

Credit rating agencies in a post-Enron world: Congress revisits the NRSRO concept

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ABSTRACT

This paper gives an overview of the regulatory reforms in the US credit rating industry, most notably through the Credit Rating Agency Reform Act of 2006. The paper first explicates the developments that accelerated the regulatory reform in the credit rating industry and puts them in the broader context of the Sarbanes–Oxley Act of 2002. Next, the paper explains that the no-action letter NRSRO designation process has been replaced by a voluntary registration process that no longer has as essential criterion that a credit rating agency must be ‘nationally recognized’. The Securities and Exchange Commission (SEC) aims to improve the quality and integrity of the credit rating industry foremost by increasing competition between credit rating agencies, be it among existing credit rating agencies or be it through de novo entrants. Moreover, the SEC has been equipped with enforcement powers,

which include the suspension and revocation of the NRSRO status. These powers may be put into effect, for example, when a credit rating agency does not comply with procedures regarding the prevention of the misuse of material non-public information, certain (prohibited) conflicts of interest, and other abusive practices. In addition, credit rating agencies are subject to (onsite) examination and extensive documentation retention and management programmes. While important barriers to de novo entry into the credit rating industry have been eliminated, it remains to be seen whether and to what extent increased competition in the credit rating industry will be realised and will have the desired effect of improving the quality and integrity of the credit rating industry. Given the influence of credit rating agencies in the capital markets and their regulatory responsibility as private-sector watchdogs, increased oversight of the credit rating industry is a necessary and laudable development. Credit rating agencies currently remain prominently in the spotlight of national, federal, and international securities regulators.

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INTRODUCTION

Nationally Recognized Statistical Rating Organizations (‘NRSROs’) enjoy an incredible degree of power and influence in the capital markets for debt securities. Moody’s Investor Service, Inc. (‘Moody’s’) and Standard & Poor’s

Division of the McGraw-Hill Companies, Inc. ('Standard & Poor's') currently dominate the US market for the rating of debt securities, in what has been termed a duopoly or a government sponsored cartel. Fitch Ratings, Inc., as a result of the consolidation of several credit rating agencies during the 1990s, takes a third place in the US market for the rating of debt securities, while it dominates the European market. In addition, there are two smaller, specialised credit rating agencies that have adopted NRSRO status in the US: A.M. Best Company, Inc. and Dominion Bond Rating Service Limited. Finally, two Japanese bond rating firms, that is, Rating and Investment Information, Inc. and Japan Credit Rating Agency, Ltd., have recently adopted NRSRO status in the US, bringing the total number of no-action letter NRSROs to seven. Two hearings have been held by the US Senate, respectively, in 2002 and 2006 to assess the role of NRSROs in the capital markets, in addition to several hearings initiated by the US House of Representatives and the Securities and Exchange Commission ('SEC') in an attempt to 'rate the rating agencies'. As a result, Congress enacted the Credit Rating Agency Reform Act of 2006 ('Credit Rating Agency Act'), and the SEC promulgated regulations pursuant to the Credit Rating Act.

Credit ratings were already in use by the banking and insurance sector in the 1930s and 1940s, albeit not by reference to the NRSRO designation. Credit ratings were used as arbiters to propound 'safety-and-soundness' regulations, and effectively established 'uniformity in the definition of "investment grade" across the banking and insurance regulators'.¹ The secure power of the 'big three' NRSROs in the US market is mainly explained by the fact that the NRSRO concept, hence the status of credit rating agencies that have been designated NRSRO, has traditionally been created by the SEC in 1975 through the no-action letter process. The no-action letter process entails that the Division of Market Regulation of the SEC, upon request, provides written assurance

that it will not recommend enforcement action to the SEC, for example, against broker-dealers. In 1975, by way of a no-action letter, the SEC exempted broker-dealers from the net-capital requirements of Rule 15c3-1 under the Securities Exchange Act of 1934.

When computing their net capital, broker-dealers are permitted to deduct from their net worth certain percentages of the market value ('haircuts') of securities rated investment grade by a credit rating agency of national repute.² Broker-dealers who hold investment grade securities are exempted to that extent from the net capital they are required to maintain by the SEC. A credit rating agency was considered an NRSRO when the Division of Market Regulation of the SEC provided written assurance that it will not recommend enforcement action to the SEC (no-action letter) against broker-dealers for purposes of Rule 15c3-1 under the Securities Exchange Act of 1934, when broker-dealers consider the credit ratings of the credit rating agency as credit ratings of a credit rating agency of national repute.

Since 1975, the concept of NRSRO (as a regulatory designation provided by the SEC through the no-action letter process) has been adopted in several other federal regulations and legislation, including foremost, the Investment Company Act of 1940, which under Rule 2a-7 limits mutual funds to invest only in securities that are rated by an NRSRO in the two highest rating categories for short-term debt, and limits the amount of securities to be held that are not rated in the highest rating category. Furthermore, several banking laws and regulations, especially after the savings and loans crises, restrict banking institutions only to hold debt securities that are rated investment grade by (at least two) NRSROs. Finally, numerous other federal rules and regulations employ the NRSRO concept.³

NRSROs provide information and advise to (prospective) investors about the credit-worthiness of an issuer of debt securities, and particular financial instruments. Their

judgment as to the creditworthiness of an issuer is often decisive for the access of an issuer to the capital markets. As a result, NRSROs yield not only great power, but also a great responsibility. Not only do NRSROs decide which companies are sufficiently creditworthy to have access to (the higher regions of) the capital markets for debt securities, they also have the power to keep those who do not qualify as creditworthy out, by discouraging to invest in and by alerting investors of issuers and their securities that do not deserve the designation 'investment grade'. This paper gives a synopsis and assessment of the recent regulatory steps taken by the US Congress to empower and gird into action the SEC to exert further and increased oversight of the credit rating industry.

The US Congress has done so first through the enactment of the Sarbanes–Oxley Act of 2002 (SOX), by requiring a study of the role and function of credit rating agencies in the securities market pursuant to Section 702 of SOX,⁴ and, moreover, as a result of several studies and hearings, by the enactment of the 'Credit Rating Agency Reform Act of 2006'.⁵ This paper is organised as follows. First, in the first section, we examine the role of credit rating agencies in the Enron saga, which, together with the collapse of WorldCom and others, prompted the promulgation of Section 702 of SOX, and, as a result, led to the adoption of the Credit Rating Agency Act. Moreover, in the second section, we explicate the corporate governance framework that existed antecedent to the Enron saga, which was clearly insufficient, and the framework put in place as of September 2006, by exploring the principal corporate governance issues, principles, and rules in the credit rating industry. In addition, in the third section, we elaborate on the regulations issued by the SEC pursuant to the Credit Rating Agency Act. Finally, in the last section, we not only give an assessment of the results of this paper, but also consider the merits and demerits of a possibly 'tethered' credit rating industry.

WHAT WAS THE ROLE OF CREDIT RATING AGENCIES IN THE ENRON SCANDAL?

