Rating Agency Reform: A Preliminary Assessment

By Peter Barwick, Esq.

The implosion of the subprime mortgage market has revealed structural problems in the securitization industry. Among the market participants whose credibility has been most severely affected are the major credit rating agencies, identified in federal law and regulations as “nationally recognized statistical rating organizations,” or NRSROs. Many financial instruments backed by subprime residential-mortgage-backed securities that were highly rated by the NRSROs have defaulted, resulting in significant losses to investors. This has resulted in widespread criticism of the NRSROs and in calls for reform of the ratings process.

The severity of the subprime crisis has put pressure on market regulators to act quickly to address perceived problems. To date, two steps have been taken toward reform of the NRSROs. First, on June 5, New York Attorney General Andrew Cuomo announced a settlement with Standard & Poor’s, Moody’s Investors Service and Fitch Ratings that addressed issues of compensation, disclosure and due diligence in the rating of residential-mortgage-backed securities. Then, later in the month, the Securities and Exchange Commission promulgated for comment its proposed rules for NRSROs.1

As of the date of publication of this article, the SEC indicated in recent statements to the media that it will be revising at least some of the proposed rules in the near future, perhaps as early as mid-November.2 In particular, it is likely that the agency’s rules regarding conflicts of interest and disclosure requirements pertaining to NRSROs will be modified at this time. As this article is based on the proposed rules in their current form, these prospective changes are likely to affect aspects of the analysis offered herein.

Background of NRSRO Reform

The SEC first established the term “nationally recognized statistical rating organization” in 1975, when it incorporated the concept into the net capital rule for broker-dealers under the Securities Exchange Act of 1934.3 Its purpose was to provide an objective standard for determining the risk of various securities when setting related capital requirements. Despite this limited original intent, in the 30 years since introduction of the NRSRO concept, it has been incorporated into a wide range of federal and state legislation, rules issued by domestic and foreign financial regulators, and private contracts.

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A chronic problem in the NRSRO market from its inception has been a lack of competition. The initial process for recognition of NRSROs was through issuance of no-action letters by the SEC. Among the criteria used to evaluate potential NRSRO status, the most important, not surprisingly, was whether the entity was “nationally recognized” as an issuer of credible and reliable ratings.4 Unfortunately, this created a Catch-22 for rating agencies: Qualifying as an NRSRO required national recognition, but attracting the business necessary to become nationally recognized required being an NRSRO. Following its designation of S&P, Moody’s and Fitch as the initial NRSROs, the SEC did recognize several additional NRSROs, but subsequent mergers brought the total number back down to the original three as recently as 2003.5

After the accounting debacle at Enron, NRSROs came under heavy criticism for how slowly they reduced their ratings of the company.6 Congress held hearings on the subject, and the SEC undertook its own examination of the NRSROs.7 Under the Sarbanes-Oxley Act of 2002, Congress also instructed the SEC to undertake a comprehensive review of the NRSROs and to report on its findings.

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The concerns raised by these and later investigations eventually led to congressional action in September 2006 with passage of the Credit Rating Agency Reform Act. Among other things, the Reform Act replaced the SEC staff approval system for the designation of NRSROs with a voluntary registration system under which recognition as an NRSRO is conditioned on meeting specific criteria identified in the Reform Act and designed not to favor any particular business model.

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The purpose of this change was to enhance competition in the NRSRO market by making it easier for additional entities to qualify. In this regard the Reform Act has been successful, as there are currently 12 NRSROs, up from five when it was signed into law.

Another significant aspect of the Reform Act is that it gives the SEC new regulatory powers over the NRSROs. These powers include express authority to pursue enforcement actions against any NRSRO that issues ratings in contravention of the procedures set forth in its registration application.

The Reform Act also gives the SEC authority to issue rules to designate

- The records an NRSRO must make and retain;
- The financial reports an NRSRO must furnish to the commission on a periodic basis;
- The specific procedures an NRSRO must implement to manage the handling of material nonpublic information;
- The conflicts of interest an NRSRO must manage or avoid altogether; and
- The practices that an NRSRO must not engage in if the SEC has determined they are unfair, coercive or abusive.

