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Credit Rating Agency Reform Act of 2006

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Abstract. P.L. 109-291, the Credit Rating Agency Reform Act of 2006, was enacted to correct the perceived problems created by the absence of statutory regulation of credit rating agencies. Credit ratings have become an important component of the financial reputation of a rated company. However, especially since the bankruptcies of Enron and WorldCom, whose debt had been rated investment grade, there has been concern that perhaps credit rating agencies should be regulated. P.L. 109-291 requires a credit rating agency which wishes to be considered a "nationally recognized statistical rating organization" to file an application with the Securities and Exchange Commission. The application must disclose detailed information about the agency and about its methodology used in granting credit ratings. This type of full and accurate disclosure underlies the philosophy behind all of the major federal securities laws.

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Summary

P.L. 109-291, the Credit Rating Agency Reform Act of 2006, was enacted to correct the perceived problems created by the absence of statutory regulation of credit rating agencies. Credit ratings have become an important component of the financial reputation of a rated company. However, especially since the bankruptcies of Enron and WorldCom, whose debt had been rated investment grade, there has been concern that perhaps credit rating agencies should be regulated. P.L. 109-291 requires a credit rating agency which wishes to be considered a "nationally recognized statistical rating organization" to file an application with the Securities and Exchange Commission. The application must disclose detailed information about the agency and about its methodology used in granting credit ratings. This type of full and accurate disclosure underlies the philosophy behind all of the major federal securities laws. This report will not be updated.

P.L. 109-291, the Credit Rating Agency Reform Act of 2006, was enacted to correct the perceived problems created by the absence of statutory regulation of credit rating agencies. Credit rating agencies rate the creditworthiness of public companies and the debts of those companies so that a potential creditor or investor will have a presumably professional, objective opinion as to the likely risk of any investment in a particular company. These ratings have become an important component of the financial reputation of a rated company.

> Ratings have taken on great significance in the market, with investors trusting that a good credit rating reflects the results of a careful, unbiased and accurate assessment by the credit rating agencies of the rated company....
>
> Credit ratings, which are expressed in a letter grade, provide an assessment of creditworthiness, or the likelihood that debt will be repaid.[1]

Over the past several years, particularly with the scandals involving such major corporations as Enron and WorldCom, increased attention has focused on the role of credit rating agencies in the operation of the securities markets.[2] Section 702 of the Sarbanes-Oxley Act of 2002[3] required the Securities and Exchange Commission (SEC or Commission) to "conduct a study of the role and function of credit rating agencies in the operation of the securities market." In January 2003, the SEC issued its report, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets.* In June 2003, the Commission issued a concept release in order to solicit public comments about issues concerning credit rating agencies, including the issue of whether credit rating agencies should continue to be used for regulatory purposes under the federal securities laws and whether, if these ratings are used, there should be a formal process of determining whose ratings should be used and what kind of oversight to apply to these credit rating agencies.[4]

The SEC's 2003 Concept Release stemmed from ongoing concerns regarding the development of the Nationally Recognized Statistical Rating Organization (NRSRO) concept. In 1975, the Commission issued the Net Capital Rule,[5] which set new net capital requirements for broker-dealers and required these broker-dealers to take a larger discount on below investment grade bonds than for investment grade bonds. The rule required that the ratings come from a "nationally recognized statistical ratings organization." There was some concern that there was no official federal statutory or regulatory definition of "nationally recognized statistical ratings organization." Instead, "[u]pon request the staff of the Division of Market Regulation [of the SEC would] provide a 'no-action' letter"[6] to a credit rating agency if it granted the agency's request to

[1] Staff of Senate Comm. on Governmental Affairs, 107th Cong., Financial Oversight of Enron: The SEC and Private Sector Watchdogs 76-77 (S. Prt. 107-75 2002).

[2] The major credit rating agencies maintained investment grade ratings on Enron's debt until close to the time of Enron's bankruptcy filing. 60 WASH & LEE L. REV. 309, 323 (2003).

[3] P.L. 107-204.

