Calendar No. 590

109TH CONGRESS, *2d Session* | SENATE | REPORT 109–326

CREDIT RATING AGENCY REFORM ACT OF 2006

SEPTEMBER 6, 2006.—Ordered to be printed

Mr. SHELBY, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

R E P O R T

[To accompany S. 3850]

The Committee on Banking, Housing, and Urban Affairs reported S. 3850, a bill to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. The Committee reports favorably an original bill, and recommends that the bill do pass.

INTRODUCTION

In the wake of highly publicized failures by the large credit rating agencies to warn investors in a timely manner about the impending bankruptcies of Enron, WorldCom, and others, the Congress, in section 702(b) of the Sarbanes-Oxley Act of 2002, directed the Securities and Exchange Commission ("SEC" or "Commission") to examine the role and performance of rating agencies, barriers to entry into the rating industry, and conflicts of interest plaguing rating agencies. The SEC published its Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets [1] in January 2003. In its review, the SEC documented its unsuccessful efforts since 1994 to define "nationally recognized statistical rating organizations" ("NRSROs") and establish a regulatory program to oversee such NRSROs.

Over the years, the SEC has been criticized at times for not awarding more NRSRO designations and thereby perpetuating an anticompetitive industry, and for failing to supervise and inspect NRSROs to ensure compliance with the federal securities laws and NRSRO requirements. NRSROs have been criticized by a broad

[1] Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002, U.S. Securities and Exchange Commission, January 2003.

array of interested parties with respect to conflicts of interest, ratings that significantly lag the markets, and anticompetitive and abusive business practices.

PURPOSE OF THE LEGISLATION

The purpose of the "Credit Rating Agency Reform Act" ("the Act") is to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.

HEARINGS

On February 8, 2005, the Committee held a hearing titled "Examining the Role of Credit Rating Agencies in the Capital Markets." The following witnesses testified at the hearing: Ms. Kathleen A. Corbet, President, Standard & Poor's ("S&P"); Mr. Sean J. Egan, Managing Director, Egan-Jones Ratings Company; Mr. Micah S. Green, President, The Bond Market Association; Mr. Yasuhiro Harada, Executive Vice President, Rating and Investment Information, Inc.; Mr. Stephen W. Joynt, President and Chief Executive Officer, Fitch Ratings ("Fitch"); Mr. James A. Kaitz, President and Chief Executive Officer, Association for Financial Professionals; and Mr. Raymond W. McDaniel, Jr., President, Moody's Investors Service, Inc. ("Moody's").

On March 7, 2006, the Committee held a hearing titled "Assessing the Current Oversight and Operations of Credit Rating Agencies." The following witnesses testified at the hearing: Mr. Paul Schott Stevens, President, Investment Company Institute; Mr. Glenn Reynolds, Chief Executive Officer, CreditSights, Inc.; Ms. Vickie Tillman, Executive Vice President for Credit Market Services, S&P; Mr. Frank Partnoy, Professor of Law, University of San Diego School of Law; Ms. Colleen Cunningham, President and Chief Executive Officer, Financial Executives International; Mr. Damon Silvers, Associate General Counsel, AFL–CIO; Mr. Jeffrey Diermeier, President and Chief Executive Officer, CFA Institute; and Mr. Alex Pollock, Resident Fellow, American Enterprise Institute.

BACKGROUND AND NEED FOR LEGISLATION

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.[2] The rating agencies also have access to, and receive, non-public information because of their exemption from Regulation Fair Disclosure,[3] an SEC rule that prohibits companies from disseminating material information to a select audience.

At the largest rating organizations, the process for developing an initial rating on an issuer is generally as follows: analysts (i) re-

[2] Rating agencies that use solely quantitative methods generally do not meet with issuers.
[3] 17 CFR 243.100–243.103.

view financial statements and draft a preliminary rating; (ii) visit management of the issuer; (iii) prepare a brief report explaining the rationale for the rating; and (iv) make a presentation to the rating committee, which then determines a final rating. The rating and report is sent to the issuer to ensure that it is factually accurate and does not disclose any confidential information. The rating, paid for by the debt issuer, is disseminated to the public at no cost. The report accompanying the rating is available to paid subscribers. Ratings are monitored on an ongoing basis.

