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# Global Securities Group Client Alert

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## SEC RATING AGENCY REFORM IMPOSES DISCLOSURE BURDENS ON STRUCTURED FINANCE PARTICIPANT INTERACTIONS WITH RATING AGENCIES

### Introduction

Effective June 2, 2010, issuers, sponsors and underwriters (collectively, “arrangers”) that pay for a credit rating of a structured finance product will be required to maintain information on a password-protected Internet Web site for the benefit of qualifying nationally recognized statistical rating organizations (“NRSRO”), whether or not the NRSRO has been hired to determine an initial credit rating or to monitor a credit rating. This client alert summarizes these new requirements and addresses a few of the practical implications.

The requirements are included in Release No. 34-61050 (the “Release”)<sup>1</sup> issued by the Securities and Exchange Commission (the “Commission”), which imposes additional disclosure and conflict of interest requirements on NRSROs. Among other things, the Release amended Rule 17g-5 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). The Release indicates a compliance date of June 2, 2010.<sup>2</sup>

The Release requirements apply only to NRSROs in connection with the rating of structured finance products. However, by requiring NRSROs to publicly disclose any rating that they are hired to provide and to include in their retention agreements an undertaking to provide information to any other NRSRO, the Commission has indirectly imposed regulatory compliance obligations on other market participants. The hired NRSRO must provide the relevant arranger’s Web site address on the Web site that the hired NRSRO is required to maintain. The Commission believes that by making information available to multiple NRSROs, investors will be better protected against conflicts of interest that arise between arrangers and the NRSROs they hire to determine or monitor credit ratings. Further, the Commission believes that encouraging and facilitating credit ratings of structured finance products by non-hired NRSROs will improve the overall quality of credit ratings and promote competition in the credit ratings industry, effectively making it harder for arrangers to exert influence over hired NRSROs.<sup>3</sup>

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### **The Mechanics of Amended Rule 17g-5**

In the release, the Commission refers to issuers, sponsors and underwriters collectively as “arrangers”, but it is likely that issuers and sponsors will most often maintain and administer the required Web site. We expect that any underwriting agreement or any purchase agreement in Rule 144A distributions will now customarily include a covenant by the issuer or sponsor of a structured finance product to maintain the required Web site and to comply with the arranger obligations under amended Rule 17g-5. Issuers and their sponsors will likely prefer this allocation of responsibility as they will have an enhanced interest in controlling the disclosure of information for credit rating purposes. In certain circumstances, however, it may be preferable for investment banks to manage the Web site, based on their knowledge of and experience with market practices. If the issuer or sponsor asks the underwriters to take on this responsibility, we would expect it would be carried out under a contractual agency arrangement or a sub-contract, with primary responsibility remaining with the issuer or sponsor.

#### *Arranger’s Written Representation to the NRSRO*

Any NRSRO that is hired to rate a structured finance product must obtain a written representation<sup>4</sup> that the arranger will:

- make the information it provides to hired NRSROs available to other qualifying NRSROs on an identified password-protected Web site, whether the information was provided for the purpose of determining an initial rating or for monitoring a rating;
- post that information on the arranger’s Web site at the same time it is given to the hired NRSRO, whether it be new or updated information; and
- present the information in a manner that indicates to other NRSROs accessing the Web site which information should be relied on to determine or monitor the credit rating, thereby assuring that all NRSROs are using the correct information when determining a credit rating.<sup>5</sup>

#### *Information Required to be Disclosed*

Arrangers are required to post on the Web site “all information” that the arranger provides to the hired NRSRO for the purpose of determining an initial credit rating or for credit rating surveillance. During the comment period prior to the adoption of the amended rule, the Commission considered but ultimately decided not to include a provision that would have required an arranger to represent that it would not provide any information to the hired NRSRO that was “material” without also posting that information on the arranger’s Web site. Instead, the Commission chose to require that “all information” that the arranger provides to the hired NRSRO must be posted, without a limiting standard of materiality.

