Clients&FriendsMemo

U.S. Department of Labor Proposes New Criteria for Which Entities Would Qualify as "Rating Agencies" in Connection with the Underwriter Exemptions

January 8, 2013

Introduction

On December 28, 2012, the U.S. Department of Labor (the "**DOL**") published a proposed amendment to the so-called "Underwriter Exemptions,"[1] which provide relief from certain of the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**"). The Underwriter Exemptions are a group of individual prohibited transaction exemptions ("**PTEs**") and EXPRO final authorizations that permit employee benefit plans subject to ERISA or Section 4975 of the Internal Revenue Code ("**Plans**") to, among other things, purchase certain securities representing interests in asset-backed or mortgage-backed investment pools. This relief is subject to several conditions, including that such securities be rated in one of the three[2] highest rating categories by one of a defined set of credit rating agencies (each a "**Rating Agency**"). The DOL's proposed amendment would revise the definition of "Rating Agency" in the Underwriter Exemptions to remove any references to specific agencies, and to instead provide a set of self-executing criteria that an agency must meet in order to be considered a Rating Agency.

The proposed new criteria would be effective for purchases of securities by Plans on or after the date of publication of the final amendment, although the DOL indicated that relief would also apply "prospectively" to previously issued securities rated by agencies that later qualify under the proposed criteria, as discussed further below.

Background

The definition of "Rating Agency" currently used in the Underwriter Exemptions references the following agencies: Standard & Poor's Rating Services ("**S&P**"); Moody's Investor Services, Inc.

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1 77 Fed. Reg. 76773. The proposal contains a list of the individual exemptions that would be amended.

2 In the case of a "Designated Transaction," securities rated in one of the four highest rating categories may qualify under the Underwriter Exemptions. *Id*., at 76774. Securitizations of commercial or residential mortgage loans are "Designated Transactions."

("**Moody's**"); Fitch Inc.; DBRS Limited; and DBRS, Inc. The DOL last revised this list in 2007, when PTE 2007-05 amended the existing Underwriter Exemptions to include DBRS Limited and DBRS, Inc. as Rating Agencies. In adopting that amendment, the DOL noted that expanding the list of Rating Agencies would provide Plan investors with broader access to information, and would increase the competition among credit rating agencies to provide more accurate and timely ratings.

In the aftermath of the recent financial crisis, additional credit ratings agencies entered the market. The Dodd-Frank Wall Street Reform and Consumer Protection Act created new requirements for credit rating agencies designated as, or applying for designation as, a nationally recognized statistical ratings organization ("**NRSRO**") with the Securities and Exchange Commission ("**SEC**"), including that NRSROs be subject to more stringent regulatory oversight.

In proposing this amendment to the Underwriter Exemptions, the DOL acknowledged letters suggesting that the definition of "Rating Agency" be further revised to include additional NRSROs. These letters argued, much as the DOL stated in 2007, that increasing the number of NRSROs qualified to provide ratings under the Underwriter Exemptions would broaden investor choice and promote greater accountability of rating agencies to investors.[3] To address these concerns, and to account for the regulatory developments surrounding credit rating agencies, the DOL's proposed amendment would eliminate the specific list of agencies currently set forth in the Underwriter Exemptions and replace the definition of Rating Agency with a set of self-executing criteria.

Proposed Change to Definition of Rating Agency

The proposed amendment would replace the current definition of "Rating Agency" in the Underwriter Exemptions with the requirement that a Rating Agency:

> (i) be currently recognized by the SEC as an NRSRO;
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> (ii) has indicated on its most recently filed SEC Form NRSRO that it rates "issuers of asset-backed securities"; and
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> (iii) has had at least 3 "qualified ratings engagements" within the 12 months preceding the transaction.

As used in (iii) above, a "qualified ratings engagement" is one (a) requested by an issuer or underwriter of securities in connection with the initial offering of the securities; (b) for which the

[3] 77 Fed. Reg., at 76775.

credit rating agency is compensated for providing ratings; (c) which is a public rating;[4] and (d) which involves the offering of securities of the type that would be granted relief by the Underwriter Exemptions.

Impact

New Agencies. To the best of our knowledge, the credit rating agencies that would newly qualify as Rating Agencies under the proposed definition are Kroll Bond Rating Agency ("**Kroll**") and Morningstar, Inc. The DOL expressed its understanding that agencies specifically identified in the existing Underwriter Exemptions would continue to meet the definition of "Rating Agency" under the proposed amendment. Therefore, should the amendment be adopted as proposed, the definition of Rating Agency should encompass the following firms:

- S&P
- Moody's
- Fitch
- Kroll
- Morningstar, Inc.
- DBRS Limited *and*
- DBRS, Inc.

As the Rating Agency criteria will be self-executing, this list would be subject to change without additional action by the DOL. Plan fiduciaries will be responsible for confirming that any rating for a security acquired pursuant to the Underwriter Exemptions was issued by an agency qualifying under the final criteria. For these purposes, fiduciaries will be able to rely on representations by a credit rating agency that it meets these criteria.

Prospective Relief. The relief provided by the amended Rating Agency definition would apply prospectively to previously issued securities rated by any credit rating agency that qualifies as a Rating Agency, *even if* the rating was issued before the later of (i) the publication of the final amendment or (ii) the credit rating agency qualifying as a Rating Agency. Therefore, Plans relying on the amended Underwriter Exemptions to purchase securities rated by a Rating Agency will *not* need to consider when a particular security was issued or rated, or when the relevant Rating Agency qualified as such under the new definition.

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[4] While the amendment provides no guidance as to the meaning of the term "public rating," it is our understanding that the term means that the rating is generally available to the market. One hopes that the final exemption will provide a more precise definition.

Scope. The proposed revisions to "Rating Agency" apply solely to the term as it is used in the Underwriter Exemptions. Other DOL exemptions, including the similar exemptions providing relief for credit card securitizations and the group of exemptions known as the "Underwriting Syndicate Exemptions,"[5] also currently reference specific credit rating agencies. We expect that these exemptions will be amended separately.

Timing

The revisions to the definition of "Rating Agency" discussed in this memorandum will be effective only upon publication of the final amendment. The DOL will accept written comments on the proposed amendment until February 11, 2013.

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If you have any questions regarding the amendment to the Underwriter Exemptions, please contact:

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[5] These exemptions are described on the Employee Benefits Security Administration's website listing of exemptions as "Underwriting Syndicate" exemptions. Other practitioners refer to them as "Affiliate Underwriter Exemptions." The exemptions prescribe conditions under which an asset manager can purchase securities in the primary market for a Plan client when an affiliate of the asset manager has one or more certain specified roles in the transaction (the permissible roles vary depending on the specific exemption).