Clients&FriendsMemo

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

July 30, 2013

Introduction

On July 9, 2013, the U.S. Department of Labor (the **"DOL"**) published an 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 at or above a level[2] prescribed in the Underwriter Exemptions by one of a defined set of credit rating agencies (each a **"Rating Agency"**). The DOL's amendment revises the definition of "Rating Agency" in the Underwriter Exemptions to remove any references to specific agencies, and instead provides a set of self-executing criteria that an agency must meet in order to be considered a Rating Agency. The new definition is effective as of July 9, 2013 for purchases of both newly issued and previously issued securities by Plans.

Background

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

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1 78 Fed. Reg. 41090. The amendment contains a list of the individual exemptions that have been amended.

2 In the case of a "Designated Transaction," which includes securitizations of commercial or residential mortgage loans as well as securitizations of auto loans, securities rated in one of the four highest rating categories may qualify under the Underwriter Exemptions. In the case of other transactions falling under the Underwriter Exemptions, the securities must be rated in one of the three highest rating categories given by a Rating Agency. Id., at 41092.

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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 (**"Dodd-Frank 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. Additionally, section 939A of the Dodd-Frank Act required each Federal agency to review any "regulation" issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument, as well as any references in such regulations regarding credit ratings. The agency would then be required to modify any such regulation to remove any references to, or requirements of reliance on, credit ratings, and to instead substitute in such regulations a standard of credit-worthiness determined to be appropriate by the agency.

On June 21, 2013, the DOL issued a proposed amendment to certain prohibited transaction class exemptions (**"Class Exemptions"**) in accordance with section 939A. In the preamble accompanying the proposal, the DOL indicated its belief that Class Exemptions are "regulations" for purposes of section 939A, and as a result, it was proposing alternative creditworthiness standards, as applicable, for Class Exemptions that referenced the use of credit ratings.

The Underwriter Exemptions, in contrast, are *individual* PTEs, which fall outside the scope of the DOL's interpretation of "regulations," and therefore, outside the scope of section 939A. Accordingly, the Underwriter Exemptions continue to require the use of credit ratings given by a qualified set of Rating Agencies. Nevertheless, to address concerns regarding the limited scope of "Rating Agency," on December 28, 2012, the DOL proposed a separate amendment to the Underwriter Exemptions that would replace the existing definition with a set of self-executing criteria. In proposing this amendment, 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]

Change to Definition of Rating Agency

The final amendment replaces the current definition of "Rating Agency" in the Underwriter Exemptions with the requirement that a Rating Agency:

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

(i) is currently recognized by the SEC as an NRSRO;

(ii) has indicated on its most recently filed SEC Form NRSRO that it rates "issuers of asset-backed securities"; and

(iii) has had, within a period not exceeding 12 months prior to the initial issuance of the securities, at least three "qualified ratings engagements," where a "qualified ratings engagement" is one (i) requested by an issuer or underwriter of securities in connection with the initial offering of the securities; (ii) for which the credit rating agency is compensated for providing ratings; (iii) which is made public to investors generally; and (iv) which involves the offering of securities of the type that would be granted relief by the Underwriter Exemptions.

In response to concerns raised by commenters in connection with the initial proposal, the DOL clarified the following additional points:

- While plan fiduciaries may demonstrate that they have fulfilled their fiduciary responsibilities to the plan by accepting direct representations by credit rating agencies that the Rating Agency criteria have been met, it is also possible for plan fiduciaries, consistent with their duties under section 404 of ERISA, to alternatively rely on material, indirect representations by rating agencies in making such confirmations.
- Once a rating agency qualifies as a Rating Agency as of the initial offering of a securitization transaction, it shall remain qualified as a Rating Agency for purposes of the particular securities issued in that transaction to the extent that the rating agency is still updating its rating of the security.
- While a Rating Agency's rating of securities sold as part of an initial offering may be counted as a "qualified ratings engagement," subsequent updates of the same security by such Rating Agency do not count as a "qualified ratings engagement."
- A rating that is "made public to investors generally" (originally termed a "public rating" in the proposed amendment) excludes ratings available only to a controlled number of investors.[4]

Impact

New Agencies. To the best of our knowledge, the credit rating agencies that newly qualify as Rating Agencies under the amended definition are Kroll Bond Rating Agency **("Kroll")** and Morningstar, Inc. We believe that most but perhaps not all of the agencies specifically identified under the previous definition of "Rating Agency" continue to meet the definition of "Rating Agency" under the new criteria.

[4] The DOL noted that a rating may be made public to investors generally in addition to being set forth in an offering document that is received by a controlled number of participants.

As the Rating Agency criteria is self-executing, this list may be subject to change over time. 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 these criteria. For these purposes, fiduciaries will be able to rely on representations by a credit rating agency that it meets these criteria.

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 became effective upon publication of the final amendment on July 9, 2013.

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[5] These exemptions are described on the Employee Benefit Security Administration's website listing of exemptions as "Underwriting Syndicate" exemptions. Other practitioners refer to them as "Affiliated 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).