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Credit Agency Reform Act Signed into Law

Introduction

On September 29, 2006, President Bush signed into law the Credit Rating Agency Reform Act of 2006 ("the Act"). The Act amends the Securities Exchange Act of 1934 ("Exchange Act") and is intended to improve the quality of credit ratings, and to protect investors by fostering accountability, transparency, and competition in the credit rating industry.

The Act provides "[a] new [clearly] defined and accountable registration process,"[1] by granting the Securities and Exchange Commission ("SEC" or "the Commission") the authority to register Nationally Recognized Statistical Rating Organizations ("NRSROs").[2] NRSRO status is key to the business of rating agencies, because, among other things, an NRSRO-rated security can be used to satisfy the SEC's net capital rule for broker-dealers as an indicator of those firms' liquidity.[3] In addition, at least ten other SEC forms, rules, and regulations use the term "nationally recognized statistical rating organization."[4] Some of the key provisions of the Act are:

- The SEC will have exclusive authority for NRSRO registration and qualification
- A credit rating agency will be able to register as an NRSRO if it meets criteria set forth in the Act
- The SEC will oversee the registered NRSROs through examinations and enforcement actions
- The SEC is directed to issue rules regarding conflicts of interest and the misuse of non-public information by NRSROs
- Registered NRSROs will be subject to disclosure requirements that enhance transparency of the industry, including disclosure of procedures and methodologies used in determining credit ratings, and disclosure of conflicts of interest[5]

Brief History of NRSROs

The modern ratings business was founded in the early twentieth century. Regulatory

1 Press Release, House Committee on Financial Services, President Signs Credit Rating Agency Reform, (Sept. 29, 2006) (http://financialservices.house.gov/news.asp).

2 The SEC is required to adopt rules and regulations by June 26, 2007, and make them effective by March 23, 2008. Also, the SEC is required to review its existing rules and regulations that employ the terms "nationally recognized statistical rating agency" or "NRSRO," and amend or revise them in accordance with purposes of the Act as the SEC may prescribe "as necessary or appropriate in the public interest or for the protection of investors." The Act, Section 4, adding new Section 15E(n) to the Security Exchange Act. *See also, infra,* Section III. C., and accompanying notes.

3 *Credit Rating Agencies: President Signs Bill Reforming Process for NRSRO Designation*, 38 Fed. News 40 1681 (2006).

4 *See infra*, note 9, citing several of the other SEC rules that refer to "nationally recognized statistical rating organization," and a citation to testimony listing more of them.

5 *Supra* note 1.

decisions, the development of complex financial products, the globalization of financial markets, and other factors contributed to the increased importance of credit ratings in the past few decades.[6] Since 1975, the SEC "has relied on credit ratings from market-recognized credible rating agencies [i.e., NRSROs] for distinguishing among grades of creditworthiness in various regulations under federal securities law."[7] Prior to the enactment of the Act, a credit rating agency could be recognized as an NRSRO only through the SEC staff no-action letter process. Critics of this process asserted that it was opaque, and it severely limited competition within the credit ratings industry.

The term 'NRSRO' was originated by the SEC for use in SEC rules and regulations. As the importance of credit rating agency ratings increased, so too did the concept of (and use of the term) NRSRO spread. Currently, ratings by NRSROs are used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts.[8]

Beginning in the last decade of the twentieth century, the SEC and Congress increasingly reviewed several issues surrounding credit rating agencies, particularly the regulatory oversight of them. In 1994, the SEC solicited comments from the public on the appropriate role of credit ratings in federal securities law rules, and for the need to establish more formal procedures for recognizing and monitoring the activities of NRSROs. As a result of the comments received, the SEC proposed a rule in 1997 that would have defined the term NRSRO in the Net Capital Rule (Rule 15c3-1 under the Exchange Act).[9] However, the SEC never acted on the proposal.

