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June 26, 2008

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Summary

On June 16, the SEC made public new rules intended to increase transparency and reduce conflicts of interest in the credit rating process for fixed-income instruments. The Commission had voted to propose the rules on June 11. One controversial proposal aired during the run-up to the formal release of the proposed rules – a requirement that rating agencies use a special symbol to identify ratings on structured products – seems unlikely to go into effect. The other key transparency proposals, which would require agencies to disclose their ratings, rating actions, and rating performance, may produce a marginal increase in rating quality, although one might question why market actors apparently did not demand this data. The proposal may be most important for what it does not do: The SEC does not plan to forbid the “issuer-pays” system, in which the rating agencies are paid by the parties whose products are being evaluated. Although the SEC apparently has the power to ban issuer-pays and recognizes that the arrangement creates potential conflicts of interest, the proposed rules address issuer-pays only through a half measure that appears unlikely to be effective.

Background

The vast majority of fixed-income instruments issued in the United States receive ratings from one or more credit rating agencies, the three most important of which are Moody's, Standard & Poor's, and Fitch Ratings. The major agencies describe their ratings as reflecting an issue or issuer's creditworthiness, embedding information about some combination of the probability of default and the expected loss on default, although the exact combination is not clear in all cases. Investors rely on these ratings to varying degrees in assessing credit risk.

Credit ratings have also been incorporated into the financial regulatory framework. Many regulations depend on ratings issued by agencies that have the status of “nationally recognized statistical rating organization” (NRSRO) – a designation conferred by the SEC through a registration process. The term “NRSRO” apparently originated in the mid-1970s, when the SEC adopted net capital rules requiring broker-dealers to maintain “net worth” equal to a specified fraction of liabilities. The

rules provide for specified deductions, or “haircuts” for different securities in performing this calculation, and securities with high ratings from NRSROs receive dramatically smaller haircuts, reflecting a presumption that such securities are more liquid and less risky.

NRSRO status subsequently became important in other contexts. For example, SEC rules limit money market funds to investments in securities that receive high NRSRO credit ratings. Agency credit ratings figure into calculations of capital adequacy for banks (under both longstanding U.S. rules and the Basel II accord) and insurance companies (under state laws). Institutional investor guidelines, perhaps influenced by judicial decisions protecting fiduciaries from liability if they invest in highly rated instruments, often limit holdings to securities that receive high (“investment-grade”) ratings from the agencies. Agency ratings figure into private contracts, which often contain “ratings triggers” under which an entity suffers adverse consequences from a rating agency downgrade. These rules imbue ratings with significance (and value) even if the agencies do a poor job of assessing creditworthiness.

Rating agencies came under fire in 2001, when both Moody's and Standard & Poor's maintained an investment-grade rating on Enron up until four days before the company declared bankruptcy. The resulting uproar earned the agencies unwelcome Congressional attention, and the Sarbanes-Oxley Act of 2002 ordered the SEC to review agencies' regulatory treatment and report back to Congress, setting off a process that culminated in the Credit Rating Agency Reform Act of 2006.

It seems clear that improving market competition, not enabling regulation, was the principal focus of the 2006 Act. Most of its provisions relate to reducing regulatory barriers to entry by forcing the SEC to act quickly according to a transparent process to allow agencies to become registered NRSROs. The Act also expressly forbade both the SEC and the states from “regulat[ing] the substance” of credit ratings and required that the SEC's rules under the Act be “narrowly tailored” to the Act's requirements. The Act did, however, grant the SEC rulemaking power in a few discrete areas, including insider trading, conflicts of interest,

enumerated tying-like practices,¹ and specification of information to be provided and updated in connection with registration as an NRSRO.

