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*Credit Rating Agency Regulatory Reform: A Side-by-Side
Comparison of H.R. 2990 and S. 3850*

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September 19, 2006

Abstract. The congressional response to the perceived problems surrounding the NRSRO process and its potentially undesirable consequences has led to the introduction of two bills in the 109th Congress. H.R. 2990 (Fitzpatrick), the Credit Rating Agency Duopoly Relief Act of 2006, passed the House on July 12, 2006, in a vote closely divided along partisan lines. Soon afterwards, on August 2, S. 3850 (Shelby), the Credit Rating Agency Reform Act of 2006, was voted out of the Senate Banking and Urban Affairs Committee with significant bipartisan support. This report compares the major provisions of the two legislative proposals.

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September 19, 2006

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Credit Rating Agency Regulatory Reform: A Side-by-Side Comparison of H.R. 2990 and S. 3850

Summary

Credit rating agencies assess the probability that a securities issuer will default by failing to repay principal and interest on the security. Globally, there are about 130 agencies, but Moody's and Standard & Poor's (S&P) combine for about 80% of overall market share, with Fitch accounting for about a 15% share.

In 1975, the Securities and Exchange Commission (SEC) issued the Net Capital Rule, which set new capital requirements for broker-dealers and required them to take a larger discount on their bond holdings deemed to be below investment grade by a rating agency that it recognized as a *nationally recognized statistical rating organization* (NRSRO). Since then, a growing number of federal, state, and foreign government statutes and regulations have adopted NRSRO ratings as reference points or triggers. However, there is no statutory definition of an NRSRO. When a rating agency requests NRSRO status, it applies to the SEC Division of Market Regulation for NRSRO designation, a decision-making process that is often both uncertain and of an indefinite time span.

Currently, five rating agencies have NRSRO designation: Fitch; Moody's; S&P; the A.M. Best Company, which rates insurance and reinsurance firms; and the Dominion Bond Rating Service Limited, a Canadian-based firm.

Like other providers of financial market analysis, the major NRSROs play a critical role as financial sentries or gatekeepers whose assessments can help warn against corporate meltdowns. Their record, however, is imperfect. For example, in 2001, Moody's, S&P, and Fitch issued favorable credit ratings of WorldCom bonds three months before the company declared bankruptcy. Additional concerns exist over the way in which the NRSRO process may impede non-NRSROs' access to more profitable segments of the rating industry.

In the 109th Congress, two legislative responses to the perceived shortcomings of the NRSRO protocol are H.R. 2990 (Fitzpatrick), the Credit Rating Agency Duopoly Relief Act of 2006, which passed the House on July 12, 2006, and S. 3850 (Shelby), the Credit Rating Agency Reform Act of 2006, which was voted out of the Senate Banking and Urban Affairs Committee on August 2, 2006. Both bills would scrap the current NRSRO designation process and instead would allow entities with at least three consecutive years as rating agencies to register with the SEC as NRSROs. S. 3850 would permit the SEC to reject a rating agency's application for NRSRO registration if it determined that the rater lacked sufficient financial and managerial resources, whereas H.R. 2990 would impose no such test. Each bill, if enacted, would be likely to significantly expand the number of NRSROs.

This report provides a side-by-side comparison of the bills' major provisions; it will be updated as events dictate.

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Credit Rating Agency Regulatory Reform: A Side-by-Side Comparison of H.R. 2990 and S. 3850

Introduction

Credit rating agencies assess the probability that a securities issuer will default by failing to repay principal and interest on the security. Two rating agencies dominate the rating industry — Moody's and Standard & Poor's (S&P) who combine for about 80% of the overall market share. Fitch Ratings has about a 15% share. Globally, there are about 130 agencies.