Enron was a company that consistently received good credit ratings at the upper levels, up until four days before Enron filed for bankruptcy.⁶ As late as March 2000, Moody's gave Enron a 'Baa1', and Standard & Poor's and Fitch rated Enron as 'BBB+' indicating a very good credit quality. Credit ratings were important for Enron, because a good credit rating, that is, investment grade and above, provided Enron the stability to operate and expand its trading business as well as the opportunity to access the capital markets to meet its liquidity needs. Enron had repeatedly sought improved ratings by the credit rating agencies, despite the fact that it embarked on a business that involved substantial amounts of risk. Because Enron's collapse was so shocking and problematic out of its sheer size and out of the widespread and unashamed fraud, Congress started a broad investigation into that collapse. The investigation by the Senate Governmental Affairs Committee focussed not only on the role of the SEC and that of private-sector watchdogs, that is, the board of directors of Enron, the auditors, but also the Wall Street analysts and credit rating agencies.⁷ It is striking at first that among those enumerated above as private-sector watchdogs, credit rating agencies were in a particularly privileged position. The credit rating agencies had no relationship with Enron that could in any way constitute a direct interlock of interests between them. Sure, Enron was an issuer of debt securities that were rated by credit rating agencies, apart from the company itself as a corporate entity, and hence paid for the services of the credit rating agencies, but that is not different from any other company that credit rating agencies assess as to their creditworthiness. In fact, one could assert very strongly, that of the private-sector watchdogs enumerated above, the credit rating agencies were in the best position to raise red flags to the market, precisely because of the fact that they not only had access to material

non-public financial information of Enron,⁸ but also because the credit rating agencies were not affected by classical conflicts of interest that would render them beholden to Enron in particular. The credit rating agencies cannot be made afoul of conflicts of interest that had rendered them beholden in any way to Enron, which cannot be said of the other private-sector watchdogs; but they failed to exercise the due urgency and probing investigation, so as to signal and inform the capital markets of the impending implosion of Enron. In this section, therefore, we will explore the role of the credit rating agencies in the collapse of Enron. We will examine the corporate governance issues, principles, and rules in the credit rating industry more fully in the second section.

Enron had been engaged in widespread fraud for quite a while, and it seems to have been only a matter of time that the facade would surface. In early October 2001, Enron informed the credit rating agencies of a \$2.2bn write-down because of accounting adjustments. In addition, Ken Lay, who had resumed the role of Enron's CEO after Jeffrey Skilling's resignation in August 2001, tried to reassure the credit rating agencies that, nevertheless, a downgrade was not necessary, because Enron would shore up its balance sheet.⁹ On 17th October, 2001, however, the *Wall Street Journal* broke the story with a report about Enron's off-balance sheet arrangements, and the SEC started to investigate the allegations of the report, while Enron's CFO Andrew Fastow resigned. Ironically, this did not prompt the credit rating agencies to act. Rather, credit rating agencies began to take notice of Enron's possibly undeserved credit rating status, when in early November 2001, reports abounded that Enron was seeking a substantial equity investor or acquirer for the company to address its liquidity problems.¹⁰ Enron had to draw-down its line of credit to the amount of \$3bn with its banks at the end of October 2001 and by 5th November, 2001, when informed of the drawdown by Enron, Moody's, and Standard & Poor's decided to lower Enron's credit rating to

just two notches above 'junk', while Fitch lowered Enron's rating to just one notch above 'junk'. Enron's business model was predicated upon an 'investment grade' rating, and a downgrade to 'junk' would have disastrous effects.¹¹ It would not only hamper its ability to enter into agreements with counterparties in relation to its trading operations, but it would also 'trigger' provisions in a number of agreements of Enron, so as to constitute a default or to require cash collateral, that is, accelerated payment.

In this period, absent a proximate equity investor or acquirer, the credit rating agencies would have difficulty in maintaining Enron's rating (just) above 'junk' grade. Simultaneously, without an 'investment grade' credit rating, Enron would surely face systematic default and bankruptcy, because it would constitute a triggering event under (private party) agreements, because counterparties would not trade with a below-investment grade trading company, and because it would foreclose access to the capital markets. The independent judgment of the credit rating agencies, therefore, was significant and could have a decisive impact on Enron's downfall and how (and at what stage) it would affect the capital markets. Enron was able to prolong its investment grade rating by the credit rating agencies, though, because Dynegy, Inc., another Houston energy company, expressed an interest in a merger with Enron. The possible merger with Dynegy was conveyed to Moody's in detail on 6th November, 2001, and was scheduled to be announced on 8th November, 2001. With the business combination, the new entity, according to Moody's, could maintain an investment grade rating, but the first proposal was not acceptable to Moody's, because the merger agreement contained too many 'outs' for Dynegy. Most significantly for Moody's, the agreement contained 'material adverse changes' ('MACs') clauses that allowed Dynegy to terminate the transaction, among others, upon a decline in Enron's credit rating.¹² Moody's was concerned about the transaction, because without the

merger Enron could not sustain an investment grade rating, while the merger agreement contained MAC clauses, indicating for Moody's that Dynegy and the banks were not sufficiently committed to the merger. As a result, Moody's decided to lower Enron's credit rating below-investment grade on 7th November, 2001, and informed Enron of Moody's' decision on 8th November, 2001, that it would issue a press release that day announcing the downgrade. Enron postponed its planned announcement of the merger, and made efforts to prevent the announcement of the downgrade by Moody's, and to encourage Moody's not to downgrade Enron's rating below-investment grade.

Soon after Moody's informed Enron of its planned downgrade, Moody's received phone calls from J.P. Morgan Chase, Citigroup, and ChevronTexaco, a major shareholder of Dynegy. Citigroup CEO Michael Carpenter expressed the concern to Moody's that any threat to the stability of Enron would seriously disrupt the energy markets. Moody's indicated that such a concern was rather an issue for the appropriate government agency to address, and that, when applicable, the government 'could organize a "rescue" as it had done for Long Term Capital Management'.¹³ In a separate meeting on the same day, J.P. Morgan Chase expressed similar concerns about the systemic risk from an Enron collapse — disruption in the energy and financial markets. Moody's responded to J.P. Morgan Chase that systemic risks issues were the government's problem. When contacted by Citigroup and J.P. Morgan Chase about the possible downgrade (*sic*) and that it could have a serious impact on the energy markets, the financial markets, and even on the banking system, both the Treasury Department and the Federal Reserve Bank of New York indicated that it was a bad idea for them to interfere with the credit rating business. Also, it was to no avail, when Ken Lay had contacted Commerce Secretary Don Evans for support *vis-à-vis* the credit rating agencies.¹⁴ Rather, Moody's wanted assurance that Dynegy would close on the transaction, by

removing the MAC clauses and by raising the litigation thresholds. The banks responded by committing to an additional equity infusion, while Dynegy agreed to remove the MAC clauses and to raise the litigation thresholds. ChevronTexaco reiterated its strong 'soft' support for the transaction. As a result, because of these developments, in the evening of 8th November, 2001, Moody's convened a credit committee to reconsider Enron's rating.

