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SEC Adopts Credit Rating Agency Reform Rules

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On August 27, 2014, the SEC adopted new rules for credit rating agencies implementing 14 rulemaking requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The new rules are designed to enhance governance, protect against conflicts of interest and increase transparency. The new rules apply to credit rating agencies registered with the SEC as “nationally recognized statistical rating organizations,” or NRSROs. Certain of the new rules applicable to NRSROs will take effect 60 days after publication in the Federal Register, while certain others will take effect nine months after publication in the Federal Register, the latter of which are delayed to provide time for NRSROs, issuers, underwriters and other affected parties to prepare for the changes resulting from the new requirements.¹

Internal Control Structure

Dodd-Frank amended Section 15E(c) of the Securities Exchange Act of 1934 (the “Exchange Act”), to require NRSRO’s to establish, maintain, enforce and document an effective internal control structure. The SEC adopted rules that require an NRSRO to establish and document an effective internal control structure to govern the implementation of and adherence to policies for determining credit ratings. The rules require an NRSRO to consider when implementing, maintaining, and enforcing its internal control structure, a number of factors, which include, among others:

- With regard to implementation, whether controls were designed to ensure that a newly developed or updated methodology for determining credit ratings is subject to an appropriate review and management approval process, prior to, and subsequent to, implementation.
- Public posting of, and public comment considerations being given to, proposed new or updated ratings methodology and posting of market participant comments with respect to the need to update current methodologies.
- With respect to determining ratings, that the work of the lead analyst is reviewed (for example by a rating committee process)

- With regard to maintenance, whether controls were designed to ensure that an NRSRO conducts periodic reviews of whether it has devoted enough resources to implement and operate its internal control structure as designed.
- With regard to enforcement, whether controls were designed to ensure that additional training is provided with respect to employees who fail to adhere to requirements imposed by an NRSRO's internal control structure.

Report on the Effectiveness of the NRSRO's Internal Control Structure

The rules, effective on January 1, 2015, require an NRSRO to file an annual report with the Commission regarding the effectiveness of the internal control structure with a prohibition of management concluding that the internal control structure was effective if any material weakness was identified. The first report would cover the fiscal year that ends on or after January 1, 2015 with the first management certification filed after the end of calendar year 2015.

Sales and Marketing Conflict of Interest

The SEC amended Section 15E(h) of the Exchange Act to prevent the sales and marketing considerations of an NRSRO from influencing its credit rating decisions. In particular, the SEC enacted an "absolute prohibition" against persons in NRSROs that participate in sales and marketing activities, or are influenced by sales and marketing considerations from participating in, determining or monitoring credit ratings or developing or approving rating procedures. Consequently, an NRSRO must strictly separate these two roles under the new rule. In instances where an NRSRO is found to be in violation, the new rule provides the SEC with the authority to suspend or revoke the registration of the NRSRO in question.

"Look-Back" Review

Dodd Frank amended Section 15E(h) of the Exchange Act with a view towards closing the "revolving door" between NRSROs and the companies whose products they rate. The rule requires an NRSRO to conduct what are called "look-back" reviews in any instance where the prospect of future employment by an issuer or underwriter may have influenced a credit analyst in determining a credit rating. If an NRSRO determines that a conflict of interest exists and the employee was influenced in his or her determination of a credit rating, the NRSRO must promptly revise the credit rating in accordance with rules prescribed by the SEC.

Certification of ABS Third-Party Due Diligence Provider

New Rule 17g-10 requires providers of third-party diligence services for Asset Backed Securities, "ABS", to file a new Form ABS Due Diligence-15E certifying to the NRSRO producing a credit rating the description of the work performed, a summary of the findings and conclusions of the diligence service provider and any relevant NRSRO due diligence criteria that the provider intended to meet. On September 4, 2014 the Commission also adopted new ABS disclosure and Registration Requirements.²

² <http://www.sec.gov/rules/final/2014/33-9638.pdf>