Certain kinds of information are mentioned in the amended rule as examples of the kind of information that should be posted on the arranger’s Web site if such information is provided to hired NRSROs. For example, if information about “the characteristics of the assets” underlying or referenced by a security and the legal structure of the security is provided to a hired NRSRO by an arranger in connection with an initial credit rating for a security, then such information should be posted. Similarly, for an ongoing rating, if an arranger provides information about “the characteristics and performance of the assets” underlying or referenced by a security to a hired NRSRO, then such information should be posted.<sup>6</sup>

The amended rule also requires that information provided to the hired NRSRO by contractual third parties, such as trustees or loan servicers, should be included on the arranger’s Web site. The amended rule therefore encompasses all information that an issuer, sponsor or underwriter provides to the hired NRSRO either directly or by contracting with a third party.<sup>7</sup> In summary, all information relevant to an initial rating or rating surveillance that was provided to a hired NRSRO should be posted on the arranger’s Web site.

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*Method of Providing Information*

The Commission considered but decided not to require arrangers to provide information to hired NRSROs and other NRSROs in the same manner.<sup>8</sup> For example, the amended rule does not prohibit arrangers from delivering written materials directly to hired NRSROs while posting that same material on their Web sites for other NRSROs to access. It also allows arrangers to participate in face to face meetings with hired NRSROs and then post any information that was provided at such meetings on the arranger's Web site for the benefit of other NRSROs.

The amended rule states that when the arranger provides information, in written or oral form, to the hired NRSRO, it must also post that information on its Web site "at the same time" for the benefit of the non-hired NRSROs.<sup>9</sup> The Commission did not provide further guidance as to what would satisfy the "at the same time" requirement, though in the Release the Commission refers to the information being posted on the arranger's Web site "contemporaneously" with the provision of information to the hired NRSRO.<sup>10</sup> If the information is provided in written form, this timing requirement should be relatively straightforward to comply with, as the arranger should be able to provide the information to the hired NRSRO and post to the Web site contemporaneously. A potential timing issue arises with oral communications with hired NRSROs, particularly if the communications are not previously scheduled. In such situations, we expect that the acceptable market practice may be to emulate the requirements established by Regulation FD for disclosure of material nonpublic information. Thus, arrangers would post the relevant information "promptly" after disclosure, meaning "as soon as reasonably practicable" but no later than 24 hours thereafter.<sup>11</sup>

In order to assure compliance with the amended rule, arrangers may need to adjust their method of providing information to hired NRSROs. Oral communications, for example, may need to be accompanied by some form of written record that can be posted to and accessed on the arranger's Web site. The Commission referenced one commenter who argued that the proposed rules would cause a "chilling effect" on oral communications between arrangers and hired NRSROs. The Commission responded by recognizing that while the process of information exchange from the arranger to the NRSRO would likely be formalized and that written information would likely replace oral communications, the results of a more formal process would mean greater accuracy and the creation of a better record which would lead to more transparency in the credit rating process.<sup>12</sup>

Although there is a requirement that the arranger's Web site indicate which information should be relied upon at any given time for purposes of rating the relevant security,<sup>13</sup> there is no indication in the amended rule as to when information need no longer be provided. The Commission has indicated that if a rating process ceases prior to a rating being issued, information need no longer be provided.<sup>14</sup> Otherwise, we believe the information will need to be maintained as long as any hired NRSRO continues to maintain a rating and the arranger continues to provide information to any hired NRSRO.

Another issue that arrangers will face will be to determine which historical information to post to the Web site. It may be that a rating will depend in part on information previously provided to a hired NRSRO in connection with the rating of a previously-issued security of the same sponsor. The amended rule, however, does not seem to contemplate any information provided to the NRSRO prior to the request for the initial rating.<sup>15</sup> It would seem, however, that if information is necessary to provide the rating it should be made available to the non-hired NRSROs through the arranger's Web site. There is no clear answer on how far back such information would need to be provided.

