Congress Ends Duopoly by Reforming Process for Designating Credit Rating Agencies

CCH Analysis by James Hamilton, J.D., LL.M.

Introduction

A process begun in 2002 by the Sarbanes-Oxley Act has culminated in the legislative reform of the procedures for designating nationally recognized credit rating agencies. Now, four years, one SEC report, and seven congressional hearings later, the Credit Rating Agency Reform Act (P.L. No. 109-291) creates a new regulatory system for identifying and overseeing the nationally recognized agencies that issue credit ratings. The Act establishes a transparent registration process through the SEC for rating agencies wishing to become nationally recognized and a time certain in which a decision must be made. The measure balances the need to increase the number of credit rating agencies from the current five with the need to ensure quality ratings.

Under the Act, which took effect September 29, 2006, applicants seeking to become rating agencies must disclose: procedures used to determine ratings; policies to prevent the misuse of inside information; conflicts of interest; a code of ethics; and the type of ratings that the applicant intends to use. Qualified agencies that register with the SEC are called nationally recognized statistical rating organizations (NRSROs). A preemption provision gives the Commission exclusive NRSRO registration and qualification authority. Through examinations and enforcement, the SEC will oversee the registered NRSROs. The Act also directs the SEC to issue rules regarding NRSROs' conflicts of interest and the misuse of inside information.

The Act reforms an opaque process that provided applicants with little guidance on the substance and procedures by which they would be evaluated. Currently, only five ratings agencies are designated NRSROs by the SEC, with two of the agencies essentially constituting a duopoly with an 80% market share. Many more entities aspire to be so designated but languish for years without an up-or-down vote on admission to this elite club.

Background

A credit rating is a rating agency's assessment with respect to the ability and willingness of an issuer to make timely payments on a debt instrument, such as a bond, over the life of that instrument. Investors use ratings to help price the credit risk of fixed-income securities. In order to determine an appropriate rating, credit analysts use publicly available information, market and economic data, and often engage in discussions with senior management of the debt issuer. Rating agencies earn their revenues pursuant to one of two business models: either (1) by receiving a fee from an issuer to give a rating to that issuer or (2) by charging investors to subscribe for access to the ratings of issuers who do not pay the rating agency.

The largest NRSROs wield enormous power in the global capital markets system. 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 mutual funds, banks, credit unions, insurers, state pension funds, local governments, and local school boards. In fact, many institutional investors buy debt only if it has been rated by an NRSRO.

Issues surrounding ratings agencies are important to the financial community, particularly to money market funds, since SEC Rule 2a-7 limits them to investing in securities rated by an NRSRO in the two highest ratings categories. In addition, Congress has incorporated the term NRSRO into a wide range of legislation. For example, when Congress defined the term mortgage related security in Exchange Act Section 3(a)(41), as part of the Secondary Mortgage Market Enhancement Act of 1984, it required that such securities be rated in one of the two highest rating categories by at least one NRSRO.

The firms designated as nationally recognized statistical rating organizations have historically been recognized as such by SEC staff through the no-action letter process. Until passage of the reform act, the term NRSRO remained undefined by the Commission after three decades and there was no formal application process. Some applicants waited a decade without a final decision by the staff.

Currently there are only five NRSROs, making for an extremely concentrated industry. The largest rating agencies, S&P and Moody's, occupy approximately 80 percent of industry market share as measured by revenues.

Congressional Mandate and Intent

In light of this duopoly and the substantial barriers to entry, Sarbanes-Oxley Act Section 702 directed the SEC to conduct a study of the role of credit rating agencies in the operation of the securities market, including an examination of the role of credit rating agencies in the evaluation of issuers, the importance of that role to investors, any impediments to the rating agencies' accurate appraisal of issuers, any barriers to entry into the business of acting as a credit rating agency, measures to improve the dissemination of information about issuers when the agencies announce credit ratings, and any conflicts of interest in the operation of credit rating agencies.

The Credit Rating Agency Reform Act establishes fundamental reform and improvement of the designation process. Most importantly, 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. Congress believes that eliminating the artificial barrier to entry will enhance competition and provide investors with more choices, higher quality ratings, and lower costs.