These existing rules were established in June 2007 with the SEC’s adoption of Rules 17g-1 through 17g-6 under the Reform Act.

The grant of regulatory power to the SEC under the Reform Act is tempered by the requirement that any new rules the agency proposes to govern NRSROs be narrowly tailored for their intended purpose. Also, in keeping with long-standing practice regarding credit rating agencies, the Reform Act prohibits the SEC from regulating either the substance of any credit rating or the procedures and methodologies used by an NRSRO to determine its ratings.

The Proposed Rules

As noted, the two primary governmental responses addressing NRSRO problems in the wake of the subprime crisis have been the settlement engineered by the New York attorney general and the SEC’s release of the proposed rules. Of these, the proposed rules are the more far-reaching.

The SEC issued the rules under the regulatory authority of the Reform Act. They were published in two stages, the first published June 16 and the second July 1. The comment period for the June release ended July 25 while the comment period for the July release ran through Sept. 5.

They deal primarily with the rating process for structured products, but some of them apply to all credit ratings issued by NRSROs.

The proposed rules fall into three broad categories:

- Conflicts of interest;
- Disclosure and recordkeeping requirements; and
- Elimination of statutory and regulatory reliance upon the NRSRO concept.

The various provisions under each category will be briefly described, and the more substantive provisions will then be separately analyzed.

Conflicts of Interest

The June release proposes to modify the existing rules regarding conflicts of interest. Currently, NRSROs are required to disclose certain conflicts of interest and establish policies to address them, while other conflicts are prohibited entirely. The June release adds conflicts to each of these categories.

Regarding those conflicts the NRSROs are required to disclose and manage, the June release adds a provision prohibiting an NRSRO from issuing or maintaining a credit rating where the NRSRO was paid for such rating, unless the NRSRO discloses all information provided to it and used in determining the initial rating or in conducting ongoing surveillance.

The June release also categorically bans several conflicts of interest, including:
• Issuing or maintaining a rating where the NRSRO or an associated person has provided recommendations regarding structural or other aspects of the entity offering the rated security;

• Issuing or maintaining a rating where the fee paid for the rating was negotiated, discussed or arranged by any NRSRO employee involved in the rating process, including the process for developing or approving the methodologies used to determine the rating; and

• Issuing or maintaining a rating where any NRSRO employee involved in determining or approving the rating has received a gift in excess of $25 from the issuer, sponsor or underwriter.

Introducing a separate rating symbol for structured products would leave investors uncertain as to what level of risk was contemplated by the rating.

Disclosure and Recordkeeping

The June release imposes significant additional disclosure requirements on NRSROs. As noted above, where an NRSRO is paid to provide a rating, it is required to disclose all information provided to it by third parties in connection with the rating. In addition, the June release requires each NRSRO to disclose:

• The procedures and methodologies it used to determine credit ratings;

• With respect to each rating of a structured finance security, a report detailing differences in the rating methodology used and the risk characteristics of such security, unless such security is issued using a modified ratings designation;

• Information regarding asset verification, including whether and how the NRSRO relies upon such asset verification in issuing a rating;

• A record showing all rating actions and the date of such actions, within six months of such rating action; and

• Performance statistics regarding all classes of credit ratings issued by the NRSRO, including default rates within each category, showing at a minimum performance in each class over one-, three- and 10-year periods.

The June release also imposes certain recordkeeping obligations on the NRSROs. In cases where a quantitative model was a substantial component in determining a rating, the NRSRO must maintain records of material deviations from the model in the issuance of a final rating. It also must maintain records of complaints against ratings analysts.

