Far-reaching and intrusive

While there are differences in their approach, the proposed US and EU reforms will have a heavy impact on the securitisation market

Vilified by many politicians and policymakers for their perceived role in causing or contributing to the recent financial crisis, the credit rating agencies are the subject of significant reform proposals in both the EU and the US that threaten to have impacts far beyond just the affected rating agencies.

Fair or not, the credit rating agencies have been widely criticised for conflicts of interest arising from the issuer-paid model of compensation that some allege caused a race to the bottom in applicable methodology and analysis, and ratings arbitrage by arrangers and issuers to obtain the most favourable rating possible.

They are also criticised generally for lack of transparency regarding the rating methodologies used by the rating agencies and the alleged inconsistent application thereof to particular issuers or securities, and these form key elements of proposed reforms on both sides of the Atlantic.

US approach

Even before the recent financial crisis and following criticism of the inability of the rating agencies to foresee the deteriorating and precarious financial condition of several large corporate collapses like Enron, the US Congress passed the Credit Rating Agency Reform Act (CRA Reform Act) in 2006 and the US Securities and Exchange Commission (SEC) adopted implementing rules in 2007.

These rules required (i) registration (in lieu of the prior no-action letter process) of nationally-recognised statistical rating organisations (NRSROs) and certain recordkeeping and reporting thereby, and (ii) disclosure and management by the NRSROs of specified conflicts of interest (and prohibited NRSROs from rating certain issuers an/or securities where other specified conflicts of interest exist).

> “Credit rating agencies in the EU garnered criticism due to their credit ratings of securitised instruments”

Initial crisis response

At the outset of the crisis in July 2008, the SEC proposed amendments to its CRA Reform Act rules that (i) expanded the scope of regulated conflicts of interest of NRSROs, (ii) required additional disclosure, recordkeeping and reporting by NRSROs, (iii) required the use by NRSROs of ratings that differentiated the ratings of structured finance securities from other ratings, and (iv) amended other SEC rules to remove any requirement for a specified NRSRO rating.

This was followed by the SEC in February 2009 proposing additional rule amendments regarding NRSRO conflicts of interest and additional disclosure, recordkeeping and reporting by NRSROs and re-proposing other conflicts of interest and disclosure requirements.

Then in October 2009, the SEC re-opened the comment period for its proposed rule amendments that would remove requirements for specified ratings, and proposed new rules that would require disclosure of credit ratings and related information (including preliminary ratings) in registration statements.

The SEC also issued a concept release regarding the proposed rescission of Rule 436(g) under the Securities Act of 1933 (as amended, the Securities Act), which affords protection to the NRSROs from liability as experts for their ratings of registered securities.

Transparency and regulated conflicts of interest

In November 2009, the SEC proposed an amendment to its rules under the Securities Exchange Act of 1934 (as amended, the Exchange Act) regarding disclosure and management of certain conflicts of interest of NRSROs.

This added an additional conflict of interest when the related NRSRO issues or maintains a rating for a security or money-market instrument issued by an asset pool or as part of an asset-backed or mortgage-backed securities transaction that was paid for by the related issuer, sponsor or underwriter.

The SEC subsequently adopted amendments to Exchange Act Rule 17g-5 that require an NRSRO that issues or maintains a rating for a structured finance product for which there is this type of issuer-paid conflict to (i) maintain a password-protected website that is accessible by non-hired NRSROs for free, and (ii) to list on this website the following: the type of structured finance product; the name of the related issuer; the date on which the related rating process was initiated; and the internet website address where the issuer, sponsor or underwriter of the related structured finance product maintains certain required information.

Also, the related NRSRO must obtain an undertaking by the issuer, sponsor or underwriter of the related structured finance product that it will maintain an identified password-protected website that includes all information provided to the NRSRO for the purpose of determining the initial rating, and for any subsequent surveillance, of that structured finance product, in each case, at the same time as that information is provided to that NRSRO.

The issuer, sponsor or underwriter must also provide access to that website by any non-hired NRSRO that requests such access and provides a required certification to the hired NRSRO that (i) it is accessing that website solely for the purpose of determining or monitoring a credit rating, (ii) will maintain the information that it accesses confidential and will treat it as material non-public information, and (iii) will determine the credit rating for at least 10% of the issued structured finance products for which it accesses information if it accesses information for 10 or more issued structured finance products in any calendar year covered by the certification.

EU approach

Unlike in the US, there was no substantive regulation of credit rating agencies in the EU prior to the recent financial crisis. Instead, regulation in the EU consisted primarily of the self-regulatory guidelines established

pursuant to the International Organisation of Securities Commission's (Iosco) code of fundamental principles for credit rating agencies.

In addition to the Iosco code, the EC implemented, primarily through the Market Abuse Directive, limited regulations affecting credit rating agencies in the EU, but did not provide a comprehensive regulatory framework. EU regulators had viewed this self-regulatory approach (with minimal statutory obligations) for credit rating agencies to be sufficient as recently as 2006.

