credit ratings in at least one class of credit ratings for which they are registered. Consequently, applying this rule to issuer-paid ratings should result in a substantial amount of new information for users of credit ratings. It also will allow market observers to begin analyzing the information and developing performance metrics based on it.

The Commission is mindful of the potential impact on NRSROs that determine issuer-paid credit ratings. Therefore, the Commission has taken a number of steps to minimize the impact on NRSROs and enable them to be able to continue to sell downloads and data feeds of their current credit ratings. For example, an NRSRO subject to the disclosure requirement would not be required to disclose a rating action taken with respect to an outstanding credit rating until six months after the action occurs.

In addition, by requiring NRSROs to publicly disclose ratings action histories for a limited percentage of their outstanding issuer-paid credit ratings, market participants, academics and others should still be able to use the information to perform analysis comparing how the NRSROs subject to the disclosure rule perform in the classes of credit ratings for which they are registered. This process will be facilitated by the requirement that the ratings actions data be provided in XBRL format, which will provide a uniform standard format for presenting the information and allow users to dynamically search and analyze the information. This should facilitate the processing of the information and enhance the ability of users to compare information across different NRSROs subject to the disclosure by ratings classes. The Commission believes the random 10% of ratings

histories and 500 ratings per class thresholds will result in the disclosure of a sample suitable for performing statistical analyses of NRSRO performance generally with respect to issuer-paid credit ratings.

NRSROs that sell subscriber-paid credit ratings have suggested that requiring all the histories of these ratings to be publicly disclosed could reduce competition by putting them out of business or adversely impacting their business.<sup>41</sup> They stated that this would be the case even with a substantial time lag between the date a rating action is taken and the date the action must be publicly disclosed. An NRSRO that determines issuer-paid credit ratings stated that ratings history data has substantial commercial value even after 6 months.<sup>42</sup> The Commission wants further input on this issue before deciding on whether the rule should also apply to subscriber-paid credit ratings. As noted above, the Commission, in a separate release, is seeking comment on whether to impose additional means of increasing the amount of information publicly available with respect to the ratings histories of subscriber-paid credit ratings. The Commission wants to carefully balance the commercial and competitive concerns expressed by NRSROs that determine subscriber-paid credit ratings with the Commission's objective of fostering accountability and comparability among all NRSROs. Therefore, in that release, the Commission asks detailed questions about the potential impact of applying the rule to subscriber-paid credit ratings. The responses to those questions will inform the Commission's deliberations as to whether this rule ultimately should be expanded to cover subscriber-paid credit ratings.

The amended rule further provides that the information must be made public on the NRSRO's corporate Internet Web site in XBRL format. The rule provides that in

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<sup>41</sup> See Realpoint Letter; Rapid Ratings Letter.

<sup>42</sup> See S&P Letter.

preparing the XBRL disclosure, an NRSRO must use the List of XBRL Tags for NRSROs as specified on the Commission's Web site. In order to allow NRSROs subject to this requirement sufficient time to implement this new disclosure requirement and the Commission time to develop the List of XBRL Tags for NRSROs, the compliance date of the amendment to paragraph (d) is delayed until 180 days after publication in the Federal Register.<sup>43</sup>

The Commission is adopting these amendments, in part, under authority to require NRSROs to make and keep for specified 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.<sup>44</sup> The Commission believes the 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. The internal record of the complete ratings histories of each outstanding credit rating required under new paragraph (a)(8) of Rule 17g-2 will be useful to the Commission in performing its examination and oversight functions. The data could be analyzed to determine if NRSROs are following their own methodologies in their ratings actions and whether additional disclosure is necessary. This could provide valuable information that could be indicative of problems in the ratings process unrelated to the analytical process, such as conflicts of interest. The Commission notes that this recordkeeping requirement applies to all credit ratings regardless of whether they are issuer-paid or subscriber-paid. The disclosure

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<sup>43</sup> The Commission notes that the ability of NRSROs to comply with the amended rule depends on the availability of the List of XBRL Tags for NRSROs on the Commission's Web page. If the publication of those materials is delayed, the Commission will consider delaying compliance with the rule.

<sup>44</sup> See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

requirements will assist users of credit ratings to compare the relative performance of NRSROs that determine issuer-paid credit ratings. This could enhance competition by making it easier for smaller NRSROs to develop proven track records of determining accurate credit ratings.

The Commission received numerous comments on the proposed amendments to paragraphs (a)(8) and (d) to Rule 17g-2 as proposed.<sup>45</sup> Many commenters expressed support for the proposal, stating that the proposed rule would be a meaningful step in furthering competition in the credit rating industry and could benefit the investor community.<sup>46</sup> One commenter suggested that the proposed rule should require the sorting of records by classes of credit ratings and that the six month time lag should be reduced.<sup>47</sup> Other commenters suggested either reducing<sup>48</sup> or lengthening<sup>49</sup> the proposed six month time lag.

One NRSRO supported the proposal but believed the record of ratings histories should be limited to 10 years.<sup>50</sup> The Commission notes that in order to make the information more meaningful, users seeking to analyze NRSRO performance should be able to review the entire history of a given rating. Imposing a time limit – and therefore eliminating the ability to compare a current rating against the initial rating – would curtail the usefulness of this information.

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<sup>45</sup> See Nappier Letter; ICI Letter; RBDA Letter; R&I Letter; Moody's Letter; ABA Business Law Committee Letter; Realpoint Letter; CMSA Letter; DBRS Letter; ABA Letter; Council Letter; S&P Letter; Second SIFMA Letter; Pollock Letter; IBFED Letter; Egan Jones Letter; Fitch Letter; ASF Letter; Multiple-Markets Letter; CFA Institute Letter; Rapid Ratings Letter; AFP Letter; Colorado PERA Letter; R&I Letter; DBA Letter; NCRC Letter; Citi Letter; Raingard Letter.

<sup>46</sup> See, e.g., AFP Letter; Colorado PERA Letter.

<sup>47</sup> See Second SIFMA Letter.

<sup>48</sup> See Multiple-Markets Letter; CFA Institute Letter; ICI Letter; RBDA Letter; NCRC Letter.

<sup>49</sup> See Realpoint Letter; S&P Letter; Pollock Letter; Multiple-Markets Letter.

<sup>50</sup> See DBRS Letter.

A number of commenters raised substantial concerns with the proposal.<sup>51</sup> For example, NRSROs and others noted that NRSROs that determine subscriber-paid credit ratings make the ratings available for a fee.<sup>52</sup> These commenters argued that requiring them to make all the ratings publicly available for free – even with a six month time lag – could cause them to lose subscribers.

Commenters also raised concerns that requiring an NRSRO that determines issuer-paid credit ratings to make all ratings actions available free of charge in a machine readable format would cause them to lose revenues they derive from selling downloadable packages of their credit ratings.<sup>53</sup> These commenters also questioned whether the requirement would be permitted under the US Constitution, arguing that it could be considered a taking of private property without compensation.<sup>54</sup>

The Commission is adopting paragraph (a)(8) to Rule 17g-2, the recordkeeping provision, substantially as proposed, but, as noted above, has made substantial changes to paragraph (d), the public disclosure provision. Specifically, rather than disclose the ratings history for each outstanding credit rating, an NRSRO must disclose, in XBRL format and on a six-month delay, ratings action histories for a randomly selected sample of 10% of the outstanding credit ratings for each rating class for which the NRSRO has issued 500 or more ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated.

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<sup>51</sup> See R&I Letter; ABA Business Law Committee Letter; DBRS Letter; S&P Letter; Fitch Letter; ASF Letter; Multiple-Markets Letter; AFP Letter; Moody's Letter.

<sup>52</sup> See ABA Business Law Committee Letter; Realpoint Letter; Pollock Letter; Egan-Jones Letter; Multiple-Markets Letter; Rapid Ratings Letter; AFP Letter; R&I Letter; Moody's Letter.

<sup>53</sup> See S&P Letter; Moody's Letter.

<sup>54</sup> See S&P Letter; Egan-Jones Letter; Fitch Letter; R&I Letter;

The Commission believes that by limiting the ratings actions histories that need to be disclosed to a random selection of 10% of outstanding credit ratings, applying the requirement to issuer-paid credit ratings only, and allowing for a six-month delay before a ratings action is required to be disclosed, the amendment as adopted addresses the concerns among commenters that the rule would cause them to lose revenue. With respect to NRSROs that earn revenues from issuer-paid credit ratings but sell access to packages of the ratings as well, the Commission believes that customers that are willing to pay for full and immediate access to downloadable information for all of an NRSRO's ratings actions are unlikely to reconsider their purchase of that product due to the ability to access ratings histories for 10% of the NRSRO's outstanding issuer-paid credit ratings selected on a random basis and disclosed with a six-month time lag. The 500 ratings threshold and random selection are designed to provide a sufficient sample of data upon which to draw reasonable inferences about the quality of ratings generally issued by NRSROs. The random 10% sample of issuer-paid credit ratings and six month time lag are designed to make it less likely that current purchasers of data about issuer-paid credit ratings could reliably find the information they want, and so NRSROs could continue to sell downloads and data feeds of the credit ratings. As such, the Commission believes that the changes made to the amendment address the commenters' concerns while still facilitating greater accountability for issuer-paid NRSROs, enhanced third-party development of performance measurement statistics for issuer-paid credit ratings, and increased competition among all NRSROs.

The Commission has decided not to impose the same disclosure obligation on subscriber-paid credit ratings at this time out of competitive concerns raised, but is still



considering how to make more information publicly available and accessible about the performance of these ratings. The Commission believes that the rule as adopted will address the concerns expressed by commenters and at the same time foster greater accountability of NRSROs with respect to their issuer-paid credit ratings as well as increase competition among NRSROs by making it easier for persons to analyze the actual performance of their credit ratings.

The amendment as adopted also will require that the data be made available in XBRL format, using the List of XBRL Tags for NRSROs as specified on the Commission's Web site. Several NRSROs provided information arguing that an XBRL format could be particularly costly and that the burden on smaller NRSROs could be particularly acute.<sup>55</sup> They suggested that if the Commission adopted the rule as proposed, that the Commission allow NRSROs sufficient time to develop the necessary systems to implement the XBRL format or, in the alternative, to implement this required disclosure as a pilot program.<sup>56</sup>

The Commission believes, however, that the XBRL format will benefit market participants seeking to develop their own performance statistics using the ratings history data to be made public by the NRSROs. Requiring NRSROs to make histories of ratings actions for issuer-paid credit ratings publicly available using the interactive data format rather than using other machine readable format will enable market participants, academics and others to analyze this information more quickly, more accurately, and at a lower cost. The Commission believes that this will enhance the ability of end-users to

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<sup>55</sup> See, e.g., DBRS Letter, Moody's Letter.

<sup>56</sup> See Fitch Letter; DBRS Letter; Multiple-Markers Letter; CFA Institute Letter; ICI Letter; R&I Letter; Moody's Letter.

compare the rating performance of different NRSROs, which will foster NRSRO competition.

For purposes of the internal records required by new paragraph (a)(8), the NRSRO will be required to keep its records up to date to reflect the complete ratings history of each outstanding credit rating (including the current rating). However, for purposes of the requirement to make publicly available ratings action histories for a random sample of 10% of outstanding issuer-paid credit ratings in each class of credit rating for which the NRSRO is registered and has 500 or more such credit ratings outstanding, the NRSRO will be permitted to delay disclosure of a rating action for six months. As noted above, this limited disclosure and the six month time lag is expected to mitigate the concerns regarding the loss of revenues that NRSROs derive from selling data feeds and downloadable packages of their current outstanding issuer-paid credit ratings and histories of the ratings.

Because NRSROs withdraw ratings and rated instruments mature, the number of ratings made public in a particular class may fall below the 10% threshold. In order to continue to make a large sample of information publicly available, the Commission is requiring NRSROs to replenish the sample when it falls below 10%. Consequently, paragraph (d) of Rule 17g-2 provides that the NRSRO must replace a rating that rolls off for these reasons with a new randomly selected rating from the impacted class of credit ratings. In order to protect against the possibility of “cherry picking” ratings that may make the performance of the NRSRO more favorable, the Commission believes it is important that both the initial selection and any replenishment of ratings be randomly selected. The Commission is not specifying how the NRSROs must randomly select the

initial ratings disclosed under paragraph (d) of Rule 17g-2 or how they must randomly select ratings going forward to maintain the 10% sample. The Commission believes the NRSROs should develop a selection process that they can demonstrate to be random.

Finally, the Commission is adopting amendments to the instructions to Exhibit 1 of Form NRSRO to require that NRSROs subject to the new requirements of Rule 17g-2(d) as amended disclose the Web address where the XBRL Interactive Data File with the required information can be accessed. The Commission did not receive any comments on this aspect of the proposal and is adopting the requirement with modifications to reflect the modifications to the final rule discussed above. This rule amendment is designed to inform persons who use credit ratings where the sample of ratings histories for each class of issuer-paid credit ratings for which the NRSRO is registered can be obtained.

## **2. A Record of Material Deviation from Model Output**

The Commission proposed amending paragraph (a)(2) of Rule 17g-2 to require NRSROs to make a record documenting the rationale when a final credit rating materially deviates from the rating implied by a quantitative model used in the rating process if the model was a substantial component of the rating process. Under this paragraph, as amended, if a quantitative model was a substantial component in the process of determining the credit rating of a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, the NRSRO is required to make a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued. The purpose of this rule is to enhance the recordkeeping process in order to enable Commission staff, as

well as an NRSRO's internal auditors, to understand the methodologies through which analysts developed the credit rating issued by the NRSRO.

The Commission is adopting 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.<sup>57</sup> The Commission believes this 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, the Commission 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 will assist the Commission in evaluating whether an NRSRO is adhering to its disclosed procedures for determining ratings. As the Commission has noted, "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."<sup>58</sup> In the absence of such a recordkeeping requirement, there may be no way to determine whether an NRSRO adhered to its stated methodologies for obtaining a certain category of credit rating (e.g. AAA) as indicated by the model results, that is, whether adjustments to the result implied by the model were made 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,

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<sup>57</sup> See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

<sup>58</sup> June 5, 2007 Adopting Release, 72 FR at 33582.

including the prohibition on issuing or modifying credit ratings for unfair, abusive or coercive reasons. The new recordkeeping requirement will allow Commission staff to review whether an NRSRO is adhering to its disclosed procedures for determining structured finance ratings and complying with Rule 17g-6.<sup>59</sup>

The Commission received 18 comments addressing this proposal.<sup>60</sup> Many commenters strongly supported the proposal.<sup>61</sup> NRSROs and others, however, expressed concern over the possibility that the rule could lead to the regulation of the substance of ratings and the overemphasis of quantitative models at the expense of applying qualitative factors.<sup>62</sup> These commenters argued that the model is just one tool in the rating process and that the proposal may lead to generalizations of models in order to avoid material differences.<sup>63</sup> One commenter noted that this record may cause examiners to ignore the role qualitative factors play in developing ratings.<sup>64</sup> Another commenter noted that models are not as integral to the process of rating commercial mortgage-backed securities.<sup>65</sup>

In part in response to these comments, the Commission has narrowed the application of the rule to ratings of structured finance products. This will lessen the recordkeeping burden on an NRSRO and address commenters' concerns that the

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<sup>59</sup> 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).