Moody's determined that the new information constituted and expressed a sufficient commitment to the merger by Dynegy, and therefore that a downgrade below-investment grade was not warranted at the time. Therefore, on 9th November, 2001, Moody's announced that it was lowering Enron's credit rating to 'Baa3', the lowest investment grade rating. Fitch issued a two-notch downgrade on Enron to 'BBB-' (just one level above junk), and Standard & Poor's also downgraded Enron to 'BBB-' (one notch above junk). All credit rating agencies retained Enron's credit rating above investment grade through 28th November, 2001, with the proposed merger as the principal justification. Despite another \$500m restatement on 8th November, 2001, the possibility of financial fraud did not figure as a concern for the credit rating agencies. Furthermore, on 19th November, 2001, Enron filed its Form 10-Q, which disclosed that the Standard & Poor's downgrade on 9th November, 2001, had triggered a demand obligation for \$690m, to the surprise of both the Enron management and the credit rating agencies. This raised no important concerns for the credit rating agencies and did not affect the credit rating of Enron. Only when over the next few days the likelihood of a merger seemed more and more remote, and on 28th November, 2001, with reports that Dynegy had revised the agreement to include additional ways to terminate the transaction without additional cash infusions from the banks, did the credit rating agencies decide to give up on Enron and downgrade Enron below-investment grade.¹⁵ As a result, on 28th November, 2001,

Moody's downgraded Enron five notches to 'B2', Standard & Poor's downgraded Enron six notches to 'B-', and Fitch lowered Enron more than eight notches to 'CC'. Four days later, on 1st December, 2001, Enron filed for bankruptcy.

The report of the Staff of the Committee for Governmental Affairs in 2002, seriously questioned the passive attitude of the credit rating agencies with respect to the accuracy of the financial facts in determining the creditworthiness of Enron. The report stated that the rating analysts had taken too narrow a focus in determining the problems of Enron, by focusing on short-term problems, like cash flow, counterparty confidence, or whether the Dynegy merger would succeed, rather than on more fundamental problems, such as questionable transactions and suspect accounting. The Committee concluded that 'the credit rating agencies' approach to Enron fell short of what the public had a right to expect, having placed its trust in these firms to assess corporate creditworthiness for the purposes of federal and state standards'.¹⁶ The committee allotted the shortcomings of credit rating agencies to their lack of accountability, that is, their practical immunity from lawsuits and nonexistent regulatory oversight.¹⁷ Furthermore, the Committee indicated that the credit rating agencies displayed insufficient review of company materials, while they were in a very good position to investigate possible misbehaviour. Footnote 16 of Enron's 2000 10-K filing, for example, referred to off-balance sheet entities that involved related-party transactions, but they were only assessed by the credit rating agencies in relation to their impact on cash flow. Standard & Poor's was aware of the off-balance sheet entities, because it had rated some of these in relation to debt offerings, and with more diligent investigation could have become aware of the flaws in Enron's 2001 10-K filing. Standard & Poor's analysts, moreover, had not read Enron's proxy statement, which would have brought to their attention the related-party transactions, and that possible fraud

was afoot. Although credit rating agencies enjoyed greater access to company information compared to any outsider, because of their market power, that is, their ability to downgrade obligors, and because of their exemption from Regulation F-D and First Amendment Free Speech and Free Press Clause protections (and related exemptions under the Investment Advisers Act of 1940), they did not put Enron's financial statements to the test. In consecutive Senate and SEC hearings, credit rating agencies consistently referred and deferred to the responsibility of auditors as to the accuracy of financial statements. That stance of the credit rating agencies, with strict deferral to the auditors as to the accuracy of the financial statements, that is, their 'input', misses the fundamental point that those financial statements affect their rating, that is, their 'output', and hence that they must exert diligence and skepticisms with respect to the information they receive from issuers or obligors.¹⁸ With the introduction of the Credit Rating Agency Act, Congress has attempted to increase the level of competition, accountability, and transparency in the credit rating agency, and, as a result, to therewith improve the quality of the credit ratings by NRSROs. We now turn to the new regulatory regime of the credit rating industry through an analysis of the NRSRO concept and an expose of the Credit Rating Agency Act, which constitutes a true revolution in the (regulation of the) credit rating industry.

WHAT IS THE CURRENT CORPORATE GOVERNANCE REGIME OF THE CREDIT RATING INDUSTRY?

In this section we describe the development of the NRSRO concept, from its SEC no-action letter origins to its SEC-supervised and registered present nature. Therewith, we explicate the current regulatory regime of the credit rating agencies that are NRSROs and the issues and principles that gave rise to the current regime, as embodied by the Credit Rating Agency Act. Before the Credit Rating Agency



Act, the Nationally Recognized Credit Rating Agency concept had an altogether different meaning. NRSROs were credit rating agencies that were issued no-action letters by the SEC. Under the Credit Rating Agency Act, the NRSROs are stripped from their status of 'no-action letter' NRSRO, and are required to register with the SEC to regain their NRSRO status. Other credit rating agencies, that were not previously issued a no-action letter — some of the credit rating agencies had waited for more than a decade without a (positive) response — can also register under the Credit Rating Agency Act for an NRSRO status, and are entitled to a process within 90 days, which, as elaborated below, absent good cause, cannot exceed 120 days. The registration-based NRSRO process is a real parting with the past system, which operated on a no-action letter basis and had as principal condition that the credit ratings of a credit rating agency were widely recognised by the investment community as from a credit rater with national repute. The circularity of the recognition process,¹⁹ whereby only credit rating agencies of national repute became NRSROs, and only credit rating agencies with NRSRO designation obtain a repute of national significance, because of the regulatory reference to the NRSRO concept has explicitly been discarded by the Credit Rating Agency Act. The national recognition criterion still figures in some form in the Credit Rating Agency Act, of course, but no longer does it pose a substantial barrier to entry for new credit rating agencies, so as to preclude them from a plausible (and timely) shot at NRSRO status.

When the SEC first granted NRSRO designation to credit rating agencies in 1975, it did not define the NRSRO concept. During the no-action letter era, the NRSRO concept was determined by a number of criteria developed by the SEC's experience from the no-action process. In determining whether to issue a no-action letter, that is, whether a credit rating agency can be considered an NRSRO, the SEC's staff reviewed a credit rating agency's

operations, position in the marketplace, and other specific factors. A review of the credit rating agency's operational capability and ratings process included: per as (1) the organisational structure of the credit rating agency, (2) the credit rating agency's financial resources, (3) the size and quality of the credit rating agency's staff, (4) the credit rating agency's independence from companies it rates, (5) the credit rating agency's rating process, and (6) whether the credit rating agency has internal procedures to prevent the misuse of non-public information and whether those procedures are followed. The single most important factor, however, was whether the credit rating agency was 'nationally recognized' in the US as an issuer of credible and reliable ratings by the predominant users of securities ratings.²⁰ This factor raised a number of concerns among market participants, and had already prompted the Department of Justice to react to a proposed rule in 1997 defining the NRSRO concept in a similar fashion.