In 1975, the Securities and Exchange Commission (SEC) issued the Net Capital Rule, which set new capital requirements for broker-dealers and required them to take a larger discount on their bond holdings deemed to be below investment grade by a rating agency that it recognized as a *nationally recognized statistical rating organization* (NRSRO). Since then, a growing number of federal, state, and foreign government statutes and regulations have adopted NRSRO ratings as reference points or triggers. But there is no statutory definition of an NRSRO. When a rating agency requests NRSRO status, it applies to the SEC Division of Market Regulation for NRSRO designation. And through what is known as the no-action letter process,¹ the division can take an indefinite amount of time to determine whether to grant the designation, a decision that is significantly based on whether the applicant is a nationally recognized issuer of credible ratings.

Currently, five rating agencies have NRSRO designations: Fitch; Moody's; S&P; the A.M. Best Company, which rates insurance and reinsurance firms and received NRSRO status in 2005; and the Dominion Bond Rating Service Limited, a Canadian-based firm that was granted NRSRO status in 2003.

In addition to other sources of financial market analysis like securities analysts, the major NRSROs also play a critical role as financial sentries or gatekeepers whose assessments can help warn against corporate meltdowns. Their record, however, is imperfect. In 2001, Moody's, S&P, and Fitch issued favorable credit ratings of WorldCom bonds three months before the company declared bankruptcy. Moody's and S&P provided favorable bond ratings for Enron corporate bonds just before the firm's bankruptcy. The collapse of these firms eventually cost investors billions of

¹ A no-action letter is an SEC communication stipulating that the agency does not object to a course of action proposed by a registrant. They are generally issued after an applicant has made a request.

dollars and provoked widespread criticism of the agencies both in and out of Congress.

These concerns, to which the NRSROs respond that they were themselves the victims of corporate deceit, exist alongside criticism that the NRSRO selection process is an anticompetitive mechanism that impedes non-NRSROs' access to the more profitable segments of the rating industry.

The congressional response to the perceived problems surrounding the NRSRO process and its potentially undesirable consequences has led to the introduction of two bills in the 109th Congress. H.R. 2990 (Fitzpatrick), the Credit Rating Agency Duopoly Relief Act of 2006, passed the House on July 12, 2006, in a vote closely divided along partisan lines. Soon afterwards, on August 2, S. 3850 (Shelby), the Credit Rating Agency Reform Act of 2006, was voted out of the Senate Banking and Urban Affairs Committee with significant bipartisan support.

Both bills would scrap the SEC's current no-action-letter-based NRSRO designation process with its central focus on whether an agency is *nationally recognized* as an issuer of credible ratings, and with its indefinite decision making time frames. Both would amend the Securities Exchange Act of 1934 to allow interested entities with at least three consecutive years as rating agencies to register with the SEC as NRSROs, which would involve the submission of performance measurement statistics, a description of their rating methodology, details of ethics policies, and disclosure of conflicts of interest. Under both bills, once the SEC received a credit agency's application to register as an NRSRO, it would have up to 120 days — with the possibility of an extension if deemed necessary — to determine whether to deny or grant the registration.

S. 3850 would allow the SEC to reject a rating agency's application for NRSRO registration if it determined the applicant lacked sufficient financial and managerial resources. H.R. 2990 has no such requirement.

S. 3850 would require NRSRO applicants to provide written certifications from at least 10 of their institutional customers to the SEC. Applicants would also have to provide a list of their 20 largest issuers and subscribers by the amount of net revenues received in the previous year. Neither provision is part of H.R. 2990.

S. 3850 would also direct the SEC to issue rules on NRSRO conflicts of interest and the misuse of non-public information conflicts of interest, provisions that are absent from H.R. 2990.

Either bill, if enacted, would be likely to significantly expand the number of NRSROs from the current five.

This report compares the major provisions of the two legislative proposals. Key differences between the two bills have been italicized.

