KIRKLAND & ELLIS LLP

KIRKLAND ALERT

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The SEC's "Arranger-Paid Rule" for Ratings of Structured Finance Products:

Arrangers Will Be Held to a "Hire" Standard

The SEC has adopted a new set of provisions that will indirectly, but dramatically, burden sponsors of structured finance products. These requirements, the "Arranger-Paid Rule," will require a sponsor seeking a rating on or after June 2, 2010, to post to a Web site all information provided for the purpose of obtaining that rating.

Overview. The SEC's Rule 17g-5 under the Securities Exchange Act of 1934 addresses conflicts of interest that the SEC believes affect debt ratings issued by nationally recognized statistical rating organizations, or ***NRSROs.***[1] Rule 17g-5, which we call the **Ratings Conflict Rule**, identifies potential conflicts and specifies how those conflicts are to be managed. Some conflicts are simply prohibited, such as the ownership by a rating agency employee of securities of an issuer for whom the employee has responsibility. Other conflicts are permitted so long as the NRSRO makes suitable disclosure in SEC filings or manages the conflict appropriately.

The Ratings Conflict Rule generally applies to all debt ratings issued by NRSROs—corporate bonds, municipal securities, asset-backed securities and mortgage-backed securities. The SEC had identified eight different conflicts for which it provided various rules.

Late last year, the SEC adopted amendments to the Ratings Conflict Rule and to another rule governing the conduct of NRSROs (SEC Rel. No. 34-61050 (Nov. 23, 2009)), in the release that we call the **Adopting Release**. The amendments to the Ratings Conflict Rule relate to a "new" conflict that the SEC identified, which occurs by virtue of an NRSRO:

> *[i]ssuing or maintaining a credit rating for a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction that was paid for by the issuer, sponsor, or underwriter of the security or money market instrument.*

The SEC collectively refers to issuers, sponsors and underwriters as ***arrangers***, so we call this new set of provisions the **Arranger-Paid Rule**. We refer to an NRSRO hired by an arranger as a **Hired NRSRO**.

The Arranger-Paid Rule became effective as of February 1, 2010, although it has a compliance date of June 2, 2010. Arrangers intending to obtain a credit rating on a structured finance product after June 2, 2010, need to prepare to comply with the Arranger-Paid Rule by June 2.

Hired NRSRO To Maintain Password-Protected Web site. The Arranger-Paid Rule imposes additional disclosure requirements on Hired NRSROs and arrangers. New clause (a)(3)(i) requires each NRSRO to maintain a password-protected Web site containing a list of each structured finance security or money market instrument for which it is *currently in the process of determining an initial credit rating* as a Hired NRSRO. This list must identify the type of security or money market instrument, the name of the issuer, the date the rating process was initiated and the Web site address where the issuer, sponsor or underwriter of the security represents that certain information regarding the securities (as described below) can be found. New clause (a)(3)(ii) requires the Hired NRSRO to provide unlimited access to its Web site to any non-Hired NRSRO that provides a copy of the qualifying annual certification described in FAQ 12 below.

Arranger To Maintain Password-Protected Web site. New clause (a)(3)(iii) requires each Hired NRSRO to obtain from the arranger of a structured finance product a *written representation that can reasonably be relied upon* by the Hired NRSRO that the arranger will:

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[1] Italicized language in this *Kirkland Alert* is terminology taken directly from the Adopting Release.

(a) maintain the information described in subparagraphs (c) and (d) below at an identified password-protected Web site that presents the information in a manner indicating which information currently should be relied on to determine or monitor the credit rating;

(b) provide access to the Web site during each calendar year to any non-Hired NRSRO that provides its qualifying annual certification for that year;

(c) post on the Web site *all information* that the issuer, sponsor or underwriter provides to the Hired NRSRO, or contracts with a third party to provide to the Hired NRSRO, *for the purpose of determining the initial credit rating* for the security, including information about the characteristics of the assets underlying or referenced by the security and the legal structure of the security, at the same time the information is provided to the Hired NRSRO; and

(d) post on the Web site *all information* the issuer, sponsor or underwriter provides to the Hired NRSRO, or contracts with a third party to provide to the Hired NRSRO, *for the purpose of undertaking credit rating surveillance* on the security, including information about the characteristics and performance of the assets underlying or referenced by the security, at the same time the information is provided to the Hired NRSRO.