<sup>60</sup> See CMSA Letter; DBRS Letter; Council Letter; S&P Letter; Second SIFMA Letter; Fitch Letter; Lockyer Letter; ASF Letter; Multiple-Markets Letter; CFA Institute Letter; Rapid Ratings Letter; AFP Letter; Colorado PERA Letter; R&I Letter; Moody's Letter; ABA Business Law Committee Letter; DBA Letter; NCRC Letter.

<sup>61</sup> See Council Letter; Second SIFMA Letter; CFA Institute Letter; AFP Letter; Colorado PERA Letter; DBA Letter NCRC Letter.

<sup>62</sup> See DBRS Letter; S&P Letter; Rapid Ratings Letter; R&I Letter; Moody's Letter; ABA Business Law Committee Letter.

<sup>63</sup> See, e.g., DBRS Letter.

<sup>64</sup> See Moody's Letter.

<sup>65</sup> See CMSA Letter.

requirement could have negative effects on the ratings process for other classes of credit ratings where qualitative analysis is predominant and models have a more marginal role.

Further, the Commission does not believe that the requirement will cause NRSROs to abandon qualitative analysis when determining credit ratings for structured finance products. The Commission does not believe that the record-making required by the amendment will be extensive. For example, if the NRSRO's methodologies permit an analyst to adjust required credit enhancement levels up or down for the various tranches of a structured finance issuer based on certain qualitative factors, the NRSRO could document the rationale for any material difference between the credit rating implied by the model and the final rating by describing the qualitative factor or factors that were relied on. In addition to benefiting the Commission's regulatory and oversight functions, this requirement may serve to assist analysts in ensuring that their use of qualitative factors follows the procedures documented in the NRSRO's methodologies.

The Commission also notes that the NRSROs will be responsible for making the determination of when a model constitutes a "substantial component" of the rating process as well as when a difference between the rating issued and the rating implied by the model is "material." NRSROs should document in their ratings methodologies the models they deem to be substantial components of a ratings process for structured finance products and the magnitude of deviation from the rating implied by the model and rating issued that they deem material.<sup>66</sup>

For the foregoing reasons, the Commission is adopting the rule with the modification discussed above.

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<sup>66</sup> For example, the Commission believes the expected loss and cash flow models used by the NRSROs to rate RMBS and CDOs are substantial components of the rating process.

### 3. Records Concerning Third-Party Analyst Complaints

The Commission proposed adding a new paragraph (b)(8) to Rule 17g-2 requiring NRSROs to retain records of any complaints about the performance of a credit analyst. The Commission is adopting this amendment with the modifications discussed below. Under this paragraph, an NRSRO is required to retain any written communications received from persons not associated with the NRSRO that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating. The purpose of this rule is to allow Commission examiners the opportunity to review external complaints and how the NRSRO addressed them.

The Commission is adopting 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 the furtherance of the Exchange Act.<sup>67</sup> The Commission believes this requirement is necessary and appropriate in the public interest and for the protection of investors, or otherwise in furtherance of the Exchange Act, because it will assist Commission examiners in reviewing how NRSROs handle the conflicts inherent in the issuer-pay and subscriber-pay models: namely, that clients have an economic interest in the ratings issued by the NRSRO and may seek to influence the rating process by complaining about an analyst who does not issue ratings favorable to that interest. Commission examiners will be able to review the complaint file and follow-up with the relevant persons within the NRSRO as to how a particular complaint was handled. The

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<sup>67</sup> See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

potential for such a review by Commission examiners could reduce the willingness of an NRSRO to re-assign or terminate a credit analyst to placate a client that desires a different rating.

Commenters generally supported the proposal.<sup>68</sup> Some commenters requested clarification that rule does not require the retention of oral communications.<sup>69</sup> The Commission did not intend the rule to apply to oral communications. Consequently, the rule text has been modified to clarify that it only applies to “written” communications. One NRSRO expressed concern that privacy and labor laws in some non-U.S. jurisdictions would prevent monitoring of an employee’s electronic communications.<sup>70</sup> The Commission intended the rule to apply to communications received by the NRSRO from outside parties such as subscribers or persons who pay to obtain credit ratings. The amendment was not intended to require the retention of complaints sent internally between, for example, employees of the NRSRO. The Commission has clarified the rule’s scope in this regard by specifying that it only applies to complaints from persons not associated with the NRSRO.

For the foregoing reasons, the Commission is adopting the proposed rule with the modifications discussed above.

#### **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,

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<sup>68</sup> See Council Letter; S&P Letter; MBA Letter; Fitch Letter; CFA Institute Letter; Rapid Ratings Letter; AFP Letter; Colorado PERA Letter; Moody’s Letter.

<sup>69</sup> See Moody’s Letter; S&P Letter.

<sup>70</sup> See S&P Letter.



changing, or withdrawing a credit rating.”<sup>71</sup> The Commission proposed to add the word “monitoring” to this list. The intent was 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 – will better clarify this requirement. The Commission received 5 comments on this proposed amendment, all of which were supportive of the change.<sup>72</sup> The Commission is adopting this amendment as proposed.

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

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 proposed amending the rule to require a report showing the number of rating actions taken by the NRSRO during the fiscal year in each class of credit rating for which the NRSRO is registered. In the June 16, 2008 Proposing Release, the Commission indicated that a “credit rating action”

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<sup>71</sup> 17 CFR 240.17g-2(b)(7).

<sup>72</sup> See S&P Letter; Multiple-Markets Letter; CFA Institute Letter; Rapid Ratings Letter; Moody’s Letter.

includes upgrades, downgrades, or placements of the rating on watch for an upgrade or downgrade.<sup>73</sup>

The Commission received 10 comments on this proposal.<sup>74</sup> Commenters were generally supportive of the proposal. One commenter recommended that the final rule should make clear what is meant by “class of credit rating” and establish a measurement period.<sup>75</sup> The Commission notes that the rule requires the report to cover each of the classes of credit rating identified in Section 3(a)(62)(B)(iv) of the Rating Agency Act<sup>76</sup> for which the NRSRO is applying for registration or is registered. Further, as discussed below, the note to the paragraph clarifies that for the purposes of this requirement, the asset-backed securities class must include all structured finance products. The Commission further notes that the measurement period is on a fiscal year basis.

One commenter believed that the proposal is unclear or overbroad regarding the scope of a report on “credit rating actions.” This commenter also noted its belief that the proposed rule was inappropriate because ratings changes are not financial statements, and stated that the proposed requirement should be relocated to Rule 17g-2.<sup>77</sup> In response, the Commission notes that it is adopting this requirement, in part, 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].”<sup>78</sup>

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<sup>73</sup> June 16, 2008 Proposing Release, 73 FR at 36234.

<sup>74</sup> See S&P Letter; Fitch Letter; Multiple-Markets Letter; ICI Letter; Rapid Ratings Letter; AFP Letter; Moody’s Letter; ABA Business Law Committee Letter; NCRC Letter; Raingard Letter.

<sup>75</sup> See Fitch Letter.

<sup>76</sup> 15 U.S.C. 78c(a)(62)(B)(iv).

<sup>77</sup> See Moody’s Letter.

<sup>78</sup> See Section 17(a)(1) of the Exchange Act (15 U.S.C. 78q(a)(1)).

The Commission is adopting this amendment by adding paragraph (a)(6) to Rule 17g-3. Paragraph (a)(6) requires an NRSRO to provide the Commission with an unaudited report of the number of credit rating actions (upgrades, downgrades, placements on credit watch, and withdrawals) during the fiscal year in each class of credit rating for which the NRSRO is registered with the Commission. As proposed, the Commission did not identify the types of credit rating actions that should be used to generate the report. Instead, it identified them in the preamble as being upgrades of credit ratings, downgrades of credit ratings, placements of credit ratings on watch for an upgrade or downgrade. The final rule text identifies the types of ratings actions that should be included in order to provide greater clarity. In addition, the Commission is adding “withdrawals” to the types of credit rating actions that must be included in the “credit ratings actions” reported by the NRSRO. The Commission views a withdrawal as a “credit rating action” since ceasing to monitor a credit rating is a significant change to the rating and, as such, is comparable to a downgrade, upgrade and placement on watch in terms of the potential impact on the rated obligor or security. Moreover, the inclusion of withdrawals in the report addresses the concerns that led the Commission to propose requiring that withdrawals be included in the default statistics generated for Exhibit 1 to Form NRSRO. As discussed above, NRSROs raised substantial compliance concerns with the proposal to require withdrawals in the performance statistics. This change is intended to address their concerns regarding that proposed amendment while at the same time ensuring that any disproportionate amount of ratings withdrawals in a class of ratings will be captured in the ratings action information provided to the Commission for examination and oversight purposes.

The new rule includes a note to paragraph (a)(6) clarifying 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<sup>79</sup> an NRSRO must 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. As discussed in the June 16, 2008 Proposing Release, this note 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).”<sup>80</sup> The Commission also notes that the report required under paragraph (a)(6) to Rule 17g-3 will be furnished to the Commission on a confidential basis, to the extent permitted by law, consistent with the other reports furnished to the Commission under Rule 17g-3.<sup>81</sup>

The Commission believes this 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 will 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 rating 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

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<sup>79</sup> 15 U.S.C. 78c(a)(62)(B)(iv).

<sup>80</sup> See June 16, 2008 Proposing Release, 73 FR at 36234.

<sup>81</sup> 17 CFR 240.17g-3; see also, June 5, 2007 Adopting Release, 72 FR at 33592.

substantial increase in upgrades also could be the result of the NRSRO attempting to gain favor with issuers and underwriters.

As discussed in the June 16, 2008 Proposing Release, the Commission recognizes that an increase in the number of ratings actions in a particular class of credit rating may be the result of macroeconomic factors broadly impacting the rated obligors or securities.<sup>82</sup> In this case, the ratings actions are presumably 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 Commission expects that the report will be a valuable tool to improve the focus of examination resources. For these reasons, the Commission is adopting the amendment with the modifications described above.

#### **D. Amendments to Rule 17g-5**

Rule 17g-5 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 others are prohibited outright. In the June 16, 2008 Proposing Release, the Commission identified three additional conflicts that would be prohibited under paragraph (c) of the rule.<sup>83</sup> The Commission received a number of comments on the

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<sup>82</sup> See June 16, 2008 Proposing Release, 73 FR at 36235.

<sup>83</sup> Id., 73 FR at 36226-36228. The Commission also proposed amendments to paragraphs (a) and (b) of Rule 17g-5 that would require an NRSRO to manage the conflict of being repeatedly paid by arrangers of structured finance products by prohibiting the NRSRO from rating such a product

proposed amendments.<sup>84</sup> As discussed below, the Commission is adopting the amendments but with revisions designed in part to address concerns raised by commenters.

**1. Rule 17g-5 Prohibition on Conflict of Interest Related to Rating an Obligor or Debt Security where the Obligor or Issuer Received Ratings Recommendations from the NRSRO or Person Associated with the NRSRO**

The Commission proposed adding a new paragraph (c)(5) to Rule 17g-5 prohibiting the conflict that arises when an NRSRO or its affiliate makes recommendations on how to achieve a desired rating and then rates the obligor or debt instrument that was the subject of the recommendations. The final rule being adopted adds this new paragraph to Rule 17g-5. Under this paragraph, an NRSRO is prohibited from issuing or maintaining a credit rating with respect to an obligor or security where the NRSRO or a person associated with the NRSRO 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. The purpose of this rule is to address the potential lack of impartiality that could arise when an NRSRO determines a credit rating based on a corporate structure that was developed after consultations with the NRSRO or its affiliate on how to achieve a desired credit

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unless, among other things, information about the underlying assets was disseminated to persons not involved in the rating process. *Id.*, 73 FR at 36219-36226. The Commission received many thoughtful comments on the proposal that identified substantial issues as to how the proposed amendments would operate in practice. The Commission is re-proposing the amendments in a separate release. See [Companion Proposing Release](#).

<sup>84</sup> See MICA Letter; ICI Letter; Rapid Ratings Letter; ABA Business Law Committees Letter; NCRC Letter; Nappier Letter; Egan-Jones Letter; Lockyer Letter; RBDA Letter; Moody's Letter; A.M. Best Letter; Euler Letter; Realpoint Letter; CMSA Letter; LIUNA Letter; DBRS Letter; Council Letter; DPW Letter; S&P Letter; Second SIFMA Letter; IBFED Letter; MBA Letter; Fitch Letter; ASF Letter; Trepp Letter; CFA Institute Letter; Roundtable Letter; Colorado PERA Letter; CGSH Letter; SPA Letter; R&I Letter; CreditSights Letter; DBA Letter; Citi Letter; Lehman Letter; Raingear Letter; JCR Letter; Second Realpoint Letter.

rating. In simple terms, the rule prohibits an NRSRO from rating its own work or the work of an affiliate.

The Commission is adopting this amendment to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.<sup>85</sup> This section of the statute provides 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.<sup>86</sup> The Commission believes this amendment is necessary and appropriate in the public interest and for the protection of investors because it addresses a 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.<sup>87</sup> This amendment will prohibit this conduct based on the Commission’s belief that it creates a conflict that cannot be effectively managed insomuch 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.

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<sup>85</sup> 15 U.S.C. 78o-7(h)(2).

<sup>86</sup> Id.

<sup>87</sup> 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. 2-3.

The Commission received 33 comments addressing this proposal.<sup>88</sup> Most of the comments supported the proposal, although some commenters expressed concern that the provision may limit appropriate dialogue between an NRSRO and a person seeking a credit rating or subject to an existing rating.<sup>89</sup> Several commenters asked that the Commission clarify the type of communications that would be acceptable feedback during the ratings process. As stated in the June 16, 2008 Proposing Release, it is not the Commission's intent to prohibit the flow of information between an NRSRO and the obligor, issuer, underwriter, or sponsor during the rating process.<sup>90</sup> For example, the Commission does not view an explanation by an NRSRO of the assumptions and rationales it uses to arrive at ratings decisions and how they apply to a given rating transaction as a recommendation. Consequently, in the case of a residential mortgage-backed security, an NRSRO, after putting the underlying assets through an expected loss model run, may communicate the results to the sponsor and discuss how loan characteristics such as FICO scores, geographic concentrations, or loan-to-value ratios may have driven the results.

