

Credit Rating Agencies

The Dodd-Frank Act includes reforms that address credit rating agencies and the credit ratings they provide. The Act seeks to impose corporate governance guidelines, reduce conflicts of interest, and improve the rating process through enhanced controls and greater transparency. Furthermore, the Act will greatly expand the SEC's oversight and enforcement powers and seeks to make it easier for investors to bring civil lawsuits against rating agencies. In addition, the reforms seek to reduce reliance on ratings as a litmus test for credit quality in favor of broader standards that encompass multiple factors and credit criteria.

Corporate Governance and Conflict of Interests

The Act requires rating agencies to:

- establish internal controls to monitor adherence to credit rating policies and procedures;¹
- submit annual compliance reports to the SEC;²
- maintain an independent board of directors, or in the case of a rating agency that is subsidiary, an independent committee of the parent's board of directors, which is tasked with certain responsibilities related to the rating agency subsidiary;³
- take steps to prevent sales and marketing considerations from influencing ratings;⁴
- apply qualification standards to credit analysts;⁵ and
- establish procedures to evaluate possible conflicts of interest related to former employees and provide public reports to the SEC regarding former employees in certain circumstances.⁶

The Act also includes a provision encouraging the SEC to adopt rules designed to reduce conflicts of interest by placing restrictions on the ability of rating agencies to provide services other than credit ratings.⁷

A newly created office of the SEC will administer standards relating to rating agencies and conduct periodic compliance examinations.⁸ In addition, the SEC will be permitted to suspend or revoke a rating agency's registration for a particular class of securities for failure to satisfy certain requirements.⁹

Modifications to the Credit Rating Process

The Act imposes new rules relating to credit rating procedures and methodologies.¹⁰ To increase transparency in the ratings process, rating agencies will be required to use a standardized form to

¹ Act § 932(a) (to be codified at 15 U.S.C. § 78o-7(c)(3)).

² *Id.*

³ Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(t)(2)).

⁴ Act § 932(a) (to be codified at 15 U.S.C. § 78o-7(h)(3)).

⁵ Act § 936.

⁶ Act § 932(a)(4) (to be codified at 15 U.S.C. § 78o-7(h)(4)).

⁷ Act § 939H.

⁸ Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(p)).

⁹ Act § 932(a)(3) (to be codified at 15 U.S.C. § 78o-7(d)(2)).

¹⁰ Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(r)).

publicly disclose their rating methodology, a description of issuer data considered in the rating process and any additional information that the SEC may require.¹¹ It remains unclear how detailed the SEC will require these descriptions to be and if the SEC will require any additional disclosure. In addition, issuers and underwriters of asset-backed securities will be required to publicly disclose the findings of any third-party diligence reports they obtain, and the thoroughness of the review performed in producing such reports must be publicly disclosed and certified by the provider of the diligence service.¹² See “Securitization.”

To facilitate comparisons among rating agencies, each agency will be required to periodically disclose information demonstrating, in hindsight, the degree of accuracy of its prior credit ratings.¹³

To broaden the scope of information considered in determining credit ratings, rating agencies will be required to consider credible and significant information from sources other than the issuer.¹⁴ In addition, whistle blower provisions will require rating agencies to refer information received from a third party about material violations of law by an issuer to appropriate regulatory authorities.¹⁵

The Act also requires the SEC to study issues related to the credit rating process for structured finance products.¹⁶ To address so-called “rating-shopping” by issuers and underwriters of such products, the SEC will be authorized to establish a mechanism to change how the initial rating agency is selected.¹⁷ See “Securitization.”

Increased Potential Liability

Securities Act. Prior to the effectiveness of the Act, Rule 436(g) exempts rating agencies from liability under Section 11 of the Securities Act.¹⁸ The Act rescinds this exemption, thus exposing rating agencies to expert liability if they consent to the inclusion of a credit rating in a registration statement.¹⁹ In order to defend against a Section 11 claim, a rating agency would be required to show that it had reasonable grounds to believe, and did in fact believe, that the included credit rating was accurate.

The implications of this reform could have profound effects on the securities offering process for rated securities, particularly structured finance products for which ratings have traditionally played a central role. It remains unclear how rating agencies will react to this change; however, rating agencies have successfully challenged claims on constitutional grounds in the past, arguing that ratings are protected by the First Amendment.²⁰ In 2009, the SEC proposed rescinding Rule 436(g). In the proposing release, the SEC acknowledged that rating agencies previously had indicated that they would refuse to consent to the inclusion of a credit rating in an issuer’s registration statement.²¹ It also is possible that rating agencies

¹¹Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(s)).

