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REPORT

CREDIT RATING AGENCIES

Dodd-Frank Wall Street Reform and Consumer Protection Act: An Examination of the Credit Rating Agency Provisions

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Act''). The law covers a wide variety of topics in an effort to address the causes of the recent financial crisis. With respect to credit rating agencies, the Act provides for improved regulation by mandating increased accountability, stronger internal controls to avoid conflicts of interest and to better ensure the accuracy of ratings, elimination of reliance on ratings by federal agencies, and enhanced transparency to allow investors and other users to evaluate accuracy and to compare the performance of different agencies.

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As indicated below, many of the requirements to be imposed have been left by Congress to regulations to be prescribed by the Securities and Exchange Commission and many actions that had been proposed in Congress have been relegated to studies to be conducted over the next several years. Generally, the SEC is required to issue final regulations with respect to credit rating agencies within one year of the date the legislation was enacted, which is July 21, 2011. Certain aspects of the Act

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are effective immediately, however, which already threatened to bring public offerings of securities to a halt and has prompted a great deal of discussion among industry participants as to the meaning and scope of the new regulations.

Accountability

Liability for Information Filed. Under Section 15E of the Securities Exchange Act of 1934 (the ''34 Act''), which covers the registration of Nationally Recognized Statistical Rating Organizations (''NRSROs'') with the SEC, NRSROs will be required to ''file'' information which previously only needed to be ''furnished''. Accordingly, NRSROs will be subject to liability under Section 18 of the '34 Act in the event that any such filings contain false or misleading statements of material fact.

''*Accuracy*''. The Act also empowers the SEC to temporarily suspend or permanently revoke the registration of an NRSRO with respect to a particular class of securities if the SEC finds that the NRSRO has failed to produce ''accurate'' ratings for that class for a sustained period of time. Currently, there is no indication as to how the SEC will make that determination.

''*Expert*'' *Liability*. Rule 436(g) under the Securities Act of 1933 (the ''33 Act''), which had provided that credit ratings assigned by an NRSRO would not be considered part of a registration statement prepared or certified by an expert, was immediately nullified by the Act. Written consent of an NRSRO must thus be obtained by a registrant in order to include a credit rating in a registration statement, and NRSROs are therefore subject to liability under Section 11 of the '33 Act for misstatements or omissions of material facts in connection with credit rating disclosure.

In response to these measures, each of Moody's, S&P, Fitch, and DBRS issued statements indicating that they are unwilling to provide the required consent. This left issuers subject to Regulation AB (''Reg AB'') disclosure requirements in a Catch-22 situation, since credit rating disclosure is required under Reg AB when the issuance of offered securities is conditioned upon receipt of a certain rating. In order to resolve the problem and provide the industry with a transition period in which to adapt to the new statutory requirements, the SEC issued a 'no-action' letter on July 22 allowing issuers to omit credit ratings from registration statements until January 24, 2011.

The SEC also posted Compliance and Disclosure Interpretations (''CD&Is'') to provide guidance for issuers not subject to Reg AB as to when consent of an NRSRO is required for disclosure of a credit rating. The SEC clarified that for issuers not subject to Reg AB disclosure requirements, consent of an NRSRO is not required if a credit rating is included in a registration statement or Section 10(a) prospectus in connection with disclosure of a credit rating change, the liquidity of the registrant, the cost of funds for a registrant, or terms of agreements. In addition, the SEC clarified that ratings information included in a Rule 433 free writing prospectus or communications in compliance with Rule 134 do not require NRSRO consent.

Internal Controls

Section 15E has also been amended to require NRSROs to ''establish, maintain and enforce an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings''.

Annual Report Requirement

The SEC must prescribe rules requiring NRSROs to submit to the SEC annual internal controls reports describing the responsibility of the NRSRO's management in establishing and maintaining internal controls, assessing the effectiveness of their internal control structures, and containing an attestation of the CEO.