The Commission recognizes that providing this type of information during the rating process allows the person seeking the rating to make adjustments in response to the information provided by the NRSRO. However, the free flow of information between the NRSRO and the person increases the transparency of the rating process. Moreover,

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<sup>88</sup> See Realpoint Letter; CMSA Letter; LIUNA Letter; DBRS Letter; JCR Letter; Council Letter; DPW Letter; S&P Letter; Second SIFMA Letter; IBFED Letter; Nappier Letter; MBA Letter; Fitch Letter; Lockyer Letter; ASF Letter; Multiple-Markets Letter; CFA Institute Letter; ICI Letter; RBDA Letter; Roundtable Letter; Rapid Ratings Letter; AFP Letter; Colorado PERA Letter; CGSH Letter; SPA Letter; R&I Letter; Moody's Letter; ABA Business Law Committees Letter; DBA Letter; NCRC Letter; Raingear Letter; A.M. Best Letter.

<sup>89</sup> See, e.g., CMSA Letter; LIUNA Letter; DBRS Letter; JCR Letter; Second SIFMA Letter; IBFED Letter; MBA Letter; Fitch Letter; Roundtable Letter; AFP Letter.

<sup>90</sup> June 16, 2008 Proposing Release, 73 FR at 36226.



NRSROs generally make their models available to persons seeking ratings. Sponsors of structured finance securities can run potential asset pools through the models before bringing the transactions to the NRSRO to be rated. This gives them an understanding of the rating that the NRSRO likely will determine, particularly with respect to more standardized structured finance products. The Commission believes this level of transparency before and during the rating process benefits the credit markets by allowing participants to gain an understanding and, ultimately, to assess the methodologies used by the NRSROs. The alternative – restricting the flow of information – would make the rating process more opaque.

The Commission notes, however, that if the feedback process turns into recommendations by the NRSRO about changes to the structure, assets, liabilities or activities of the obligor or security that the person seeking the rating potentially could make to obtain a desired credit rating, the NRSRO would be in violation of the new rule. For example, in the case of a residential mortgage-backed security, the NRSRO would not be prohibited from informing the sponsor that the expected loss model indicated that the underlying loan pool was too concentrated in a certain geographic region to receive the desired rating given the level of credit enhancement proposed. On the other hand, if an analyst recommends how to change the composition of the loans in the pool to achieve the desired rating, the NRSRO would be making a recommendation about the assets of the issuer and, consequently violate the rule. The sponsor must take the model results from the NRSRO and decide independently how to adjust the asset pool to achieve the desired rating. If changes are made, the NRSRO will run the new pool through the model as if it were a new transaction and report the results to the sponsor.

Some argue that even this process of providing sponsors with information they can use to make adjustments during the rating process should be prohibited. The Commission disagrees because locking down the structure prior to the rating process could have serious adverse consequences. Investors seek securities with specific credit ratings. If sponsors cannot make adjustments to obtain those ratings, then the securities ultimately issued and rated may not be marketable.

The Commission understands that NRSROs are concerned about how to draw the line between permissible and unlawful communication of information.<sup>91</sup> In response, the Commission notes that NRSROs who provide the greatest clarity to the marketplace about their ratings methodologies will need to provide less explanation during the ratings process. Thus, NRSROs can mitigate the risk that communications during the rating process will violate the rule by enhancing their disclosures about their ratings methodologies, including about the qualitative factors they consider and the quantitative models and the assumptions underlying those models they employ. For these reasons, the Commission believes the new prohibition creates a strong incentive for NRSROs to improve their disclosures, which, in turn, will benefit the users of credit ratings and, by extension, the credit markets.

Some commenters stated that this conflict should not be prohibited but, instead, included among the conflicts that must be disclosed and managed.<sup>92</sup> Several commenters also suggested that the conflict should not be prohibited when the affiliate (as opposed to the NRSRO) makes the recommendation. The commenters suggested that measures such as information barriers could address the conflict adequately without the need to prohibit

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<sup>91</sup> See, e.g., Fitch Letter, JCR Letter.

<sup>92</sup> See, e.g., Realpoint Letter; DPW Letter; S&P Letter; ICI Letter; Colorado PERA Letter; R&I Letter; Moody's Letter.

it outright.<sup>93</sup> The Commission believes that an NRSRO cannot remain objective when rating its own work or that of an affiliate. As stated in the June 16, 2008 Proposing Release, the Commission believes it would be difficult for the NRSRO to remain objective if an affiliate were providing advice to obligors, issuers and sponsors about how to obtain desired credit ratings because the financial success of the affiliate would depend on issuers getting the ratings they sought after taking steps recommended by the affiliate.<sup>94</sup> This may create undue pressure on the NRSRO's credit analysts to determine credit ratings that favored the affiliate. The Commission believes this pressure may undermine protective measures such as information barriers between the NRSRO and the affiliate as they both would be under the common control of a group that benefited from the affiliate's financial success.

Finally, several commenters requested that the Commission clarify whether this conflict applies only to structured finance ratings or whether it applies to all ratings classes.<sup>95</sup> The Commission intends that this prohibited conflict would apply across all ratings classes.

For the reasons discussed above, the Commission is adopting the amendment as proposed.

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

The Commission proposed prohibiting the conflict that arises when persons within an NRSRO responsible for determining credit ratings or developing methodologies for determining credit ratings participate in fee discussions. The final rule

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<sup>93</sup> See, e.g., Fitch Letter; Moody's Letter.

<sup>94</sup> See June 16, 2008 Proposing Release, 73 FR at 36226.

<sup>95</sup> See, e.g., Lockyer Letter, RBDA Letter, A.M. Best Letter.

being adopted adds a new paragraph (c)(6) to Rule 17g-5.<sup>96</sup> Under this paragraph, an NRSRO is prohibited from issuing or maintaining a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining or approving credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models. The purpose of this rule is to remove the persons most directly involved in making the judgments that credit ratings are based on from fee negotiations and, thereby, insulate them from a process that could make them more or less favorably disposed toward a client or class of clients.

As proposed, the rule did not explicitly mention persons involved in approving credit ratings, although it implicitly included them by including persons involved in “determining” credit ratings.<sup>97</sup> The Commission notes that both determiners and approvers engage in analysis that results in a final rating, and the Commission intends them both to be covered by prohibitions aimed at protecting the integrity of this process. Therefore, the Commission is clarifying today that for the purposes of Rule 17g-5, the terms “determine,” “determined,” and “determining” include both persons who develop credit ratings and persons who approve credit ratings. This clarification reflects the Commission’s intent when it proposed the rule and is designed to remove any potential ambiguity that could arise if some of the Rule 17g-5 prohibitions cover persons who determine and approve credit ratings and others only cover persons who determine credit ratings.

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<sup>96</sup> 17 CFR 240.17g-5.

<sup>97</sup> June 16, 2008 Proposing Release, 73 FR at 36226-36228.

The Commission is adopting this amendment to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.<sup>98</sup> This section of the statute provides 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.<sup>99</sup> The Commission believes this amendment is necessary and appropriate in the public interest or for the protection of investors because it addresses 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 when 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

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<sup>98</sup> 15 U.S.C. 78o-7(h)(2).

<sup>99</sup> Id.

difficult to negotiate fees with issuers. For these reasons, the Commission believes that this conflict should be prohibited.

The Commission received 19 comments addressing this proposal, most of which supported its goal.<sup>100</sup> NRSROs, while agreeing in principle with the rule, raised a number of questions. First, several NRSROs suggested that the Commission revise the language of the amendment to conform to the International Organization of Securities Commissions' "Code of Conduct Fundamentals for Credit Rating Agencies" (the "IOSCO Code").<sup>101</sup> The IOSCO Code provides that credit rating agencies "should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate." The Commission believes, however, that the IOSCO Code provision would be insufficient to accomplish the goal of fully effectuating the separation within NRSROs of persons involved in fee discussions from persons involved in the credit rating analytical process. In particular, the IOSCO Code's language would allow persons involved in approving the methodologies and processes used to determine credit ratings to negotiate ratings fees, which could make them reluctant to adjust a model to make it more conservative if doing so would make it more difficult to negotiate fees with issuers.

In addition, other commenters, including the NRSROs, asked that the Commission clarify that the prohibition does not apply to internal communications.<sup>102</sup>

They stated that senior managers (some of whom may be covered by the prohibition)

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<sup>100</sup> See Realpoint Letter; CMSA Letter; LIUNA Letter; DBRS Letter; S&P Letter; Nappier Letter; Fitch Letter; ASF Letter; Multiple-Markets Letter; CFA Institute Letter; ICI Letter; Rapid Ratings Letter; AFP Letter; Colorado PERA Letter; Moody's Letter; ABA Business Law Committees Letter; NCRC Letter; Rainguard Letter; A.M. Best Letter.

<sup>101</sup> See, e.g., S&P Letter; Fitch Letter; A.M. Best Letter. A copy of the IOSCO code is available at [www.iosco.org](http://www.iosco.org).

<sup>102</sup> See, e.g., S&P Letter; Fitch Letter; A.M. Best Letter.

participate in internal discussions relating to fees to ensure that a fee charged is in proportion to the work performed by the NRSRO. The Commission recognizes that credit analysts may need to provide information on expected staffing and resource requirements to the persons involved in fee discussions so the latter can factor such information into the fees charged.

Some commenters stated that this conflict should be subject to the requirement to disclose and manage, as opposed to being prohibited.<sup>103</sup> The Commission disagrees for several reasons. There does not appear to be a compelling reason for credit analysts and model developers to participate in fee discussions. Furthermore, their involvement in that process creates greater risk that they will develop a favorable or negative view of the client or a class of clients based on how the negotiations proceed. This could influence the judgment they exercise in determining credit ratings or developing credit rating methodologies.

Several commenters noted that small NRSROs may need to have some analysts or model developers participate in fee discussions given their staffing levels.<sup>104</sup> These commenters suggested that the rule should include an exemption for such NRSROs.<sup>105</sup> The Commission agrees that the rule could potentially raise difficulties in certain circumstances for an NRSRO with a small staff. Consequently, the Commission will review requests by small NRSROs for exemptions from the rule under Section 36 of the Exchange Act based on their specific circumstances. The Commission notes that it has

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<sup>103</sup> See, e.g., DBRS Letter; ASF Letter; Multiple-Markets Letter; Moody's Letter.

<sup>104</sup> See, e.g., DBRS Letter; Multiple-Markets Letter; CFA Institute Letter; Colorado PERA Letter; ABA Business Law Committees Letter.

<sup>105</sup> See, e.g., Fitch Letter; Rapid Ratings Letter; Moody's Letter.

provided two small NRSROs with temporary exemptive relief from the prohibition in Rule 17g-5 against receiving 10% or more of their net revenues from a single client.<sup>106</sup>

For the reasons discussed, the Commission is adopting the amendment as proposed and clarifies, as noted above, that persons responsible for “approving” credit ratings are covered by the prohibition as well as the provisions of Rule 17g-5 as a whole.

### **3. Rule 17g-5 Prohibition of Conflict of Interest Related to Receipt of Gifts**

The Commission proposed adding a new paragraph (c)(7) to Rule 17g-5<sup>107</sup> prohibiting the conflict that arises when persons responsible for determining or approving credit ratings receive gifts from the persons being rated or the sponsors of the persons being rated.<sup>108</sup> The final rule being adopted includes this new paragraph. Under this paragraph, an NRSRO is prohibited from issuing or maintaining 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. The purpose of this rule is to eliminate the potential undue influence that gifts can have on those responsible for determining credit ratings.

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<sup>106</sup> See Order Granting Temporary Exemption of LACE Financial Corp. from the Conflict of Interest Prohibition in Rule 17a-5(c)(1) of the Securities Exchange Act of 1934, Exchange Act Release No. 57301 (February 11, 2008); Order Granting Temporary Exemption of Realpoint LLC from the Conflict of Interest Prohibition in Rule 17a-5(c)(1) under the Securities Exchange Act of 1934, Exchange Act Release No. 58001 (June 23, 2008).

<sup>107</sup> 17 CFR 240.17g-5.

<sup>108</sup> See June 16, 2008 Proposing Release, 73 FR at 36227-36228.



The Commission is adopting this amendment to Rule 17g-5, in part, pursuant to the authority in Section 15E(h)(2) of the Exchange Act.<sup>109</sup> This section of the statute provides 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.<sup>110</sup> The Commission believes the amendment is necessary and appropriate in the public interest or for the protection of investors because it addresses a potential practice that could impair the objectivity, and, correspondingly, the quality, of a credit rating.

The Commission received 18 comments on the proposed amendment, most of which agreed in principle with the proposal.<sup>111</sup> One commenter suggested that this conflict should be disclosed and managed instead of prohibited.<sup>112</sup> The Commission disagrees because other than in the most obvious cases it would be very difficult to determine whether an analyst was swayed by gifts to adjust a rating. Persons seeking credit ratings for an obligor or debt security could use gifts in an attempt to gain favor with the analyst. 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. In either case, there is little ability to "manage" the analyst's motivations. Therefore, the Commission

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<sup>109</sup> 15 U.S.C. 78o-7(h)(2).

<sup>110</sup> Id.

<sup>111</sup> See S&P Letter; Nappier Letter; Lockyer Letter; ASF Letter; Multiple-Markets Letter; CFA Institute Letter; ICI Letter; Roundtable Letter; Rapid Ratings Letter; AFP Letter; R&I Letter; Moody's Letter; ABA Business Law Committees Letter; Foutch Letter; DBA Letter; NCRC Letter; Raingeard Letter; A.M. Best Letter.

<sup>112</sup> See Moody's Letter.

believes that an absolute prohibition on gifts, with the exception of minor incidentals such as those provided in business meetings, is appropriate.

Several NRSROs noted the potential for cultural misunderstandings over the proposed gift limit, noting that issuers from other countries may be embarrassed or offended by the prohibition. One NRSRO suggested in response that the Commission include an exemption or higher dollar threshold for gifts from foreign issuers, while another cited such potential misunderstandings in support of its suggestion that the conflict be disclosed and managed instead of prohibited.<sup>113</sup> The Commission recognizes that a prohibition may pose initial difficulties with certain foreign issuers but believes that over time, and given the uniformity of the rule across NRSROs, such issuers will come to understand and accept the prohibition.