The agencies rate both long-term and short-term debt. S&P, Fitch, and others designate investment grade, or lower risk, long-term debt with ratings of AAA, AA, A and BBB, and speculative grade, or higher risk, with BB, B, CCC, CC, C and D. The rating classification system employed by Moody's uses Aaa, Aa, A and Baa for investment grade and Ba, B, Caa, Ca and C for speculative grade. The historic default rate for AAA-rated securities is well under one percent in any given ten-year period. For B-rated securities, the ten-year probability of default is approximately 45 percent.

The modern ratings business was founded nearly a century ago when Mr. John Moody first published ratings on railroad bonds. Although S&P and Moody's remain the dominant companies, the industry has undergone dramatic changes in the past few decades. Around 1970, the leading credit raters moved away from a pure subscription model to a hybrid one where issuers pay for ratings and subscribers receive in-depth reports explaining the basis for each rating. In the past few decades, credit ratings have assumed increased importance due to regulatory decisions, the development of complex financial products such as asset-backed securities and credit derivatives, the globalization of financial markets, and other factors. The industry is much larger today simply because the bond markets have experienced such dramatic growth. For example, S&P has more than 700,000 ratings outstanding and issues 500–1,000 rating actions each day. In recent years, the increase in structured finance transactions has been responsible for explosive revenue growth at the rating agencies.

I. Overview of regulatory landscape

The largest NRSROs, S&P and Moody's, 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. Regulatory actions have tended to insulate industry leaders from competition.[4] Yet, once accorded this privileged status, they are virtually unregulated.

Following corporate scandals at Enron, WorldCom, and elsewhere, Congress and the securities regulators adopted new rules governing the conduct of public companies, corporate boards and officers, accountants, stock research analysts, investment bankers, and attorneys. Rating agencies are not subject to similar regulation

[4] See, e.g., Mr. Alex J. Pollock, "End the Government-Sponsored Cartel in Credit Ratings," American Enterprise Institute for Public Policy Research, January 2005, at 1. Mr. Pollock explains that the NRSRO designation is an "extremely valuable franchise" that "allows entry into a cartel with only three U.S. members, which represent about 95 percent of sector revenues" (at 1).

in spite of widespread criticism for failing to warn investors about several of the largest bankruptcies in U.S. history, conflicts of interest, anticompetitive and abusive business practices, and an absence of transparency, regulatory oversight, and meaningful competition.

II. NRSRO system

The SEC originally adopted the term "NRSRO" in 1975 solely for determining capital charges on different grades of debt securities under the Net Capital Rule.[5] The Net Capital Rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary securities positions. These "haircuts" provide a margin of safety against losses that might be incurred by broker-dealers in those positions. The Commission determined that it was appropriate to apply a lower haircut to securities held by a broker-dealer that were rated investment grade by a nationally recognized rating agency because those securities typically were lower-risk investments. The requirement that the rating agency be "nationally recognized" was designed to ensure that its ratings were credible and reasonably relied upon by the marketplace.

Since 1975, increased marketplace and regulatory reliance on credit ratings has made use of the NRSRO concept more prevalent. Some regulations issued by the Commission incorporate the concept by cross-reference to the Net Capital Rule. For example, under Rule 2a–7 of the Investment Company Act of 1940, money market funds are limited to investing in securities rated by an NRSRO in the two highest ratings categories for short-term debt. Also, Congress has incorporated this concept into legislation such as the Federal Deposit Insurance Act.

Over the past few decades, financial regulators have increasingly used credit ratings to help monitor the risk of investments held by regulated entities and to provide an appropriate disclosure framework for securities of differing risks. In fact, ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts. Most of these laws and regulations define eligible portfolio investments for institutional investors as those rated in one of the highest investment grade categories by at least one NRSRO. Today, it has become standard industry practice for most issuers to purchase ratings from two or more rating agencies.