The SEC finished its rules in June 2007, just as the “worldwide credit crisis” was about to hit. During the crisis, structured products with high credit ratings – most notoriously products based on pools of subprime mortgages – experienced much higher levels of credit stress than their credit ratings would suggest, and rating agencies came under a renewed round of public scrutiny. Rating quality for structured products started to look very poor just as the measures intended to improve ratings quality over time started to take effect, and the crisis spurred the SEC to undertake prescriptive regulatory action under a statute that was premised on faith in market forces rather than regulation. Although one could ask whether rating agencies actually gave poor-quality ratings, rather than just getting unlucky, official reports on the crisis such as those issued by the President's Working Group on Financial Markets (March 2008) and the International Organization of Securities Commissions (May 2008) took the agencies to task. After several months of investigation, focusing on structured products, the SEC developed the current proposal.

Key Elements of the Proposed Rules

Separate Symbol Rule for Structured Products: The most controversial proposal would require agencies to differentiate between the ratings they issue on structured products (securities based on pools of assets such as mortgages, auto loans, or credit-card receivables) and the ratings they issue on corporate bonds. The rules would require the agencies *either* to use different rating symbols for

structured products *or* to issue a report with each rating describing the rating methodology it used and disclosing the differences between ratings of structured products and ratings of other securities.

This is the most controversial of the proposed rules, and the separate symbol seems unlikely to survive. Indeed, this idea has evidently been watered down significantly in the time between conception and proposal. It seems that the requirement was originally conceived to *require* a separate symbol and that option of meeting the requirement by issuing a report was added in response to opposition. Even so diluted, one of the three Commissioners dissented from the decision to propose the rule. This provision also is the only proposal so far to draw vocal criticism from the private sector. The Securities Industry and Financial Markets Association (SIFMA), a leading trade group for the finance industry, called the proposal “cosmetic” and emphasized the possibility that the rule might force fire-sale disposition of certain structured products that would become ineligible to be held by their present owners because the instruments would no longer carry the ratings required by investment guidelines and regulations. Moreover, the separate-scale requirement is particularly vulnerable to legal challenge as it arguably regulates the substance of credit rating. Agencies would not be able, for example, to give an unmodified “AAA” rating to structured products. They could argue that the SEC is prescribing the definition, and therefore the substance, of the unmodified AAA rating.

Given the fierce opposition to using a separate symbol for structured products, it seems unlikely that the major agencies will adopt this approach even the separate-symbol option is included in the final rules.

Transparency Rules: The SEC is proposing both generally applicable transparency rules and transparency rules that are specific to structured products. Generally applicable rules include requirements that agencies: (a) make all their ratings and subsequent rating actions publicly available; (b) publish performance statistics for 1, 3, and 10 years within each rating category; (c) disclose how frequently credit ratings are reviewed, whether different models are used for ratings surveillance than for initial ratings, and whether changes made to models are applied retroactively to existing ratings; (d) make an annual report of the number of ratings actions they took in each ratings class, and maintain a database of all ratings actions on the agency's Web site; and (e) require

¹ The enumerated practices include conditioning the issuance of a rating on an issuer's purchasing other services from the agency, modifying or threatening to modify a credit rating based on whether the issuer purchases other services from the agency, and “notching” – the practice of lowering or threatening to lower a credit rating on a structured product unless the agency also rates the underlying securities on which the structured product is based. Although it is reasonable to read the Act as commanding the SEC to ban these practices, the SEC did not consider itself so bound. The merits of notching were the single most commented-on issue in the 2007 rules, and the SEC ultimately prohibited notching only if practiced with anticompetitive intent

documentation of the rationale for any significant out-of-model adjustments.

Transparency rules specific to structured products include requirements that agencies: (a) disclose the way they rely on the due diligence of others to verify the assets underlying a structured product; and (b) disclose the information a credit rating agency uses to determine a rating on a structured product.