Frequently Asked Questions. The Arranger-Paid Rule leaves many questions unanswered and certain terms open to interpretation. Here are our thoughts on some frequently asked questions:

(1) What is the purpose of these amendments? The Arranger-Paid Rule was designed to further the purposes of the Credit Rating Agency Reform Act of 2006, which directed the SEC to establish a registration and oversight program for NRSROs. The goal of that Act was to "improve ratings quality for the protection of investors and in the public interest of fostering accountability, transparency and competition in the credit rating industry."

The SEC's primary goal in adopting the Arranger-Paid Rule is to promote issuance of credit ratings by non-Hired NRSROs, thereby giving users of credit ratings more views on the creditworthiness of the security. Another goal is to reduce the ability of arrangers with repeat ratings business to influence Hired NRSROs into assigning better than warranted ratings. By providing non-Hired NRSROs with access to the information provided to the Hired NRSROs, the SEC expects that non-Hired NRSROs will issue additional (and uninfluenced) ratings. That's the theory, anyway. We've heard that the major rating agencies generally do not intend to issue unsolicited ratings, except perhaps when they believe their views are not being expressed on particular issues.

(2) What structured finance products are covered by the Arranger-Paid Rule? The Adopting Release specifies that the Arranger-Paid Rule:

> *cover[s] the full range of structured finance products, including, but not limited to, securities collateralized by static and actively managed pools of loans or receivables (e.g., commercial and residential mortgages, corporate loans, auto loans, education loans, credit card receivables, and leases), collateralized debt obligations, collateralized loan obligations, collateralized mortgage obligations, structured investment vehicles, synthetic collateralized debt obligations that reference debt securities or indexes, and hybrid collateralized debt obligations*.

The scope statement reads like the SEC's laundry list, covering every asset class and structure that the SEC staff could identify (or which had been the subject of negative headlines of late). Moreover, the Arranger-Paid Rule does not carve out securities or transactions exempt from the registration requirements, privately placed securities or resales pursuant to Rule 144A. But legitimate questions can still be raised about the scope of this rule. For example, what of credit-linked notes that reference a corporate obligor but are secured by a pool of assets? Or catastrophe bonds, also backed by a pool of assets, where the payout is tied to the (non) occurrence of a weather event?

The biggest scope question, we think, is whether or how the Arranger-Paid Rule applies to interests in pools or securities sold to conduits issuing asset-backed commercial paper, or **ABCP**, and to the ABCP itself. In classic ABCP deals, a conduit acquires interests in unrated—but credit-enhanced—pools of receivables, which it finances by issuing ABCP. The ABCP rating has often initially been obtained years, or even decades, earlier, and is based on the strength of the conduit's liquidity, its program credit enhancement and the enhancement of the individual pools. If an unrated pool of receivables is added after June 2 to an ABCP conduit

that obtained its ratings prior to June 2, an excellent argument can be made that the arranger of the pool should not be subjected to the Arranger-Paid Rule, even if the conduit has its ratings affirmed by Hired NRSROs for the purpose of funding that pool. We think most market participants have become comfortable with this reading of the rule.

However, as a result of the current regulatory regime for risk based capital, many U.S. banks have been moving in the direction of asking sponsors to obtain express ratings on the interests in assets they are funding through the conduits administered by these U.S. banks. In that case, there seems little doubt that the Arranger-Paid Rule will apply directly to the ratings sought for the interests in the sponsor's pool.