The firms designated as "nationally recognized statistical rating organizations" are recognized as such by Commission staff through the no-action letter process. Currently, there are only five NRSROs: S&P, Moody's, Fitch, Dominion Bond Rating Service Limited and A.M. Best Company. It is an extremely concentrated industry. The largest rating agencies—S&P and Moody's—have approximately 80 percent of industry market share as measured by revenues. S&P and Moody's rate more than 99 percent of the debt obligations and preferred stock issues publicly traded in the United States. Hearing witnesses testifying before the Committee expressed concern

[5] 17 CFR 240.15c3–1. Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers, Release No. 34–11497 (June 26, 1975), 40 FR 29795 (July 16, 1975).

about this level of concentration and called S&P and Moody's a "partner monopoly"[6] and an "oligopoly."[7] They have also been called a "government-sponsored cartel."[8]

III. SEC efforts to oversee the rating industry

For more than a decade, the SEC has attempted to devise a regulatory scheme for rating agencies. These efforts were prompted by concerns that the SEC had never defined the term and that there was inadequate oversight of NRSROs. To address these issues, the Commission issued a Concept Release in 1994[9] soliciting public comment on the appropriate role of ratings in the federal securities laws and whether formal procedures were needed for recognizing and monitoring the activities of NRSROs.

The 1994 Concept Release led to a rule proposal in 1997,[10] which would have amended the Net Capital Rule by defining "NRSRO" and establishing a formal application process for NRSRO recognition. Under the proposal, Commission staff would consider five factors in deciding whether to grant the NRSRO designation. Whether an entity was "nationally recognized" would be accorded the most significance.[11] The Department of Justice filed a comment letter stating that the recognition requirement "is likely to create a nearly insurmountable barrier to new entry into the market for NRSRO services."[12] The proposed rule was never adopted.

In 2002, the Commission issued an Order[13] directing investigation, pursuant to Section 21(a) of the Securities Exchange Act and the examination authority of the Advisers Act, into the role of credit rating agencies in the U.S. securities markets. These SEC examinations of the then-three NRSROs (S&P, Moody's, and Fitch), ostensibly triggered by the NRSRO failures relating to Enron, revealed numerous problems.[14] SEC examiners found (i) potential conflicts of interest resulting from the issuer-paid business model of the NRSROs; (ii) that NRSRO marketing of supplementary, fee-based services, including corporate consulting, exacerbated the inherent conflict in the NRSRO business model; (iii) the potential for

---

[6] Testimony of Mr. Sean Egan, Managing Director, Egan-Jones Ratings Company, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 8, 2005, at 1–2. Mr. Egan asserted that it was a mistake to refer to S&P and Moody's as an oligopoly. He said the two ratings firms were more accurately characterized by the Department of Justice as a "partner monopoly" because S&P and Moody's "do not compete against each other for the two ratings which are normally required. This is important. They do not compete against each other . . . what I mean by that is that if S&P is brought into a transaction, Moody's is soon to follow, so they both get paid for issuing." See also the testimony of Mr. Glenn Reynolds, Chief Executive Officer, CreditSights, Inc., before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 7, 2006, at 4 (also referring to S&P and Moody's as a "partner monopoly").

[7] Partnoy, op. cit., at 4. Mr. Partnoy also said "the NRSRO regime poses a serious threat to the financial system" (at 4).

[8] Pollock, op. cit. Mr. Pollock, in a subsequent opinion piece, suggests that "shared monopoly" may be the most accurate description. See "Cartel to Competition," American Enterprise Institute for Public Policy Research, July 18, 2006.

[9] Nationally Recognized Statistical Rating Organizations, Release No. 34–34616 (August 31, 1994), 59 FR 46314 (September 7, 1994).