Several commenters asked that the Commission clarify how the \$25 limit would operate<sup>114</sup> and some suggested a higher limit such as \$50 or \$100.<sup>115</sup> The \$25 limit is not designed to be an exception to the prohibition on giving gifts. Rather, it is intended to permit the exchange of items that are incidental to routine business interactions such as meetings. For example, if an analyst meets with an issuer to discuss a credit rating, the issuer could provide the analyst with note pads, pens and light refreshments, provided they did not have an aggregate value exceeding \$25. The Commission notes that the rule is not intended to allow an analyst to accept a gift, regardless of its value, that has no use in conducting the meeting. In addition, the Commission wishes to clarify that the \$25 limit is per analyst and per interaction and not a one-time or annual limit.

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<sup>113</sup> See, e.g., S&P Letter, Moody's Letter.

<sup>114</sup> See, e.g., S&P Letter; Roundtable Letter; R&I Letter; Moody's Letter.

<sup>115</sup> See, e.g., S&P Letter; CFA Institute Letter; Roundtable Letter; ABA Business Law Committees Letter; A.M. Best Letter.

The Commission also intends that the rule be prospective. Therefore, the fact that an analyst received a gift from a person seeking a credit rating prior to the rule's effective date will not preclude the NRSRO from issuing a credit rating determined by the analyst.

Finally, a few commenters asked the Commission to clarify whether this amendment applied only to structured finance ratings or whether it applied to all ratings classes.<sup>116</sup> The Commission believes that there is no reason to limit this prohibition to structured finance ratings: any person seeking a credit rating could attempt to gain favor with an analyst responsible for determining the credit rating by using gifts. Therefore, this prohibition applies across all classes of credit ratings.

For the reasons discussed, the Commission is adopting the amendment as proposed.

### **III. PAPERWORK REDUCTION ACT**

Certain provisions of the rule amendments contain a "collection of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").<sup>117</sup> The Commission published a notice requesting comment on the collection of information requirements in the June 16, 2008 Proposing Release and submitted the proposed amendments to the Office of Management and Budget ("OMB") for review in accordance with the PRA.<sup>118</sup> 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);

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<sup>116</sup> See, e.g., Lockyer Letter.

<sup>117</sup> 44 U.S.C. 3501 *et seq.*; 5 CFR 1320.11.

<sup>118</sup> See June 16, 2008 Proposing Release, 73 FR at 36236-36241.

- (2) Rule 17g-2, Records to be made and retained by national recognized statistical rating organizations (OMB Control Number 3235-0628); and
- (3) Rule 17g-3, Annual reports to be furnished by nationally recognized statistical rating organizations (OMB Control Number 3235-0626).

**A. Collections of Information under the Amended Rules**

The Commission is adopting 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 amendments modify rules the Commission adopted in 2007 to implement registration, recordkeeping, financial reporting, and oversight rules under the Rating Agency Act. Certain of the amendments contain recordkeeping and disclosure requirements that will be subject to the PRA. The collection of information obligations imposed by the amendments is mandatory. The amendments, however, will apply only to credit rating agencies that are registered with the Commission as NRSROs. Such registration is voluntary.<sup>119</sup>

In summary, the rule amendments 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;<sup>120</sup> (2) an NRSRO to make, keep and preserve additional records under Rule 17g-2;<sup>121</sup> (3) an NRSRO to make publicly available on its Internet Web site in XBRL format a random sample of 10% of the ratings histories in each ratings class for which it is registered and has issued 500 or more ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being

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<sup>119</sup> See Section 15E of the Exchange Act (15 U.S.C. 78o-7).

<sup>120</sup> See amendments to Form NRSRO.

<sup>121</sup> 17 CFR 240.17g-2.

rated, with each new ratings action to be reflected in such histories no later than six months after they are taken;<sup>122</sup> and (4) an NRSRO to furnish the Commission with an additional annual report.<sup>123</sup>

### **B. Proposed Use of Information**

The amendments enhance the framework for Commission oversight of NRSROs, in part in response to the recent credit market turmoil.<sup>124</sup> The collections of information in the rule amendments are designed to further 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 Act<sup>125</sup> and the rules thereunder. In addition, these rule amendments are designed to further assist users of credit ratings by requiring 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 will be required to make public as a result of the amendments will 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.”<sup>126</sup>

### **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

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<sup>122</sup> See Rule 17g-2(a)(8) and (d).

<sup>123</sup> See Rule 17g-3(a)(6).

<sup>124</sup> See 17 CFR 17g-1 through 17g-6, and Form NRSRO.

<sup>125</sup> 15 U.S.C. 78o-7.

<sup>126</sup> See Senate Report, p. 8.

NRSROs.<sup>127</sup> The Commission believes that this estimate continues to be appropriate for identifying the number of respondents for purposes of the amendments. Since the initial set of rules under the Rating Agency Act became effective in June 2007, ten credit rating agencies have registered with the Commission as NRSROs.<sup>128</sup> The registration program has been in effect for over 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 to its paperwork burden estimates as well as cost estimates.

The Commission requested comment on all aspects of the proposed estimate for the number of respondents. The Commission did not receive any comments in response to the proposed estimate. As discussed above, the Commission continues to estimate, for purposes of this PRA, that approximately 30 credit rating agencies will be registered as NRSROs and thus will be required to comply.

#### **D. Total Annual Recordkeeping and Reporting Burden**

As discussed in further detail below, the Commission estimates the total recordkeeping burden resulting from the amendments will be approximately 820 hours on an annual basis<sup>129</sup> and 4,560 hours on a one-time basis.<sup>130</sup>

The total annual and one-time hour burden estimates described below are averages across all types of NRSROs expected to be impacted by the rule amendments.

The size and complexity of NRSROs range from small entities to entities that are part of

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<sup>127</sup> See June 5, 2007 Adopting Release, 72 FR at 33607.

<sup>128</sup> 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.; Egan-Jones Rating Company; and Realpoint LLC.

<sup>129</sup> This total is derived from the total annual hours set forth in the order that the totals appear in the text:  $750 + 70 + 1000 = 1,820$ .

<sup>130</sup> This total is derived from the total one-time hours set forth in the order that the totals appear in the text:  $3,000 + 1,350 + 210 = 4,560$ .

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 amendments to Form NRSRO 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.<sup>131</sup> The total annual burden hours currently approved by OMB is 2,100, and the total one-time burden hours is 10,000. In the June 16, 2008 Proposing Release, the Commission stated that it expected that the proposed amendments would not have a material effect on the respondents' hour burden because the additional disclosures would be included within the overall preparation of the initial Form NRSRO for new applicants.<sup>132</sup> Additionally, in that release, the Commission stated it believed that the NRSROs currently registered would be required to prepare and furnish an amended Form NRSRO to update their registration applications as a result of the adoption of the proposed amendments (i.e., as of today that would be ten amended Form NRSROs).<sup>133</sup> However, the Commission stated that it believed these potential furnishings of Form NRSRO were 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.

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<sup>131</sup> 17 CFR 240.17g-1 and Form NRSRO.

<sup>132</sup> June 16, 2008 Proposing Release, 73 FR at 36237-36238.

<sup>133</sup> Id.

The Commission requested comment on all aspects of the burden estimates for Rule 17g-1 and Form NRSRO, as amended.<sup>134</sup> One commenter disagreed with the Commission that there would be no additional one-time or ongoing collection of information burdens for NRSROs to provide the additional information required in Exhibit 2 to Form NRSRO.<sup>135</sup> The commenter stated that it would need to conduct a survey of its practices, synthesize and summarize the results of the survey, and incorporate the results into Exhibit 2 of Form NRSRO.<sup>136</sup> The commenter estimated that it would take at least 100 hours to complete a global survey, involving compliance personnel, as well as senior analysts and their supervisors. In addition, the commenter estimated that it would take at least 24 hours per year on average to collect information and another 12 hours per year to incorporate descriptions of changes into Form NRSRO, as well as an additional 24 hours per year conducting compliance assessments.<sup>137</sup> The commenter noted, however, that it did not consider such one-time and ongoing compliance burdens to be excessive.<sup>138</sup>

As adopted, the amendments to the instructions to Exhibit 2 to Form NRSRO add three additional areas that an applicant and a registered NRSRO must address in the descriptions of its procedures and methodologies in Exhibit 2 to the extent they are applicable.<sup>139</sup> Because the additional requirements, as adopted, require only a description

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<sup>134</sup>

Id.

<sup>135</sup>

See Moody's Letter.

<sup>136</sup>

Id.

<sup>137</sup>

Id.

<sup>138</sup>

Id.

<sup>139</sup>

These additional areas are: 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,



of the procedures and methodologies, the Commission believes that there may have been some misinterpretation with respect to the actual requirements regarding the amendments to Exhibit 2. As stated above, the Commission notes that the instructions for Exhibit 2 to Form NRSRO require only a description of the procedures and methodologies that the NRSRO actually employs and it does not require an NRSRO to adopt specific procedures. In addition, it only requires a description of the NRSRO's general ratings procedures and methodologies as opposed to the submission and disclosure of the actual procedures and methodologies used to determine credit ratings.<sup>140</sup>

Based on clarifications discussed above, the Commission believes that the actual time expenditures of NRSROs in complying with the rules will be less than the commenter's estimates. Nonetheless, the Commission is revising the one-time hourly burden estimate upward in response to the comment. The Commission, based on the comment received and staff experience, estimates that the average time necessary for an applicant or NRSRO to gather the information on a one-time basis in order to complete the additional disclosures required by the amendments to Exhibit 2 to Form NRSRO will be 100 hours per NRSRO, which would be a one-time hour burden to the industry of 3,000 hours.<sup>141</sup> The Commission is not revising its annual burden because it believes that once an NRSRO has updated Exhibit 2 to Form NRSRO to include descriptions of these aspects of its methodologies, any further updates would be incremental and the time

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and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings.

<sup>140</sup> The instructions further provide that the description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes the applicant or NRSRO employs to determine credit ratings.

<sup>141</sup> 100 hours x 30 NRSROs = 3,000 hours.

burdens associated with completing the updates are reflected in the current annual burdens discussed above.

## **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.<sup>142</sup> The amendments to Rule 17g-2 require an NRSRO to make and retain two additional records and to retain a third type of record. The records to be made and retained are: (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 of a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction;<sup>143</sup> and (2) a record showing the history and dates of all previous rating actions with respect to each outstanding credit rating.<sup>144</sup> The amendments to Rule 17g-2 also require an NRSRO to make public, in XBRL format and with a six-month grace period, the ratings action information required under new paragraph (a)(8) for a random sample of 10% of the issuer paid credit ratings for each ratings class for which it has issued 500 or more issuer-paid credit ratings.<sup>145</sup> In addition, the amendments require an NRSRO to retain communications from persons not associated with the NRSRO that contain any complaints by an obligor, issuer, underwriter, or sponsor about the performance of a credit analyst.<sup>146</sup>

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<sup>142</sup> 17 CFR 240.17g-2.

<sup>143</sup> Paragraph (a)(2)(iii) of Rule 17g-2.

<sup>144</sup> Paragraph (a)(8) of Rule 17g-2.

<sup>145</sup> Amendment to Rule 17g-2(d).

<sup>146</sup> Paragraph (b)(8) of Rule 17g-2.

The Commission requested comment in the June 16, 2008 Proposing Release on the burdens that would result from the proposed amendments to Rule 17g-2.<sup>147</sup> The Commission received one comment regarding the PRA estimate for Rule 17g-2.<sup>148</sup> This commenter, a large NRSRO, stated that the Commission has significantly underestimated the initial and ongoing recordkeeping burdens associated with its proposed changes to NRSROs' recordkeeping requirements.<sup>149</sup>

The same large NRSRO submitted comments specific to the proposed amendment to Rule 17g-2(d) which would have required disclosure of the histories of rating actions for outstanding credit ratings in an XBRL format. The commenter stated that developing and agreeing upon the taxonomy and tags for an XBRL data file would take at least several hundred hours over several months or even longer and that ongoing maintenance of the database could easily exceed two months per year.<sup>150</sup> The Commission notes that the amendment as adopted specifies that in making the required information available on its Web site, an NRSRO will use the List of XBRL Tags for NRSROs as specified on the Commission's Web site, thus eliminating the need for an NRSRO to develop its own taxonomy and tags. In addition, as adopted, the amendment to Rule 17g-2(d) limits the requirement to the disclosure of a random sample of 10% of the issuer-paid credit rating histories for each ratings class for which an NRSRO has issued 500 or more issuer-paid credit ratings. This is a substantial reduction from the amount of information that would have been required by the amendment as proposed. Consequently, the amount of time required to comply with the amendment to Rule 17g-2(d), as adopted, will be

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<sup>147</sup> See June 16, 2008 Proposing Release, 73 FR at 36238-36239.

<sup>148</sup> See Moody's Letter.

<sup>149</sup> Id.

<sup>150</sup> Id.

significantly reduced for what would have been required under the proposal. Finally, the Commission notes that, in order to allow NRSROs sufficient time to implement the new disclosure requirement of Rule 17g-2(d), as amended, the compliance date for that amendment will be 180 days after publication in the Federal Register.

In addition to its comments on the XBRL portion of the proposed amendments to Rule 17g-2, the same large NRSRO submitted comments on the proposed amendment to Rule 17g-2 regarding records of material deviation from model output and the recording of complaints relating to analysts. With respect to the record of material deviation from model output, the commenter stated it would take analysts, supervisors, and senior management more than 150 hours to determine which quantitative models were a “substantial component” in determining ratings; 200 hours for compliance, legal and IT staff to develop policies, amend schedules and modify systems to comply with the rule; and 1,500 hours to develop compliance procedures and training materials. On an ongoing basis, the commenter estimated that it would take approximately 60-90 minutes to create, approve and file each record related to this amendment. Finally, the commenter estimated that, on an annual basis, it would spend 40 to 80 hours per year on compliance reviews and 200 hours per year on training.<sup>151</sup> In response to comments on the proposed rule language, the Commission narrowed the application of Rule 17g-2(a)(2)(iii) to ratings of structured finance products only. This will lessen the recordkeeping burden on an NRSRO and be responsive to commenters’ concerns that the requirement could have negative effects on the ratings process for other classes of credit ratings where qualitative analysis is predominant and models have a more marginal role.

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<sup>151</sup> Id.

Finally, the same NRSRO commenter estimated that with respect to the records of complaints about analysts under Rule 17g-2(b)(8), it would take approximately 100 hours to implement the proposed rule, draft a policy, and change its systems to capture the required records, as well as 1,500 hours to develop compliance procedures and a training module. On an ongoing basis, the commenter estimated it would take approximately 10 to 100 hours to follow-up and document each complaint. Finally, on an annual basis, the commenter estimated it would spend approximately 40 to 80 hours per year on compliance reviews and 150 hours per year on training.<sup>152</sup> With respect to this requirement, the Commission notes that it intends the rule to apply only to communications received by the NRSRO from outside parties such as subscribers or entities that pay to obtain credit ratings. The amendment was not intended to require the retention of complaints sent internally between, for example, employees of the NRSRO. Further, the Commission has clarified that the rule does not apply to oral communications.

