

Rule 17g-3: Annual financial reports to be furnished by nationally recognized statistical rating organizations

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SUPPORTING STATEMENT

A. Justification

1. Need For Information Collection

The Credit Rating Agency Reform Act of 2006<sup>1</sup> (“Rating Agency Act”), enacted on September 29, 2006, defines the term “nationally recognized statistical rating organization,” or “NRSRO” and provides authority for the Securities and Exchange Commission (“Commission”) to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies.

The Commission adopted rule amendments that will impose additional requirements on NRSROs in order to address concerns about the integrity of their credit rating procedures and methodologies in light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages.<sup>2</sup>

Rule 17g-3 contains reporting requirements. The collection of information obligations imposed by the rule is mandatory. The requirements of Rule 17g-3, however, apply only to credit rating agencies that are applying to register or are registered with the Commission as NRSROs, and registration is voluntary.

The Rating Agency Act added a new Section 15E, “Registration of Nationally Recognized Statistical Rating Organizations,”<sup>3</sup> to the Securities Exchange Act of 1934 (“Exchange Act”). Exchange Act Section 15E(k) requires an NRSRO to furnish to the Commission, on a confidential basis and at intervals determined by the Commission, such financial statements and information concerning its financial condition that the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.<sup>4</sup>

The proposed amendments to Rule 17g-3 require an NRSRO to furnish a new unaudited annual report to the Commission describing the steps taken by the NRSRO’s designated compliance officer<sup>5</sup> during the fiscal year to fulfill the compliance officer’s

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<sup>1</sup> Pub. L. No. 109-291.

<sup>2</sup> Exchange Act Release No. 59342 (February 2, 2009), 74 FR 6456 (February 9, 2009).

<sup>3</sup> 15 U.S.C. 78o-7.

<sup>4</sup> 15 U.S.C. 78o-7(k).

<sup>5</sup> See 15 U.S.C. 78o-7(j). Section 15E(j) of the Exchange Act requires an NRSRO to “designate an individual responsible for administering the policies and procedures that are required to be established pursuant to [Section 15E(g) and Section 15E(h) of the Exchange Act], and for ensuring compliance with the securities laws and rules and regulations thereunder, including those promulgated by the Commission pursuant to [Section 15E of the Exchange Act].” 15 U.S.C. 78o-7(j).

responsibilities as set forth in Section 15E(j) of the Exchange Act.<sup>6</sup> Pursuant to the proposed amendment to Rule 17g-3(a)(7), an NRSRO would be required to furnish a report to the Commission describing compliance reviews undertaken by the compliance officer during the fiscal year, the number of material compliance matters identified during the reviews and a brief description of each such matter, a description of any remediation measures implemented to address material compliance issues identified, and a description of the persons within the NRSRO who were advised of the results of the reviews.<sup>7</sup>

2. Purpose of, and Consequences of Not Requiring, the Information Collection

The collection of information included in Rule 17g-3 is necessary for Commission oversight of registered NRSROs. Specifically, this collection of information will aid the Commission in determining whether the initiation of a de-registration proceeding under Section 15E(d) of the Exchange Act would be appropriate.

3. Role of Improved Information Technology and Obstacles to Reducing Burden

The requirements of Rule 17g-3 are not designed to collect information through electronic submission. NRSROs will submit the report in paper format.

4. Efforts To Identify Duplication

No duplication is apparent.

5. Effects on Small Entities

Small entities may be affected by Rule 17g-3 because all NRSROs, regardless of size, will be required to submit the reports to the Commission on an annual basis.

6. Consequences of Less Frequent Collection

If this information were not collected as frequently, the Commission would be unable to ascertain, on an ongoing basis, whether a credit rating agency registered as an NRSRO “fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.”<sup>8</sup>

7. Inconsistencies With Guidelines In 5 CFR 1320.5(d)(2)

The collection of information would not be inconsistent with 5 CFR 1320.5(d)(2).

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<sup>6</sup> See 15 USC 78o-7(j).

<sup>7</sup> Exchange Act Release No. 61051 (Nov. 23, 2009); 74 FR 63866 (Dec. 4, 2009).

<sup>8</sup> 15 U.S.C. 15E(d).

8. Consultations Outside the Agency

All Commission rule proposals are published in the Federal Register for public comment. The comment period for the release that discusses proposed Rule 17g-7 is 60 days.<sup>9</sup> This comment period will afford the public an opportunity to respond to the proposal.

9. Payment or Gift to Respondents

Not applicable.

10. Assurance of Confidentiality

Pursuant to section 15E(k) of the Rating Agency Act, reports submitted to the Commission are submitted on a “confidential basis.”