Section 2 of the Act makes a number of findings based on the SEC study issued pursuant to Sarbanes-Oxley Section 702, congressional hearings and comments on the SEC concept releases. Specifically, Congress found that the oversight of credit rating agencies serves the compelling interest of investor protection and that additional competition is in the public interest. It was further found that the SEC has indicated it needs statutory authority to oversee the credit rating industry.

Application Process

The centerpiece of the reformed ratings regime is new Section 15E of the Exchange Act. Under that section, a credit rating agency that wants to become an NRSRO must furnish an application that contains the following information:

- Rating statistics over short-, mid-, and long-term periods
- Procedures and methodologies used to determine ratings
- Policies to prevent misuse of inside information
- Organizational structure
- Whether the rating agency has a code of ethics and, if not, why not
- Conflicts of interest related to the issuance of ratings
- The types of ratings it intends to issue, be it for financial institutions; broker-dealers; corporate issuers
- Written certifications from at least 10 of their institutional customers and a list of their 20 largest issuers and subscribers by the amount of net revenues received in the previous year. For the institutional customers, the agency must disclose ratings used for at least the three most recent years, including two certifications for each type of rating it will issue. According to Chairman Oxley, these important adjustments help guarantee that ratings used for regulatory purposes are accepted and used in the market. (Cong Rec. Sept 27, 2006, p. 7569.)
- Any other data required by the SEC

Within 90 days of receiving the application, the SEC must grant registration or institute proceedings to determine whether registration should be denied, which will be concluded within 120 days unless extended for good cause. The Commission will grant registration unless it finds that the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed and with certain of its other representations. Upon granting the registration, the completed application will be made public.

With respect to the certifications from qualified institutional buyers stating that they have used the agencies ratings, Congress intends that the term “used” should mean that the institutional buyers seriously considered the ratings in some of their investment decisions. Thus, an institution whose analysts regularly read and consider an agency’s ratings in the course of making investment decisions would have used them under the meaning of the Act. But an institution whose employees subscribe to or regularly receive the ratings but do not read them or, if they

read them, rarely or never consider them in making their investment decisions would not be deemed to have used the ratings within the meaning of Section 15E.

An NRSRO must update its application promptly if the application becomes materially inaccurate except with respect to its ratings performance statistics and the qualified institutional buyer certifications. An NRSRO must annually certify that the application documents, other than the institutional buyer certifications, remain accurate and list any material changes that occurred.

SEC Authority

The SEC has the authority to prevent NRSROs from issuing credit ratings in material contravention of those procedures that such NRSROs included in their applications and reports. Legislative history indicates that the SEC's rules must be narrowly tailored to meet the requirements of the Act and must not purport to regulate the substance of credit ratings or the procedures and methodologies by which those NRSROs determine their ratings.

The SEC can by order censure, limit, suspend, or revoke registration of the NRSRO, after notice and comment, for the protection of investors and in the public interest if the NRSRO commits any of a variety of specified types of misconduct, if the NRSRO fails to file the annual certification required, or fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity. An NRSRO can terminate registration voluntarily, however, subject to the terms and conditions of the SEC.

Prohibited Practices; Duties

An NRSRO cannot represent that it has been designated, sponsored, recommended, or approved, or that its abilities or qualifications have been passed upon by the United States or any U.S. agency or employee. A rating agency that is not registered cannot state that it is an NRSRO.

Section 15E directs the SEC to adopt rules requiring NRSROs to establish, maintain, and enforce written policies and procedures to prevent the misuse of inside information that it obtains. The SEC must also adopt rules requiring NRSROs to prohibit, or require the management and disclosure of, any conflicts of interest that arise from their business. These rules must address the compensation of the NRSRO for ratings and other services; the provision of consulting services to companies the NRSRO rates; conflicts in business relationships with the NRSRO and an entity it rates; affiliations between an NRSRO and a securities underwriter; and other potential conflicts that the SEC deems appropriate in the public interest or for the protection of investors.