In its 2003 Concept Release, the Commission articulated that "a fundamental threshold matter is the appropriate degree of regulatory oversight that should be applied to credit rating agencies."[10] Among the broad issues raised during the review of credit rating agencies were:

- Alternatives to the NRSRO designation
- Criteria for NRSRO recognition
- Examination and oversight of NRSROs
- Conflicts of interest
- Alleged anticompetitive, abusive, and unfair practices
- Transparency within the process

With respect to alternatives to the NRSRO designation, the Commission noted that some commenters suggested that the NRSRO designation be discarded. However, the Commission noted that given the regulatory objectives served by use of the NRSRO designation it was necessary to first discuss alternatives. The alternatives included: allowing broker dealers to use internally-developed credit ratings for purposes of determining the capital charges on different grades of debt securities under the Net Capital Rule; and eliminating the objective test from Rule 2a-7, which limits money market funds to investing in securities receiving high ratings from NRSROs.

Regarding recognition criteria, the Concept Release noted, "The single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings."[11] Observers of the NRSRO designation process prior to the Act widely denounced this criterion as being circular: to become widely accepted, it was argued, a credit rating agency needed the NRSRO designation, but it could not earn the NRSRO designation unless it was already widely accepted.

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6 S. REP. NO. 109-326, at 3 (2006). ("Senate Report").

7 Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, SEC Concept Release No. 33-8236 at 2 (June 4, 2003). ("Concept Release").

8 *Id.*

9 *Id.* As noted above, the term "nationally recognized statistical rating organization" is used in at least 10 SEC forms and rules in addition to the Net Capital Rule, notably: Items 10(c)(1) and 10(c)(2) of Regulation S-K, concerning filings under the Securities Act of 1933 and the Exchange Act, respectively; and Rules 2a-7 and 10(f)(3) under the Investment Company At of 1940 ("Investment Company Act"). *See also, Rating the Raters: Enron and the Credit Rating Agencies Before S. Comm. on Governmental Affairs*, 107th Cong. (2002) (testimony of Isaac C. Hunt, Jr., Commissioner, U.S. Securities & Exchange Commission (*sic*), at notes 2-5.

10 Concept Release at 2.

11 *Id.* at 5.

In 1997, the SEC proposed to amend the Net Capital Rule to include a definition of NRSRO. Included in this rule proposal was a requirement that all NRSROs register as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act"). At the time of the 2003 Concept Release, all of the then existing NRSROs were registered as investment advisers under the Advisers Act, but commenters disagreed on whether NRSROs should be subjected to such a degree of regulatory oversight, and others questioned the SEC's authority to impose such oversight. In addition to defining NRSRO, the 1997 rule proposal sought to effectively establish a formal process for recognizing NRSROs.

As registered investment advisers, NRSROs had a legal obligation to avoid conflicts of interest, and where such conflicts existed, there was an obligation to fully disclose them to their subscribers. The concerns regarding conflicts of interest largely centered around fee structures. Commenters were concerned that credit rating agencies' reliance upon issuer fees could lead to conflicts of interest and the potential for rating inflation.[12] Others believed that conflicts of interest could arise when credit rating agencies offer ancillary services, such as consulting or other advisory services, to the companies they rate. The SEC responded to these concerns by suggesting that NRSRO recognition be conditioned on a credit rating agency's implementation of procedures to address subscriber influence, and that each credit rating agency have "adequate financial resources [...] to reduce dependence on individual issuers or subscribers."[13]

In response to allegations that certain of the NRSROs engaged in anticompetitive, abusive, and unfair practices, the Concept Release suggested that the Commission could condition NRSRO recognition upon a credit rating agency not requiring its clients to purchase ancillary services as a precondition for the performance of rating services, or otherwise engaging in competitive practices considered to be aggressive, e.g., charging an issuer for an unsolicited rating.

Finally, commenters urged the importance of transparency within the credit ratings industry. The collapses of Enron and WorldCom and the attendant failure by some NRSROs to lower those companies' respective credit ratings until only days before their respective bankruptcy declarations was an impetus for the SEC's "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets." According to that report, "Rating agencies view their role as assessing the creditworthiness of issuers on an ongoing basis, and the likelihood that debt will be repaid in a timely manner."[14]

However, the rating agencies emphasized that the nature of their analysis is largely dependent on the quality and veracity of the information provided to them. That is, because the credit rating agencies rely on the debt issuers and other sources to provide them with accurate and complete information, in their opinion, they were not privy to the information necessary to forecast the spectacular bankruptcies.