**Table 1. A Comparison of Major Provisions of
H.R. 2990 and S. 3850**

Provision	H.R. 2990	S. 3850
<p>Cessation of the SEC’s current No-Action Letter-based NRSRO designation process</p>	<p>Within 30 days after the legislation’s enactment, the SEC shall cease to designate persons and companies as NRSROs as it currently under rule 15c3-1 of the agency’s rules (17 CFR 240.15c3-1). In addition, the SEC’s current no-action process for NRSRO designation would be voided. (Section 4)</p>	<p><i>Upon a designated effective date, an entity that previously relied on the SEC’s no-action letter for its NRSRO status may continue to use the designation if it has filed an application for NRSRO registration that has been approved by the SEC.</i> (Section 4)</p>
<p>Defining a credit rating agency</p>	<p>A credit agency is defined as an entity that is engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee that employs either a quantitative or qualitative^a model, or both, and receives fees from either issuers, investors, or other market participants. (Section 3)</p>	<p>A credit agency is defined as an entity that is engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee that employs either a quantitative or qualitative model; or both, and receives fees from either issuers, investors, or other market participants. (Section 3)</p>
<p>Credit rating agency experience needed to qualify for registration as an NRSRO</p>	<p>To register as an NRSRO with the SEC, a credit rating agency must have been in business for at least three consecutive years. (Section 3)</p>	<p>To register as an NRSRO with the SEC: (1) a credit rating agency must have been in business for at least three consecutive years; and (2) <i>have received written certifications from at least 10 “qualified institutional buyers” (as defined in section 230.144 (a) of title 17, Code of Federal Regulations).</i> (Section 3)</p>

Provision	H.R. 2990	S. 3850
<p>What the SEC is authorized to require of credit rating agencies interested in registering as NRSROs</p>	<p>The SEC is authorized to require a credit rating agency that elects to be registered as an NRSRO to file information that may include (1) any conflicts of interest relating to the issuance of credit ratings; (2) the procedures and methodologies used in determining credit ratings; (3) their credit ratings performance measurement statistics over short-term, mid-term, and long-term periods; (4) policies or procedures adopted and implemented to prevent the misuse of material, non-public information; and (5) its organizational structure. (Section 4)</p>	<p>The SEC is authorized to require a credit rating agency that elects to be registered as an NRSRO to file information that may include (1) any conflicts of interest relating to the issuance of credit ratings; (2) the procedures and methodologies used in determining credit ratings; (3) their credit ratings performance measurement statistics over short-term, mid-term, and long-term periods; (4) policies or procedures adopted and implemented to prevent the misuse of material, non-public information; (5) its organizational structure; (6) <i>a confidential list of the 20 largest issuers and subscribers by the amount of net revenues received in the fiscal year prior to the application date; and (7) written certifications from at least 10 “qualified institutional buyers” who have used the applicant’s ratings.</i> (Section 4)</p>
<p>The SEC’s review of an NRSRO application</p>	<p>Within 90 days after an applicant has filed for registration, the SEC shall either grant NRSRO registration or begin proceedings to determine whether registration should be denied. The proceedings shall end within 120 days from the date that the application was furnished and shall involve a determination by the SEC on whether the applicant is granted or denied NRSRO registration. If the agency finds sufficient cause for an extension, it may extend the NRSRO registration proceeding for up to 90 additional days. (Section 4)</p>	<p>Within 90 days after an applicant has filed for registration, the SEC shall either grant NRSRO registration or begin proceedings to determine whether registration should be denied. The proceedings shall end within 120 days from the date that the application was received and shall involve a determination by the SEC on whether the applicant is granted or denied NRSRO registration. If the agency finds sufficient cause for an extension, it may extend the NRSRO registration proceeding for up to 90 additional days, <i>or for longer periods with the applicant’s consent.</i> (Section 4)</p>

Provision	H.R. 2990	S. 3850
<p>Grounds for the SEC’s decision to approve an applicant’s registration as an NRSRO</p>	<p>The SEC shall grant NRSRO registration if it finds that the requirements of the preceding section are satisfied. It shall deny the registration if it does not make such a finding. In the event that the applicant is already registered, that registration would be subject to suspension or revocation. (Section 4)</p>	<p>The SEC shall grant NRSRO registration if it finds that the requirements of the preceding section are satisfied. The agency shall deny registration if it finds that the applicant <i>does not have adequate financial and managerial resources to consistently produce ratings with integrity and that comply with its procedures and methodology</i> (as disclosed above). In the event that the applicant is already registered, that registration would be subject to suspension or revocation. (Section 4)</p>
<p>Requirements for updating an applicant’s information</p>	<p>Generally, credit agencies that have gained NRSO registration would be required to promptly amend their applications with the SEC if developments have rendered previous disclosures to be materially inaccurate. And not later than 90 days after the end of each calendar year, they would also have to file registration amendments with the agency, certifying the accuracy of their disclosures and identifying any material changes since the previous year’s filings. (Section 4)</p>	<p>Generally, credit agencies that have gained NRSO registration would be required to promptly amend their applications with the SEC if developments have rendered previous disclosures to be materially inaccurate. And not later than 90 days after the end of each calendar year, they would also have to file registration amendments with the agency, certifying the accuracy of their disclosures and identifying any material changes since the previous year’s filings. (Section 4)</p>