[10] Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 34–39457 (December 17, 1997), 62 FR 68018 (December 30, 1997).

[11] Interestingly, under the proposal NRSROs were required to register under the Investment Advisers Act of 1940 ("Advisers Act") and access to corporate executives was one of the five factors weighed by Commission staff.

[12] "Comments of the U.S. Department of Justice before the Securities and Exchange Commission," March 1998.

[13] Order In the Matter of the Role of Rating Agencies in the U.S. Securities Markets Directing Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934, and Designating Officers for Such Designation (March 19, 2002).

[14] From all indications, these were the only comprehensive Commission inspections of the NRSROs since the designations were first awarded in 1975.

the NRSROs, given their substantial power in the marketplace, to improperly pressure issuers to pay for ratings and purchase ancillary services; and (iv) evidence relating to whether NRSROs were adequately protecting confidential information. The examinations suffered from an overall lack of cooperation offered by the NRSROs with respect to document production. In addition, SEC examiners found evidence that the NRSROs were possibly in violation of Section 17(b) of the Securities Act of 1933, with respect to disclosure of fees from issuers.

Later in 2002, the SEC held two days of public hearings [15] on the role and function of rating agencies. In 2003, the Commission issued the report on the operation of rating agencies that was mandated by the Sarbanes-Oxley Act.

Later in 2003, the Commission issued another Concept Release [16] soliciting public comment with respect to whether credit ratings should continue to be used for regulatory purposes under the federal securities laws, and, if so, the process of determining whose credit ratings should be used, and the level of oversight to apply to such credit rating agencies.

In 2005, the Commission proposed another rule [17] defining "NRSRO," which unlike the 1997 proposal, would not establish a formal application process or require Advisers Act registration. The 2005 proposal, which has not been acted upon, would define "NRSRO" as an entity (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) 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 (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, prevent the misuse of public information, and has sufficient financial resources to ensure compliance with these procedures.

IV. Critiques of NRSRO system: Inadequate transparency, competition, and accountability

Witnesses appearing before the Committee described the current system for approving rating agencies as vague, arbitrary, and anticompetitive.[18] The term "NRSRO" remains undefined by the Commission after three decades. There is no formal application process. Some applicants have waited a decade without a final decision by the staff. SEC commissioners are not formally involved in the decision whether to recognize new NRSROs. The most important requirement for acquiring the coveted status presents an obvious "Catch 22": to get the designation you must be nationally recog-

---

[15] The Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, Hearings Before the U.S. Securities and Exchange Commission (November 15 and 21, 2002). Full hearing transcripts are available on the SEC's Web site at http://www.sec.gov/spotlight/ratingagency.htm

[16] Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws, Release No. 33–8236 (June 4, 2003), 68 FR 35258 (June 12, 2003).

[17] Definition of Nationally Recognized Statistical Rating Organization, Release No. 34–51572 (April 19, 2005), 70 FR 21306 (April 25, 2005).

[18] See, e.g., the testimony of Mr. Alex Pollock, Resident Fellow, American Enterprise Institute, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 7, 2006, at 1.

nized, but you cannot become nationally recognized without first having the designation. Mr. Yasuhiro Harada, Executive Vice President of Rating and Investment Information, Inc., expressed the almost universal view that the national recognition requirement was a "circular test."[19] Several witnesses testifying before the Committee noted that the standard has served as a substantial barrier to entry for new entrants and that greater competition would benefit investors by generating more innovation and higher quality ratings at lower costs.[20]

Witnesses also testified that the absence of any meaningful SEC oversight of rating agencies has led to accountability problems and to questions relating to NRSRO compliance with federal securities laws and the criteria listed in the no-action letter. Mr. Frank Partnoy, Professor of Law, University of San Diego School of Law, asserted that the voluntary policing regimes are "self-serving and toothless" and that "NRSROs will not police their conduct without a credible enforcement mechanism."[21] For these reasons, the witnesses urged the Committee to replace the NRSRO system with a registration system.[22] Ms. Colleen S. Cunningham, President and Chief Executive Officer of Financial Executives International, testified that "the most effective way to increase competition in the credit rating market would be to eliminate the broken 'no action' process and replace it with transparent registration requirements . . . By establishing stringent yet clear criteria for registration, Congress would . . . generate more competition . . . more choice for issuers; lower costs . . . and higher quality service."[23]

V. Reforms included in the credit rating agency reform act

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. The Committee believes that eliminating the artificial barrier to entry will enhance competition and provide investors with more choices, higher quality ratings, and lower costs.