In comments submitted to the SEC in relation to the 'nationally recognized' criterion of the proposed definition in 1997, the Department of Justice emphasised, that '[t]he adoption of such a criterion is likely to create an insurmountable barrier to de novo entry into the market for NRSRO services. For this reason, the recognition requirement is likely to be anticompetitive and could lead to higher prices for securities ratings than would otherwise occur'.²¹ Partly dissuaded by the concerns of the Department of Justice, the SEC did not act on the 1997 proposed rule. The same concerns were raised anew, though, when the bankruptcy filings of Enron in 2001 and WorldCom in 2002 resuscitated the NRSRO designation discussion. In the meantime, once recognised as an NRSRO, the SEC had but little regulatory oversight over the credit rating agencies and even under the Investment Advisers Act of 1940, the SEC had very little effective control. The Investment Advisers Act of 1940 prohibits fraud, imposes fiduciary duties on advisers with respect to their advice,

requires that advisers maintain certain books and records, and allows the SEC to examine registered advisers to assure compliance with the Act. Although NRSROs are, however, registered as investment advisers under the Investment Advisers Act of 1940 — they are registered on a voluntary basis as recommended by the staff of the SEC — the credit rating agencies claim the applicability of the exemptions under the ‘bona fide publisher’ provision of the 1940 Act, in addition to the protection from the First Amendment Free Speech and Free Press Clauses, to abstain from any document retention and production to the SEC.²² Furthermore, subject to certain conditions, NRSROs are exempted from the requirements of Regulation F-D, from Section 11 liability, and from prospectus liability under Section 12(a)(2) of the Securities Act of 1933. NRSROs arguably are part of the financial press, and hence deserve the protections constitutionally accorded to financial press under the First Amendment.²³ As a result, the accountability and transparency in the credit rating industry, in addition to competition in and entry barriers to the credit rating business, have become important issues in reforming the credit rating industry, precisely because the quality of the information and the process involved with creating and assessing such information are essential to the quality of the information disseminated by the credit rating industry. This is all the more pertinent, because the market has come to rely more and more on the credit ratings of NRSROs and for an increasing number of debt securities.²⁴

Moreover, since the 1970s, the revenue model of the NRSROs shifted from a subscriber model, whereby investors pay for rating manuals to make informed investment decisions, to an issuer model, whereby obligors pay for the services of NRSROs to obtain the requisite independent rating (for regulatory purposes). This has raised a number of concerns in relation to conflicts of interest and abusive practices in the credit rating industry. Specifically, it focused attention on the extent to

which rating agencies are rendered ‘beholden’ to the issuers they rate and from which they receive payment, the development of ancillary businesses, the practices of ‘notching’ and ‘tying’, the practice of unsolicited ratings, and misuse of material non-public information. The conflicts of interest and abusive practices issues were further exacerbated through the lack of accountability and transparency in the credit rating industry, and related to these industry specifics, the absence of any effective oversight by the SEC.

The ancillary businesses include rating assessment services, where issuers present hypothetical scenarios to the credit rating agencies to determine how their ratings would be affected by a proposed transaction, for example by a merger, asset sale, or stock repurchase. Rating assessments pose another conflict of interest to the extent that credit rating agencies may find it difficult to give an independent credit rating postliminary to the preliminary rating in the rating assessment, but that is incongruent with the preliminary rating. In addition, issuers may be pressured into using the ancillary services out of fear that failure to do so could adversely impact their credit rating, or even may come to believe that purchasing those services could help their credit rating. The ancillary businesses also include risk management and consulting services, which has raised concerns analogous to consulting services by auditors.²⁵ Tying entails the abusive practice, whereby rated companies are forced to purchase ancillary services. Notching involves the lowering of ratings on asset-backed securities unless the rating firm rates a substantial portion of the assets making up the securities, especially relevant for the structured finance market. Unsolicited ratings involve sending an unsolicited rating with a bill or a letter of encouragement to pay for the credit ratings.

Unregulated and without the incentives for self-regulation, the credit rating industry is prone to several situations of misuse of material non-public information. First, a credit rating

agency's subscribers could be given preferential access to rating analysts, so as to inappropriately learn of potential rating actions or other material non-public information. Furthermore, investors could be harmed if a rating is unduly influenced by a person with a vested interest in the level of the rating. In addition, a rating analyst could use material non-public information for improper purposes or may tip that information to others.²⁶ Moreover, without the mechanism for disclosure of these possible misuses of material non-public information or conflicts of interest, the investment market would have to rely on the credit rating agencies themselves to prevent possible misuse and conflicts of interest, that is, would ultimately ask credit rating agencies to be judges in their own cause. Therewith, we have already anticipated one of the regulatory innovations introduced by the Credit Rating Agency Act, which addresses and attempts to curb the abusive practices and conflicts of interest among others by increased reporting requirements, in addition to eliminating root and branch the anti-competitive aspects of the traditional no-action letter NRSRO designation. We now turn to the regulatory regime for the credit rating industry established by the Credit Rating Agency Act.

The Credit Rating Agency Act, first, introduces Section 3(a)(60) to the Securities Exchange Act of 1934 by defining 'Credit Rating' as 'as assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments'. Furthermore, Section 3(a)(61) of the 1934 Act now defines the term 'credit rating agency' as any person "'(A) engaged in the business of issuing credit ratings on the internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company"; "(B) employing either a quantitative or qualitative model, or both, to determine credit ratings"; and "(C) receiving fees from either issuers, investors, or other market participants, or a combination thereof"'. Moreover,

Section 3(a)(62) now gives a definition of the term NRSRO. In lieu of 'nationally' or 'generally recognized', Section 3(a)(62) rather focuses on whether a credit rating agency "'(A) has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under [the newly introduced] section 15E"; "(B) issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix)", with respect to (i) financial institutions, brokers, or dealers; "(ii) insurance companies"; "(iii) corporate issuers"; "(iv) issuers of asset-backed securities (...); "(v) issuers of government securities, municipal securities, or securities issued by a foreign government"; or "(vi) a combination of one or more categories of obligors described in any of the clauses (i) through (v)"; and "(C) is registered under section 15E"'.

As a result, Section 15E of the Securities Exchange Act introduces a voluntary registration system predicated upon transparency and accountability, for credit rating agencies that wish to be NRSROs for regulatory purposes. Section 15E requires disclosure, among others, of ratings performance, conflicts of interest, and the procedures used in determining credit ratings. In addition, for the purposes of registration under Section 15E, the credit rating agency must furnish an application that contains the following required information: per as (1) (iii) policies or procedures to prevent misuse of material non-public information; (2) (iv) organisational structure; (3) (v) whether the rating agency has a code of ethics and, if not, the reasons; (4) (vi) conflicts of interest related to the issuance of ratings; (5) (vii) the types of ratings it intends to issue; (6) (viii) on a confidential basis, a list of the largest issuers and subscribers that use the rating services; (7) (ix) on a confidential basis, certifications from at least ten Qualified Institutional Buyers (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; and (8) (x) other data required by the SEC.²⁷

With the exception of confidential information, all other submitted information contained in the application must be made publicly available by the NRSRO on its website, or on any other comparable, readily accessible means.