An issue arises as to what it means to post "all information" that has been provided to a hired NRSRO. Does this mean any communication must be at least summarized and put on the Web site? We believe that this result would not be reasonable. The goal is to place the NRSROs on an even playing field. To some degree, this question may be answered by reference to the disclosure requirements contained in Regulation FD for U.S. publicly reporting issuers. An issuer of a structured finance product should determine if information provided in written form to, or in oral communications with, a hired NRSRO contains any new or updated information. If so, then the information needs to be contemporaneously posted on the Web site. Mere explanations of information previously provided to a hired NRSRO would not, in our view, need to be posted to the Web site. Thus, many calls with the NRSRO during the rating process may not provide new information. However, as a general rule, any memoranda or other written responses should be posted to assure compliance,

and arrangers will need to maintain records of communications with NRSROs to evidence their efforts to determine whether new information has been supplied. As the requirement reaches to third parties, contacts between an arranger's counsel and a hired NRSRO will need to be monitored, and such counsel will need to provide the arranger with information about all such contacts.

#### *Non-Hired NRSRO Certification Requirements*

Under amended Rule 17g-5, each NRSRO not hired by an arranger that desires to access information on new ratings in process at other NRSRO Web sites and the related information provided by arrangers to hired NRSROs must annually execute and furnish to the Commission a certification that states that, among other things:

- it will access the relevant Web sites solely for the purpose of determining or monitoring credit ratings;
- it will keep the information it accesses confidential and treat it as material nonpublic information;
- it will determine and maintain credit ratings for at least 10% of the issued securities and money market instruments for which it accesses information if it accesses such information for 10 or more issued securities or money market instruments in the calendar year covered by the certification; and
- either (1) the number of issued securities and money market instruments for which it accessed information in the most recent calendar year and the number of such securities or money market instruments for which it determined and maintained credit ratings or (2) that it did not access information on any such securities in such year.<sup>16</sup>

The Commission considers the certification sufficient for assuring confidentiality by non-hired NRSROs and has placed the burden on the arranger to prevent the misuse of its information. The Commission suggested that arrangers could interpose a confidentiality agreement requirement as a protection to the arranger prior to providing information so that there is privity of contract with the non-hired NRSRO. The Release suggests that this could be done through a window (a click-through screen) on the password-protected Web site, which would require the non-hired NRSRO, after entering its password to gain access to the Web site, to click "Agree" before being able to access the information.<sup>17</sup>

#### **To Which Securities Do the New Rules Apply?**

In comments to the proposed rule, the Commission was asked to limit the scope of the amended rule to securities meeting the definition of "asset-backed securities" under Regulation AB or, if not, to be more specific about its scope. The Commission specifically declined to limit the scope of the amended rule to such definition, and declined to provide a definitive definition. The Release states that the Commission intends the amended rule "to cover the full range of structured finance products, including but not limited to securities collateralized by static and actively managed pools of loans and receivables."<sup>18</sup> Further, we believe that the Commission intended the amended rule to apply to securities that are registered with the Commission as well as those that are offered in reliance on an exemption from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"), such as in a private placement or an offering pursuant to Rule 144A or Regulation S.

Although ordinary mortgage-backed securities, credit card receivable transactions and lease receivable securitizations where payment depends generally on a diversified portfolio of financial assets are clearly covered by amended Rule 17g-5, there are hybrid structures that may require clarification. Although there have been questions raised, asset-backed commercial paper programs that are new after June 2, 2010 would likely be covered. However, it is unclear whether the Commission envisioned including within the amended rule "enhanced" equipment note pass through certificates ("EETC Certificates"), which are customarily issued to raise funds for a single corporate credit. In informal advice, the Commission staff has in the past indicated that EETC Certificates supported by notes of a single corporate entity are not within the purview of Regulation AB. As indicated above, this would not necessarily be determinative as to whether amended Rule 17g-5 applies.

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In our view, EETC Certificates should be treated as a corporate secured bond and not as a security backed by an asset pool or an asset-backed security. We base our view in part on the approach taken by the staff of the Commission in the American Airlines, Inc. no action letter dated July 28, 1987,<sup>19</sup> where the Commission agreed that the sole “issuer” for purposes of the Securities Act, the Exchange Act and the Trust Indenture Act of 1939 in EETC Certificate transactions is the airline obligor on the underlying equipment notes. We believe that the types of information to be maintained on a Web site under amended Rule 17g-5 are all directed to structure or asset performance, which are quantitative and objective kinds of information. Making this information available to non-hired NRSROs puts them on an equal footing to rate the particular security. EETC Certificates, however, are essentially corporate credits, as the underlying notes supporting the securities are wholly dependent on repayment by the company sponsoring the EETC Certificates issuance. Therefore the information to determine an appropriate rating for EETC Certificates is more extensive than just structural information, and includes the kind of “soft” and more subjective evaluations that go into a corporate credit rating. Though not clear in the Release, we believe the better view would be that amended Rule 17g-5 should not apply to EETC Certificates “issued” by a single company obligor.