Credit rating agencies that choose to register as NRSROs must disclose important information such as ratings performance, conflicts of interest, and the procedures used in determining ratings. Rating performance statistics will be updated annually. This infor-

---

[19] Testimony of Mr. Yasuhiro Harada, Executive Vice President, Rating and Investment Information, Inc., before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 8, 2005, at 2. Mr. Harada explained that his ratings firm, the most recognized firm in Japan and the broad Asian markets, had unsuccessfully sought NRSRO status for a decade. He said it "has been an exercise in delay and disappointment" (at 2).

[20] See, e.g., the testimony of Mr. Paul Schott Stevens, President, Investment Company Institute, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 7, 2006, at 5–7.

[21] For a groundbreaking and highly influential analysis of credit rating agencies, see Mr. Partnoy's law review article, "The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies," Washington University Law Quarterly, Fall 1999.

[22] See, e.g., Stevens, op. cit., at 7.

[23] Testimony of Ms. Colleen Cunningham, President and Chief Executive Officer, Financial Executives International, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 7, 2006, at 4.

mation will facilitate informed decisions by giving investors the opportunity to compare the ratings quality of different firms.

Witnesses testifying at the Committee's rating agency hearings asserted that the bankruptcies at Enron, WorldCom, and other corporations demonstrated that NRSROs are not providing investors with timely and accurate ratings.[24] All of the then-three NRSROs rated Enron at investment grade until only four days before default. WorldCom was rated investment grade debt only 42 days prior to its bankruptcy filing. Mr. Sean Egan, Managing Director of Egan-Jones Ratings Company, citing these and other missed calls,[25] testified that the rating industry is a "dysfunctional . . . partner monopoly" that is in "crisis." [26]

Several witnesses described the business model for the dominant rating agencies as inherently conflicted.[27] Debt issuers pay the rating agencies for their rating. In addition, rating agencies increasingly market ancillary, fee-based consulting services, thus exacerbating the basic conflict.[28] The Act addresses these concerns by requiring registration form disclosure of any conflict of interest relating to the applicant's issuance of credit ratings, and by requiring the Commission to adopt rules prohibiting conflicts of interest or requiring the management and disclosure of such conflicts.

Prior to the Committee mark-up of the Act, a broad coalition of interested parties that typically offer different ideological perspectives expressed support for the bipartisan product:

The Investment Company Institute said the Act "brings much needed sunlight to credit ratings" and "will benefit a wide range of market participants."

The AFL–CIO expressed its "strong support" for the legislation and said it would "protect the investing public against conflicts of interest within the credit rating agencies . . . [and] encourages in a responsible manner greater competition."

The Association for Financial Professionals said the bill will "foster competition, stimulate innovation, hold credit rating agencies accountable, and improve the quality of information available to investors, and, as a result, restore confidence in the credit ratings market."

The Bond Market Association said the bill would create a "more competitive credit rating industry [that] will contribute to more robust and efficient capital markets that will ultimately benefit investors and the overall economy."

Consumer Federation of America wrote that it will "help ensure that only high quality ratings will be used for economically important regulatory purposes" and praised the bill's requirements for "certifications by Qualified Institutional Buyers . . . and [for] giv-

---

[24] In testimony before the Committee, the NRSROs explained their performance by saying that Enron and WorldCom also misled them.