¹²Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(s)(4)).

¹³Act § 932(a)(8) (to be codified at 15 U.S.C. § 78o-7(q)).

¹⁴Act § 935 (to be codified at 15 U.S.C. § 78o-7(v)).

¹⁵Act § 934 (to be codified at 15 U.S.C. § 78o-7(u)).

¹⁶Act § 939F(b).

¹⁷Act § 939F(d)(1).

¹⁸Rating agencies which are not “nationally recognized statistical rating organizations” were not covered by the Rule 436(g) exemption from liability under Section 11 of the Securities Act. As a result of this reform, all rating agencies will be treated the same for the purposes of such liability.

¹⁹Act § 939G.

²⁰See *Compuware Corp. v. Moody’s Inv. Servs., Inc.*, 499 F.3d 520 (6th Cir. 2007).

²¹See Concept Release on Possible Recession of Rule 436(g) Under the Securities Act of 1933 (SEC Release No. 33-9071). In a companion release, the SEC also proposed requiring issuers to include credit ratings and related information in registration statements when credit ratings are used in connection with the offering (SEC Release 33-9070).

would seek to refuse to permit the inclusion of credit ratings in private offering documents.²² To the extent that rating agencies follow such an approach, adjustments in the marketing of securities may be required, especially with regard to securities in which investors were historically reliant on ratings to assess credit quality.

Exchange Act. The Act confirms the availability of civil remedies against rating agencies by specifically making the enforcement and penalty provisions of the Exchange Act applicable to rating agencies in the same manner the provisions currently apply to registered public accountants and securities analysts.²³ The Act also excludes credit ratings from the protection of the safe harbor provisions for forward-looking statements of the Private Securities Litigation Reform Act of 1995.²⁴

The Act alters the pleading standards that were implemented by the Private Securities Litigation Reform Act of 1995 as applied to actions for money damages against rating agencies.²⁵ Under the standards in place prior to the enactment of the Act, to survive a motion to dismiss a claim based on Rule 10b-5, a plaintiff had to allege facts giving rise to a “strong inference” that the defendant knowingly or recklessly made a material misstatement or omission.²⁶ In the context of credit ratings, courts required plaintiffs to plead that the rating agency did not genuinely believe its opinions regarding credit quality or that the opinions lacked basis in fact.²⁷ Plaintiffs were often unable to satisfy this pleading burden in actions against rating agencies. Under the Act, a pleading against a rating agency would satisfy the state-of-mind requirement if it alleges facts with particularity giving rise to a strong inference that the rating agency knowingly or recklessly “failed to conduct a reasonable investigation” of the factual elements relied upon in evaluating the credit risk of the rated security. The determination of what constitutes a “reasonable investigation” will be based on a court’s consideration of the particular facts and circumstances.

It should be noted that the reforms do not purport to modify the elements of a Rule 10b-5 claim that plaintiffs must ultimately satisfy after the pleading stage, nor do they purport to impair the First Amendment defenses traditionally employed by rating agencies, particularly in the case of unsolicited ratings.

In addition, the Act replaces references to “furnish” with references to “file” in certain provisions of the Exchange Act that govern a rating agency’s application for registration and related amendments.²⁸ These applications contain information about the rating agency and its business, including its credit ratings performance, procedures and methodologies, and conflicts of interest. By requiring the rating agencies to file (as opposed to merely furnish) certain materials, this reform effectively subjects rating agencies to Section 18 of the Exchange Act, which provides a civil remedy for misleading statements made in applications and other documents filed with the SEC under the Exchange Act.

²²The SEC has proposed mandating the inclusion of ratings information in 144A offerings with Exxon Capital exchange rights (SEC Release 33-9070).

²³Act § 933(a) (to be codified at 15 U.S.C. § 78o-7(m)(1)).

²⁴*Id.*

²⁵Act § 933(b)(2) (to be codified at 15 U.S.C. § 78u-4(b)(2)(B)).

²⁶15 U.S.C. § 78u-4(b)(2).