Furthermore, NRSROs are required to update their applications 'promptly' if the applications become 'materially inaccurate' except with respect to the performance statistics and the QIB certifications. NRSROs must annually certify that their application documents (except for the QIB certifications) remain accurate and list any material changes. Moreover, the SEC has enforcement authority to prevent NRSROs from issuing credit ratings in material contravention of the procedures included in their applications and reports, including procedures relating to the prevention of misuse of non-public information and conflicts of interest. In this respect, the SEC can issue an order to censure, limit, suspend, or revoke registration of the NRSRO, after notice and comment, 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'.²⁸ Furthermore, the SEC must promulgate rules to require NRSROs to establish, maintain, and enforce written policies and procedures to prevent the misuse of material non-public information.²⁹ Moreover, the SEC must promulgate rules to prohibit, or require the management and disclosure of, any conflicts of interest that arise from the issuance of credit ratings. These rules specifically, but nonexhaustively, include: per as (1) compensation of the NRSRO for ratings and other services, (2) the provision of consulting services to companies the NRSRO rates, (3) the conflicts in business relationships with the NRSRO and the entity it rates, (4) affiliations between an NRSRO and a securities underwriter, and (5) other potential conflicts that the SEC deems appropriate in the public interest or for the protection of investors.³⁰

Moreover, Section 15E(i) of the Exchange Act restricts NRSROs from certain activities that specifically relate to possible unfair, coercive, or abusive practices, as determined and prohibited (through rules promulgated) by the SEC. Those rules specifically pertain to: per as (1) conditioning or threatening to condition an issuer's credit rating on the purchase of other services or products, that is, 'tying'; (2) 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, that is, 'notching'; and (3) modifying or threatening to modify a credit rating based on whether the issuer or an affiliate will purchase the credit rating or any other service or product from the NRSRO, that is, 'unsolicited ratings'. In addition, NRSROs are required to designate a compliance officer who will be responsible for administering the policies and procedures to prevent misuse of material non-public information and conflicts of interest, and for compliance with the securities laws.³¹ Finally, under Section 15E(k) each NRSRO shall, on a confidential basis, furnish the SEC with financial statements in so far as determined necessary and appropriate by the rules of the SEC. The Credit Rating Agency Act explicitly revokes and declares as *void* any previously issued no-action letter designating credit rating agencies as NRSROs, and directs the SEC as well as other regulatory agencies in the US to review regulations that use the NRSRO concept, so as to align them with the NRSRO concept introduced by the Credit Rating Agency Act. Credit rating agencies who wish to be NRSROs for regulatory purposes have to register with the SEC under Section 15E. The SEC shall grant registration within 90 days of receiving the application, or institute proceedings to determine whether registration should be denied, which will be concluded within 120 days of receiving the application, unless extended for good cause.

WHAT ARE THE RULES PROMULGATED BY THE SEC?

To further the goals of the Rating Agency Act, the SEC has promulgated and adopted rules, effective as per 18th July, 2007.³² Therewith, the SEC strives to further the goal of increasing competition in the credit rating industry. The rules, according to the SEC, provide a transparent process to apply for registration as an NRSRO, which, moreover, does not favour a particular business model or larger, established firms. As a result, it will be easier for more credit rating agencies to apply for registration. Increased competition in the credit rating industry could lower the cost to issuers, obligors, and underwriters of obtaining credit ratings.³³

Moreover, increased disclosure requirements, according to the Commission, will allow users of credit ratings to compare the credit ratings of different NRSROs. 'Although the information an NRSRO will provide on its Form NRSRO and to comply with the rules cannot substitute for an investor's due diligence in evaluating a credit rating, it will aid investors by providing a publicly accessible foundation of basic information about an NRSRO'.³⁴ Under the Rating Agency Act and the rules adopted there under by the SEC, an NRSRO is required to disclose information about its credit ratings performance statistics, its methods for determining credit ratings, its organisational structure, its procedures to prevent the misuse of material non-public information, the conflicts of interest that arise from its business activities, its code of ethics, and the qualifications of its credit analysts and credit analyst supervisors.³⁵ In addition, the rules implement the examination authority of the SEC granted by the Rating Agency Act to periodically evaluate compliance with the regulatory scheme set forth in Section 15E of the Exchange Act³⁶ (which implements the Credit Rating Agency Act) and the rules promulgated there under. In this regard, the Rating Agency Act provides that all records of an NRSRO are subject to such reasonable periodic, special, or

other examination by representatives of the SEC as the SEC deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in the furtherance of the purposes of the Securities Exchange Act of 1934.

In the same spirit, NRSROs thus are subject to disclosure, record keeping, and annual financial reporting requirements, as well as requirements, as set forth above and elaborated below, regarding the prevention of misuse of material, non-public information, the management of conflicts of interest, and certain prohibited acts and practices. These disclosure and compliance requirements, which represent a major increase in the oversight of NRSROs, are designed to improve the integrity of NRSROs. An increase in investor confidence in the integrity of NRSROs and the ratings they issue, according to the SEC, could promote participation in the securities markets and facilitate capital formation.³⁷ Furthermore, better quality ratings, according to the SEC, could also reduce the likelihood of an unexpected collapse of a rated issuer or obligor, therewith reducing risks to individual investors and to the financial markets. Finally, increased oversight, according to the SEC, could increase the accountability of an NRSRO to its subscribers, investors, and other persons who rely on the credibility and objectivity of credit ratings in making an investment decision.³⁸

For that purpose, first, under the rules promulgated by the SEC pursuant to the Rating Agency Act, the SEC prescribes an extensive record making and retention program for NRSROs.³⁹ These include documentation of the established procedures and methodologies used by the NRSRO to determine credit ratings. The record-keeping rules allow SEC examiners, for example, to review whether an NRSRO is following its stated procedures and methodologies and otherwise complying with the Rating Agency Act.⁴⁰ The records and books to be made and retained must be complete and current. The SEC provides that the following books and records must be made

and retained: per as (1) records of initial entry into the accounting system of an NRSRO and records reflecting entries to and balances in all general ledger accounts of the NRSRO for each fiscal year; (2) records with respect to each current credit rating of the NRSRO indicating (as applicable): (i) the identity of any credit analyst(s) that participated in determining the credit rating before, (ii) the identity of the person(s) that approved the credit rating before it was issued, (iii) whether the credit rating was solicited or unsolicited, and (iv) the date the credit rating action was taken; (3) an account record for each person (eg, an obligor, issuer, underwriter, or other user) that has paid the NRSRO for the issuance or maintenance of a credit rating, indicating the identity and address of the person and the credit rating(s) determined or maintained for the person; (4) an account record for each subscriber to the credit ratings and/or credit analysis reports of the NRSRO indicating the identity and address of the subscriber; (5) a record listing the general types of services and products offered by the NRSRO;⁴¹ (6) a record documenting the established procedures and methodologies used by the NRSRO to determine credit ratings; and (7) a record that lists each security and money market instrument and its corresponding credit rating issued by an asset pool or as part of any asset- or mortgage-backed securities transaction where the NRSRO, in determining the credit rating for the security or money market instrument, treats assets within such pool or as a part of such transaction that are not subject to a credit rating of the NRSRO by any or a combination of the following methods: (i) determining credit ratings for the unrated assets; (ii) performing credit assessments or determining private credit ratings for the unrated assets; (iii) determining credit ratings or private credit ratings, or performing credit assessments for the unrated assets by taking into consideration the internal credit analysis of another person; or (iv) determining credit ratings or private credit ratings, or performing credit assessments for the unrated assets by

taking into consideration (but not necessarily adopting) the credit ratings of another NRSRO.