11. Sensitive Questions

Not applicable. Questions of a sensitive nature are not asked.

12. Estimate of Respondent Reporting Burden

The number of respondents subject to the rule depends, in part, on the number of entities that meet the statutory requirements for eligibility for registration. Further, registration is voluntary, and, consequently, the number of respondents will also depend on the number of entities that choose to register with the Commission. The Commission estimates that approximately 30 credit rating agencies will register with the Commission as NRSROs under section 15E of the Exchange Act.

The Commission estimates that each NRSRO that registers with the Commission will take, on average, approximately 200 hours to prepare for and submit annual audited financial statements for a total of 6,000 hours (200 hours x 30 NRSROs).

The Commission estimates that the average time necessary for an applicant or NRSRO to establish an internal process to conform its systems to generate a report in compliance with Rule 17g-3(a)(6) will be 100 hours per NRSRO, for a total one-time hour burden to the industry of 3,000 hours.<sup>10</sup> The Commission believes, however, that once an NRSRO complies with the amendment to Rule 17g-3 in the first year, that preparation of the new annual report will become routine. To account for this one-time burden of 3,000 hours and the possibility that new credit rating agencies will register as NRSROs, the Commission is averaging this burden estimate over the three year approval period.

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<sup>9</sup> Exchange Act Release No. 61051 (Nov. 23, 2009); 74 FR 63866 (Dec. 4, 2009).

<sup>10</sup> 100 hours x 30 NRSROs = 3,000 hours.

With respect to the proposed amendment to Rule 17g-3, the Commission estimates, based on staff experience, that the amount of time it would take to prepare a report describing the steps taken by the designated compliance officer during the fiscal year to administer the policies and procedures that are required to be established pursuant to paragraphs (g) and (h) of Section 15E of the Exchange Act (management of conflicts of interest and prevention of the misuse of material nonpublic information); and to ensure compliance with the securities laws and rules and regulations thereunder under proposed Rule 17g-3(a)(7), would be approximately 30 hours per year for a total annual hour burden of 900 hours.<sup>11</sup>

Consequently, the Commission is increasing the annual burden estimate by 900 hours for a total annual burden estimate for Rule 17g-3 of 7,900 hours (6,000 + 1,000 + 900).

### 13. Estimate of Total Annualized Cost Burden

The cost of an audit by an independent public accountant varies substantially with the size and complexity of the NRSRO. The current OMB estimate is that, on average, an NRSRO will pay an independent public accountant approximately \$15,000 per year to perform an audit or audit procedures that are required by Rule 17g-3.<sup>12</sup> Therefore, the annual cost burden to the industry is approximately \$450,000.<sup>13</sup>

Given the potentially sensitive nature of the proposed report, the Commission also preliminarily believes that an NRSRO would likely engage outside counsel to assist it in the process of drafting and reviewing the proposed report under Rule 17g-3. The Commission estimates that the time an outside attorney would spend on this work would depend on the size and complexity of the NRSRO. The Commission estimates that, on average, an outside counsel would spend approximately 20 hours assisting an NRSRO and its designated compliance officer in drafting and reviewing the proposed report on a one-time basis for an aggregate burden to the industry of 600 hours.<sup>14</sup> Based on industry sources, the Commission estimates that the cost of an outside counsel would be approximately \$400 per hour. For these reasons, the Commission estimates that the average one-time cost to an NRSRO would be approximately \$8,000<sup>15</sup> and the one-time cost to the industry would be approximately \$240,000.<sup>16</sup>

### 14. Estimate of Cost to Federal Government

There would be no additional costs to the Federal Government.

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<sup>11</sup> 30 hours x 30 NRSROs = 900 hours.

<sup>12</sup> Based on staff experience, it is estimated that the annual audit report for a small NRSRO will range from \$3,000 - \$5,000 while the annual audit report for a large NRSRO would be substantially greater.

<sup>13</sup> \$15,000 x 30 NRSROs = \$450,000.

<sup>14</sup> 30 NRSROs x 20 hours = 600 hours.

<sup>15</sup> \$400 per hour x 20 hours = \$8,000.

<sup>16</sup> \$8,000 x 30 NRSROs = \$240,000.

15. Explanation of Changes in Burden

The changes in annual burden hours are a result of the proposed amendment to paragraph (a)(7) of Rule 17g-3.

16. Information Collection Planned for Statistical Purposes

Not applicable. There is no intention to publish the information for any purpose.

17. Explanation as to Why Expiration Date Will Not Be Displayed

Not applicable.

18. Exceptions to Certification

Not applicable.

B. Collection of Information Employing Statistical Methods

The collection of information does not employ statistical methods, nor would the implementation of such methods reduce the burden or improve the accuracy of results.