Provision	H.R. 2990	S. 3850
<p>The elements of the SEC’s authority to enforce NRSRO accountability</p>	<p>The SEC would have the authority to take action against NRSROs who violate the procedures, criteria, and methodologies contained in registration applications. It also would authorize the agency to censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any NRSRO or person associated with an NRSRO has been found to: a) have been in violation of certain federal laws; b) have been convicted during the 10-year period preceding the date of furnishing the NRSRO application; and c) have been punished for any crime that is punishable by imprisonment for a period of one or more years, or a substantially equivalent crime by a foreign court. (Section 4)</p>	<p>The SEC would have the authority to take action against NRSROs who violate the procedures, criteria, and methodologies contained in registration applications. It also would authorize the agency to censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any NRSRO or person associated with an NRSRO has been found to: a) have been in violation of certain federal laws; b) have been convicted during the 10-year period preceding the date of furnishing the NRSRO application; c) have been punished for any crime that is punishable by imprisonment for a period of one or more years, or a substantially equivalent crime by a foreign court; and d) <i>have failed to file the required certifications or to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.</i> (Section 4)</p>
<p>Limitations on the SEC’s authority over NRSROs</p>	<p>None of the legislation’s rules on the SEC’s authority over the NRSRO registration process shall be interpreted to give the agency the authority to regulate the substance of credit ratings or the procedures and methodologies by which NRSROs determine ratings.</p>	<p>None of the legislation’s rules on the SEC’s authority over the NRSRO registration process shall be interpreted to give the agency the authority to regulate the substance of credit ratings or the procedures and methodologies by which NRSROs determine ratings.</p>
<p>Public availability of information NRSROs submit to the SEC</p>	<p>Generally, upon being registered as an NRSRO by the SEC, a credit rating agency must make the information and documents it furnished to the agency as part of the registration process publicly available through either its website or an alternative readily accessible means.</p>	<p>Generally, upon being registered as an NRSRO by the SEC, a credit rating agency must make the information and documents it furnished to the agency as part of the registration process publicly available through either its website or an alternative readily accessible means.</p>

Provision	H.R. 2990	S. 3850
<p>SEC adoption of rules to prevent misuse of nonpublic information</p>	<p>The SEC shall adopt rules or regulations to require policies or procedures designed to prevent NRSROs from the misuse of the material, nonpublic information that they collect. (Section 4)</p>	<p>The SEC shall adopt rules or regulations to require policies or procedures designed to prevent NRSROs from the misuse of the material, nonpublic information that they collect. (Section 4)</p>
<p>SEC adoption of rules for the prevention of conflicts of interest</p>	<p>The SEC, as it deems necessary or appropriate, shall adopt rules or regulations to prohibit, or require the management or disclosure of, any conflicts of interest relating to the issuance of ratings by an NRSRO that shall include (1) the manner of an NRSRO's compensation for ratings or related services; (2) the consulting, advisory, or other services provided by an NRSRO; (3) the nature of the business ties, ownership interests, or other financial or personal associations between an NRSRO and entities who do business with it; and (4) affiliations between an NRSRO and entities that underwrite the securities or money market instruments rated by the NRSRO. (Section 4)</p>	<p>The SEC shall issue rules to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of ratings by an NRSRO that shall include (1) the manner of an NRSRO's compensation for ratings or related services; (2) the consulting, advisory, or other services provided by an NRSRO; (3) the nature of the business ties, ownership interests, or other financial or personal associations between an NRSRO and entities who do business with it; (4) affiliations between an NRSRO and entities that underwrite the securities or money market instruments rated by the NRSRO; and (5) <i>any other potential conflicts of interest that the SEC deems necessary for the public interest or for the protection of investors.</i> (Section 4)</p>