[25] Egan, op. cit., at 1–2. Mr. Egan also referenced the California utilities, Global Crossing, AT&T Canada, and Parmalat as prominent examples where the NRSROs failed to protect investors.

[26] Egan, op. cit., at 1–2.

[27] Rating agencies acknowledge the inherent conflict of issuers paying for ratings. But they argue that it is effectively managed inasmuch as analysts do not benefit financially from any of their rating decisions. Analysts are not permitted to own any of the securities they follow. Also, because the fees from each issuer amount to less than one percent of overall revenues, the rating agencies argue that no issuer is likely to impair independence.

[28] See, e.g., testimony of Mr. James A. Kaitz, President and Chief Executive Officer, Association for Financial Professionals, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 8, 2005, at 6. See also Partnoy, op. cit., at 4.

ing the . . . SEC . . . authority to deny NRSRO status to rating agencies that lack the financial and managerial resources to produce ratings of integrity."

Financial Executives International said the bill "positively addresses three issues of great importance to our members: competition, accountability, and conflicts of interest," and "urge[d] Congress to enact this important legislation this year."

Fitch said it "represents a significant step forward to prudently enhance competition in the rating agency industry."

Fidelity Investments said the bill "will improve ratings quality by fostering transparency and accountability."

Ratings and Investment Information, Inc. commended the bill for "establishing a much more transparent application process and, most importantly, prescribing a specific timeline within which the agency must act."

COMMITTEE CONSIDERATION

On August 2, 2006, the Committee considered a managers' amendment offered by Chairman Shelby and Senator Sarbanes that revised the base text of the Committee Print. The managers' amendment made essentially two changes. First, it ensured that the SEC would not regulate the rating methodologies used to determine ratings. Second, it clarified that rating agencies registering under the bill would not in any way waive or otherwise diminish any right, privilege, or defense that such rating agencies may otherwise have under State or Federal law. The amendment also made some technical changes to the Committee Print. On a unanimous vote, the Committee reported the bill, as amended, to the Senate for consideration.

SECTION-BY-SECTION ANALYSIS OF THE ACT

Section 1. The Short Title is "Credit Rating Agency Reform Act of 2006."

Section 2. Findings are based on the SEC study issued pursuant to Section 702 of the Sarbanes-Oxley Act, Senate Banking Committee and House Financial Services Committee hearings in the 108th and 109th Congresses, comments on the SEC Concept Releases and Proposed Rules, and "facts otherwise disclosed and ascertained." Specifically, Congress finds that: (1) Credit ratings, reports, and related documents are distributed and contracts negotiated by use of the mails and means of interstate commerce; (2) ratings related to the purchase and sale of securities traded on exchanges and in interstate commerce; (3) the transactions "substantially . . . affect interstate commerce and securities markets, the national banking system, and the national economy"; (4) oversight of such credit rating agencies serves the compelling interest of investor protection; (5) the two largest rating agencies serve the vast majority of the market, and additional competition is in the public interest; and (6) the Commission has indicated it needs statutory authority to oversee the credit rating industry.

Section 3. Definitions are added to Section 3(a) of the Exchange Act for CREDIT RATING, CREDIT RATING AGENCY, NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION, PERSON ASSOCIATED WITH A NATIONALLY RECOGNIZED

STATISTICAL RATING ORGANIZATION, and QUALIFIED INSTITUTIONAL BUYER ("QIB" or "QIBs").

Section 4. Registration creates a new Section 15E of the Exchange Act with subsections as follows:

(a) A credit rating agency that wants to become an NRSRO must furnish an application that contains the following required information: (i) rating statistics over short-, mid-, and long-term periods; (ii) procedures and methodologies that the rating agency uses to determine ratings; (iii) policies or procedures to prevent misuse of material nonpublic information; (iv) organizational structure; (v) whether the rating agency has a code of ethics and, if not, the reasons; (vi) conflicts of interest related to the issuance of ratings; (vii) the types of ratings it intends to issue (financial institutions; broker-dealers; insurance companies; corporate issuers; issuers of asset-backed securities; and issuers of government securities); (viii) on a confidential basis, a list of the 20 largest issuers and subscribers that use the rating services; (ix) on a confidential basis, certifications from at least 10 QIBs that they have used the ratings for at least the three most recent years, including two certifications for each type of rating it will issue—no QIB will be liable in any private right of action for what it states in a certification; and (x) other data the SEC requires.