It seems that investors would find it useful if the information covered by the transparency rules were disclosed, particularly if they are interested in measuring how well rating agencies perform. The special focus on making it easier for investors to “look through” structured products to the underlying capital pools certainly is understandable given the environment. But one might reasonably ask why this information wasn't already demanded by the market. The fact that market forces have not required the agencies to divulge such data on a regular basis so far suggests that a rule requiring them to do so may not have a terribly great effect.

Potential explanations for the fact that the market has not demanded the information so far include the idea that investors don't find it cost-effective to monitor rating-agency performance and the idea that investor preferences aren't important to rating-agency behavior because agencies are paid by issuers. If either of those explanations is correct, there may be a marginal benefit to enhanced transparency: if the information is more readily available, investors may find monitoring slightly more cost-effective with the rule in effect, and even if investor preferences don't affect rating agency behavior, more readily available information on agency quality may help them calibrate how much weight to give ratings in their investment decisions. The requirements to disclose how frequently ratings are reviewed and what ratings actions are taken could conceivably help address situations such as Moody's failure for several months in 2007-08 to correct a coding error that the agency says caused it to incorrectly give its highest rating to billions of dollars worth of CPDOs.²

² A CPDO is a structured product introduced in 2006 in which the investment vehicle takes leveraged long credit exposure to an index of corporate credit spreads and sells notes to investors. The vehicle dynamically adjusts its leverage in an attempt to meet the terms of the notes as market conditions change without using “excess” leverage. If spreads tighten, leverage is reduced. If spreads widen, leverage is increased.

Given that costs also appear small (the information to be disclosed appears to be already available or easily compiled), the rule may be justified but doesn't seem terribly significant.

Although the SEC's legal authority in this area is not crystal clear and the rating agencies themselves have not yet announced their position on the transparency rules, the rules do seem likely to be adopted in some form. They may be modified somewhat to be consistent with transparency guidelines that apparently are being developed in a private-sector process involving SIFMA and the rating agencies under the aegis of the President's Working Group on Financial Markets.

Conflict-of-Interest Rules: The most significant rule here does attempt to address the issuer-pays conflict in a limited way. It would prohibit the arranger of a structured product offering from paying for a rating for that offering unless “all information” provided to the agency in connection with the offering is disclosed through a means designed to provide reasonably broad dissemination of the information. The idea is that other rating agencies besides those paid by the arranger could then issue ratings and that these unsolicited ratings would keep the paid rating agency honest. It seems unlikely that these ratings will produce a major deterrent effect. Someone has to pay for these outside ratings, and if investors are willing to pay for them, then one wonders why issuers should pay for the original ratings. If the issuer-pays model presents a conflict of interest, as the proposal (and many commentators) recognize, why permit issuers to pay for any ratings?

This category also includes rules: (a) prohibiting agencies from making “recommendations” to the issuers/arrangers of products they rate; (b) prohibiting anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it; and (c) prohibiting gifts from those who receive credit ratings to those who rate them. These rules do not appear highly significant, and the ban on “recommendations” could do more harm than good. For many structured products, agencies currently are transparent in their methodology, so that issuers can structure the products and investors can evaluate them accordingly. The SEC's comments on the proposed rules expressly endorse such transparency, and if the ban on “recommendations” is interpreted broadly enough to interfere with this practice, it seems ill-advised. If, on the other hand, the ban on “recommendations” is interpreted narrowly, it seems fairly easy for a rating agency to

circumvent it. The other two rules, while unobjectionable, seem cosmetic.

Revisiting Ratings-Based Regulation: The SEC is set to consider at its next meeting a proposal to “reduce undue reliance” on NRSRO ratings in substantive regulations. A thoughtful reconsideration of the role of ratings in regulation certainly is a good idea, especially because rating agencies say ratings measure creditworthiness, and some SEC regulations use ratings as proxies for characteristics other than creditworthiness, such as liquidity. Indeed, a case can be made – and has been made – that ratings-dependent regulation should be eliminated root and branch. But regulators need some way of measuring risk in order to set capital requirements for regulated companies such as banks and insurance companies. Market-based measures are of questionable utility when instruments are illiquid, and regulators probably lack the resources to come up with good ratings on the tens of thousands of instruments the agencies cover.