In addition, NRSROs are required to retain the following records that specifically relate to its business as a credit rating agency: per as (1) significant records (eg, bank statements, invoices, and trial balances) underlying the information included in the annual financial reports furnished by the NRSRO to the SEC; (2) internal records, including non-public information and work papers, used to form the basis of a credit rating issued by the NRSRO; (3) credit analysis reports, credit assessment reports, and private credit rating reports of the NRSRO and internal records, including non-public information and work papers, used to form the basis for the opinions expressed in these reports; (4) compliance reports and compliance exception reports; (5) internal audit plans, internal audit reports, documents relating to internal audit follow-up measures, and all records identified by the internal auditors of the NRSRO as necessary to perform the audit of an activity that relates to its business as a credit rating agency; (6) marketing materials of the NRSRO that are published or otherwise made available to persons that are not associated with the NRSRO; (7) external and internal communications, including electronic communications, received and sent by the NRSRO and its employees that relate to initiating, determining, maintaining, changing, or withdrawing a credit rating; (8) internal documents that contain information, analysis, or statistics that were used to develop a procedure or methodology to treat the credit ratings of another NRSRO for the purpose of determining a credit rating for a security or money market instrument issued by an asset pool or part of any asset- or mortgage-backed securities transaction; (9) for each security or money market instrument identified in the record required to be made and retained under paragraph (a)(7) of §240.17g-2, any document that contains a description of how assets within such pool or

as a part of such transaction not rated by the NRSRO but rated by another NRSRO were treated for the purpose of determining the credit rating of the security or money market instrument; and (10) form NRSROs (including Exhibits and accompanying information and documents) submitted to the SEC by the NRSRO. Finally, the record making and retention program, in addition to the NRSRO as an entity, also applies to its credit rating affiliates, and any partner, officer, director, branch manager, and employee of the NRSRO or its credit rating affiliates, occupying a similar status or performing similar functions.⁴²

As a result, an NRSRO is required to disclose in its public filings with the SEC a general description of its procedures and methodologies for determining credit ratings. In this regard, the NRSRO thus also must make public certain performance measurement statistics including historical downgrade and default rates within each of its credit rating categories over the short, medium, and long terms. These statistics, according to the SEC, should serve as important indicators of the performance of an NRSRO over time in terms of its ability to assess the creditworthiness of issuers and obligors. That will increase, according to the SEC, the transparency to users of credit ratings with respect to the accuracy of an NRSRO's ratings.⁴³

Secondly, pursuant to the Rating Agency Act, the SEC has provided rules in relation to the prevention of misuse of material non-public information. Pursuant to section 15(E)(g)(1) of the Exchange Act NRSROs must establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information. The written policies and procedures must at the least pertain to the prevention of the following: per as (1) the inappropriate dissemination within and outside the NRSRO of material non-public information obtained in connection with the performance of credit rating services; (2) a person within the NRSRO purchasing, selling, or otherwise

benefiting from any transaction in securities or money market instruments when the person is aware of material, non-public information obtained in connection with the power, of credit rating services that affects the securities or money market instruments; and (3) the inappropriate dissemination within and outside of the NRSRO of a pending credit rating on the internet or through another readily accessible means.⁴⁴

Thirdly, as per the regulations issued by the SEC under the Rating Agency Act, NRSROs are prohibited from having certain conflicts of interest, while it must disclose and establish, maintain, and enforce written policies and procedures for other conflicts of interest.⁴⁵ Accordingly, NRSROs must disclose and establish written policies and procedures to address and manage the following conflicts of interest: per as (1) being paid by issuers or underwriters to determine credit ratings with respect to securities or money markets instruments they issue or underwrite; (2) being paid by obligors to determine credit ratings with respect to the obligors; (3) being paid for services in addition to determining credit ratings by issuers, underwriters, or obligors that have paid the NRSRO to determine a credit rating; (4) being paid by persons for subscriptions to receive or access the credit ratings of the NRSRO and/or for other services offered by the NRSRO where such persons may use the credit ratings of the NRSRO to comply with, and obtain benefits or relief under, statutes and regulations using the term *nationally recognised statistical rating organisation*; (5) being paid by persons for subscriptions to receive or access the credit ratings of NRSRO and/or for other services offered by the NRSRO where such persons also may own investments or have entered into transactions that could be favourably or adversely impacted by a credit rating issued by the NRSRO; (6) allowing persons within the NRSRO to directly own securities or money market instruments of, or having other direct ownership interests in, issuers or obligors

subject to a credit rating determined by the NRSRO; (7) allowing persons within the NRSRO to have a business relationship that is more than an arms length ordinary course of business relationship with issuers or obligors subject to a credit rating determined by the NRSRO; (8) having a person associated with the NRSRO that is a broker or dealer engaged in the business of underwriting securities or money market instruments; and (9) any other type of conflict of interest relating to the issuance of credit ratings by the NRSRO that is material to the NRSRO and that is identified by the NRSRO in Exhibit 6 to Form NRSRO.⁴⁶

Moreover, an NRSRO is explicitly prohibited from having the following conflicts of interest relating to the issuance or maintenance of a credit rating as a credit rating agency: per as (1) the NRSRO issues or maintains a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equalling or exceeding 10 per cent of the total net revenue of the NRSRO for the fiscal year;⁴⁷ (2) the NRSRO issues or maintains a credit rating with respect to a person (excluding a sovereign nation or an agency of a sovereign nation) where the NRSRO, a credit analyst that participated in determining the credit rating, or a person responsible for approving the credit rating, directly owns securities of, or has any other direct ownership interest in, the person that is subject to the credit rating; (3) the NRSRO issues or maintains a credit rating with respect to a person associated with the NRSRO; and (4) the NRSRO issues or maintains a credit rating where a credit analyst who participated in determining the credit rating, or a person responsible for approving the credit rating, is an officer or director of the person that is subject to the credit rating. In addition, next to the NRSRO, the prohibition encompasses the credit rating affiliates of an NRSRO identified on Form NRSRO, and any partner, officer, director, branch manager, and employee of the NRSRO or its credit rating

affiliates (or any person occupying a similar status or performing similar functions).

Fourthly and finally, under the Rating Agency Act, the SEC has formulated rules to prohibit NRSROs from engaging unfair, coercive, or abusive practices, which include the following: per as (1) conditioning or threatening to condition the issuance of a credit rating on the purchase by an obligor or issuer, or an affiliate of the obligor or issuer, of any other services or products, including pre-credit assessment products, of the NRSRO or any person associated with the NRSRO; (2) issuing, or offering or threatening to issue, a credit rating that is not determined in accordance with the NRSRO's established procedures and methodologies for determining credit ratings, based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the NRSRO or any person associated with the NRSRO; (3) modifying, or offering or threatening to modify, a credit rating in a manner that is contrary to the NRSRO's established procedures and methodologies for modifying credit ratings based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other services or product of the NRSRO or any person associated with the NRSRO; and (4) issuing or threatening to issue a lower credit rating, lowering or threatening to lower an existing credit rating, refusing to issue a credit rating, or withdrawing or threatening to withdraw a credit rating, with respect to securities or money market instruments issued by an asset pool or as part of any asset- or mortgage-backed securities transaction, unless all or a portion of the assets within such pool or part of such transaction also are rated by the NRSRO, where such practice is engaged by the NRSRO for an anticompetitive purpose.