Based on the modifications and clarifications discussed above, the Commission believes that the actual time expenditures of NRSROs in complying with the rules will be less than the commenter's estimates. Nonetheless, the Commission is revising its hourly burden estimates upward in response to the comment.

With respect to the amendments to Rule 17g-2, the Commission estimates, based on staff information gained from the NRSRO examination process and in response to comments received, that the total one-time and annual recordkeeping burdens will increase approximately 15% and 10%, respectively. The Commission believes that the one-time burden to set up and/or modify a recordkeeping system to comply with the

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<sup>152</sup> Id.

amendments would be greater than the ongoing annual burden. Once an NRSRO has set up or modified its recordkeeping system to comply with the amendments, its annual hour burden would be increased only to the extent it would be required to make and retain additional records. In the June 16, 2008 Proposing Release, the Commission estimated that the total one-time and annual recordkeeping burdens would increase approximately 10% and 5%, respectively.<sup>153</sup> Thus, the Commission estimates that the one-time burden that each NRSRO will spend implementing a recordkeeping system to comply with Rule 17g-2, as amended, will be approximately 345 hours,<sup>154</sup> for a total one-time burden of 10,350 hours for 30 NRSROs,<sup>155</sup> which represents an increase in the currently approved PRA burden under Rule 17g-2 of 1,350 total one-time burden hours.<sup>156</sup> The Commission estimates that an NRSRO would spend an average of 279 hours per year<sup>157</sup> to make and retain records under Rule 17g-2 as amended, for a total annual hour burden under Rule 17g-2 of 8,370 hours.<sup>158</sup> This estimate will result in an increase in the currently approved PRA burden under Rule 17g-2 of 750 annual burden hours.<sup>159</sup> As discussed above, the increase in annual burden hours will result from the increase in the number of records an NRSRO will be required to make and retain under the amendments to Rule 17g-2. The Commission notes that the PRA estimates for Rule 17g-2 are averages across all types of NRSROs expected to be affected by the rule amendments. The size and complexity of NRSROs range from small entities to entities that are part of complex global

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<sup>153</sup> See June 16, 2008 Proposing Release, 73 FR at 36238-36239.

<sup>154</sup> 300 hours x 1.15 = 345 hours. This will result in an increase of approximately 45 hours per NRSRO for the one-time hour burden.

<sup>155</sup> 345 hours x 30 respondents = 10,350 hours.

<sup>156</sup> 11,700 hours – 10,350 hours = 1,350 hours.

<sup>157</sup> 254 hours x 1.10 = 279 hours. The amendments would result in an increase of approximately 25 annual burden hours per NRSRO for Rule 17g-2.

<sup>158</sup> 279 hours x 30 respondents = 8,370 hours.

<sup>159</sup> 8,370 hours – 7,620 hours = 750 hours.

organizations employing thousands of credit analysts. Consequently, the burden hour estimates for Rule 17g-2 represent the average time across all NRSROs.

In addition, the amendments to Rule 17g-2 require an NRSRO to make publicly available on its Web site in XBRL format ratings action histories for a random sample of 10% of its outstanding issuer-paid credit ratings in each class of credit rating for which it is registered and has determined 500 or more issuer-paid credit ratings.<sup>160</sup> Based on information furnished on Form NRSRO, seven of the ten currently registered NRSROs issue 500 or more issuer-paid credit ratings in at least one of the classes of credit ratings for which they are registered. The Commission believes that even as the number of registered NRSROs expands to the 30 ultimately expected to register, this number will remain relatively constant, as new entrants are likely to predominantly determine subscriber-paid credit ratings, at least in the near future. In addition, the Commission believes that each of the NRSROs affected by this new requirement already has, or will have, an Internet Web site. As noted above, the amendment as adopted specifies that in making the required information available on its Web site, an NRSRO will use the List of XBRL Tags for NRSROs as specified on the Commission's Web site, thus eliminating the need for an NRSRO to develop its own taxonomy and tags and significantly reducing the amount of time required to comply with the amendment.

Therefore, based on staff experience, the Commission estimates that, on average, an NRSRO subject to the requirement will spend approximately 30 hours to publicly disclose the required information in an XBRL format and, thereafter, 10 hours per year to

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<sup>160</sup> See amendment to Rule 17g-2(d).

update this information.<sup>161</sup> Accordingly, the total aggregate one-time burden to the industry to make the history of rating actions publicly available in an XBRL format will be 210 hours,<sup>162</sup> and the total aggregate annual burden hours will be 70 hours.<sup>163</sup>

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.<sup>164</sup> 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.<sup>165</sup> In response to comments discussed above, the Commission estimates that the amendments to Rule 17g-2 would alter this per firm estimate upward by approximately \$800.<sup>166</sup> For example, in the PRA for the proposed rules requiring the submission of risk/return summary information using interactive data, the Commission estimated that software and consulting services would be used by mutual funds for an increase of approximately \$803 per mutual fund.<sup>167</sup> The Commission believes that the requirement

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<sup>161</sup> 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 June 5, 2007 Adopting Release, 72 FR at 33609.

<sup>162</sup> 30 hours x 7 NRSROs = 210 hours.

<sup>163</sup> 10 hours x 7 NRSROs = 70 hours.

<sup>164</sup> See June 5, 2007 Adopting Release, 72 FR at 33609, 33610.

<sup>165</sup> Id.

<sup>166</sup> See Interactive Data for Mutual Fund Risk/Return Summary, Securities Act Release No. 8929 (June 10, 2008), 73 FR 35442 (June 23, 2008).

<sup>167</sup> Id.



to publicly disclose certain ratings action histories in an XBRL format would result in a similar cost.

### 3. 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.<sup>168</sup> The Commission is amending Rule 17g-3 to require an NRSRO to furnish the Commission with an additional report: an unaudited report of the number of credit ratings actions (upgrades, downgrades, placements on credit watch, and withdrawals) 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 NRSRO is registered with the Commission.<sup>169</sup>

The total annual burden currently approved by OMB for Rule 17g-3 is 6,000 hours, based on the fact that it will take an NRSRO, on average, approximately 200 hours to prepare for and file the annual reports.<sup>170</sup> 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.<sup>171</sup> This estimate is based on 30 NRSROs hiring an independent public accountant on an annual basis for an average of \$15,000.<sup>172</sup>

The Commission requested comment in the June 16, 2008 Proposing Release on the burdens that would result from the proposed amendments to Rule 17g-3.<sup>173</sup> One

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<sup>168</sup> 17 CFR 240.17g-3.

<sup>169</sup> See Rule 17g-3(a)(6).

<sup>170</sup> 200 hours x 30 NRSROs = 6,000 hours. See June 5, 2007 Adopting Release, 72 FR at 33610.

<sup>171</sup> Rule 17g-3 currently requires six reports. Only the first report – financial statements – need be audited.

<sup>172</sup> \$15,000 x 30 NRSROs = \$450,000. See June 5, 2007 Adopting Release, 72 FR at 33610.

<sup>173</sup> See June 16, 2008 Proposing Release, 73 FR at 36239.

commenter, a large NRSRO, estimated that it would cost \$300,000 to build and test a system to comply with this amendment and that its ongoing costs would be \$70,000 per year.<sup>174</sup> The commenter did not provide specific data and analysis to support the estimates.<sup>175</sup> The Commission believes that most NRSROs already will have the information that it needs in order to comply with the amendment to Rule 17g-3 with respect to each class of credit ratings for which it is registered. In addition, the Commission emphasizes that this amendment does not prescribe a specific format for the report. Consequently, the Commission believes that the actual time expenditures of NRSROs in complying with the rule amendment will be less than the commenter's estimates. Nonetheless, the Commission is revising its PRA estimate for Rule 17g-3 upward in response to the comment.

The Commission, based on the comment received and staff experience, estimates that the average time necessary for an applicant or NRSRO to establish an internal process to conform its systems to generate a report in compliance with the amendment will be 100 hours per NRSRO, for a total one-time hour burden to the industry of 3,000 hours.<sup>176</sup> The Commission believes that once an NRSRO complies with the amendment to Rule 17g-3 in the first year, that preparation of the new annual report will become routine. To account for this one-time burden of 3,000 hours and the possibility that new credit rating agencies will register as NRSROs, the Commission is averaging this burden estimate over the three year approval period. Consequently, the Commission is increasing the annual burden estimate by 1,000 hours for a total annual burden estimate for Rule 17g-3 of 4,000 hours.

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<sup>174</sup> See S&P Letter.

<sup>175</sup> Id.

<sup>176</sup> 100 hours x 30 NRSROs = 3,000 hours.

#### **E. Collection of Information Is Mandatory**

The recordkeeping requirements for the rule amendments are mandatory.

#### **F. Confidentiality**

The disclosures required under the amendments to Rule 17g-1 and Form NRSRO will be made publicly available on Form NRSRO. The books and records information to be collected under the amendments to Rule 17g-2 will 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 will be required to make public, in XBRL format and with a six-month grace period, the ratings action histories for a random sample of 10% of the issuer-paid credit ratings for each ratings class for which it has issued 500 or more issuer-paid credit ratings.<sup>177</sup> The information collected under the amendment to Rule 17g-3 will be generated from the internal records of the NRSRO and will be furnished to the Commission on a confidential basis, to the extent permitted by law.<sup>178</sup>

### **IV. COSTS AND BENEFITS OF THE AMENDED RULES**

The Commission is sensitive to the costs and benefits that result from its rules. The Commission identified certain costs and benefits arising from these amendments and requested comment on all aspects of the cost-benefit analysis contained therein, including identification and assessment of any costs and benefits not discussed in the analysis.<sup>179</sup>

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<sup>177</sup> Amendment to Rule 17g-2(d).

<sup>178</sup> 15 U.S.C. 78o-7(k).

<sup>179</sup> 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-

The Commission sought comment and data on the value of the benefits identified. The Commission also requested comment on the accuracy of the cost estimates in each section of the cost-benefit analysis, and requested those commenters to provide data so the Commission could improve the cost estimates, including identification of statistics relied on by commenters to reach conclusions on cost estimates. Finally, the Commission requested estimates and views regarding the costs and benefits for particular types of market participants, as well as any other costs or benefits that might result from the adoption of the 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.<sup>180</sup> 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.”<sup>181</sup>

The Commission requested comment on all aspects of the benefits of the amendments as proposed.<sup>182</sup> In addition, the Commission requested specific comment on available metrics to quantify these benefits and any other benefits the commenter may

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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 June 5, 2007 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.”

<sup>180</sup> Senate Report, p. 2.

<sup>181</sup> Id., p. 7.

<sup>182</sup> See June 16, 2008 Proposing Release, 73 FR at 36241-36243.

identify, including the identification of sources of empirical data that could be used for such metrics.<sup>183</sup> The Commission did not receive any comments in response to this request.

The amendments are designed to further the goals of the Rating Agency Act, including fostering transparency in the credit rating agency industry. Since the adoption of the final rules implementing the Rating Agency Act in 2007,<sup>184</sup> the Commission has identified a number of areas where it is appropriate to enhance the current regulatory program for NRSROs.

Consequently, the Commission is adopting amendments that 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 amendments will 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.<sup>185</sup>

Rule 17g-1 prescribes a process for a credit rating agency to register with the Commission as an NRSRO using Form NRSRO,<sup>186</sup> and requires that a credit rating agency provide information required under Section 15E(a)(1)(B) of the Exchange Act

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<sup>183</sup>

Id.

<sup>184</sup>

See June 5, 2007 Adopting Release.

<sup>185</sup>

See Senate Report, p. 2.

<sup>186</sup>

See Rule 17g-1.

and certain additional information.<sup>187</sup> Form NRSRO is also the means by which NRSROs update the information they must publicly disclose. The amendments to the instructions to Exhibit 1 to Form NRSRO will 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.<sup>188</sup> In addition, these amendments will make it easier for an NRSRO to demonstrate that it has a superior ratings methodology or competence and, thereby, attract clients.

The amendments to the instructions to Exhibit 2 of Form NRSRO are designed to provide greater clarity around three areas of the NRSROs' rating processes 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 amendments will 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 believes that these enhanced disclosures in the Exhibits to Form NRSRO will make it easier for market participants to select the NRSROs that are performing well and have the highest quality processes for determining credit ratings. The Commission expects that providing market participants with enhanced disclosures will lead to increased competition and the promotion of capital formation through a restoration of confidence in credit ratings.

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<sup>187</sup> See Section 15E(a)(1)(B) of the Exchange Act. 15 U.S.C. 78o-7(a)(1)(B).

<sup>188</sup> 17 CFR 240.17g-1 and Form NRSRO.

The amendments to Rule 17g-2 are designed to provide greater documentation of the ratings process to assist Commission staff in its examination function as well as to provide greater information to users of issuer-paid credit ratings about the performance of an NRSRO's issuer-paid credit ratings. The additional records will 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 for a structured finance product;<sup>189</sup> (2) a record showing the history and dates of all previous rating actions with respect to each outstanding credit rating; (3) a record, to be made publicly available, showing the history and dates of a 10% random sample of issuer-paid credit ratings, for each ratings class for which an NRSRO is registered and has issued 500 or more issuer-paid credit ratings, of all previous rating actions with respect to each outstanding credit rating;<sup>190</sup> and (4) any written complaints regarding the performance of a credit analyst in determining credit ratings.<sup>191</sup> These records will assist the Commission in monitoring whether an NRSRO is complying with provisions of Section 15E of the Exchange Act and the rules thereunder. The Commission will be better able to monitor 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 impartiality of its credit ratings, including its ratings of structured finance products.

In addition, the amendment to Rule 17g-2(d) will require an NRSRO to make publicly available a random sample of 10% of the issuer-paid credit ratings actions

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<sup>189</sup> Paragraph (a)(2)(iii) of Rule 17g-2.

<sup>190</sup> Paragraph (a)(8) of Rule 17g-2.