Conflicts of Interest

Separation of Ratings from Sales and Marketing. The SEC is required to issue rules to prevent sales and marketing considerations from influencing the production of ratings. NRSROs will be subject to suspension or revocation of their registration if, upon notice and hearing, the SEC finds that these rules have been violated in a way that affected a rating. The rules must provide an exception for small NRSROs where separation of sales and marketing is not practical.

Look-back Requirement. NRSROs will be required to put in place procedures reasonably designed to ensure that, if any employee of an issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating had previously been employed by the NRSRO and participated in determining a credit rating of that entity during the one-year period before the rating action, the NRSRO will conduct reviews to determine whether conflicts of interest influenced the rating, and will revise the rating as appropriate. The SEC will be required to periodically review the look-back procedures and code of ethics policies of each NRSRO.

Employment Transitions. NRSROs will be required to report to the SEC (and the SEC will be required to disclose to the public) when an individual who had been an employee of the NRSRO within the previous five years becomes employed by an obligor, issuer, underwriter, or sponsor of a security or money market instrument that was rated by the NRSRO during the 12 months before the employee transitioned to his or her new position, in cases where the employee was a senior officer of the NRSRO or participated in or supervised someone participating in rating the obligor, issuer, underwriter, or sponsor.

Rule to Prevent Conflicts of Interest. The Act sets forth the sense of Congress that the SEC should exercise its rulemaking authority to prevent improper conflicts of interest arising from NRSRO employees providing services to issuers, including consulting and advisory services, in addition to providing credit ratings to those issuers.

Corporate Governance

Independent Board. Each NRSRO must have a board of directors, at least half but no fewer than two members of which are independent. To be independent, a board member may not, other than in the capacity of member of the board, accept a fee from the NRSRO, be associated with the NRSRO or any affiliated company, or be involved in determining a rating in which it has a financial interest. Some of the independent members must be users of NRSRO ratings.

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Duties of Board. The NRSRO board of directors will be required to oversee the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings and addressing and dealing with conflicts of interest, the effectiveness of the internal control system, and compensation and promotion policies.

If the SEC determines that compliance with these provisions is an unreasonable burden for a small NRSRO, the SEC may permit that NRSRO to delegate these responsibilities to a committee including at least one person who is a user of NRSRO ratings.

Regulation of NRSROs

Office of Credit Ratings. The Act requires the SEC to establish an Office of Credit Ratings within the SEC to administer rules regarding the practice of determining ratings, promoting rating accuracy, and ensuring that ratings are not influenced by conflicts of interest.

Examinations. The Office of Credit Ratings will be required to conduct examinations of NRSROs at least annually to review management of conflicts of interest, internal controls, governance, and implementation of its policies, procedures, and rating methodologies.

Inspection Reports. The SEC will make available to the public a summary of its findings with regard to material regulatory deficiencies, including whether the NRSRO has appropriately addressed recommendations of the SEC and any responses by the NRSRO.

Penalties. The SEC will be required to establish fines and other penalties applicable to NRSROs violating the provisions of Section 15E.

Private Right of Action

Statements Made by Credit Rating Agencies. Section 15E(m) of the '34 Act is amended so that the penalty and enforcement provisions of the '34 Act apply to statements made by a credit rating agency in the same manner and to the same extent as they apply to statements made by a registered public accounting firm or a securities analyst under the securities laws. These statements are not deemed to be forward-looking statements for purposes of the safe harbor pursuant to Section 21E of the '34 Act. There is no longer a bar against private rights of action as there previously had been under Section 15E(m).

State of Mind

Section 21D(b)(2) of the '34 Act is amended so that, with respect to private securities fraud actions for money damages against a credit rating agency or a controlling person, it is sufficient that a complaint state with particularity the facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk, or (ii) to obtain reasonable verification of such factual elements from sources independent of the issuer and underwriter that the credit rating agency considered competent.

Duty to Report Tips Alleging Material Violations of Law

Each NRSRO must report to the appropriate authority any credible information it receives alleging that an issuer of securities rated by the NRSRO has committed or is committing a material violation of law.