CONCLUSION

The Credit Rating Agency Act turns the world upside down for NRSROs, not only by

eliminating a substantial market entry barrier as the 'nationally recognized' criterion for NRSRO designation purposes, and putting into place a transparent and expedient voluntary registration process, but also by requiring financial accountability to the SEC and active self-regulation of potential abusive practices and conflicts of interest, managed by a compliance officer, backed by mandatory public disclosure mechanisms, and with the SEC effectively equipped with enforcement powers. Among these powers are that the SEC can strip or suspend a credit rating agency of NRSRO status when not in compliance with procedures and rules, for example, in relation to the misuse of material non-public information and conflicts of interest. Moreover, NRSROs are explicitly prohibited from certain potentially abusive practices, including the misuse of material non-public information, notching, tying, and (when abusive) the practice of unsolicited ratings. These activities have not been completely prohibited by the Credit Rating Agency Act, but the abusive aspects as they pertain to the credit rating of a (prospective) paying issuer have sufficiently been curtailed. As a result, Congress has given some leeway to NRSROs by giving them the opportunity to persuade the SEC that in individual cases those practices are not (intended to be) unfair, coercive, or abusive. Furthermore, Congress has explicitly refrained from regulating the ratings themselves and the process aspects of the business of credit rating. The substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings are explicitly placed beyond the purview of any regulator, the SEC included. As a result, the credit rating agencies have not substantially been tethered in what they are designed to do: to issue credit ratings. Credit rating agencies, as before, remain completely free to disseminate whatever credit rating they determine is accurate, and to use the methodologies and procedures they deem appropriate to arrive at their credit ratings. Nevertheless, the Credit

Rating Agency Act has put in place mechanism of disclosure, accountability, and SEC enforcement, to curb any potential excesses of that freedom, especially when it comes to unfair, coercive, or abusive practices, misuse of material non-public information, and conflicts of interest. Therewith, it has set the stage for a full-fledged corporate governance and regulatory framework for the credit rating industry.

The regulatory oversight introduced by the Rating Agency Act aims to safeguard the integrity of the rating industry in issuing credit ratings, so as to put investors and obligors in the position to evaluate for themselves what best to do with the ratings of credit rating agencies. In addition to significant disclosure requirements, for example, pertaining to performance measurement statistics; extensive conflicts of interest provisions, provisions that address the handling of material non-public information by an NRSRO and prohibit certain unfair, coercive, or abusive practices by NRSROs; the new regulatory framework requires an expansive documentation retention and management program. Importantly, the documentation that the credit rating agency must keep and manage, including, for example, communications by relevant analysts is subject to a periodic review or examination by the SEC for compliance purposes. To illustrate, while the credit rating agency must disclose and manage a wide spectrum of possible conflicts of interest pertaining to its business in the broad sense of the term, the credit rating agency is at the same time prohibited from having certain (other) conflicts in all circumstances. An (onsite) examination by the SEC, for example, may reveal noncompliance with the prohibition of having above said conflict. And, under the current regulatory framework for the credit rating industry, this may result in the SEC to strip or suspend a credit rating agency of its NRSRO status. The oversight of the integrity of the process through which credit rating agencies, who wish to be considered an NRSRO (for regulatory purposes), produce and issue their ratings, has therewith been

equipped with teeth by the Rating Agency Act.

The above, therefore, explicitly does not regard the substantial process through which the NRSRO renders its credit rating: 'the Commission is ever mindful of the explicit intent of Congress that we not substitute the Commission's judgment for that of the rating agencies'.⁴⁰ Rather than directly regulating the 'input' aspects of a credit rating, the US Congress has chosen for the path of increased transparency and, moreover, more competition in the credit rating industry to improve the quality of the information disseminated by NRSROs. Whether that path will be successful and will achieve its goal fully and timely (to be successful) remains to be seen. Although the NRSRO status is now subject to a voluntary registration system, it is unlikely that the no-action letter NRSROs will not register for (or not be granted) NRSRO status, given the regulatory significance of the NRSRO designation. As per 1st May, 2008, a total of nine credit rating agencies have applied for and have been granted registration as an NRSRO, including the big three credit rating agencies.⁴⁸ These nine credit rating agencies have received NRSRO status, but, of course, it is now more accurate to explicate the abbreviation 'NRSRO' as Nationally Registered Statistical Rating Organization.⁴⁹

Despite the elimination of a substantial artificial market entry barrier in the form of the 'nationally recognized' criterion, the three largest credit rating agencies, large partly because of the no-action letter designation, will most likely not lose market position in the immediate future, because market participants will continue to rely on their ratings instead of the 'less reputable' firms. Moreover, it would be relatively costly to replace the many private arrangements.⁵⁰ The costs of replacing the many references or rating triggers in the many private contracts will not weigh against the potential benefits from shifting to another credit rating agency.⁵¹ In addition, (prospective) obligors or issuers will weigh the potential

benefits from changing to another credit rating agency with the costs associated with adapting their activities and (inner compliance) mechanisms that are focused on improving credit ratings,⁵² to a set of new, and hence less determinable, credit rating criteria of that other credit rating agency. Other credit rating agencies, in this regard, will continue to be confronted by the economies of scale maintained by the big three NRSROs, that is, Moody's, Standard & Poor's, and Fitch.⁵³ That also raises the question of a (private) regulatory race to the bottom.⁵⁴

Future discussion of the credit rating industry, and the potential effects of that discussion for the corporate and financial governance landscape, will have to take these concerns into consideration.⁵⁵ The credit rating industry remains prominently on the regulatory spotlight for the immediate future. In addition to the periodic assessment of the regulatory framework by the SEC established by the Rating Agency Act and the rules of the SEC issued there under, various initiatives have been taken by regulators. To illustrate, the President's Working Group has been requested by the US President to examine the role of credit rating agencies in lending practices, how their ratings are used, and how securitisation has changed the mortgage industry and related business practices. The policy statement, issued in the March of 2008,⁵⁶ discusses, among others, the impact of credit rating agencies on lending practices, how their ratings are used, and how securitisation has changed the mortgage industry and related business practices.⁵⁷

In addition to initiatives by various national securities regulators,⁵⁸ the International Organization of Securities Commissions ('IOSCO') has created a credit rating agency task force, for example, to explore the role of credit rating agencies in developing structured finance products, and how they manage the conflicts of interest that arise in providing rating services.⁵⁹ Finally, in Europe, the European Commission has asked the Committee of European Securities Regulators ('CESRs') to

provide the European Commission with technical analysis and advice to assess the need for introducing European legislation or other solutions.⁶⁰ As a result, CESR has established a task force relating to the credit rating industry and the whole spectrum of issues that pertain to the integrity and resilience of the capital markets.⁶¹ CESR issued its report in the May of 2008 and contains various proposals to increase the oversight of Credit Rating Agencies.⁶² Although CESRs' recommendations are less rigorous than the measures in the US, they explicitly take the measures already taken by the SEC into consideration. Lastly, mention should also be made of the reports by the European Securities Markets Expert Group and the Financial Stability Forum.⁶³

All in all, it should be born in mind that credit rating agencies are merely one aspect of the regulatory landscape, albeit in the form of a private-sector watchdog, and that they have been increasingly perceived and relied upon as such. Overregulation of the credit rating industry must, of course, be avoided, but the role and significance of the credit raters for the capital markets is such that it may not be permitted that the credit raters form a weak link in the regulatory 'chain', especially when a pro-active and prudent stance of the legislator may prevent such weaknesses from materialising, suddenly, and unexpectedly. Therefore, the oversight of the credit rating industry, most prominently now in the US, and gradually also in Europe, is a laudable development.