Response to crisis

The recent financial crisis, however, caused a sharp reversal of regulators' opinions and rapid action was taken to significantly reinforce and expand the Iosco code and other regulation of credit rating agencies in the EU through the enactment of Regulation (EC) No 1060/2009 of the European Parliament and of the Council on credit rating agencies (the EU regulation).

The EU regulation aims to ensure that credit ratings used in the EU are "independent, objective and of adequate quality." To achieve its aims, the EU regulation forbids regulated entities, such as credit institutions, in the EU from using a credit rating "for regulatory purposes" unless it has been issued (i) by a credit rating agency that is established in the European Community and is registered under the EU regulation (a Registered CRA), (ii) by a credit rating agency outside of the EU that is endorsed by a Registered CRA in the same corporate group, or (iii) outside of the EU by a credit rating agency that is certified to be subject to equivalent regulation of another jurisdiction.

Once registered, a credit rating agency must comply with an array of organisational and operational standards designed to ensure that credit ratings are independent, of adequate quality and transparent.

Conflicts of interest

Registered CRAs are broadly required to take all necessary steps to avoid issuing a credit rating affected by any existing or potential conflict of interest with the entity or financial product being rated. Beyond this broad mandate, the EU regulation sets out specific organisational and operational standards with which registered CRAs must comply.

Under the EU regulation, a registered CRA must be organised "in a way that ensures that its business interest does not impair the independence or accuracy of the credit rating activities."

Specifically, the EU regulation requires each registered CRA to ensure that (i) its supervisory board is comprised of at least "one third, but no less than two" members that are independent of its credit rating activities, (ii) its senior management is of "good repute," and (iii) there exists an effective compliance department that operates independently of its credit rating activities.

Additionally, the EU regulation prevents the compensation of the supervisory board and the compliance department from being linked to the business performance of the registered CRA.

A registered CRA must also implement operational procedures that "identify, eliminate or manage and disclose, clearly and prominently, any actual or potential conflicts of interest that may influence the analyses and judgments" in connection with the provision of a credit rating.

On top of this, a registered CRA that has identified any of the following conflicts of interest is prohibited from issuing a credit rating for the affected entity (or financial product): (i) the registered CRA (or the rating analyst) has an ownership interest in the rated entity (this does not include holdings in diversified collective investment schemes and other managed investment funds, such as pension funds); (ii) the registered CRA is linked (either directly or indirectly) to the rated entity by control; (iii) the rating analyst is a member of the supervisory board of the rated entity; or (iv) the rating analyst (or the person who approved the credit rating in question) has had a relationship with the rated entity or a related third party which may cause a conflict of interest.

Registered CRAs also are not permitted to

Dodd-Frank Act and credit rating agency reforms

More recently, the US Congress included several important reforms affecting credit rating agencies in its omnibus financial services reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), that was passed into law on July 21 2010.

These reforms generally increase the power of the SEC to oversee NRSROs and include:

- new requirements for NRSRO internal controls and transparency regarding rating methodologies, assumptions, limitations and volatility;
- the establishment of an Office of Credit Ratings within the SEC to administer the SEC's rules relating to NRSROs to promote accuracy in NRSRO ratings and to ensure that ratings are not unduly influenced by conflicts of interest; and
- the SEC to make public the essential findings of NRSRO examinations as well as any related responses by that NRSRO to any finding of material regulatory deficiency.

Also, Title IX of the Dodd-Frank Act specifically amended the Exchange Act to:

- provide that statements made by credit rating agencies are not forward-looking statements for purposes of the SEC's related safe-harbour;
- apply the penalty and enforcement provisions of the Exchange Act to credit rating agencies to the same extent and in the same manner as to registered accounting firms;
- remove the Exchange Act interpretation provision that nothing in the Exchange Act should be construed as creating a private right of action under the Exchange Act with respect to NRSROs (thereby permitting the Exchange Act to be so construed); and
- provide special rules for claims for money damages against a credit rating agency, for purposes of pleading a state of mind, that it is sufficient to state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed:
  - o to conduct a reasonable investigation of the related rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or
  - o to obtain reasonable verification (including by means of sampling techniques that do not amount to an audit) of such factual elements from other sources that the credit rating agency considers competent and that are independent of the issuer and the underwriter.

Repeal of Rule 436(g)

Of course, the oft-cited first unintended consequence of the Dodd-Frank Act was the immediate repeal of Rule 436(g) under Section 939G thereof, which threatened to freeze public markets for structured finance securities (including consumer finance securitization) when the credit rating agencies refused to consent to their ratings being referred to in registration statements (although required to be so referenced).

The SEC promptly granted temporary no-action relief until January 24 2011, subsequently extended by the SEC on November 23 2010 pending further required rulemaking under the Dodd-Frank Act for asset-backed securities and rating agency reforms.

EU obligations for rating structured finance instruments

The EU regulation imposes strict obligations on credit rating agencies when rating structured finance instruments, including the following.