Section 15E directs the SEC to issue a number of other new rules within 270 days of enactment. For example, the Commission must adopt rules requiring NRSROs to address any acts or practices that the Commission determines to be unfair, coercive, or abusive, including those related to:

- conditioning or threatening to condition an issuer's credit rating on the purchase of other services or products;

- lowering or threatening to lower a credit rating, or refusing to rate securities or money market instruments issued by an asset pool, unless a portion of the assets in the pool also is rated by the NRSRO; and

- modifying or threatening to modify a credit rating based on whether the issuer or an affiliate will purchase other services from the NRSRO.

Legislative history indicates that Congress intends that the Commission, as a threshold consideration, must determine that the practices subject to prohibition are unfair, coercive, or abusive before adopting rules prohibiting those practices.

With respect to threatening to lower a credit rating issued by an asset pool unless the assets are also rated by the same NRSRO, Congress recognizes that there are instances when a rating agency may refuse to rate securities or money market instruments for reasons that are not intended to be anticompetitive. Indeed, in this section, Congress intends that the Commission, after resolving the threshold consideration, should prohibit only those rating refusals that occur as part of unfair, coercive, or abusive conduct.

The Act also requires each NRSRO to designate an individual responsible for compliance with the securities laws. This compliance officer will particularly ensure compliance with the SEC rules designated pursuant to the mandates of Section 15E.

Each NRSRO must also, on a confidential basis, furnish the SEC with financial statements as the Commission determines by rule to be necessary or appropriate. The financial statements will be furnished at intervals to be determined by the SEC. In addition, the SEC can require that the financial statements be certified by an independent public accountant.

Upon enactment, a credit rating agency can only be registered as an NRSRO by applying under the new law. Existing NRSROs will no longer be able to rely on the no-action letters the SEC staff has issued. The Commission will notify other federal agencies that use the NRSRO designation in their rules and regulations about its actions to implement the new law.

Federal Preemption

The manager's amendment to Section 15E added a federal preemption provision that gives the SEC exclusive oversight authority to register, license, or qualify a nationally recognized agency, except that state securities commissions retain the ability to bring enforcement actions to combat fraud or deceit.

Legislative history indicates that this preemption is based on existing language in the Investment Advisers Act and should be viewed narrowly as limiting a state's authority to regulate the day-

to-day activities of credit rating agencies. The provision should not be construed to apply to typical state governmental functions in which states are users of credit ratings. Thus, states will continue to have the ability to oversee their departments, programs, and political subdivisions with regard to debt issuance conditions, contract specifications, and investment standards for governmental funds, such as pension portfolios and financial reserves. Similarly, the preemption should not be taken to apply to the regulation of insurers and bank solvency standards and generic business licensing requirements normally applied to entities performing business within a state. (Cong. Rec., Sept. 27, 2006, p. H7569.)

Other Provisions

Section 5 of the reform act provides that any NRSRO report required by Commission rules is deemed to be furnished and not filed. In addition, the statute authorizes the SEC to adopt reporting and recordkeeping requirements for NRSROs.

The Act commands the SEC to report annually to the Senate Banking Committee and House Financial Services Committee about the applicants for registration, actions taken on these applications, and the views of the Commission on the state of competition, transparency, and conflicts of interest among NRSROs.

Similarly, the Government Accountability Office is directed to report to Congress within four years, but not earlier than three years, on the impact of the new law on the quality of ratings; the financial markets; competition among NRSROs; the incidence of inappropriate conflicts and sales practices; and the process for registration. Also, the GAO should report on the problems, if any, faced by business organizations resulting from the Act's implementation and recommend solutions to such problems

A discrete section of the Act contains definitions to relevant terms in the credit rating industry. Importantly, and for the first time, the term nationally recognized statistical rating organization is defined as a credit rating agency that has been in business for at least three consecutive years immediately before applying for 15E registration and obtains 15E registration status. A credit rating agency means any person engaged in the business of issuing credit ratings on the Internet or through another readily accessible means for free or a reasonable fee, but does not include a commercial credit reporting company. To satisfy the definition, the agency must also employ either a quantitative or qualitative model, or both, to determine credit ratings.