### **Conclusion**

Issuers, sponsors and underwriters of structured finance products will need to develop procedures to comply with the representations that they will be required to make to NRSROs so that the NRSROs can comply with amended Rule 17g-5. As a result of the amendments, these structured finance market participants have a heightened responsibility to make certain that NRSROs with access to the password-protected Web site have the same base of information as hired NRSROs. Also, for any security secured by assets or cash flows from assets that is primarily the obligation of one obligor or relatively few obligors, a determination will need to be made as to whether or not the security is covered by amended Rule 17g-5.

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<sup>1</sup> Release No. 34-61050; File No. S7-04-09; 74 Fed. Reg. 63832 (December 4, 2009). <http://www.sec.gov/rules/final/2009/34-61050fr.pdf>.

<sup>2</sup> The Release does not address whether the rule will apply to ratings where a written agreement providing for a rating by an NRSRO was executed prior to June 2, 2010 but the rating is issued after that date. Some commentators have suggested that since the rule sets forth requirements for a contract with an NRSRO, and the contract will be in place prior to June 2, 2010, the rule should not apply even if the securities are issued after June 2, 2010. However, an amended contract could be put in place, and any contract after the issuance of amended Rule 17g-5 but prior to effectiveness of the rule could contemplate compliance on and after June 2, 2010. The rule was issued with long advance time prior to its effectiveness. Another view would be that amended Rule 17g-5 should apply to the largest number of issuers possible, and issuers will have had a number of months to prepare for complying with the rule, if only on and after June 2, 2010. It is also unclear whether all communications with the NRSROs that occurred prior to June 2, 2010 would need to be posted or just those communications commencing on and after June 2, 2010. We understand that the staff of the Commission will be addressing the transition issue shortly.

<sup>3</sup> Release, p. 63851. The Commission rationalized the heightened set of conflict rules for structured finance products by stating that it believes that certain arrangers are sources of frequent, repeated deal-based revenue and therefore have an ability to exert undue influence on NRSROs. The Release contrasts such arrangers with “a corporate issuer that may bring far less ratings business to the NRSRO.” Release, p. 63844.

<sup>4</sup> Rule 17g-5(a)(iii). The Commission adopted language to provide for written representations to ensure that the process would be formally documented and executed. Release, p. 63847.

<sup>5</sup> Rule 17g-5(a)(iii). Release, p. 63846-7.

<sup>6</sup> Release, p. 63846-7.

<sup>7</sup> Release, p. 63848.

<sup>8</sup> Release, p. 63848.

<sup>9</sup> The Commission has also amended Regulation FD to accommodate the information disclosure program and permit the disclosure of material, non-public information to an NRSRO that has not been hired by the arranger, solely for the purpose of allowing the NRSRO to determine or monitor a credit rating, irrespective of whether the NRSRO makes its ratings publicly available. Release, p. 63850.

<sup>10</sup> Release, p. 63847.

<sup>11</sup> 17 CFR § 243.101(d).

<sup>12</sup> Release, p. 63847.

<sup>13</sup> *Id.*

<sup>14</sup> Release, p. 63846.

<sup>15</sup> Release, p. 63847.

<sup>16</sup> Rule 17g-5(e). The purpose of the 10% benchmark is to ensure that non-hired NRSROs are indeed determining credit ratings when accessing arrangers’ Web sites. Release, p. 63848-9.

<sup>17</sup> Release, p. 63849.

<sup>18</sup> Release, p. 63844. Specific examples cited by the Commission include collateralized debt obligations, collateralized loan obligations, collateralized mortgage obligations, structured investment vehicles, synthetic collateralized debt obligations that reference debt securities or indexes, and hybrid collateralized debt obligations. *Id.*

<sup>19</sup> 1987 SEC No-Act. LEXIS 2373.

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