(3) Does the Arranger-Paid Rule apply to securities issued and initially rated before June 2, 2010? Does the rule apply to securities for which a Hired NRSRO was engaged before June 2, 2010, but for which it does not issue the initial rating until after that date? Due to some sloppy drafting by the SEC, it is possible to read the Arranger-Paid Rule to apply to securities for which an initial credit rating was obtained from a Hired NRSRO prior to June 2, 2010, but for which an arranger is providing information to the Hired NRSRO on or after June 2 for the purpose of credit rating surveillance.

The interpretive difficulty arises because the subject of the clause that requires arrangers to maintain a Web site, is "such security"—and the correct antecedent reference is unclear. We think the far better reading is that the correct reference is to securities for which initial ratings were issued on or after June 2, 2010. Otherwise, the Arranger-Paid Rule would apply to an enormous universe of previously issued ratings.

On the question of whether the rule applies to ratings that are "in process" on June 2, 2010, but are not initially issued until after that date, the text of the rule and the Adopting Release provide essentially no guidance. The Arranger-Paid Rule has a "compliance date" of June 2, but there is no guidance as to the meaning of that term.

Ultimately, the burden probably falls on Hired NRSROs to reach determinations on these issues, because it is the Hired NRSRO who cannot issue a rating unless it has obtained the necessary representation in the appropriate circumstances.

(4) When is a Hired NRSRO obligated to list a security being rated? A Hired NRSRO's obligation to list an issuer and security on its Web site arises when the NRSRO starts the process of determining an initial credit rating. At that point, the NRSRO needs to list the security on its Web site and obtain the arranger's representation regarding the posting of information on the arranger's Web site. We expect that each Hired NRSRO will, immediately upon being notified of a new ratings assignment, present each arranger with a form request for a written representation in compliance with the rule. We would further expect that Hired NRSROs would not accept information from arrangers unless and until the Hired NRSRO has received the requisite representation.

(5) What information must be made available on the arranger's Web site and how long must it remain on the Web site? An arranger should be prepared to post to its Web site *all information* that is provided by the arranger, or by a third party with whom the arranger has contracted, to the Hired NRSRO *for the purpose of determining the initial credit rating or undertaking credit rating surveillance*. So a sponsor or issuer will need to be aware of any information provided by its underwriters to the Hired NRSRO (and consider adding representations to that effect in the underwriting agreement). The text of the Arranger-Paid Rule does not provide any gloss on the meaning of *all information*.

Arrangers need to recognize the breadth of the rule: *all information* would seem to include not just factual and statistical information regarding assets of the securitized pool, previously securitized pools, information about the transaction structure and rating agency presentation materials. It would also seem to include certifications, assessments with compliance and other reports of the servicer, trustees or accountants, e-mail correspondence with the Hired NRSRO and drafts and final copies of disclosure and operative documents, opinions and ancillary documents. Although an arranger could deliver information directly to Hired NRSROs while separately posting it to the arranger Web site, we think the likely practice will be to post the information to the Web site for review by both Hired NRSROs and non-Hired NRSROs.

The arranger will need to make this information available on its Web site for the life of the security (i.e., for so long as the arranger provides to the Hired NRSRO information for the purpose of undertaking credit rating surveillance). The arranger must present the infor-

mation in a manner indicating which information currently is operative for the purpose of determining the credit rating.

(6) Does "all information" include oral information? The answer to this question is of utmost importance to many market participants. A favorable resolution (that is, a conclusion that oral information is not covered) would remove what seems to be the biggest practical issue to implementation of the Arranger-Paid Rule. We think that market participants would agree that the great bulk of information provided for the purpose of determining ratings or enabling surveillance is delivered in writing; oral communications in the ordinary course tend to be used to confirm interpretations and clear up ambiguities, rather than to convey material new information.

We understand that the major NRSROs are not convinced that the information required to be posted includes oral information. Arrangers, for their part, would very much like to avoid having to post oral information in some form, as the effort required would be substantial compared to any benefit that might be derived. However, some market participants seem to have concluded that the Arranger-Paid Rule does cover oral information, and that the only realistic way to comply is to move entirely to submission of written information to NRSROs.