²⁷See *In re IBM Corp. Sec. Litig.*, 163 F.3d 102 (2d Cir. 1998) (discussing securities law liability related to opinions).

²⁸Act § 932(a) (to be codified at 15 U.S.C. § 78o-7); possibly due to an error in the Act, references to “furnish” are not changed to “file” in 15 U.S.C. § 78o-7(a)(1)(A), which is related to initial applications by rating agencies.

Sole Reliance on Credit Ratings

Prior to the effectiveness of the Act, institutional investors, including banks, insurers and money market funds were permitted to rely solely on credit ratings when making certain investment decisions. The Act seeks to compel such investors to conduct an independent investigation into the multiple factors that influence the risk profile of a security and thereby diminish their reliance on credit ratings. The Act seeks to achieve this objective by replacing references to credit ratings in certain federal laws with a requirement that such investors consider the creditworthiness of a security, thus encouraging these investors to consider factors beyond the security's credit rating.²⁹

In addition, every federal agency will be required to study any regulation it has issued that requires the assessment of creditworthiness or the use of credit ratings and replace such references to credit ratings with references to broader standards of creditworthiness where the agency determines such changes are appropriate.³⁰

Elimination of Automatic Regulation FD Exemption

Regulation FD was adopted to prevent selective disclosure to those who would reasonably be expected to trade securities on the basis of the information or provide others with advice about securities trading.³¹ The Act removes an existing blanket exemption from Regulation FD for information provided to rating agencies;³² the impact of the removal of this exemption is unclear. Under Regulation FD, material nonpublic information made available by or on behalf of an issuer to certain defined parties, including brokers, dealers, investment advisers, institutional investment managers, investment companies, certain persons associated with the foregoing and holders of the issuer's securities (each a "Covered Recipient"), also must be made available to the public.³³

Following the effectiveness of the Act, if a rating agency were deemed to be a Covered Recipient, then Regulation FD could apply to information that rating agency receives from the issuer. In addition, a Regulation FD obligation may be triggered if a rating agency were deemed to be acting as an agent of the issuer and further deemed to have disclosed nonpublic issuer information to a Covered Recipient on the issuer's behalf.³⁴ However, the public disclosure of the information would not be required in either of these circumstances if another exemption to Regulation FD applies.

Notably, the Act does not modify the exemption that permits nonpublic information to be shared with a person who agrees to maintain the information in confidence.³⁵ An open question is whether such contractual protections will be effective in light of the Act's increased disclosure requirements related to credit ratings and the credit rating process or, in the case of certain structured finance products, where disclosure of nonpublic information to other rating agencies is required by Rule 17g-5(a)(3). In light of the removal of the blanket Regulation FD exemption, issuers and underwriters seeking to avoid a Regulation FD disclosure requirement will need to carefully evaluate whether an exemption from Regulation FD applies prior to furnishing sensitive information to a rating agency.

²⁹Act § 939.

³⁰Act § 939A.

³¹Selective Disclosure and Insider Trading (SEC Release 33-7881) (Modified August 21, 2009).

³²Act § 939B.

³³17 C.F.R. § 243.100(b).

³⁴See 17 C.F.R. § 243.101(c).

³⁵17 C.F.R. § 243.100(b)(2)(ii).

Additional Studies of Credit Rating Process

The Act requires the SEC and the Comptroller General of the United States to undertake studies related to rating agencies and the credit rating process to facilitate future rulemaking. The SEC is required to conduct studies on conflicts of interest and standardizing credit rating terminology and the market stress conditions under which credit ratings are evaluated.³⁶ The Comptroller General is required to conduct studies on alternative means for compensating rating agencies and the creation of an independent professional organization for credit rating analysts.³⁷

* * *

The Act requires rating agencies to implement significant changes in their business practices. Heightened corporate governance standards, new policies and procedures related to the credit rating process, and the potential for fines, penalties and increased private litigation are intended to increase the transparency and integrity of the rating process. However, at least in the near term, these reforms can be expected to increase the amount of time and the volume of information required to obtain credit ratings, possibly increasing the amount time needed to bring a securities offering to market. In addition, the reforms will most likely result in higher fees charged by rating agencies to compensate them for incremental administrative, compliance and operating costs and increased exposure to third-party claims.

³⁶Act §§ 939(h) & 939C.

³⁷Act §§ 939D & 939E.