Within 90 days of receiving the application, the SEC shall 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 QIBs stating that they have "used" the agencies" ratings, the Committee intends "used" to mean that the QIB seriously considered the ratings in some of their investment decisions. Thus, a QIB 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 bill. A QIB 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.

(b) An NRSRO must update its application "promptly" if the application becomes "materially inaccurate" except with respect to its ratings performance statistics and the QIB certifications. An NRSRO must annually certify that the application documents (other than the QIB certifications) remain accurate and list any material changes that occurred.

(c) The SEC has the authority to prevent NRSROs from issuing "credit ratings in material contravention of those procedures" which such NRSROs included in their applications and reports. The SEC's rules "shall be narrowly tailored to meet the requirements of this title . . . and shall not purport to regulate the substance of credit ratings or the procedures and methodologies" by which such NRSROs determine their ratings.

(d) 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."

(e) An NRSRO can terminate registration voluntarily, subject to the terms and conditions of the SEC.

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

(g) The Commission must promulgate rules to require NRSROs to establish, maintain, and enforce written policies and procedures to prevent the misuse of material nonpublic information that it obtains.

(h) The Commission must promulgate rules to require NRSROs to prohibit, or require the management and disclosure of, any conflicts of interest that arise from their business. These rules must address: (A) compensation of the NRSRO for ratings and other services; (B) the provision of consulting services to companies the NRSRO rates; (C) conflicts in business relationships with the NRSRO and an entity it rates; (D) affiliations between an NRSRO and a securities underwriter; and (E) other potential conflicts that the SEC deems appropriate in the public interest or for the protection of investors.

(i) The Commission must promulgate rules to require NRSROs to address any acts or practices that the Commission determines to be "unfair, coercive, or abusive," including those related to: (A) conditioning or threatening to condition an issuer's credit rating on the purchase of other services or products; (B) 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 (C) modifying or threatening to modify a credit rating based on whether the issuer or an affiliate will purchase other services from the NRSRO.

The Committee intends that the Commission, as a threshold consideration, must determine that the practices subject to prohibition under this section are unfair, coercive, or abusive before adopting rules prohibiting such practices.

With respect to the activities described in subparagraph (B), the Committee 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, the Committee intends that the Commission, after resolving the threshold consideration described above, should prohibit only those rating refusals that occur as part of unfair, coercive, or abusive conduct.

(j) Each NRSRO must designate an individual responsible for compliance with the securities laws.

(k) Each NRSRO shall on a confidential basis furnish the Commission with financial statements as the Commission determines by rule to be necessary or appropriate.

(l) Upon enactment of the Act, 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 Commission 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.

(m) (1) Registration does "not constitute a waiver of, or otherwise diminish, any right, privilege, or defense that a nationally recognized statistical rating organization may otherwise have under any provision of State or Federal law, including any rule, regulation, or order thereunder." (2) The law does not create a private right of action regarding any report furnished by an NRSRO under this law.

(n) The Commission shall issue rules implementing the new law, and review and amend (as appropriate) existing rules, within 270 days after the date of enactment.

(o) This section shall become effective on the earlier of the date on which regulations are issued in final form or 270 days after enactment of this section.

(p) Conforming amendments [to various statutory provisions].

Section 5. Any report that an NRSRO is required by Commission rules to make is deemed to be "furnished" and not filed. The SEC is authorized to adopt reporting and recordkeeping requirements for NRSROs.

Section 6. The Commission annually shall report to the Senate Banking Committee and House Financial Services Committee about the applicants for registration, actions taken on these applications, and views of the Commission on the state of competition, transparency, and conflicts of interest among NRSROs.