The SEC has provided the market with a confusing array of provisions. The February 2009 re-proposing release for the Arranger-Paid Rule stated outright that oral information would not be covered, and nothing in the Adopting Release expressly contradicted that position. But the plain language of the Arranger-Paid Rule—*all information*—could certainly be read to include oral information. Further, the SEC said in the Adopting Release:

> *The Commission acknowledges that the requirements of paragraph (a)(3) of Rule 17g-5 as a whole likely will formalize the process of information exchange from the arranger to the NRSRO for structured finance products, including the written submission of information that may, in the past, have been provided orally.*

However, other language in the Adopting Release can be construed to mean that the SEC believes that oral information is not necessarily included in what is required to be placed on the Web site. For example, just after the language quoted above, the SEC went on to note that, if practice were to change to create more written disclosures, it would mean that an NRSRO analyst could rely more often on the written record and less often on his or her notes or memory regarding oral disclosures. But if the SEC intended to require disclosure of all oral information on the Web site, it should not have made that reference to notes or memory—instead, it should have referenced the required disclosure by the arranger of the oral information.

It is also worth noting that the Securities Act of 1933 makes significant distinctions between written disclosures and oral disclosures in terms of filing requirements; oral disclosures generally do not need to be filed. A differentiation of the rules for written and oral information in the Arranger-Paid Rule would be quite consistent with the approach under the Securities Act.

In putting all of these interpretive and policy considerations together, we think a reasonable basis exists for an arranger to take the position that oral information delivered in the ordinary course described above is not required to be provided on the arranger's Web site. But our view is not universally held, and this issue is presently causing great consternation in the market. If market participants do not come to a consensus, or if the view prevails that all oral communications must be filed, then it would seem appropriate for the American Securitization Forum or another group to approach the SEC with an interpretive request.

(7) If an arranger engages multiple Hired NRSROs that each request different information, what information should be posted by the arranger to its Web site? The arranger will need to make available on its Web site any information it provides to any Hired NRSRO for the purpose of determining the initial credit rating or undertaking credit rating surveillance.

(8) Other than posting the information described above to its Web site, is an arranger required to provide additional information to a non-Hired NRSRO or answer a non-Hired NRSRO's questions? No. An arranger is not required to provide information in addition to the information provided to the Hired NRSRO or to respond to any questions from a Non-Hired NRSRO.

(9) Does the SEC provide guidance on when information is provided "for the purpose of determining" the initial credit rating or undertaking credit rating surveillance? No. The Adopting Release does not define the scope of the information that an arranger will

need to post to its Web site. Arrangers with multiple relationships with a Hired NRSRO—such as the rating of both arranger-sponsored ABS and the arranger's corporate debt—will need to determine what information is provided to the Hired NRSRO for the purpose of the credit rating on a structured finance product and what information is provided for another reason. Arrangers need to understand how the Hired NRSRO will use and rely upon the information provided.

An arranger might wonder if it could restrict the use of information provided to the Hired NRSRO by inserting in the engagement letter disclaimers or prohibitions on reliance upon types of information (for example, oral communications) or expressing those disclaimers/prohibitions before providing information to the Hired NRSRO. We would expect Hired NRSROs to resist that type of limitation; if an arranger were to persist, the result might well be the advent of litigation-style discovery processes.

(10) Is there an enforcement mechanism against the arranger for a failure to maintain or post the required information to its Web site? If the arranger breaches its representation to the Hired NRSRO, what are the consequences? The SEC makes clear in the Adopting Release that the Hired NRSRO is not required to enforce the arranger's compliance. Nonetheless, the Arranger-Paid Rule indirectly places the burden of enforcement on the Hired NRSRO. In order to issue its credit rating, the Hired NRSRO must be able to reasonably rely upon the arranger's representation. The question of whether a Hired NRSRO's reliance is reasonable will depend on the facts and circumstances; the Adopting Release says that relevant factors would include: (1) ongoing or prior failures by the arranger to adhere to its representations; or (2) a pattern of conduct by the arranger where it fails to promptly correct breaches of its representations. If the Hired NRSRO has knowledge of a prior breach or is aware of other facts that make its reliance on the representation not reasonable, the Hired NRSRO should not issue a future credit rating.