Elimination of NRSRO References

The July release, issued in three parts, proposes to eliminate reliance upon the NRSRO concept in various federal statutes and regulations. Specifically, it contemplates the following changes:

• To Form S-3, in connection with S-3 eligibility for asset-backed issuers, it replaces the “investment grade” standard with a requirement for $250,000 minimum denominations for initial sales and resales and limits initial sales to qualified institutional buyers;

• To Form S-3, in connection with S-3 eligibility for non-asset-backed issuers, it replaces the “investment grade” standard with a requirement that an issuer have sold $1 billion in non-convertible debt securities in the previous three years;

• To Regulation AB of the Securities Act of 1933, it eliminates references to investment grade ratings from Items 1112 (significant obligors) and 1114 (credit enhancement);

• To Regulation M, it replaces the exemption from Regulation M for investment-grade securities and asset-backed securities with exemptions not tied to ratings;

• To Rule 2a-7 of the Investment Company Act, it modifies the criteria for selection and monitoring of “eligible securities” to eliminate reference to ratings;

• To Rule 15c3-1 of the Exchange Act, it replaces the reliance on ratings to determine net capital amounts with a subjective determination by the broker-dealer; and

• To Rule 3a-7 of the Investment Company Act, it deletes this exception to the ICA entirely.

Assessment

The proposed rules raise a host of issues and concerns, many of which are addressed in the comment letters submitted to the SEC. A review of the full range of such issues is beyond the scope of this article. Instead, it will analyze certain of the more substantial issues presented under each category.
Conflicts of Interest

One of the conflicts of interest prohibited by the proposed rules is issuance of a rating by an NRSRO where an employee or associated person has been involved making recommendations regarding the structure or other aspects of the issuer. On its face, this concern seems to have merit, but a closer examination calls into question the assumptions that would make this a conflict of interest. Given that the primary goal in designing structured finance transactions is to ensure a desired rating for the higher classes of securities, it makes no sense that the NRSRO analyst’s communications with the issuer explaining the changes to the deal structure or collateral needed to achieve this objective would represent a conflict of interest.

As the American Bar Association notes in its comment letter to the SEC, “In structured finance transactions, the rating is not placed on an existing structure; instead, the structure is designed, through discussions between the rating agency and the arrangers, to achieve the specified rating.” In addition to this fundamental conceptual issue, it is all but impossible to imagine that such a restriction on communication between the NRSRO analyst and the issuer would work in practice.

Disclosure

A number of the more substantial issues raised by the proposed rules relate to the provisions requiring new disclosures of information. As set forth above, the proposed rules, in connection with the issuance of paid ratings by an NRSRO, require the release of all third-party information received in connection with the determination of its rating.

In its discussion of this provision in the proposing release, the SEC expressly declines first to identify whether the NRSRO, issuer or underwriter ultimately is responsible for the release of such information and second to provide a safe harbor to the NRSRO based on its obtaining from the issuer a representation that all necessary information has been released. By excluding such protection, this amendment effectively puts the burden on the NRSRO to determine what information is required from the issuer.

As noted by the ABA, such a result amounts to “a delegation to the credit rating agencies of the responsibility for setting disclosure requirements for this industry.” This represents a significant departure from the traditional division of responsibilities in the structured finance markets, in which the SEC sets the parameters of required disclosure, and issuers and underwriters are responsible for materiality determinations and any related liability.

In its comment letter Standard & Poor’s describes this as a “radical reordering of the roles and responsibilities of the parties involved in a securities offering.”

Rather than effect such a dramatic reordering of the residential-mortgage-backed-securities markets, the ABA recommends using Regulation AB to address further disclosure requirements. As the ABA points out in its letter, the formulation of Regulation AB involved extensive input from all transaction parties, including investors, as to what information was necessary to be disclosed in the securitization process.

One goal of the changes is to reduce the NRSROs’ incentive to produce a favorable rating in order to be retained and thus compensated by the issuer.

To the extent the SEC now considers further disclosure necessary, such additional requirements should presumably be established through an amendment process under Regulation AB, subject to comment from interested parties. In the event such an approach is not adopted, the SEC at a minimum should provide NRSROs with a safe harbor based on representations from the issuer that all necessary information has been provided.

An approach that puts the burden of disclosure and potential liability on the NRSRO has other problems as well. For one thing, it would create the conditions for endless conflict with the issuer over what constitutes necessary information. This would be especially problematic with respect to confidential and proprietary information, as well as legal opinions and accountant’s reports with restrictions on use.