Enhanced Disclosure Requirements

SEC Rule as to Disclosure. The SEC must issue a rule requiring NRSROs to publicly disclose information on the initial credit rating given to each obligor, security, and money market instrument, and on any subsequent rating change.

Content and Type of Disclosure. The disclosures made by each NRSRO must (i) be similar so that users can compare credit ratings performance across NRSROs, (ii) be clear and informative, (iii) include performance information over a range of years and for a variety of types of credit ratings, including for withdrawn credit ratings, (iv) be freely available and easily accessible on its website, and (v) include an attestation that the rating is based solely on an independent evaluation of the risks and merits of the instruments being rated.

Form Accompanying Ratings

The SEC will require each NRSRO to prescribe a form to accompany each publication of a credit rating which is easy to use, comparable across security type, and readily available to credit rating users.

Qualitative Content: The form will be required to include disclosure of (i) the credit rating, (ii) the main assumptions and data used in making the rating determination, (iii) potential limitations of the credit rating, (iv) information on the reliability, accuracy, or quality of the data used in making a credit rating determination, (v) information as to limitations of essential data such as limits on the scope of historical data and accessibility to certain documents, (vi) whether and to what extent third party due diligence services were used by the NRSRO, a description of the information that third party reviewed, and a description of the third party's conclusions, and (vii) information as to conflicts of interest.

Quantitative Content: The form will also be required to include disclosure of (i) factors that could lead to a change in the credit rating and the magnitude of change to be expected under various market conditions, (ii) information on the content of the rating, including the historical performance of the rating, and the expected probability of default and consequent loss, and (iii) information on the sensitivity of the rating to assumptions made in the rating process.

Third Party Due Diligence

The issuer or underwriter of any asset-backed security will be required to make publicly available the findings and conclusions of any third party due diligence report it obtains. Any third party due diligence provider employed by an NRSRO, issuer, or underwriter must provide written certification to the NRSRO that it conducted a thorough review of the data and documenta-

tion used by an NRSRO to make a rating determination in a form to be established by the SEC, and the NRSRO will be required to disclose the certification to the public.

Although the Act is not clear in this regard, the SEC has stated its belief that this provision is not immediately effective, but rather that it has up to one year after the date the legislation was enacted, which is July 21, 2011, to put this rule in place. While the scope of the phrase ''third party due diligence report'' is somewhat unclear, a review of the legislative history of the Act indicates that it is meant to refer to the type of loan-level diligence done by third party diligence contractors. No distinction is made between public and private deals in connection with this disclosure requirement, and there is no indication whether the SEC will make any such distinction.

Elimination of Regulation FD Exemption

Under Regulation FD, if an issuer or any person acting on behalf of an issuer discloses material nonpublic information about the issuer or its securities to certain enumerated entities, the issuer must make such disclosure public. The current rule exempts disclosures made to credit rating agencies. The SEC is required to revise Regulation FD by October 19th to remove the exemption for disclosures to credit rating agencies.

Credit rating agencies have stated that they will work with issuers to ensure that they may continue to receive confidential information as part of the rating process. Issuers may be able to continue to provide such information to credit rating agencies without making the information public based on an exception for disclosures made to persons who expressly agree to maintain the disclosed information in confidence by having the credit rating agency sign a confidentiality agreement. Credit rating agencies could also argue that they may receive confidential information based on the exception for disclosures made to persons who owe a duty of trust or confidence to the issuer. These issues are likely to be addressed by the SEC rules to be promulgated in accordance with the Act.

Methodologies and Procedures

SEC Rules as to Procedures and Methodologies. The SEC must prescribe rules requiring NRSROs to:

- ensure that credit ratings are determined using procedures and methodologies that are approved by the board of the NRSRO and in accordance with the NRSRO's policies and procedures,
- ensure that material changes to credit rating procedures and methodologies are applied consistently to all credit ratings, as applicable, within a reasonable period of time, and that the reasons for the change are publicly disclosed, and
- notify credit rating users of the version of a procedure or methodology used to determine a particular rating, when a material change to a procedure is made, when an error is identified, and the likelihood that a material change in procedure will result in a rating change.