Also, sponsors and issuers should expect representations related to complying with the Arranger-Paid Rule and indemnification of the underwriters to be included in the underwriting agreement.

(11) How long must the NRSROs maintain a list of securities for which it is in the process of determining an initial rating? The Hired NRSRO can remove from its Web site information about the issuer and the security upon publication of the initial rating. A Hired NRSRO may also remove the information if the arranger decides to terminate the ratings process before an initial rating is published.

(12) What does a non-Hired NRSRO need to do to gain access to the Hired NRSRO's or the arranger's Web site? Not much, in the short term, and not much more, in the longer term. New clause (e) of the Ratings Conflict Rule requires a non-Hired NRSRO to provide the Hired NRSRO and arranger a copy of a certification, which we call a **qualifying annual certification**, provided by the non-Hired NRSRO to the SEC that the non-Hired NRSRO has either (1) determined and maintained credit ratings for at least 10 percent of the issued securities for which it accessed information in the calendar year prior to the year covered by the certification, if it accessed the information for 10 or more issued securities; or (2) has not accessed information 10 or more times in the calendar year prior to the year covered by the certification. The qualifying annual certification includes a statement that the non-Hired NRSRO is using the information *solely for purposes of determining or monitoring credit ratings* and that it will *keep the information it accesses … confidential and treat it as material nonpublic information subject to its written policies and procedures.*

The non-Hired NRSRO must provide this certification for each calendar year in which it seeks access to a Hired NRSRO's or arranger's Web site. For 2010, this certification is meaningless, because there were no Web sites to access for this purpose in 2009. For 2011 and beyond, the qualifying annual certification has somewhat more bite, as the NRSRO must publish ratings for at least 10 percent of the securities for which it accesses Web sites as a non-Hired NRSRO.

(13) Does the Arranger-Paid Rule require that a non-Hired NRSRO keep information posted to an arranger's Web site confidential? The Arranger-Paid Rule requires a non-Hired NRSRO to certify to the SEC that it will keep information confidential. But the Arranger-Paid rule does not require the non-Hired NRSRO to make this certification to the arranger. The Adopting Release states that the Arranger-Paid Rule "will not prevent the arranger from employing a simple process requiring non-[H]ired NRSROs to agree to keep the information they obtain from the arranger confidential, provided that such a process does not operate

to preclude, discourage, or significantly impede non-[H]ired NRSROs' access to the information, or their ability to issue a credit rating based on the information." Arrangers should consider adding a simple confidentiality agreement in a click-through screen on their Web site that appears before the non-Hired NRSRO gains access to the information. Arrangers can also enter into written confidentiality agreements with each non-Hired NRSRO, but this may prove administratively burdensome and prolonged negotiations may be seen as precluding, discouraging or significantly impeding the non-Hired NRSRO's access. Impeding a non-Hired NRSRO's access may prevent a Hired NRSRO from being able to reasonably rely on the arranger's representations, thereby preventing the Hired NRSRO from issuing or maintaining its rating.

The SEC also adopted an amendment to Regulation FD to permit disclosure of material, non-public information to an NRSRO solely for the purpose of determining or monitoring a credit rating pursuant to the Arranger-Paid Rule.

(14) As among a sponsor, an issuer and an underwriter, who is responsible for establishing and maintaining the "arranger Web site?" The SEC does not specify, so it is up to the transaction participants to make this determination. May we suggest a quick game of "Rock, Paper, Scissors" at the outset of each transaction? Okay, we doubt the investment banks would be authorized to play that game.

The burden, no doubt, will fall to the sponsor to make these arrangements. The sponsor could establish its own Web site. In addition, we understand that several third party service providers are putting together platforms to host these Web sites for sponsors (or the occasional underwriter!).

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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