<sup>191</sup> Paragraph (b)(8) of Rule 17g-2.

histories, in an XBRL format and with a six-month grace period, for each ratings class for which it has issued 500 or more issuer-paid credit ratings. This XBRL disclosure requirement will allow the marketplace to better compare the performance of different NRSROs that determine issuer-paid credit ratings, since it will shift the source of data formatting from end-users to NRSROs submitting interactive data, thus eliminating the need for end-users to make interpretive decisions on how to compare data fields across NRSROs' reported rating histories. This additional disclosure also may make NRSROs more accountable for their issuer-paid credit ratings by enhancing the transparency of their ratings performance. The Commission believes the XBRL format will benefit market participants seeking to develop their own performance statistics using the ratings history data to be made public by the NRSROs because it will require them to present the information in a standard format. Making the information available in an XBRL format will facilitate the process of creating better and more useful means to analyze how a given NRSRO performed in a certain class of issuer-paid credit ratings and compare that broader performance across NRSROs subject to the public disclosure rule, increasing the transparency of the results of their rating processes and encouraging competition within the industry by making it easier for users of issuer-paid credit ratings to judge the output of such NRSROs. As noted above, the Commission believes that the XBRL format will increase access to information in the financial marketplace and transform the manner in which individual investors, financial intermediaries, analysts, the financial media, and others access, use, and ultimately understand the wealth of available data. Requiring NRSROs to provide this disclosure in a single industry standard format will offer market



participants the benefits of simplification, increased transparency, and ease of comparisons.

The amendment to Rule 17g-3 will require an NRSRO to furnish an additional annual report to the Commission: an unaudited report of the number of credit ratings actions (upgrades, downgrades, placements on credit watch, and withdrawals) 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 NRSRO is registered with the Commission.<sup>192</sup> The 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 will 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 amendments to Rule 17g-5 will 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.<sup>193</sup> The Commission believes that the amendments to Rule 17g-5 will promote the disclosure and management of conflicts of interest and mitigate potential

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<sup>192</sup> See Rule 17g-3(a)(6).

<sup>193</sup> See Rule 17 CFR 240.17g-5(c)(5)-(7).

undue influences on an NRSRO's credit rating process, particularly with respect to credit ratings for structured finance products.<sup>194</sup> These amendments will, in turn, increase confidence in the integrity of NRSRO ratings and, thereby, promote capital formation.

## **B. Costs**

The cost of compliance to a given NRSRO will depend on its size and the complexity of its business activities. The size and complexity of the ten NRSROs vary significantly. For example, the three largest NRSROs account for approximately 98% of all outstanding credit ratings as reported on their most recent Form NRSROs. In addition, these three NRSROs also employ approximately 92% of the credit analysts among the ten registered NRSROs. In the June 16, 2008 Proposing Release, the Commission provided 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 amendments.<sup>195</sup>

The Commission also sought comment on its cost estimates and the assumptions behind the estimates. One of the largest NRSROs provided cost data for the proposed rules but, significantly, only in summary form.<sup>196</sup> That is, the NRSRO provided estimates for the total one-time and on-going costs to comply with each proposed rule but did not identify the particular components of each total cost estimate. For example, the NRSRO did not identify the amount of each cost estimate that would be due to internal costs such as employee salaries and internal systems developments; nor the amount of

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<sup>194</sup> See 15 U.S.C. 78o-7(a)(1)(B)(vi) and (h).

<sup>195</sup> See June 16, 2008 Proposing Release, 73 FR at 36243-36247.

<sup>196</sup> See S&P Letter.

each cost that would be due to external costs such as the need to purchase software to comply with a recordkeeping requirement in a rule. Nonetheless, the Commission believes that the summary form cost estimates provided by the NRSRO do provide some basis for revising the Commission's earlier cost estimates because they reflect the experience of a large highly complex NRSRO that has been subject to existing Commission rules. However, the Commission does note that, because the cost estimates were provided in summary form, the Commission cannot identify specific components of the cost estimates that are linked to a recordkeeping requirement and, therefore, subject to the PRA. Consequently, the Commission continued to analyze the PRA burden estimates separately from these summary cost estimates.

For the reasons discussed above, the cost estimates below are calculated for two categories of NRSROs. The first category is comprised of the three largest NRSROs in terms of the number of credit ratings outstanding. As noted above, these three firms account for 98% of the credit ratings outstanding. The second category is comprised of the seven smaller NRSROs currently registered with the Commission. These NRSROs account for the remaining 2% of credit ratings outstanding. The theory behind this analysis is that the total cost to the NRSRO industry resulting from an amendment will be incurred by each NRSRO in approximate proportion to the percentage of the total credit ratings it issues. As discussed below, the Commission is determining a total cost to the industry using the summary cost figures provided by the large NRSRO by estimating that, since this firm accounts for 47% of the credit ratings outstanding, its summary cost estimate is 47% of the total cost to the industry. Having derived a total cost to the industry using this NRSRO's summary cost estimates, the Commission allocates a

percentage of that total cost to the two different categories of NRSROs: 98% for the first category and 2% for the second category. Further, the Commission estimates an average cost per NRSRO by dividing the amount of the total cost allocated to the first category by the three NRSROs in that category and the amount of the total cost allocated to the second category of NRSROs by the seven NRSROs in that category.

The Commission continues to estimate that 30 NRSROs ultimately may register. However, because the Commission assumes the total number of ratings extant would remain stable, the total cost to the industry likely would remain stable and be reallocated among new entrants. Therefore, for the purposes of cost estimates derived using this analysis, the Commission is not including the potential 20 new entrants in either the first or second categories of NRSROs for the purposes of determining the cost per NRSRO.

Additionally, the Commission notes that ten credit rating agencies are currently registered with the Commission as NRSROs and subject to the statutory and regulatory requirements for NRSROs. The cost of compliance to these firms will vary depending on which classes of credit ratings an NRSRO issues. For example, NRSROs that issue credit ratings for structured finance products – the focus of many of these new requirements – will incur higher compliance costs than NRSROs that do not issue credit ratings or that issue relatively few credit ratings in that class. The Commission notes that the bulk of the structured finance credit ratings outstanding are issued by NRSROs in the first category.

This method of calculating costs also differs from the one used in the June 16, 2008 Proposing Release in that it is not derived by multiplying the number of burden hours estimated for purposes of the PRA by hourly costs of personnel expected to

undertake the responsibilities for complying with the amendment. As noted above, the Commission received summary cost data from the NRSRO in its comments that did not separate internal costs from external costs or paperwork burdens from other economic impacts. Nonetheless, the Commission believes that using the summary cost information provided by the NRSRO allows for a more robust method of estimating the total economic impact of the amendments. The Commission believes that for purposes of the cost-benefit analysis this methodology provides a more conservative method for estimating costs because it is based on the experience of an NRSRO that has been subject to existing Commission rules and it accounts for the substantial variance in size and complexity of the 10 registered NRSROs. For example, the methodology provides a basis for assessing the different cost impacts the rules will have on the largest NRSROs, which skew the total costs to the industry.

### **1. Amendments to Form NRSRO**

The Commission is amending the instructions to Exhibit 1 to Form NRSRO to require the disclosure of 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 new amendments refine 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 need to be broken out over 1, 3 and 10 year periods.<sup>197</sup>

The Commission also is amending the instructions to Exhibit 2 to Form NRSRO to require enhanced disclosures about the procedures and methodologies an NRSRO uses

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<sup>197</sup> See instructions to Exhibit 1, Form NRSRO.

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.

In the June 16, 2008 Proposing Release, the Commission preliminarily stated that it believed 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.<sup>198</sup> Specifically, the Commission estimated 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.<sup>199</sup> For these reasons, the Commission originally estimated that the average one-time cost to an NRSRO would be \$12,740<sup>200</sup> and the total aggregate cost to the currently registered NRSROs would be \$114,660.<sup>201</sup>

The Commission received one comment on these proposed costs. The commenter, a large NRSRO, estimated that it would have to build systems to comply with each new amendment to Form NRSRO, resulting in a one-time cost to the NRSRO

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<sup>198</sup> See June 16, 2008 Proposing Release, 73 FR at 36244.

<sup>199</sup> Id.

<sup>200</sup> The Commission estimated 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 x \$270) + (10 hours x \$194)].

<sup>201</sup> \$12,740 x 9 NRSROs = \$114,660.

of \$6,710,000.<sup>202</sup> The commenter further estimated that its costs on an annual basis would be \$1,860,000.<sup>203</sup> The commenter did not break down these cost estimates or provide supporting data. Although the Commission believes existing systems could be adjusted instead of rebuilt to comply with the new Exhibit instructions, the Commission is taking into account the comment received regarding the cost and, therefore, is revising its cost estimates.

The Commission believes the costs incurred by the NRSROs will be in approximate proportion to the number of credit ratings they issue. The commenter that provided cost estimates for this rule amendment is the largest NRSRO in terms of credit ratings outstanding. As such, it accounts for approximately 47% of the total outstanding credit ratings reported by all registered NRSROs on their most recent Form NRSROs. The Commission estimates that this NRSRO will incur 47% of the total costs to the NRSROs from this amendment. Consequently, the total one time cost to the industry will be approximately \$14,276,600<sup>204</sup> and the total annual cost to the industry will be \$3,957,400.<sup>205</sup> Furthermore, the three largest NRSROs constituting the first category account for approximately 98% of the total credit ratings outstanding among all NRSROs and, therefore, the Commission estimates they will incur approximately \$13,991,100<sup>206</sup> of the total one-time cost to the industry and approximately \$3,878,300<sup>207</sup> of the total annual cost to the industry. Consequently, the Commission estimates that they will incur approximately \$4,663,700<sup>208</sup> per firm in one time costs and approximately \$1,292,800<sup>209</sup>

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<sup>202</sup> See S&P Letter.

<sup>203</sup> Id.

<sup>204</sup>  $\$6,710,000 \times 100 = \$671,000,000$ ;  $\$671,000,000/47 = \$14,276,600$ .

<sup>205</sup>  $\$1,860,000 \times 100 = \$186,000,000$ ;  $\$186,000,000/47 = \$3,957,400$ .

<sup>206</sup>  $\$14,276,600 \times .98 = \$13,991,100$ .

<sup>207</sup>  $\$3,957,400 \times .98 = \$3,878,300$

<sup>208</sup>  $\$13,991,100/3 = \$4,663,700$ .

per firm in annual costs. The seven remaining NRSROs account for 2% of the credit ratings outstanding among all NRSROs and, therefore, the Commission estimates they will incur approximately \$285,500<sup>210</sup> of the total one time costs to the industry and approximately \$79,100<sup>211</sup> the total annual costs to the industry. Consequently, the Commission estimates that they will incur approximately \$40,790<sup>212</sup> per firm in one time costs and \$11,300<sup>213</sup> per firm in annual costs. The Commission further estimates that the cost per NRSRO within each category will vary based on their relative sizes.

Finally, the Commission has made changes to the final amendments to Form NRSRO that will minimize the burdens. Therefore, the Commission anticipates that the costs could be lower than those estimated here for NRSROs in both the first and second categories.

## **2. Amendments to Rule 17g-2**

Rule 17g-2 requires an NRSRO to make and preserve specified records related to its credit rating business as well as to make a portion of those records available publicly.<sup>214</sup> The amendments to Rule 17g-2 will require an NRSRO to make and retain two additional records and retain a third type of record. The records to be made and retained are: (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;<sup>215</sup> and (2) a record showing the history and dates of all previous rating actions with respect to each

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<sup>209</sup> \$3,878,300/3 = \$1,292,800.

<sup>210</sup> \$14,276,600 x .02 = \$285,500.

<sup>211</sup> \$3,957,400 x .02 = \$79,100.

<sup>212</sup> \$285,500/7 = \$40,790.

<sup>213</sup> \$79,100/7 = \$11,300.

<sup>214</sup> 17 CFR 240.17g-2.

<sup>215</sup> Paragraph (a)(2)(iii) of Rule 17g-2.



outstanding credit rating.<sup>216</sup> In addition, the amendments will require an NRSRO to make publicly available a random sample of 10% of the issuer-paid credit ratings actions histories, in an XBRL format and with a six-month grace period, for each ratings class for which it has issued 500 or more ratings under the issuer-pay model.<sup>217</sup> Finally, the amendments will require an NRSRO to retain written communications that contain any complaints by an obligor, issuer, underwriter, or sponsor about the performance of a credit analyst.<sup>218</sup>

The Commission requested comment in the June 16, 2008 Proposing Release on the costs that would result from the proposed amendments to Rule 17g-2.<sup>219</sup> In addition, the Commission requested specific comment on whether the proposals imposed 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.<sup>220</sup> The Commission asked that commenters provide specific data and analysis to support any comments they submit with respect to the burden estimates.<sup>221</sup> The Commission received two comments on the proposed amendments.<sup>222</sup> The first commenter, a large NRSRO, stated that the comment period did not provide time to fully assess the costs and benefits of the proposed rule.<sup>223</sup> The second commenter, also a large NRSRO, stated that its one-time cost would be \$10,660,000 and its annual cost would be \$3,260,000.<sup>224</sup> The commenter did not provide any data or analysis to support this view.

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<sup>216</sup> Paragraph (a)(8) of Rule 17g-2.

<sup>217</sup> Paragraph (d) of Rule 17g-2.

<sup>218</sup> Paragraph (b)(8) of Rule 17g-2.

<sup>219</sup> See June 16, 2008 Proposing Release, 73 FR at 36244-36245.

<sup>220</sup> Id.

<sup>221</sup> Id.

<sup>222</sup> See Moody's Letter; S&P Letter.

<sup>223</sup> See Moody's Letter.

<sup>224</sup> See S&P Letter.

The Commission is sensitive to the costs of the new amendments to NRSROs. The Commission is therefore revising its cost estimates based on the comments received.<sup>225</sup> The Commission believes the costs incurred by the NRSROs will be in approximate proportion to the number of credit ratings they issue. The commenter that provided cost estimates for this rule amendment is the largest NRSRO in terms of credit ratings outstanding, accounting for approximately 47% of the total outstanding credit ratings reported by all registered NRSROs on their most recent Form NRSROs. The Commission estimates that this NRSRO will incur 47% of the total costs to the NRSROs from this amendment. Consequently, the total one time cost to the industry will be approximately \$22,680,900<sup>226</sup> and the total annual cost to the industry will be \$6,936,200.<sup>227</sup> Furthermore, the three largest NRSROs constituting the first category account for approximately 98% of the total credit ratings outstanding among all NRSROs and, therefore, the Commission estimates they will incur approximately \$22,227,300<sup>228</sup> of the total one-time cost to the industry and approximately \$6,797,500<sup>229</sup> of the total annual cost to the industry. Consequently, the Commission estimates that they will incur approximately \$7,409,100<sup>230</sup> per firm in one time costs and \$2,265,800<sup>231</sup> per firm in annual costs.

The seven remaining NRSROs account for 2% of the credit ratings outstanding among all NRSROs and, therefore, the Commission estimates they will incur

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<sup>225</sup> To address commenter concerns, the Commission has employed a different methodology for these cost estimates than that used in the June 16, 2008 Proposing Release. For a discussion of the Commission's original cost estimates, see June 16, 2008 Proposing Release, 73 FR at 36244 – 36245.

<sup>226</sup>  $\$10,660,000 \times 100 = \$1,066,000,000$ ;  $\$1,066,000,000/47 = \$22,680,900$ .

