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CREDIT AGENCY REFORM ACT OF 2006

The Credit Rating Agency Reform Act of 2006 (the “Act”) was passed by the 109th Congress with the stated purpose of “improv[ing] ratings quality for the protection of investors” and promoting “accountability, transparency, and competition in the credit rating agency industry.” President Bush signed the Act on September 29, 2006.

I. Background

The Act is concerned with the issuance and use of credit ratings — opinions promulgated by credit rating agencies regarding the ability and willingness of an issuer to make timely payments on debt instruments it has issued over the life of that instrument. Investors use credit ratings to help evaluate the credit risk of fixed-income securities and their issuers. The largest rating agencies, Standard & Poor’s and Moody’s, rate the vast majority of the debt obligations and preferred stock issues publicly traded in the United States. The Act does not focus on other services offered by credit rating agencies — such as financial strength ratings or other risk analyses — except to the extent the provision of those services may affect the independence and objectivity of that agency’s credit ratings.

Among the many rating agencies currently doing business globally, only five have to date been designated by the SEC as nationally recognized statistical rating organizations (“NRSROs”) — Standard and Poor’s, Moody’s, Fitch, Dominion Bond Rating Service Limited and A.M. Best Company. A number of federal and state regulations (as well as private arrangements) require the use of NRSRO ratings in connection with certain investment decisions. For instance, the Federal Deposit Insurance Act generally proscribes savings and loans from holding non “investment grade securities,” which are defined as securities rated in one of the four highest categories by at least one NRSRO. Similarly, a number of states have adopted regulations regarding the retirement funds of state workers that limit the types of investments pension funds can make to those of a certain quality or risk profile. The benchmark often used in these types of regulations is whether the securities, or the entities issuing them, have investment grade ratings from an NRSRO. Private parties, too, often restrict permissible investments to those carrying a rating above a certain level from one or more NRSRO. One of the articulated concerns leading to the passage of the Credit Agency Reform Act of 2006 is the historic difficulty other rating agencies have faced obtaining NRSRO status.

II. Changes to the NRSRO Designation Process

The Act seeks to increase the number of NRSROs (and thereby competition among rating agencies) by codifying the designation process. While the SEC historically designated NRSROs through the no-action letter process, the SEC never published formal rules regarding NRSRO designation or its evaluation criteria. Upon the effective date of the Act, however, a rating agency may seek designation by submitting an application to the SEC which includes, among other things, information about its credit ratings performance over a period of time; its internal procedures and methodologies for determining credit ratings; its policies and procedures to prevent the misuse of material, nonpublic information and to guard against potential conflicts of interest; its organizational structure; its code of ethics; its potential conflicts of interest; and a list of its 20 largest issuers and subscribers and the revenues received therefore. In addition, a rating agency seeking to be designated as NRSROs will be required under the Act to submit (on a confidential basis) written certifications of unaffiliated institutional buyers that have used the agency's credit ratings for at least 3 years. Such certifications are not required for NRSROs designated prior to passage of the Act. Institutional buyers attesting to an applicant's credit ratings are protected from potential liability for those certifications by a "no private right of action" clause in the Act.

The Act provides that the SEC must grant a rating agency's application for NRSRO designation within ninety days of receipt provided that the application contains all required disclosures and certifications, except that the application may be denied if the SEC determines that the rating agency lacks the "adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply" with the agency's own procedures and methodologies. An application may also be denied if it would otherwise be subject to suspension or revocation. The Act provides that a rating agency's registration as an NRSRO may be suspended or revoked if the Commission determines that it would be in the public interest to do so and one of the following occurs:

- The rating agency or any person associated with it has committed certain enumerated offenses, has been convicted of a crime punishable by imprisonment of one or more years, or has been subjected to an SEC order barring association with an NRSRO;
- The rating agency fails to furnish annual certifications to the SEC that the information on its application is correct; or
- The rating agency fails to "maintain adequate financial and managerial resources."

III. Oversight of NRSROs

In addition to changes in the NRSRO designation process, the Act requires the SEC to conduct rule-making processes regarding the adoption by NRSROs of specific policies and procedures to prevent the misuse of material, non-public information and regarding the management of potential conflicts of interest related to, for instance, compensation received by NRSROs from issuers, the provision of consulting, advisory or other services by NRSROs, business relationships and ownership relationships of the NRSROs, and affiliations with underwriters. In addition, the Act requires the SEC to issue final rules to prohibit acts that the SEC, after a rule-making process, determines to be "unfair, coercive, or abusive."

The Act calls for the SEC to adopt such rules within 270 days of the Act's passage. To that end, the Act itself does not become effective until the sooner of 270 days following passage or the adoption by the SEC of the contemplated rules. Thus, although the Act has been passed by both houses of Congress and signed by the President, it will be some time before its impact can be fully analyzed.

The Act only applies to rating agencies that voluntarily choose to seek NRSRO designation. The Act provides no SEC oversight authority regarding non-registered rating agencies. Moreover, while the Act dictates a specific registration process and gives the SEC authority to issue certain oversight rules for those that do register, the Act does not impose or authorize substantive regulation of the credit rating process of NRSROs. Put another way, the Act does not authorize the SEC to "second guess" particular rating opinions or even the methodologies and procedures used by registered agencies.

Nor does the Act provide private parties with any new rights with respect to registered NRSROs. The Act contains, for example, a "no private right of action" provision as well as a provision making clear that registering under the Act shall not constitute a diminution or waiver by a rating agency of any rights it otherwise has under state or federal law. Specifically, over the years, courts have held that rating agencies, as financial publishers, are entitled to the protections of the First Amendment with respect to their ratings opinions. These courts have held, among other things, that rating agencies are protected by the "actual malice" standard, which insulates them from liability for their ratings unless the publications are made with "knowledge of falsity" or "reckless disregard for the truth." The Act also contains a "preemption" provision, providing that state laws which otherwise require the registration or licensing of rating agencies will not apply to NRSROs registered under the Act.

IV. Conclusion

In short, while a full evaluation of the Act will have to await the completion of SEC rule-making, a number of points are at this time clear: (i) the Act fundamentally changes the way that rating agencies are designated as NRSROs, potentially opening up the industry to increased competition; and (ii) the Act will likely result in new SEC oversight governing NRSROs, even if that oversight will not entail substantive regulation of the credit rating process.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; John Schuster at (212) 701-3323 or jschuster@cahill.com; Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Adam Zurofsky (212) 701-3137 or azurofsky@cahill.com.