Additional symbol: Perhaps the most controversial of the requirements, the EU regulation requires a credit rating of structured finance instruments to have an additional symbol which clearly differentiates it from rating categories used to rate other entities and financial instruments.

Supervisory board: When a credit rating agency issues credit ratings for structured finance instruments, its supervisory board must have at least one member that has a senior level of experience of the markets in structured finance instruments.

Additional disclosure requirements: The EU regulation also imposes a set of expanded disclosure obligations on credit rating agencies when rating structured finance instruments, including disclosure of:

(i) all information regarding its loss and cash-flow analysis;

(ii) the due diligence processes carried out in providing the rating;

(iii) guidance explaining its methodologies, models and key assumptions; and

(iv) information about all structured finance instruments submitted for its preliminary review.

provide "consultancy or advisory services to the rated entity or a related third-party regarding the corporate or legal structure, assets, liabilities or activities of that rated entity or related third party." This does not include certain ancillary services, such as market forecasts and estimates of economic trends.

There are also a number of provisions in the EU regulation designed to avoid conflicts of interest that may arise with respect to the employees (particular the rating analysts) of a registered CRA.

For example, employees involved in the rating activities are forbidden from purchasing the rated instrument, accepting gifts from the rated entity, and accepting a key management position at a rated entity within six months of leaving a registered CRA.

Quality of ratings

There is little doubt that a large part of the EU regulation is premised on the theory that independence and avoidance of conflicts of interest in the ratings process will result in higher quality credit ratings.

The EU regulation goes further though by also implementing requirements to ensure the quality of the methodologies, models and key rating assumptions used by registered CRAs. For example, registered CRAs are to ensure that rating analysts have appropriate knowledge and experience for their assigned duties.

With respect to the standards it applies to its rating methodologies and assumptions, a registered CRA is required to ensure that: (i) its credit ratings are "based on a thorough analysis of all the information that is available to it and that is relevant to its analysis according to its rating methodologies," (ii) the information it uses in assigning a credit rating is of sufficient quality and from reliable sources, and (iii) its methodologies are "rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing."

Registered CRAs are required to review their credit ratings and methodologies on an on-going basis and at least once per year (especially in light of changes in macroeconomic or financial market conditions).

In addition, following a change to its methodologies or assumptions, a registered CRA must take a series of prescribed actions. First, it must communicate the changes to the market and the likely scope of the credit ratings to be affected by the changes.

Second, the registered CRA must place the affected credit ratings under observation and review the affected credit ratings within six months of the change to its methodologies or assumptions. Finally, following its review, the registered CRA must re-rate where the changes are shown to impact the existing credit rating.

Transparency

The transparency requirements of the EU regulation are intended to maintain the objectiveness of credit ratings by ensuring adequate disclosure of information relating to the independence and quality requirements under the EU regulation.

Specifically, registered CRAs are required to disclose to the public, amongst other things, their methodologies, models and key assumptions, existing or potential conflicts of interest, historical data regarding their ratings, and a number of periodic reports.

Credit rating agencies are not permitted to charge a fee for delivering the information required by these disclosure requirements.

Structured finance instruments

Like in the US, credit rating agencies in the EU garnered most of their criticism following the recent financial crisis due to their credit ratings of securitised instruments and other structured finance instruments (especially their credit ratings associated with SIVs and CDOs).

As a result, more stringent obligations were imposed upon credit rating agencies when rating structured finance instruments (see box). The EC had also recently proposed amendments to the EU regulation that would have established website rules similar to those required by Rule 17g-5 of the Exchange Act. While there were several differences, perhaps the most essential difference was that issuers, originators and underwriters had explicit obligations under the website rules proposed in the EU.

The implementation of these website rules, however, has been postponed for further consideration, including whether the rules should apply beyond credit ratings for structured finance instruments.

The regulatory story for credit rating agencies in the EU does not end there. The EC recently published a public consultation on credit rating agencies at the end of 2010. The consultation paper is not a formal proposal of regulation, but is instead a solicitation for discussion of what, if any, further action should be taken to regulate credit rating agencies in the EU.

The consultation paper set out specific measures, such as over-reliance on credit rating agencies, competition in the credit rating agency industry, civil liability of credit rating agencies, use of credit ratings for sovereign debt ratings and further measures addressing potential conflicts of interest, that are being considered for further regulatory action.

Skepticism remains

While these reforms are both far-reaching and intrusive, it remains to be seen whether these reforms will prevent the sort of risk management failure exhibited by the credit rating agencies with respect to subprime mortgage loan risk and related securities and, further, whether they are a cost-effective means to do so.

One may be forgiven some skepticism since arguably that risk management failure had little (if anything) to do with either conflicts of interest or lack of transparency.

Indeed, many investors who suffered some of the largest losses were sophisticated financial institutions, which one would expect to be more than able to determine for themselves whether they had sufficient information or were concerned about possible conflicts of interest due to issuer-paid ratings.

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