[4] Securities Act Release No. 33-8236, 68 Fed. Reg. 35,258 (June 12, 2003).

[5] Rule 15c3-1, 17 C.F.R. § 240.15c3-1.

[6] S.Prt. 107-75, at 80. "[A] credit rating agency initiates the no-action letter process by requesting a no-action letter that will state that the Commission staff will not recommend enforcement action against persons who use the firm's credit ratings for purposes of the Commission's net capital rule." SEC proposed rule defining Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. 21,306, 21,319 (April 25, 2005). After an investigation, the Commission's staff determine whether the credit rating agency meets NRSRO criteria and either issue or deny the requested no-action letter.

obtain NRSRO status. The SEC has stated that there have been nine firms identified by the Commission staff as NRSRO's but that with consolidation there are currently five: A.M. Best Company, Inc.; Dominion Bond Rating Service Limited; Fitch, Inc.; Moody's Investors Service, Inc.; and the Standard & Poor's Division of the McGraw Hill Companies, Inc.[7]

Ratings by NRSRO's, despite there having been no official federal statutory or regulatory definition, were given significant weight in such areas as federal and state legislation, rules issued by financial regulators, and private financial contracts. A credit rating agency, particularly one with NRSRO status, was exempted from certain federal securities regulations.[8]

In 1997 the SEC proposed to amend the Net Capital Rule in order to define "NRSRO."[9] Among other requirements in the proposal for receiving NRSRO status was that a credit rating agency would be required to register as an investment adviser under the Investment Advisers Act.[10] The rule was not adopted, but in the apparently somewhat informal process that the SEC has used in issuing its no-action letter to a credit rating agency, providing it with NRSRO status, the SEC appeared to desire registration under the Investment Advisers Act by a credit rating agency seeking NRSRO status.

On April 25, 2005, in response to a number of concerns, the SEC published a proposed new rule which would have defined "nationally recognized statistical rating organization."[11] The rule, which was to be added to the Code of Federal Regulations at 17 C.F.R. section 240.3b-10, would have defined the term as any entity that:

> (a) Issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments;
>
> (b) Is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and
>
> (c) Uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.[12]

[7] 70 Fed. Reg. 21,306-21,307 (April 25, 2005).

[8] One of these exemptions concerns Regulation F-D (17 C.F.R. Part 243), which prohibits issuers from making selective disclosure of material information in order to attempt to make certain that the public has information needed to make investment decisions. This prohibition does not apply "[t]o an entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available" (17 C.F.R. § 243.100(b)(2)(iii). Another exemption concerns SEC Rule 436 (17 C.F.R. § 230.436), which was issued pursuant to section 11 of the Securities Act of 1933 (15 U.S.C. § 77k). The statute provides for civil liabilities for those attesting to the information contained in a registration statement. Rule 436 provides that a rating assigned by a nationally recognized statistical rating organization is not to be considered a part of the registration statement, thus arguably shielding a NRSRO from liability under section 11 of the Securities Act. The rule states that "the term *nationally recognized statistical rating organization* [emphasis in original] shall have the same meaning as used in Rule 15c3-1(c)(2)(vi)(F) (17 C.F.R. 240.15c3-1(c)(2)(vi)(F))" (17C.F.R. § 230.436(g)(2)).

[9] Release No. 34-39457, 62 Fed. Reg. 68,018 (Dec. 30, 1997).

[10] 15 U.S.C. §§ 80b *et seq*.

[11] 70 Fed. Reg. 21,306.

[12] 70 Fed. Reg. 21,323.

There was congressional concern, however, that the SEC might not have adequate statutory authority to oversee the credit rating agency industry. With the introduction of H.R. 2990, titled the Credit Rating Agency Duopoly Relief Act of 2005, on June 20, 2005, the 109th Congress began the process of considering legislation to regulate the registration of credit rating agencies. At the end of this legislative process, S. 3850,[13] the Credit Rating Agency Reform Act of 2006, was passed by unanimous consent by the Senate on September 22, 2006, and under suspension of the rules by the House on September 27, 2006. It was signed into law by the President on September 29, 2006, as P.L. 109-291.