Provision	H.R. 2990	S. 3850
<p>SEC adoption of rules for the prevention of prohibited acts and practices</p>	<p>The SEC may adopt rules or regulations relating to NRSROs: (1) seeking payment for a credit rating that has not been specifically requested by the issuer (an unsolicited rating); (2) conditioning or threatening to condition the issuance of a credit rating on the issuer’s purchase of other services or products; (3) lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool unless a portion of the assets within such pool also is rated by the NRSRO; and (4) modifying or threatening to modify a credit rating or otherwise departing from its standard methodologies for determining credit ratings, based on whether an issuer pays or will pay for the credit rating or any other of the NRSRO’s services or products. (Section 4)</p>	<p>The SEC may adopt rules or regulations relating to NRSROs : (1) seeking payment for a credit rating that has not been specifically requested by the issuer (an unsolicited rating); (2) conditioning or threatening to condition the issuance of a credit rating on the issuer’s purchase of other services or products; (3) lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool unless a portion of the assets within such pool also is rated by the NRSRO; and (4) modifying or threatening to modify a credit rating or otherwise departing from its standard methodologies for determining credit ratings, based on whether an issuer pays or will pay for the credit rating or any other of the NRSRO’s services or products. (Section 4)</p>
<p>NRSRO requirements for compliance officers and financial condition data</p>	<p>Each NRSO shall designate a compliance officer with responsibility for ensuring compliance with the securities laws.</p> <p>In addition, the SEC is given the authority to require NRSROs to provide it with confidential, independently audited financial statements on their financial conditions, the specific nature of the filings and the interval between such filings to be determined by the agency. (Section 4)</p>	<p>Each NRSO shall designate a compliance officer with responsibility for ensuring compliance with the securities laws.</p> <p>In addition, the SEC is given the authority to require NRSROs to provide it with confidential, independently audited financial statements on their financial conditions, the specific nature of the filings and the interval between such filings to be determined by the agency. (Section 4)</p>
<p>Notice to other agencies of the changes in the treatment of the term NRSRO</p>	<p>Within 30 days after the date of enactment, the SEC shall notify federal agencies whose rules or regulations use the term “nationally recognized statistical rating organization” of the law’s changes in the treatment of the term. (Section 4)</p>	<p>Within 30 days after the date of enactment, the SEC shall notify federal agencies whose rules or regulations use the term “nationally recognized statistical rating organization” of the law’s changes in the treatment of the term. (Section 4)</p>

Provision	H.R. 2990	S. 3850
No waiver of right of action and no creation of a private right of action	None	<i>NRSRO registration does not constitute a waiver of any right that the NRSRO might otherwise have under state or federal law. No reports provided by an NRSRO shall create a private right of action. (Section 4)</i>
Review of existing regulations	Within 360 days after the date of enactment, the SEC shall review its existing rules and regulations that employ the term “nationally recognized statistical rating organization” or “NRSRO” and promulgate new or revised rules and regulations as it deems necessary for either the public interest or the protection of investors. (Section 4)	Within 270 days after the date of enactment, the SEC shall review its existing rules and regulations that employ the term “nationally recognized statistical rating organization” or “NRSRO” and amend or revise such rules in accordance with the goals of this law as it deems necessary for either the public interest or the protection of investors. (Section 4)
Conforming amendments	Provides for conforming amendments to several Federal statutes, including the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Housing and Community Development Act of 1992.	Provides for conforming amendments to several Federal statutes, including the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Housing and Community Development Act of 1992.

a. In the qualitative approach information is gleaned from analysts’ trips to the rated firm. In the quantitative approach information is gleaned from the rated firm’s publicly available financial statements.