<sup>227</sup>  $\$3,260,000 \times 100 = \$326,000,000$ ;  $\$326,000,000/47 = \$6,936,200$ .

<sup>228</sup>  $\$22,680,900 \times .98 = \$22,227,300$ .

<sup>229</sup>  $\$6,936,200 \times .98 = \$6,797,500$ .

<sup>230</sup>  $\$22,227,300/3 = \$7,409,100$ .

<sup>231</sup>  $\$6,797,500/3 = \$2,265,800$ .

approximately \$453,600<sup>232</sup> of the total one time costs to the industry and approximately \$138,700<sup>233</sup> of the total annual costs to the industry. Consequently, the Commission estimates that they will incur approximately \$64,800<sup>234</sup> per firm in one time costs and \$19,810<sup>235</sup> per firm in annual costs. The Commission further estimates that the cost per NRSRO within each category will vary based on their relative sizes.

New paragraph (a)(8) to Rule 17g-2 requires 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.<sup>236</sup> In the June 16, 2008 Proposing Release, the Commission estimated that an NRSRO may choose to purchase a license from the CUSIP Service Bureau in order to access CUSIP numbers for the securities it rates.<sup>237</sup> 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

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<sup>232</sup> \$22,680,900 x .02 = \$453,600.

<sup>233</sup> \$6,936,200 x .02 = \$138,700.

<sup>234</sup> \$453,600/7 = \$64,800.

<sup>235</sup> \$138,700/7 = \$19,810.

<sup>236</sup> See 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 [www.edgarcompany.sec.gov](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.

<sup>237</sup> See June 16, 2008 Proposing Release, 73 FR at 36245.

on usage, i.e., how many securities or by type of security or business line.<sup>238</sup> In the June 16, 2008 Proposing Release, the Commission estimated that the license fees incurred by an NRSRO that chose to purchase a license would vary depending on the size of the NRSRO and the number of credit ratings it issues.<sup>239</sup> For purposes of this cost estimate, the Commission estimates that an NRSRO opting to purchase a license 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.<sup>240</sup> The Commission believes that this estimate continues to be valid for the purposes of new paragraph (a)(8) to Rule 17g-2.

Under paragraph (d) of Rule 17g-2, as amended, NRSROs are required to publicly provide the histories of 10% of their issuer-paid credit ratings, in each class of ratings for which they have issued 500 or more such ratings, in XBRL format and with a six month grace period. The main cost of mandated use of the XBRL format likely will be the incremental cost of developing the systems to make the information available on the NRSROs' websites in interactive format rather than machine readable format. The Commission recognizes that new systems will have to be developed regardless of the reporting format. The Commission expects that the incremental cost of reporting credit rating information in XBRL format relative to other machine readable format will not be large. The Commission bases this assessment on the responses collected through voluntary program questionnaires on the direct costs of submitting interactive data-formatted risk/return summary information by mutual funds and interactive data-formatted financial statements by reporting companies. Participating mutual funds

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<sup>238</sup> See [https://www.cusip.com/static/html/webpage/service\\_fees.html#lic\\_fees](https://www.cusip.com/static/html/webpage/service_fees.html#lic_fees).

<sup>239</sup> See June 16, 2008 Proposing Release, 73 FR at 36245.

<sup>240</sup> \$100,000 x 30 NRSROs = \$3,000,000.

indicated that the estimated direct costs of Web posting of their risk/return summary in interactive data are \$23,450 for the first submission and \$3,350 for each subsequent submission.<sup>241</sup> Reporting companies, which participated in the voluntary program questionnaire, estimated their direct reporting costs at \$40,509 for the first submission and \$13,452 for each subsequent submission.<sup>242</sup> The Commission expects that the costs to NRSROs will be closer to those for mutual funds' risk/return summary reporting, since the reporting complexity (and therefore tagging) of credit rating actions is closer to that of risk/return summaries than to quarterly financial reports. The Commission believes the incremental costs allocable to the XBRL requirement are accounted for in the per-firm one-time and annual costs described above for the two categories of NRSROs.

The Commission anticipates that the changes made to the final amendments to Rule 17g-2 will result, for NRSROs in both the first and second categories, in lower costs overall than those estimated in the June 16, 2008 Proposing Release. For example, the Commission is instead requiring that NRSROs provide a 10% sample of their issuer-paid credit ratings histories for each ratings class for which they have issued 500 or more ratings under the issuer-pay model instead of the history for all outstanding credit ratings. In addition, the Commission is specifying that this data be provided in XBRL format using the List of XBRL Tags for NRSROs as specified on the Commission's Web site, thus eliminating the need for an NRSRO to develop its own taxonomy and tags for the data. Finally, the Commission is only requiring that the record of the rationale for any material difference between the credit rating implied by the model and the final credit

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<sup>241</sup> Interactive Data for Mutual Fund Risk/Return Summary, Securities Act Release No. 8929 (June 10, 2008), 73 FR 35442 (June 23, 2008).

<sup>242</sup> Interactive Data to Improve Financial Reporting, Securities Act Release No. 8924 (May 30, 2008), 73 FR 35442 (June 10, 2008).

rating be kept for structured finance products only, rather than for all classes of ratings. These changes to the amendments to Rule 17g-2 were designed in part to reduce the costs associated with implementing the new amendments.

Finally, one commenter, an NRSRO, suggested that the requirement to post their ratings histories would destroy a revenue stream at the company.<sup>243</sup> Currently, the company charges subscribers a fee to access historical data and information on ratings actions. The Commission believes that the changes to the amendments to Rule 17g-2(d) from those that were proposed address this concern. The amendment now requires NRSROs provide a random 10% sample of their issuer-paid credit ratings histories for each ratings class for which they have issued 500 or more ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated with a six-month grace period for posting new ratings actions. The Commission believes the disclosure of 10% of the issuer-paid credit ratings, selected randomly and disclosed with a six-month time lag, will not cause persons who pay for ratings downloads to cease purchasing this service, as customers that are willing to pay for full and immediate access to all of an NRSRO's ratings actions are unlikely to reconsider their purchase of that product due to the ability to access 10% of the ratings on a six-month delayed basis free of charge. In addition, the Commission has decided not to impose the same disclosure obligation on subscriber-paid credit ratings at this time out of competitive concerns raised, but is still considering how to make more information publicly available and accessible about the performance of these ratings. The Commission believes that the rule as adopted will address the concerns expressed by commenters and at the same time foster greater accountability of NRSROs with respect to their issuer-paid credit ratings as

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<sup>243</sup> See S&P Letter.

well as increase competition among NRSROs by making it easier for persons to analyze the actual performance of their credit ratings.

### 3. Amendment to Rule 17g-3

Rule 17g-3 requires an NRSRO to furnish audited annual financial statements to the Commission, including certain specified schedules.<sup>244</sup> The amendment to Rule 17g-3 will 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. As stated in the June 16, 2008 Proposing Release, the Commission believed that the annual costs to NRSROs to comply with the proposed amendment to Rule 17g-3 would be de minimis.<sup>245</sup> The Commission preliminarily believed that an NRSRO already would have this information with respect to each class of credit ratings for which it is registered.<sup>246</sup> In addition, the amendment does not prescribe a format for the report. Consequently, the Commission estimated 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.<sup>247</sup>

The Commission requested comment in the June 16, 2008 Proposing Release on the costs that would result from the proposed amendments to Rule 17g-3.<sup>248</sup> In addition, the Commission requested specific comment on whether this proposal imposed 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

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<sup>244</sup> 17 CFR 240.17g-3.

<sup>245</sup> See June 16, 2008 Proposing Release, 73 FR at 36245-36246.

<sup>246</sup> Id.

<sup>247</sup> Id.

<sup>248</sup> Id.

from NRSROs.<sup>249</sup> The Commission asked that commenters provide specific data and analysis to support any comments they submit with respect to these burden estimates. The Commission received one comment on this cost estimate.<sup>250</sup> The commenter, a large NRSRO, estimated that it would cost \$300,000 to build and test a system to comply with this amendment and that its ongoing costs would be \$70,000 per year.<sup>251</sup> The commenter did not provide specific data and analysis to support the estimates.<sup>252</sup>

The Commission is revising its cost estimates based on the specific costs included in the comments received. The commenter that provided cost estimates for this rule amendment is the largest NRSRO in terms of credit ratings outstanding. As such, it accounts for approximately 47% of the total outstanding credit ratings reported by all registered NRSROs on their most recent Form NRSROs. The Commission estimates that this NRSRO will incur 47% of the total costs to the NRSROs from this amendment. Consequently, the total one time cost to the industry will be approximately \$638,300<sup>253</sup> and the total annual cost to the industry will be \$148,900.<sup>254</sup> Furthermore, the three largest NRSROs in the first category account for approximately 98% of the total credit ratings issued by the NRSROs and, therefore, the Commission estimates they will incur approximately \$625,500<sup>255</sup> of the total one-time cost to the industry and approximately \$145,900<sup>256</sup> of the total annual cost to the industry. Consequently, the Commission

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Id.

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Id.

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See S&P Letter.

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Id.

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$\$300,000 \times 100 = \$30,000,000$ ;  $\$30,000,000 / 47 = \$638,300$ .

254

$\$70,000 \times 100 = \$7,000,000$ ;  $\$7,000,000 / 47 = \$148,900$ .

255

$\$638,300 \times 0.98 = \$625,500$ .

256

$\$148,900 \times 0.98 = \$145,900$ .



estimates that they will incur approximately \$208,500<sup>257</sup> per firm in one time costs and \$48,600<sup>258</sup> per firm in annual costs.

The seven remaining NRSROs account for 2% of the credit ratings outstanding and, therefore, the Commission estimates they will incur approximately \$12,800<sup>259</sup> of the total one time costs to the industry and approximately \$3,000<sup>260</sup> of the total annual costs to the industry. Consequently, the Commission estimates that they will incur approximately \$1,830<sup>261</sup> per firm in one time costs and \$430<sup>262</sup> per firm in annual costs. The Commission further estimates that the cost per NRSRO within each category will vary based on their relative sizes.

#### 4. Amendments to Rule 17g-5

Rule 17g-5 requires an NRSRO to manage and disclose certain conflicts of interest and prohibits other conflicts outright.<sup>263</sup> The Commission is amending paragraph (c) to Rule 17g-5 to add three additional prohibited conflicts of interest.<sup>264</sup> In the June 16, 2008 Proposing Release, the Commission estimated that the amendments to paragraph (c) to Rule 17g-5 generally would impose de minimis costs on an NRSRO.<sup>265</sup> However, the Commission recognized that an NRSRO may incur costs related to training employees about the new requirements.<sup>266</sup> The Commission also recognized that it was

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<sup>257</sup> \$625,500/3 = \$208,500.

<sup>258</sup> \$145,900/3 = \$48,600.

<sup>259</sup> \$638,300 x .02 = \$12,800.

<sup>260</sup> \$148,900 x .02 = \$3,000.

<sup>261</sup> \$12,800/7 = \$1,830.

<sup>262</sup> \$3,000/7 = \$430.

<sup>263</sup> 17 CFR 240.17g-5.

<sup>264</sup> See Rule 17g-5(c)(5)-(7).

<sup>265</sup> See June 16, 2008 Proposing Release, 73 FR at 36246-36247.

<sup>266</sup> Id.

possible that the proposed amendments could require some NRSROs to restructure their business models or activities, in particular with respect to their consulting services.<sup>267</sup>

The Commission requested comment in the June 16, 2008 Proposing Release on the costs that would result from the proposed amendments to Rule 17g-5.<sup>268</sup> In addition, the Commission requested specific comment on whether the proposed amendments to paragraph (c) of Rule 17g-5 would impose training and restructuring costs, would impose personnel costs, or would 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 countries.<sup>269</sup> The Commission asked that commenters provide specific data and analysis to support any comments they submit with respect to these cost estimates.<sup>270</sup> The Commission received two comments on the proposed amendment, both from large NRSROs.<sup>271</sup>

One commenter said that paragraph (c)(6) would cause the NRSRO to create a number of new positions for senior chief credit officers so that drafting, approving and implementing methodologies could be handled exclusively by individuals with no involvement in the business of running an NRSRO.<sup>272</sup> The commenter also stated that it would be necessary for the NRSRO to create additional, senior positions in its issuer and intermediary relations team for individuals, such as former analysts, who were deeply familiar with the NRSRO's methodologies and procedures and could assist with fee negotiations.<sup>273</sup> The NRSRO further stated that it would have to transfer former credit

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<sup>267</sup>

Id.

<sup>268</sup>

Id.

<sup>269</sup>

Id.

<sup>270</sup>

Id.

<sup>271</sup>

See Moody's Letter; S&P Letter.

<sup>272</sup>

See Moody's Letter.

<sup>273</sup>

Id.

analysts to this team regularly and on an ongoing basis so that this team retained sufficient and current technical knowledge to handle fees.<sup>274</sup> The NRSRO did not provide specific cost estimates. Another commenter stated that it would cost \$7,830,000 for personnel time, system modifications, and training to implement the new amendments.<sup>275</sup> In addition, the NRSRO estimated that its annual, ongoing costs would be \$2,250,000.<sup>276</sup> The NRSRO did not provide a breakdown of costs with its estimate.

The Commission is revising its cost estimates based on the specific comments received. The Commission believes the costs incurred by the NRSROs will be in approximate proportion to the number of credit ratings they issue. The commenter that provided cost estimates for this rule amendment is the largest NRSRO in terms of credit ratings outstanding. As such, it accounts for approximately 47% of the total outstanding credit ratings reported by all registered NRSROs on their most recent Form NRSROs. The Commission estimates that this NRSRO will incur 47% of the total costs to the NRSROs from this amendment. Consequently, the total one time cost to the industry will be approximately \$16,659,600<sup>277</sup> and the total annual cost to the industry will be \$4,787,200.<sup>278</sup> Furthermore, the three largest NRSROs in the first category account for approximately 98% of the total credit ratings issued by the NRSROs and, therefore, the Commission estimates they will incur approximately \$16,326,400<sup>279</sup> of the total one-time cost to the industry and approximately \$4,691,500<sup>280</sup> of the total annual cost to the

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<sup>274</sup>

Id.

<sup>275</sup>

See S&P Letter.

<sup>276</sup>

See id.

<sup>277</sup>

$\$7,830,000 \times 100 = \$783,000,000$ ;  $\$783,000,000/47 = \$16,659,600$ .

<sup>278</sup>

$\$2,250,000 \times 100 = \$225,000,000$ ;  $\$225,000,000/47 = \$4,787,200$ .

<sup>279</sup>

$\$16,659,600 \times 0.98 = \$16,326,400$ .

