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Credit Rating Agencies: Current Federal Oversight and Congressional Concerns

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Summary

Credit rating agencies rate the creditworthiness of public companies so that the public will have an objective opinion as to the risk of investment. These 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. Section 702 of the Sarbanes-Oxley Act of 2002 required the Securities and Exchange Commission to study the role of credit rating agencies. Over the years, the SEC has issued reports and proposed rules, in particular concerning adoption of a definition for the term "nationally recognized statistical rating organization," but no statutory or regulatory requirements have been enacted or issued. Congress may, however, continue to pursue the issue of regulation, since hearings have been held on the issue and proposed legislation has been introduced. This report will be updated as needed.

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 been given to 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 (the 2003 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 stems 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 has been 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] provide a 'no-action' letter"[6] to a credit rating agency if it grants the agency's request to 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]

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[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.

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

Ratings by NRSRO's, despite no official federal statutory or regulatory definition, are given significant weight in such areas as federal and state legislation, rules issued by financial regulators, and private financial contracts. For example, a credit rating agency, particularly one with NRSRO status, is exempted from certain federal securities regulations. One such exemption concerns Regulation F-D,[8] 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."[9] Another exemption concerns SEC Rule 436,[10] which was issued pursuant to section 11 of the Securities Act of 1933.[11] 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 an 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 CFR 240.15c3-1(c)(2)vi)(F))."[12]

In 1997 the SEC proposed to amend the Net Capital Rule in order to define NRSRO.[13] 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.[14] The rule was not adopted, but in the apparently somewhat informal process that the SEC uses in issuing its no-action letter to a credit rating agency, providing it with NRSRO status, the SEC appears 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 define "nationally recognized statistical rating organization."[15] The rule, to be added to the Code of Federal Regulations at 17 C.F.R. section 240.3b-10, would define 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;
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> (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

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[8] 17 C.F.R. Part 243.

[9] 17 C.F.R. § 243.100(b)(2)(iii).

[10] 17 C.F.R. § 230.436.

[11] 15 U.S.C. § 77k.

[12] 17 C.F.R. § 230.436(g)(2).

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

[14] 15 U.S.C. §§ 80b *et seq*.

[15] 70 Fed. Reg. 21,306.

> (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.[16]

On June 20, 2005, Representative Fitzpatrick introduced H.R. 2990, whose short title is the Credit Rating Agency Duopoly Relief Act of 2005. The bill was referred to the Committee on Financial Services, and on June 29, 2005, the Committee's Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises held a hearing on legislative solutions for credit rating agencies. In his remarks to announce introduction of the bill, Representative Fitzpatrick stated:

> [E]very American remembers the financial hardships they faced when WorldCom and Enron went belly up. I certainly remember the broken investment accounts of my constituents and the people of Pennsylvania's 8th Congressional District. And it is extremely troubling that little known players in this crisis, Moody's and S&P, rated Enron and WorldCom at investment grade just days prior to the filing of their bankruptcies.
>
> Two firms dominate the ratings market with SEC approval, and this, Mr. Speaker, creates an uncompetitive marketplace, stifles competition from other rating agencies, lowers the quality of ratings and allows conflicts of interest to go unchecked. It is bad for the market and it is hurtful to individual investors.
>
> Last week, I introduced the Credit Rating Agencies Relief Act of 2005, H.R. 2990, which will inject greater competition, transparency and accountability in the credit rating industry through market-based reform.[17]

After setting out findings by Congress, the bill adds two new definitions to the Securities Exchange Act,[18] codifying them at 15 U.S.C. sections 78c(a)(60) and (61): "statistical rating organization" and "nationally *registered* [emphasis added] statistical rating organization."

Section 4 of the bill adds a new provision to the Securities Exchange Act to require the registration with the SEC of any statistical rating organization using the mails or interstate commerce in connection with its business. The registration procedures are specified. The Commission must issue by rule the information which the statistical rating organization must disclose, such information to include conflicts of interest faced by the organization and the management of those conflicts, the procedures and methodologies which the organization uses in determining ratings, ratings performance measurement statistics over short-term and long-term periods, and procedures in place by the organization to prevent the misuse of non-public information.

Section 5 requires every nationally registered statistical rating organization to keep books and records and disseminate reports as required by the Commission.

Section 6 requires studies and reports by the Comptroller General of the United States, including a study to identify the factors that have led to the consolidation of credit

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[16] 70 Fed. Reg. 21,323.

[17] 151CONG. REC. H5255 (daily ed. June 28, 2005).

[18] 15 U.S.C. §§ 78a *et seq*.

rating organizations, the present and future impact of consolidation on the securities markets, and solutions to any problems created by the impact of consolidation.

At the June 29, 2005, hearing on legislative solutions for credit rating agencies, Representative Kanjorski inserted into the record a document which he had requested from the SEC outlining key issues for a legislative framework for the oversight and regulation of credit rating agencies. In this document the SEC stated that a legislative approach could require registration with the SEC by credit rating agencies, broad rulemaking authority, examination and inspection of books and records, and enforcement authority.