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- (30) Section 15E(h)(2) of the Securities and Exchange Act of 1934.
- (31) Section 15E(j) of the Securities and Exchange Act of 1934.
- (32) See Securities and Exchange Commission (2007) 'Oversight of credit rating agencies registered as nationally recognised statistical rating organisations; final rule', Federal Register, 17 CFR Parts 240 and 249b, Monday, 18th June, 2007, 33564 ff., <http://www.S.E.C..gov/rules/final/2007/34-55857fr.pdf>, accessed 5th February, 2008.
- (33) *Ibid.*, 2007, at 33612.
- (34) *Ibid.*, 2007, at 33612.
- (35) *Ibid.*, 2007, at 33612.
- (36) Credit Rating Agency Reform Act of 2006, 15 U.S.C. 78o-7.
- (37) See Securities and Exchange Commission (2007) 'Oversight of credit rating agencies registered as nationally recognised statistical rating organisations; final rule', Federal Register, 17 CFR Parts 240 and 249b, Monday, 18th June, 2007, at 33612 and 33617, <http://www.S.E.C..gov/rules/final/2007/34-55857fr.pdf>, accessed 5th February, 2008.
- (38) *Ibid.*, 2007, at 33612.
- (39) *Ibid.*, 2007, at 33564, 33620 ff., Securities and Exchange Act of 1934, §240.17g-2.
- (40) See Christopher, C. (2007) 'Testimony concerning credit rating agencies, before the US senate committee on banking, housing and urban affairs', 26th September, 2007, at 5, http://banking.senate.gov/_files/ACF75B3.pdf, accessed 19th February, 2008.
- (41) See Securities and Exchange Commission (2007) 'Oversight of credit rating agencies registered as nationally recognised statistical rating organisations; final rule', Federal Register, 17 CFR Parts 240 and 249b, Monday, 18th June, 2007, at 33580, <http://www.S.E.C..gov/rules/final/2007/34-55857fr.pdf>, accessed 5th February, 2008: '(...) the Commission is interpreting the term "credit rating services" to mean any of the following: Rating an obligor (regardless of whether the obligor or any other person paid for the credit rating); rating an issuer's securities or money market instruments (regardless of whether the issuer, underwriter, or any other person paid for the credit rating); and providing credit ratings, *credit ratings data*, or *credit ratings analysis* to a subscriber'.
- (42) See Securities and Exchange Act of 1934, §240.17g-4(b).
- (43) Cf. John, J. Coffee Jr. (2007) 'The role and impact of credit rating agencies on the sub-prime credit markets', Testimony before the Senate Banking Committee, 26th September, 2007, http://banking.senate.gov/_files/ACF75B1.pdf, accessed 19th February, 2008.
- (44) See Securities and Exchange Act of 1934, §240.17g-4(a).
- (45) See Securities and Exchange Commission (2007) 'Oversight of credit rating agencies registered as nationally recognised statistical rating organisations; final rule', Federal Register, 17 CFR Parts 240 and 249b, Monday, 18th June, 2007, 33564, 33622, <http://www.S.E.C..gov/rules/final/2007/34-55857fr.pdf>, accessed 3rd September, 2007.
- (46) *Ibid.*, 2007, at 33564, 33623.
- (47) *Ibid.*, 2007, at 33580: 'Specifically, the Commission interprets "net revenues" to mean revenue earned by the applicant or NRSRO for any type of service or product, regardless of whether related to credit rating services, and net of any rebates and allowances paid or owed to the person by the applicant or NRSRO. This definition excludes revenues received by affiliates that are not part of the credit rating organization. Also the intent in describing the netting payables as "rebates or allowances" is to limit them to items that directly reduce a payable on the revenue side and to exclude unrelated payables (eg, payables for utility bills). Finally, by using the term "revenue earned" the Commission intends that the applicant and NRSRO apply its standard accounting convention for recognizing revenue'.
- (48) See <http://www.sec.gov/divisions/marketreg/ratingagency.htm>, accessed 8th August, 2008.
- (49) I am indebted to thank Frank Partnoy during the Credit Rating Agencies Lunch of 4th July, 2008, at the Amsterdam Center for Corporate Finance.
- (50) Regulators, of course, are not exposed, to the same extent as private parties are, to market

- conditions. Hence, their behaviour cannot be predicted within the same framework as that for private parties.
- (51) Cf. Lawrence, J. W. (2002) 'The credit rating industry: An industrial organisation analysis', in Levich, R.M., Majnoni, G. and Reinhart, C.M. (eds), 'Ratings, Rating Agencies and the Global Financial System', Kluwer, Boston, MA, Chapter 2.
- (52) Given the space available, I cannot elaborate here on the phenomenon of the so-called 'fetishization' of a rating, which attempts to conceptualise the effects of a rating to the actions and incentives of an obligor (attempting) to enhance or maintain its credit rating.
- (53) Given the space available, I cannot elaborate here on the impact of globalisation on the credit rating industry in the US, for example, also as envisioned by the Basel Committee.
- (54) Given the space available, I cannot elaborate here on the potential race to the bottom by credit rating agencies as private sector watch dogs (with regulatory responsibilities) and the phenomenon of rating shopping by obligors or issuers (as a result of the (potential) increase of the number of NRSROs through the Rating Agency Act).
- (55) See Securities and Exchange Commission (2005).
- (56) See The President's Working Group on Financial Markets, Policy Statement on Financial Market Developments, http://www.treasury.gov/press/releases/reports/pwgfpolicystatemktturmoil_03122008.pdf, accessed 11th July, 2008.
- (57) See Christopher, C. (2008) 'Testimony concerning oversight of nationally recognised statistical rating organisations before the US senate committee on banking, housing and urban affairs', 22nd April, 2008, <http://www.sec.gov/news/testimony/2008/ts042208cc.htm>, accessed 11th July, 2008.
- (58) See ESME (2008) 'ESME's report to the European commission, role of credit rating agencies', June 2008, http://ec.europa.eu/internal_market/securities/docs/esme/report_040608_en.pdf, accessed 8th August, 2008.
- (59) See Christopher, C. (2007) 'Testimony concerning credit rating agencies, before the US senate committee on banking, housing and urban affairs', 26th September, 2007, http://banking.senate.gov/_files/ACF75B3.pdf, accessed 19th February, 2008. I cannot elaborate here on the rapport by IOSCO, which has been published in the May of 2008: Technical Committee of the International Organization of Securities Commissions (2008) 'The Role of Credit Rating Agencies in the Structured Finance Markets', May 2008, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf>, accessed 11th July, 2008.
- (60) See CESR's technical advice to the European Commission on possible measures concerning credit rating agencies, CESR/05/139b, March 2005, <http://www.cesr-eu.org/index.php?page=groups&mac=0&id=4>, accessed 19th February, 2008.
- (61) See <http://www.cesr-eu.org/index.php?page=groups&mac=0&id=4>, accessed 8th August, 2008.
- (62) See CESR (2008) 'CESR's second report to the European commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance', http://www.cesr-eu.org/data/document/CESR_08_277.pdf, accessed 11th July, 2008.
- (63) See, respectively, ESME (2008) 'ESME's report to the European commission, role of credit rating agencies', June 2008, http://ec.europa.eu/internal_market/securities/docs/esme/report_040608_en.pdf, accessed 11th July, 2008 and FSF (2008) 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience', 7th April, 2008, http://www.fsforum.org/publications/r_0804.pdf?noframes=1, accessed 11th July, 2008.