Use of Information from Outside Sources

NRSROs must consider information about an issuer that it receives from a source other than the issuer or underwriter when producing a rating, if the NRSRO finds the information credible and potentially significant to the rating decision.

Qualifications for Credit Rating Analysts

The SEC must issue rules designed to ensure that persons employed by an NRSRO to perform credit ratings meet standards of training, experience, and competence necessary to produce accurate ratings and are tested for knowledge of the credit rating process.

Universal Rating Symbols.

The SEC must require NRSROs to establish, maintain, and enforce written policies and procedures that (i) assess the likelihood that an issuer of a security or money market instrument will default or fail to make payments in a timely manner in accordance with the terms of the instrument, (ii) clearly define the symbol used to denote the credit rating, and (iii) apply credit rating symbols in a consistent manner.

Removal of Statutory References to Credit Ratings

Certain statutory references to credit ratings are required to be removed within two years after the date the legislation was enacted, which is July 21, 2012. Regulatory bodies will be required to develop their own standards of credit-worthiness to replace these references.

Review and Modification of Federal Agency Reliance on Ratings

Each federal agency is required to review and modify its regulations to remove references to credit ratings and substitute its own standard of credit-worthiness. Certain agencies have already begun this process. For example, on August 10th, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision published an advance notice of proposed rulemaking, soliciting comments on a range of potential alternative standards of credit-worthiness to replace credit ratings in their risk-based capital rules for banking organizations.

Studies

The Act mandates that several studies be conducted to determine how best to implement further regulatory reforms.

Note to Readers

The editors of BNA's *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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NRSRO Independence: Within three years after the date the legislation was enacted, which is July 21, 2013, the SEC must conduct a study of the independence of NRSROs. The SEC must evaluate management of conflicts of interest raised by an NRSRO providing both rating and non-rating services, and the potential impact of rules prohibiting an NRSRO from providing such non-rating services to issuers it rates.

Alternative Business Models: Within 18 months after the date the legislation was enacted, which is January 21, 2012, the Government Accountability Office must conduct a study on alternative means for compensating NRSROs in order to create incentives for NRSROs to provide more accurate credit ratings.

Creation of Independent Professional Analyst Organization: Within one year after the date the legislation was enacted, which is July 21, 2011, the GAO must conduct a study on the feasibility and merits of creating an independent professional organization for NRSRO rating analysts that would be responsible for overseeing the profession in general, and for establishing a code of ethical conduct and independent standards for governing the profession.

Assigned Credit Ratings Study and Rulemaking:

■ *Study*. Within two years after the date the legislation was enacted, which is July 21, 2012, the SEC must conduct a study of (i) the credit rating process for structured finance products and the conflicts of interest associated with issuer-pay and subscriber-pay models, (ii) the feasibility of establishing a system whereby NRSROs are assigned to determine credit ratings of structured finance products, including an assessment of potential ways to determine fees, appropriate methods for paying fees, and the extent to which such a system could be viewed as the creation of a moral hazard by the Federal Government, (iii) the range of metrics that could be used to determine the accuracy of credit ratings, and (iv) alternative compensation schemes that would incentivize more accurate credit ratings.

■ *Establishment of Assignment System*. Following the study, the SEC must, as it determines is necessary or appropriate, establish a system for the assignment of NRSROs to determine initial credit ratings of structured finance products, such that the issuer, sponsor, or underwriter of the structured finance product does not make the assignment.

Section 15E(w) of the ’34 Act, as that provision would have been added by Section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010 (otherwise known as the ‘‘Franken Amendment’’), would have established a system whereby a self-regulated Credit Rating Agency Board would assign NRSROs to determine initial credit ratings of structured finance products. The SEC must implement the system described in Section 15E(w) unless it determines that an alternative system would better serve the public interest and the protection of investors.