<sup>280</sup>

$\$4,787,200 \times 0.98 = \$4,691,500$

industry. Consequently, the Commission estimates that they will incur approximately \$5,442,100<sup>281</sup> per firm in one time costs and \$1,563,800<sup>282</sup> per firm in annual costs.

The seven remaining NRSROs account for 2% of the credit ratings outstanding and, therefore, the Commission estimates they will incur approximately \$333,200<sup>283</sup> of the total one time costs to the industry and approximately \$95,700<sup>284</sup> of the total annual costs to the industry. Consequently, the Commission estimates that they will incur approximately \$47,600<sup>285</sup> per firm in one time costs and \$13,760<sup>286</sup> per firm in annual costs. The Commission further estimates that the cost per NRSRO within each category will vary based on their relative sizes.

### C. Total Estimated Costs of this Rulemaking

Based on the figures discussed above, the Commission estimates that the first year quantifiable costs related to this proposed rulemaking will be approximately \$73,085,100.<sup>287</sup>

## V. CONSIDERATION OF BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION, AND CAPITAL FORMATION

Under Section 3(f) of the Exchange Act,<sup>288</sup> 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 Act<sup>289</sup> requires the Commission to consider the anticompetitive effects of any rules the

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<sup>281</sup>  $\$16,326,400/3 = \$5,442,100.$

<sup>282</sup>  $\$4,691,500/3 = \$1,563,800.$

<sup>283</sup>  $\$16,659,600 \times .02 = \$333,200.$

<sup>284</sup>  $\$4,787,200 \times .02 = \$95,700.$

<sup>285</sup>  $\$333,200/7 = \$47,600.$

<sup>286</sup>  $\$95,700/7 = \$13,671 = \$13,670.$

<sup>287</sup>  $\$57,255,400$  (total one-time costs) +  $\$15,829,700$  (total annual costs) =  $\$73,085,100.$

<sup>288</sup> 15 U.S.C. 78c(f).

<sup>289</sup> 15 U.S.C. 78w(a)(2).

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 believes that the amendments will promote efficiency, competition, and capital formation.

The amendments to the Instructions to Exhibit 1 to Form NRSRO will require NRSROs to make more comparable disclosures about the performance of their credit ratings. These disclosures will provide more information to users of credit ratings about the relative performance of the NRSROs and, thereby, promote competition. In addition, the 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 will 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 will result from all these enhanced disclosures will make it easier for market participants to select the NRSROs that have the highest quality processes for determining credit ratings. This transparency is designed to increase competition and promote capital formation by restoring confidence in the credit ratings, which are an integral part of the capital formation process.

The amendments to Rule 17g-2 are designed to enhance the Commission's oversight of NRSROs and, with respect to the public disclosure of a percentage of the histories of their issuer-paid credit ratings, provide the marketplace with information for comparing the ratings performance of NRSROs subject to the requirement. Enhancing

the Commission's oversight will help enhance confidence in credit ratings and, thereby, promote capital formation. Increased disclosure of the histories of issuer-paid credit ratings could make the ratings performance of the NRSROs subject to this requirement more transparent to the marketplace and, thereby, highlight those firms that analyze credit risk better. The Commission believes that this enhanced disclosure will benefit smaller NRSROs to the extent they have performed better in determining issuer-paid credit ratings than other NRSROs by alerting the market to their superior performance.

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

The amendments to Rule 17g-5 will prohibit NRSROs from determining credit ratings where they or their affiliate provided recommendations about the corporate or legal structure, assets, liabilities, or activities of the obligor being rated or the issuer of the security being rated, prohibit analysts from participating in fee negotiations, and prohibit credit analysts or persons responsible for approving a credit rating from 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 are designed to increase confidence in the integrity of NRSROs and the credit ratings they issue and, thereby, enhance confidence in credit ratings and, by extension, promote capital formation.

The Commission received one comment specifically on the Commission's analysis of the whether the amendments would promote efficiency, competition, and

capital formation.<sup>290</sup> The commenter argued that the requirement to publish all ratings histories free of charge would be a “new barrier to entry” and would create “a significant disincentive to apply for the NRSRO designation” thereby reducing competition among NRSROs.<sup>291</sup> The commenter stated that if these amendments were passed, the estimate that there would be 30 NRSROs would need to be revised.

As discussed more fully in section II.B.1, in response to this comment and similar concerns raised by other commenters, the Commission has balanced the many competitive concerns expressed by commenters. The rule is designed to foster competition, by making ratings histories more accessible. However, the Commission has taken a number of steps to minimize the potential competitive effects. First, the amendments do not apply to subscriber-paid credit ratings. Second, with respect to issuer-paid credit ratings, the Commission notes that NRSROs generally make these ratings public. This publicly available, historical information currently is difficult to access and compare. The Commission expects that making this information more accessible will advance the Commission’s goal of fostering accountability and comparability among NRSROs. The Commission does not, however, expect that requiring NRSROs to make publicly available ratings action histories for a random sample of 10% of their outstanding issuer-paid credit ratings in a more accessible form six months after the rating action has been taken will have a material effect on their business. Because the Commission is requiring only a small portion of the ratings histories to be made available in a more accessible format, the Commission expects NRSROs will still be able to realize economic value from the information.

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<sup>290</sup> See Rapid Ratings Letter.

<sup>291</sup> Id.

The Commission has decided not to impose the same disclosure obligation on subscriber-paid credit ratings at this time out of competitive concerns raised, but is still considering how to make more information publicly available and accessible about the performance of these ratings. The Commission believes that the rule as adopted will address the concerns expressed by commenters and at the same time foster greater accountability of NRSROs with respect to their issuer-paid credit ratings as well as increase competition among NRSROs by making it easier for persons to analyze the actual performance of their credit ratings.

## **VI. FINAL REGULATORY FLEXIBILITY ANALYSIS**

The Commission proposed amendments to Form NRSRO, Rule 17g-2, Rule 17g-3, and Rule 17g-5 under the Exchange Act. An Initial Regulatory Flexibility Analysis (“IRFA”) was published in the June 16, 2008 Proposing Release.<sup>292</sup> The Commission has prepared the following Final Regulatory Flexibility Analysis (“FRFA”), in accordance with the provisions of the Regulatory Flexibility Act,<sup>293</sup> regarding amendments to Form NRSRO, Rule 17g-2, Rule 17g-3, and Rule 17g-5 under the Exchange Act.

### **A. Need for and Objective of the Amendments**

The amendments will prescribe additional requirements for NRSROs to address concerns raised about the role of credit rating agencies in the recent credit market turmoil. The amendments are designed to enhance and strengthen the rules the Commission adopted in 2007 to implement specific provisions of the Rating Agency Act.<sup>294</sup> 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,

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<sup>292</sup> See June 16, 2008 Proposing Release, 73 FR at 36248-36250.

<sup>293</sup> 5 U.S.C. 603.

<sup>294</sup> Pub. L. No. 109-291 (2006); see also June 5, 2007 Adopting Release.



and competition in the credit rating industry.”<sup>295</sup> The amendments are designed to further achieve these objectives and further assist the Commission in monitoring whether an NRSRO complies with the statutes and regulations applicable to NRSROs.

### **B. Significant Issues Raised by Commenters**

The Commission sought comment with respect to every aspect of the IRFA, including comments with respect to the number of small entities that may be affected by the proposed amendments.<sup>296</sup> Commenters were asked to specify the costs of compliance with the proposed rules and suggest alternatives that would accomplish the goals of the rules.<sup>297</sup> The Commission did not receive any comments on the IRFA. The Commission did, however, receive a limited number of comments that discussed the effect the rules might have on smaller credit rating agencies, although these commenters did not address whether their comments pertained to entities that would be small businesses for purposes of Regulatory Flexibility Act analysis. For example, a commenter stated that the proposed amendments, if adopted, would create a barrier to entry for new NRSROs.<sup>298</sup> In addition, several commenters suggested that small NRSROs would not be able to comply with Rule 17g-5(c)(6), which prohibits persons within an NRSRO that are responsible for determining or approving credit ratings or developing the methodologies for determining credit ratings from participating in fee discussions.<sup>299</sup> In response to these comments, the Commission will review requests by small NRSROs for exemptions from the rule under Section 36 of the Exchange Act based on their specific circumstances.

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<sup>295</sup> See Senate Report.

<sup>296</sup> See June 16, 2008 Proposing Release, 73 FR 36250.

<sup>297</sup> Id.

<sup>298</sup> See Rapid Ratings Letter.

<sup>299</sup> See, e.g., DBRS Letter; Multiple-Markets Letter; CFA Institute Letter; Colorado PERA Letter; ABA Business Law Committees Letter.

### **C. 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.”<sup>300</sup> 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 June 5, 2007 Adopting Release, the Commission believes that approximately 30 credit rating agencies ultimately may register as an NRSRO.<sup>301</sup> Of the approximately 30 credit rating agencies that may register with the Commission, the Commission estimates that approximately 20 may be “small” entities for purposes of the Regulatory Flexibility Act.<sup>302</sup>

### **D. Reporting, Recordkeeping, and Other Compliance Requirements**

The amendments will revise Form NRSRO to elicit certain additional information regarding the performance data for the credit ratings and the methods used by an NRSRO for issuing credit ratings.<sup>303</sup>

The amendments will revise Rule 17g-2 to establish additional recordkeeping requirements for NRSROs.<sup>304</sup> The amendments will 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

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<sup>300</sup> 17 CFR 240.0-10(a).

<sup>301</sup> June 5, 2007 Adopting Release, 72 FR at 33618.

<sup>302</sup> See 17 CFR 240.0-10(a).

<sup>303</sup> See amendments to Form NRSRO.

<sup>304</sup> See amendments to Rule 17g-2.

component in the process of determining a credit rating;<sup>305</sup> and (2) a record showing the history and dates of all previous rating actions with respect to each outstanding credit rating. An NRSRO also will be required to publicly disclose, in XBRL format and on a six month delay, a record showing the history and dates of all previous rating actions with respect to a random sample of 10% of the issuer-paid credit ratings for each ratings class for which an NRSRO is registered and has issued 500 or more ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated.<sup>306</sup> In addition, the NRSRO will be required to retain any complaints about the performance of a credit analyst.<sup>307</sup> These records will 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 amendments will revise Rule 17g-3 to require an NRSRO to furnish the Commission with an additional annual report: the number of ratings actions in each class of credit rating for which it is registered.<sup>308</sup> This requirement is designed to further assist the Commission in its examination function.

The amendments will revise 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

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<sup>305</sup> Paragraph (a)(2)(iii) of Rule 17g-2.

<sup>306</sup> Paragraph (a)(8) of Rule 17g-2.

<sup>307</sup> Paragraph (b)(8) of Rule 17g-2.

<sup>308</sup> See amendment to Rule 17g-3.

rating from 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.<sup>309</sup>

#### **E. Significant Alternatives**

Pursuant to Section 3(a) of the RFA,<sup>310</sup> 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 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 not establishing different compliance or reporting requirements or timetables. The Commission believes that obtaining comparable information from NRSROs regardless of size is important. Moreover, because the rules are relatively straightforward, the Commission does not believe it necessary to clarify, consolidate, or simplify compliance and reporting requirements under the rule for small entities at this time. Because the amendments are designed to improve the overall quality of ratings and enhance the Commission's oversight, the Commission is not proposing to exempt any specific small entities from coverage of the rule, or any part of the rule. However, the Commission would be willing to consider requests for exemptive relief from smaller NRSROs for which the prohibition on participating in fee discussions may

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<sup>309</sup> See amendment to Rule 17g-5.

<sup>310</sup> 5 U.S.C. 603(c).

be more difficult to comply with than for larger NRSROs. The other prohibited conflicts do not appear to impose any disproportionate impact on smaller NRSROs. The amendments are designed to allow NRSROs the flexibility to develop procedures tailored to their specific organizational structure and business models.

## **VII. STATUTORY AUTHORITY**

The Commission is adopting amendments to Form NRSRO and Rules 17g-2, 17g-3, and 17g-5 pursuant to the authority conferred by the Exchange Act, including Sections 3(b), 15E, 17, 23(a) and 36.<sup>311</sup>

### **Text of the Amendments**

#### **List of Subjects in 17 CFR Parts 240 and 249b**

Brokers, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, the Commission amends 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);

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<sup>311</sup> 15 U.S.C. 78c(b), 78o-7, 78q, 78w, and 78mm.

- 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), removing the phrase “maintaining, changing,” and in its place adding “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 four sentences 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 of a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, 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) For each outstanding credit rating, 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 written communications received from persons not associated with the nationally recognized statistical rating organization that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

\* \* \* \* \*

(d) \* \* \* In addition, a nationally recognized statistical rating organization must make and keep publicly available on its corporate Internet Web site in an XBRL (eXtensible Business Reporting Language) format the ratings action information for ten percent of the outstanding credit ratings required to be retained pursuant to paragraph (a)(8) of this section and which were paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated, selected on a random basis, for each class of credit rating for which it is registered and for which it has issued 500 or more outstanding credit ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated. Any ratings action required to be disclosed pursuant to this paragraph (d) need not be made public less than six months from the date such ratings action is taken. If a credit rating made public pursuant to this paragraph (d) is withdrawn or the instrument rated matures, the nationally recognized statistical rating organization must randomly select a new outstanding credit rating from that class of credit ratings in order to maintain the 10 percent disclosure threshold. In making the information available on its corporate Internet Web site, the nationally recognized

statistical rating organization shall use the List of XBRL Tags for NRSROs as specified on the Commission's Internet Web site.

\* \* \* \* \*

3. Section 240.17g-3 is amended by:

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

The addition and revision read as follows:

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

(a) \* \* \*

(6) An unaudited report of the number of credit ratings actions (upgrades, downgrades, placements on credit watch, and withdrawals) 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 “or” at the end of paragraph (c)(3);

b. Removing the period at the end of paragraph (c)(4) and in its place adding a semi-colon; and

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

The additions read as follows:

**§ 240.17g-5 Conflicts of interest.**

\* \* \* \* \*

(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.

\* \* \* \* \*

#### **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**

\* \* \* \* \*

#### **H. INSTRUCTIONS FOR SPECIFIC LINE ITEMS**

\* \* \* \* \*

**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). 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. In addition, the class of government securities should be separated into three additional classes: sovereigns, United States public finance, and international public finance. 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. 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. If the

Applicant/NRSRO is required to make and keep publicly available on its corporate Internet Web site in an XBRL (eXtensible Business Reporting Language) format a sample of ratings action information pursuant to the requirements of 17 CFR 240.17g-2(d), provide in this Exhibit the Web site address where this information is, or will be, made publicly available.

**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.

\* \* \* \* \*

By the Commission.

Elizabeth M. Murphy  
Secretary

Dated: February 2, 2009