Section 7. The Government Accountability Office shall study and report to the Senate Banking Committee and the House Financial Services Committee within 3–4 years after enactment 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 would report on the problems, if any, faced by business organizations resulting from the Act's implementation and recommended solutions to such problems.

CHANGES IN EXISTING LAW

On August 2, 2006, the Committee unanimously approved a motion by the Chairman to waive the Cordon rule. Thus, in the opinion of the Committee, it is necessary to dispense with the requirement of section 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

REGULATORY IMPACT STATEMENT

In accordance with paragraph 11(b), rule XXVI, of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact of the bill.

The Act seeks to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. It would result in no significant costs to either the Federal Government or state, local, and tribal governments. The Act's provisions requiring certain public disclosures and establishing rules relating to con-

flicts of interest and other matters would impose mandates on the private sector resulting in de minimis costs.

COST OF LEGISLATION

Section 11(b) of rule XXVI of the Standing Rules of the Senate, and Section 403 of the Congressional Budget Impoundment and Control Act, require that each Committee Report on a bill contain a statement estimating the cost of the proposed legislation. The Congressional Budget Office has provided the following cost estimate and estimate of costs of private-sector mandates.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, September 1, 2006.

Hon. RICHARD C. SHELBY,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for the Credit Rating Agency Reform Act of 2006.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contacts are Susan Willie (for federal costs), and Paige Piper/Bach (for the impact on the private sector).

Sincerely,

ROBERT T. MURPHY
(For Donald B. Marron, Acting Director).

Enclosure.

Credit Rating Agency Reform Act of 2006

The legislation would require the Securities and Exchange Commission (SEC) to establish a registration process for credit rating agcncies (organizations that determine the credit worthiness of securities or money market instruments) that seek to be designated by the SEC as a nationally recognized statistical rating organization (NRSRO). Under current law, thcre is no formal registration process; SEC staff currently identifies five credit rating agcncies as NRSROs.

Under the bill, SEC would impose disclosure and filing requirements on credit rating agencies seeking registration. The SEC would prohibit certain activities of registered credit rating agencies, including issuing or modifying ratings on the condition that the customer purchase other services from the credit rating agency. Registered credit rating agencies would be subject to new rules developed by the SEC designed to protect private information held by the agencies and prevent conflicts of interest. Based on information from the Commission and assuming the availability of appropriated funds, CBO estimates that implementing the registration and enforcement requirements of the bill would cost $3 million over the 2007–2011 period. Enacting the bill would not affect direct spending or revenues.

The bill contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no costs on state, local, or tribal governments.

The bill would impose a new private-sector mandate as defined in UMRA on credit rating agencies that are currently identified as NRSROs. Under current law, credit rating agencies are identified as NRSROs upon receiving a "no-action" letter from the Securities and Exchange Commission. The bill would defme the term "nationally recognized statistical rating organization" and void any "no-action" letters previously received from the SEC. Thus, the bill would require credit rating agencies that currently are identified as NRSROs to register with the SEC and follow certain requirements if they want the NRSRO designation as defined under the bill. According to government sources, only five credit rating agencies are currently identified as NRSROs. Based on information from government sources, CBO estimates that the incremental cost for those agencies to register and follow any prescribed rules would be small and fall below the annual threshold for private-sector mandates established by UMRA ($128 million in 2006, adjusted annually for inflation).

On June 29, 2006, CBO transmitted a cost estimate for H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2006, as ordered reported by the House Committee on Financial Services, on June 14, 2006. Both this bill and H.R. 2990 would require the SEC to establish a registration process for credit rating agencies; accordingly, CBO's cost estimates are the same.

The staff contacts for this cost estimate are Susan Willie (for federal costs), and Paige Piper/Bach (for the impact on the private-sector). This estimate was approved by Paul R. Cullinan, Unit Chief for the Human Resources Cost Estimate Unit, Budget Analysis Division.

○