Currently such information is shared with rating agencies but not made public, but under the proposed rules it arguably would need to be disclosed. Such conflicts would likely result in significant disruption of the deal process. To prevent this, the American Securitization Forum says, missing information should not prevent release of a rating, and instead any such rating should be accompanied by disclosure indicating what information was missing in the determination of such rating.

The SEC’s immediate purpose in adding disclosure requirements in connection with the issuance of paid ratings by NRSROs is to make available the information necessary to enable unsolicited NRSROs to provide independent ratings of the securities being issued. Behind this goal
are the assumptions that the prospect of independent ratings will provide an incentive for solicited NRSROs to maintain objectivity in the ratings process and that such independent ratings will provide a useful means of evaluating the objectivity of the paid ratings.

One problem with this rationale is that the proposed amendment does not provide for release of such information until the day of pricing. This leaves too little time for unsolicited NRSROs to produce a rating before the sale of the securities. In addition, information requested by one NSRSO may not satisfy requirements for another NRSRO, making the release of such information ineffectual.

A more basic problem with this approach is that it ignores potential conflicts of interest for unsolicited NRSROs. These conflicts of interest are less obvious, and arguably less serious, than for solicited NRSROs but are nonetheless real and important to recognize. As the American Securitization Forum notes in its comment letter, unsolicited NRSROs have a natural incentive to become solicited NRSROs, whether from the issuer or the investor side. This incentive, combined with imperfect information, casts doubt on the ratings of unsolicited NRSROs as reflecting true objectivity.19

In response to the problems of this approach, the ABA proposes “an access-based solution” in contrast to a disclosure-based solution. Specifically, the ABA suggests a system in which issuers notify all NRSROs of their intent to begin a rating process and give unsolicited NRSROs the opportunity to provide an unsolicited rating. Such unsolicited NRSROs then would be given access to a private electronic data room so they could simultaneously receive the same information as solicited NRSROs.

Another disclosure requirement under the proposed rules is the obligation of NRSROs to provide information regarding asset verification. In its current form this requirement involves publication of what amounts to boilerplate language regarding the general process the NRSRO followed in performing asset verification. The ASF’s letter instead proposes that asset verification information be made specific to each transaction rating and be provided in the form of a summary of all reports and documents given to the NRSRO to verify information about the underlying assets.20

**Differentiated Ratings**

The provision of the proposed rules that received the most attention in the comments was the proposal to require use of a different rating symbol for structured finance products or, alternatively, to issue a report detailing differences in methodology and credit risk for such securities. The response from commenting parties on this point was resoundingly negative, for reasons that are not difficult to understand. To start with, changing the ratings designation for structured products in this way actually would result in greater confusion, not clarity. The current rating system is built on the basic principle that the purpose of a rating is to assess the levels of credit risk. While these ratings take account of the specific attributes and underlying collateral of individual securities, a particular rating is intended to reflect an equivalent level of risk across asset classes. Consequently, introducing a separate rating symbol for structured products would leave investors uncertain as to what level of risk was contemplated by the rating.

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**The problem with the New York settlement is not the logic of its terms, but the regulatory inconsistency it creates.**

There are practical problems with such an approach as well. Given the widespread use of investment guidelines in financial contracts and instruments, a change in the ratings designation could require liquidation of assets or at least a suspension of acquisition of such assets until the related investment guidelines are amended. Aside from the matter of investment guidelines, the above-noted confusion with a new ratings designation likely would result in reduced demand for such securities. Any of these results would be a setback to efforts to restore liquidity to structured finance markets.

**The New York Settlement**

Less than two weeks before the release of the proposed rules, New York Attorney General Andrew Cuomo entered a settlement agreement with the three largest NRSROs — S&P, Moody’s and Fitch — that imposed significant changes on the ratings practices involving residential-mortgage-backed securities. The main provisions of the settlement are:

- **Fee reforms:** Each NRSRO must adopt a fee-for-service model in place of its traditional contingency fee model. Under the old model, NRSROs were only compensated where they were selected by an issuer to rate a transaction; under the new fee-for-service model, they will be compensated for work performed regardless of whether they ultimately are selected to rate the deal. The goal of this change is to reduce the NRSROs’ incentive to produce a favorable rating in order to be retained and thus compensated by the issuer.
Disclosure reforms: Each NRSRO must publicly disclose information regarding all securitization transactions submitted for its review. The goal of this change is to enable investors to determine whether issuers initially sought but declined to use the ratings of any affected NRSRO.