The Act

The Act defines "credit rating" to mean "an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market

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12 *Id.* at 11. Credit agencies do not normally provide personalized services to investors. Some that do so have set up separately incorporated subsidiaries to provide those services. The U.S. Supreme Court held in *Lowe v. SEC*, 472 U.S. 181 (1985), that entities that do not provide personalized investment services are not subject to the Advisers Act. As a result, there has been some question whether voluntary registration under the Advisers Act can confer regulatory jurisdiction on the SEC. The Act substantially resolves this question not by requiring all NRSROs to register with the SEC under the Advisers Act, but by providing an exclusion from the definition of "Investment adviser" for any NRSRO that does not "[engage] in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others."

The Act, Section 4(b)(3)(B). Section 4(b)(3) of the Act further adds a new Section 202(a)(28) to the Advisers Act and inserts the words "credit rating agency" after "transfer agent" in Sections 203(e)(2)(B) and 203(e)(4) of the Advisers Act. It is worthy of further note that the exclusionary language quoted above is narrower than the broad definition of investment adviser in Section 202(a)(11) of the Advisers Act, which includes any person "who, for compensation and as part of a regular business, issues or promulgates analyses or reports *concerning securities*." (Emphasis supplied.) Presumably, entities that issue or promulgate non-personalized analyses or reports concerning securities, and not in any of the other activities described in Section 202(a)(11) of the Advisers Act could still rely on the holding of the Supreme Court in *Lowe* that the Advisers Act does not apply to entities that do not provide personalized investment services.

13 Concept Release at 12.

14 *Id.* at 21.

instruments."[15] The Act also defines both NRSRO and Credit Rating Agency.

Under the Act, the term 'nationally recognized statistical rating organization' means a credit rating agency that:

- Has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under section 15E
- Issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix), with respect to:
  - Financial institutions, brokers, or dealers
  - Insurance companies or corporate issuers
  - Issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of Federal Regulations, as in effect on the date of enactment of this paragraph)
  - Issuers of government securities, municipal securities, or securities issued by a foreign government
  - A combination of one or more categories of obligors described in any of the four preceding clauses
- Is registered under section 15E[16]

"Credit rating agency" is defined to mean any person:

- Engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company
- Employing either a quantitative or qualitative model, or both, to determine credit ratings, and
- Receiving fees from either issuers, investors, or other market participants, or a combination thereof[17]

Senate Report states that the purpose of the Act is "to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry."[18] The Senate Report continues that the two largest NRSROs, Standard and Poor's ("S&P") and Moody's Investors Service, Inc. ("Moody's"), rate more than 99% of the debt obligations and preferred stock issues publicly traded in the United States. Their dominant market position—referred to as a duopoly by some, and partner monopoly by others—allow S&P and Moody's to "wield enormous power in the global capital markets system."[19] Furthermore, while "[r]egulatory actions have tended to insulate industry leaders from competition," once dubbed NRSROs, "they are virtually unregulated."[20] The Act addresses both increasing competition and regulation of NRSROs.

Registration with the SEC

New Section 15E of the Exchange Act provides that a credit rating agency that desires to become a NRSRO must submit an application to the SEC. Registration under the Act is voluntary, but, as explained above, it confers certain benefits to successful registrants.[21] Within 90 days of receiving the application, the SEC must either grant registration as an NRSRO or institute proceedings to determine whether the application for registration should be denied. These proceedings must conclude within 120 days, unless extended for good cause. Under the Act, the SEC has the authority

15 The Act, Sec. 3(a), adding a new Sec. 3(a)(60) and other sections to the Exchange Act. Unless otherwise indicated, all citations below are to Sections of the Exchange Act added by the Act.

16 The Act, Sec. 3(a)(62).

17 The Act, Sec. 3(a)(61).

18 Senate Report at 2.

19 *Id.* at 3. The Senate Report continues: "Their ratings affect the cost of capital and the structure of transactions for debt issuers, and determine which securities may be purchased by money market funds, banks, credit unions, insurers, state pension funds, local governments, and local school boards." *Id.*

20 *Id.*

21 *See, supra,* Note 12.

to prevent NRSROs from issuing credit ratings that are "in material contravention of those procedures"[22] the credit rating agency submitted in its application to be registered as an NRSRO or its reports to the SEC.