Whatever the ideal resolution of this issue, the bottom line, however, is that the SEC does not have the power to eliminate ratings-based regulation on its own even if it were inclined to do so. State and federal statutes, rules from agencies other than the SEC, international agreements, and judicial decisions all rely on ratings and give them significance apart from their actual value in assessing creditworthiness.

What the Proposed Rules Do Not Do

The proposed rules do not forbid the issuer-pays arrangement, under which the rating agency is paid by the issuer or arranger who stands to benefit from receiving a high rating. As the SEC and many commentators have noted, the system creates a conflict of interest. As explained above, the solution the SEC proposes appears unlikely to be effective.

The SEC seems to possess and claim the power to ban issuer-pays, and news accounts suggesting that the agency cannot do so because it lacks authority to regulate rating agency compensation are puzzling. The 2006 Act grants the SEC authority to “issue final rules ... to *prohibit*, or require the management and disclosure of ... any conflicts of interest relating to the issuance of credit ratings by [an NRSRO].” Moreover, the Commission has already adopted a rule under the Act that prohibits agencies from issuing ratings solicited by very large customers (defined as customers providing the agency with 10% or more of net revenue, a threshold that

apparently is not met by any customer of the three major agencies). Although rating agencies opposed that rule and argued that it was not “narrowly tailored” enough to satisfy the Act, they did not argue that the SEC flatly lacks authority in this area. Finally, the current proposed rules ban issuer-pays for structured finance products in cases where information on underlying asset pools is not widely disseminated.

The issuer-pays system creates a temptation to give overly sanguine ratings, and agencies seem especially prone to this temptation because countervailing incentives are weak. First, although agencies have incentives to safeguard their reputations, market incentives for high ratings quality are blunted by the fact that instruments with high ratings get favorable regulatory treatment under a variety of laws and regulations regardless of rating quality. If agency ratings were valuable solely because of the information they provide investors about creditworthiness, issuer-pays would be less of a problem. Investors might disregard poor-quality ratings and be unwilling to pay issuers or arrangers for instruments that carried such ratings. High quality issuers *might* therefore have some incentive to demand that the ratings agencies establish scrutinizing standards. However, because high ratings derive some of their value from the regulatory benefits that issuers receive regardless of quality, the value of a highly scrutinizing standard is likely lower, potentially even for high-quality issuers. The SEC is considering taking action to address this issue, but as noted above it does not have the power to do so effectively if it acts unilaterally.

Second, the threat of litigation does not appear to provide a strong incentive to provide high-quality ratings. Unlike many other service providers, rating agencies have not been found to owe a duty of care to end users. Agencies are potentially liable for securities fraud, but they can produce low-quality ratings without engaging in conduct that rises to the level of fraud. And they assert an intermittently successful First Amendment defense, arguing that their ratings are protected expressions of opinion on matters of public concern. Whatever one's views on the right level of liability exposure for rating agencies, it seems difficult to argue that litigation exposure currently provides much of an incentive to produce high-quality ratings.

Third, the threat of SEC enforcement is limited. The SEC has no power to prescribe quality standards under the 2006 Act and apparently cannot start enforcement proceedings against a ratings agency for using bad, careless, or reckless ratings algorithms unless the

agency's conduct violates its own disclosed rating policy.

The proposed rules may have some marginal effect in increasing transparency – although the ban on making “recommendations” about ratings to issuers could have the opposite effect if interpreted too broadly. But for the foreseeable future, it is likely that agency ratings will be paid for by issuers/arrangers, will be incorporated into the regulatory system, and will not be constrained by threats of private litigation or SEC enforcement. The regulatory system will continue both to prop up the importance of ratings and to give the agencies incentives to issue ratings that are too high.