Loan originator review: Each NRSRO must establish criteria for reviewing individual mortgage originators and disclose on its Web site its evaluation of such originators pursuant to such criteria.

Due-diligence reforms: Each NRSRO must develop and publish on its Web site criteria for the collection of due-diligence information by issuers with respect to the mortgage collateral in each transaction. The NRSROs are required to receive loan level results of the issuer’s due diligence and review such results before issuing a rating.

NRSRO independence: Each NRSRO must perform an annual review of its residential-mortgage-backed-securities business to identify practices that could compromise its independence and to remediate any such practices.

Representations and warranties: Each NRSRO must obtain representations and warranties from each issuer and other financially responsible party regarding the loans underlying any residential-mortgage-backed securities.21

These reforms might seem to be sound and reasonable measures. The problem with the settlement is not the logic of its terms, but the regulatory inconsistency it creates. This problem is first of all a result of the settlement being limited to just three of the current 12 NRSROs, albeit the largest three. In this regard, it is a problem that will only grow worse with time, as the number of NRSROs is certain to increase in light of the changes under the Reform Act intended to achieve this result. In fact, SEC Chairman Christopher Cox is on record as saying he expects there eventually could be as many as 30 NRSROs.22

The problem of inconsistency also results from the fact that these reforms are limited to residential-mortgage-backed-securities transactions and in some cases run counter to the terms of the SEC’s proposed rules. Consider, for example, the disclosure requirements imposed under the settlement, which require each affected NRSRO to disclose all information regarding any securitization submitted for its review. This requirement is inconsistent with the requirement under the proposed rules that NRSROs only need to disclose information in connection with securities for which they issued a rating.

Or consider the matter of due diligence requirements. Under the settlement, each affected NRSRO must develop specific criteria relating to loan-level diligence information to be collected by the issuer and review such information before issuing a rating. The proposed rules, in contrast, only require that the NRSRO disclose the diligence efforts it undertakes. There is no requirement that it establish separate diligence criteria to be applied by the issuer prior to issuance of a rating by the NRSRO.

A further problem with the settlement is that it arguably violates Section 4(c)(2) of the Reform Act, which prohibits the SEC (or any state or subdivision thereof) from regulating “the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings.”23

As the Mortgage Bankers Association points out in its comment letter on the proposed rules, the settlement’s requirement that affected NRSROs formulate criteria regarding their due diligence, independence, and representations and warranties appears to violate this restriction.24 Infringement on the rating process seems most likely in the case of the criteria governing due diligence, as the settlement expressly conditions issuance of a rating on the application of these criteria.

Conclusion

In response to public pressure resulting from the collapse of the subprime mortgage market, the New York attorney general and the SEC have taken the lead in seeking to address the problems at the credit rating agencies that contributed to the crisis. These actions, while well-intentioned, have in some respects been misguided. Before issuing its final rules, the SEC should reconsider the problematic aspects of its proposals in response to comments received. Also, Congress and the SEC should assert pre-emption with respect to the New York settlement, in the interests of maintaining consistency and coherence in the ratings process.

Notes


3 17 C.F.R. § 240.15c3-1.

As of Sept. 8, 2008, the following entities have registered and been approved as NRSROs: A.M. Best Co., DBRS Ltd., Egan-Jones Rating Co., Fitch Inc., Japan Credit Rating Agency Ltd., LACE Financial Corp., Moody's Investors Service, Rating & Investment Information Inc., Realpoint LLC and Standard & Poor's Ratings Services.


15 See ABA Letter, supra note 13, at 3.


17 See ABA Letter, supra note 13, at 4-5.

18 Id. at 7.


20 Id. at 6.