Section 2 of P.L. 109-291 sets forth the congressional findings leading to the need for regulation of credit rating agencies. This section, referencing the above-mentioned section 702 of the Sarbanes-Oxley Act and comments on the SEC's concept releases and proposed rules, states the finding that "credit rating agencies are of national importance." Among the reasons provided for the need for legislation to regulate credit rating agencies are that the two largest credit rating agencies [Moody's and Standard & Poor's] serve most of the market and that additional competition is in the public interest and that the SEC has stated that it needs statutory authority to oversee the credit rating industry.

Section 3 adds five new definitions to the Securities Exchange Act of 1934:[14] credit rating, credit rating agency, nationally recognized statistical rating organization, person associated with a nationally recognized statistical rating organization, and qualified institutional buyer.[15] The definition of "nationally recognized statistical rating organization" would appear to resolve uncertainty which might have existed concerning the SEC's somewhat informal recognition of such an organization. Under the new statute a "nationally recognized statistical rating organization" is a credit rating agency that has been in business as a credit rating agency for at least the three consecutive years immediately preceding the date of its application for registration as a NRSRO and which issues credit ratings certified by qualified institutional buyers concerning financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of asset-backed securities; issuers of government securities, municipal securities, or securities issued by foreign governments; or a combination of one or more categories of obligors described in any of the afore-mentioned categories.

In order to be deemed by the SEC as a nationally recognized statistical rating organization, a credit rating agency must submit in its application to the SEC detailed information, such as the following: 1. credit ratings performance measurement statistics over short-term, mid-term, and long-term periods; 2. the procedures and methodologies that the applicant uses in determining credit ratings; 3. policies or procedures adopted and implemented by the applicant to prevent the misuse of material, nonpublic information; 4. its organizational structure; 5. whether it has in effect a code of ethics and, if not, why not; 6. any conflict of interest relating to its issuance of credit ratings; 7. on a confidential basis a list of the twenty largest issuers and subscribers that use its credit rating services by amount of net revenues received in the fiscal year immediately preceding the date of submission of the application; and 8. any other information and documents

[13] On February 8, 2005, the Senate Committee on Banking, Housing, and Urban Affairs (Committee) held a hearing titled "Examining the Role of Credit Rating Agencies in the Capital Markets." On March 7, 2006, the Committee held a hearing titled "Assessing the Current Oversight and Operations of Credit Rating Agencies." The Committee on August 2, 2006, ordered an original measure to be reported. On September 6, 2006, the original measure, with written report No. 109-326, was reported to the Senate.

[14] 15 U.S.C. §§ 78a *et seq*.

[15] Adding sections 3(a)(60)-(64) to the Securities Exchange Act of 1934.

which the SEC may by rule prescribe as necessary or appropriate in the public interest or for the protection of investors.[16]

The SEC is required to follow a specific time frame and procedure in determining whether to grant the application for treatment as a nationally recognized statistical rating organization.

The legislation makes it unlawful for any nationally recognized statistical rating organization to represent or imply that it has been designated, sponsored, recommended, or approved by the United States or by any United States agency, officer, or employee.

The legislation requires each nationally recognized statistical rating organization to establish, maintain, and enforce written policies and procedures reasonably designed to address and manage any conflicts of interest that might arise.

P.L. 109-291 fits within the general philosophy of all of the major federal securities laws. This philosophy is premised upon the belief that, so long as there is full and accurate disclosure of all material information by a covered company, the investing public will have sufficient information upon which to make its investment decisions. The Credit Rating Agency Reform Act of 2006 requires a credit agency wishing to have the status of a nationally recognized statistical rating organization to disclose to the SEC significant information about its business and its methods for issuing credit ratings so that the investing public will have information to help determine the likely accuracy of credit ratings which the agency has assigned.

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[16] Section 4 of P.L. 109-291, adding section 15E to the Securities Exchange Act of 1934.