Among other things a credit agency seeking NRSRO status must provide in its application information regarding:

- Credit ratings performance measurement statistics over short-term, mid-term, and long-term periods (as applicable) of the applicant
- The procedures and methodologies that the applicant uses in determining credit ratings
- Policies or procedures adopted and implemented by the applicant to prevent the misuse, in violation of this title (or the rules and regulations hereunder), of material, nonpublic information
- The organizational structure of the applicant
- Whether or not the applicant has in effect a code of ethics, and if not, the reasons therefore
- Any conflict of interest relating to the issuance of credit ratings by the applicant
- The categories described in specified provisions of the Exchange Act with respect to which the applicant intends to apply for registration under the Exchange Act
- On a confidential basis, a list of the 20 largest issuers and subscribers that use the credit rating services of the applicant, by amount of net revenues received therefrom in the fiscal year immediately preceding the date of submission of the application
- On a confidential basis, as to each applicable category of obligor described specified clauses of the Exchange Act, written certifications described in specified clauses of the Exchange Act
- Any other information and documents concerning the applicant and any person associated with such applicant as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors[23]

The Senate Report declares that the most important reform to be yielded from the Act is that the Act

> replaces the artificial barriers to entry created by the current SEC staff approval system with a transparent and voluntary registration system that favors no particular business model, thus encouraging purely statistical models to compete with the qualitative models of the dominant rating agencies and investor subscription-based models to compete with fee-based models.[24]

Additionally, several witness who testified before the Senate committee expressed the opinion that the business model of the dominant rating agencies was "inherently conflicted" as issuers paid to receive their respective ratings.[25]

Conflicts of Interest

In addition to the conflicts of interest dealt with by the disclosures required in the application for registration set forth above, Section 15E(h) addresses that issue further. Section 15E(h)(1) requires each NRSRO to "establish, maintain, and enforce written policies and procedures reasonably designed [...] to address and manage any conflicts of interest that can arise from [its] business."

Also, 15E(h)(2) requires that the Commission to issue rules to prohibit or require the management and disclosure of any conflicts of interest, including conflicts of interest related to: the manner in which the NRSRO is compensated by the obligor for issuing credit ratings or providing related services; the provision of consulting, advisory, or other ancillary services by the NRSRO to the obligor; business relationships, ownership interest, or other financial or personal interest between the NRSRO or any person associated

22 The Act, Section 4(a). This section of the Act will become Section 15E(c)(1) of the Exchange Act.

23 The Act, Sec. 15E(a)(1)(B).

24 Senate Report at 7.

25 Senate Report at 8.

therewith and the obligor or any of the obligor's affiliates; and any affiliation of an NRSRO or any person associated therewith and any person that underwrites the securities or money market instruments that are the subject of a credit rating.[26]

Unfair, Coercive, or Abusive Business Practices

The small number of NRSROs, coupled with the evident market dominance by two NRSROs (S&P and Moody's), contributed to allegations of aggressive and coercive business practices. In response to these allegations, the Act delineates prohibited conduct. Sec. 15E(i)(1) requires that the Commission issues rules to prohibit any act or practice that the Commission determines to be "unfair, coercive, or abusive." Included in acts that are unfair, coercive, or abusive, are any act or practice relating to:

- Conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor or an affiliate thereof of other services or products, including pre-credit rating assessment products, of the NRSRO or any person associated with such NRSRO
- Lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such pool or part of such transaction, as applicable, also is rated by the NRSRO
- Modifying or threatening to modify a credit rating or otherwise departing from its adopted systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases or will purchase the credit rating or any other service or product of the NRSRO or any person associated with such organization[27]

[26] The Act, Section 4(a). These provisions will appear in Section 15(E)(h) of the Exchange Act.

[27] The Act, Section 4(a). These provisions will appear in Section 15E(i) of the Exchange Act. Section 4(b) of the Act also contains a provision conforming the definition of "credit rating agency" in the Investment Company Act of 1940 with that in the Exchange Act, and makes certain other conforming amendments to that Act.

Conclusion

The Act appears to provide a reasonable approach to the regulation of credit rating agencies, while opening the field to further entrants. It furthers transparency and provides objective standards. It is not practical to predict how many new entrants may attempt to register with the SEC. Some of the stringent conditions for that entry may deter possible entrants from applying. As mentioned earlier, those conditions include the requirement that an applicant for registration must have been in business as a credit rating agency for at least the three consecutive years immediately preceding the date of its application for registration.

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