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Rating Agency Regulation After The Dodd-Frank Act: A Mid-Course Review

The Dodd-Frank Act contains numerous provisions designed to increase oversight and accountability of the credit rating industry. Ongoing efforts to implement the provisions of the Dodd-Frank Act are affecting rating agencies and the production and use of credit ratings.

By David B.H. Martin and Matthew C. Franker

In the wake of the 2007-2008 financial crisis, credit rating agencies came under intense scrutiny as policymakers and commentators sought to reduce investors' reliance on credit ratings and remedy perceived regulatory deficiencies. The provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) relating to credit rating agencies were heavily influenced by this critique. They have substantially altered the regulatory landscape confronting credit rating agencies, in particular those registered with the U.S. Securities and Exchange Commission (SEC) as nationally recognized statistical rating organizations (NRSROs).[1] This article discusses the ongoing implementation of the Dodd-Frank Act's credit rating provisions and the expected impact that the most significant of these changes will have the use of credit ratings. These changes already are affecting the manner in which NRSROs function in capital market transactions and will be of considerable significance to market participants and their counsel as implementation of the modified regulatory regime proceeds.

Background

Congressional focus on the regulation of credit rating agencies intensified after rating agencies failed to forecast defaults by companies such as Enron and WorldCom. In response, Section 702 of the Sarbanes-Oxley Act of 2002 directed the SEC to conduct a study of the role and function of credit rating agencies in the operation of the securities market.[2] In 2003, the SEC published this study as well as a concept release seeking input on the function and oversight of rating agencies.[3] Although those efforts had little initial impact, Congress subsequently passed the Credit Rating Agency Reform Act of 2006 (Credit Rating Agency Reform Act), which, for the first time, granted the SEC statutory authority to regulate credit rating agencies.[4] In adopting the Credit Rating Agency Reform Act Congress found that credit rating agencies were of national importance and that SEC oversight of the industry was required to protect investors.

David B.H. Martin is a partner, and Matthew C. Franker is an associate, at Covington & Burling LLP in Washington, DC.

The Credit Rating Agency Reform Act contains a mandatory registration regime for credit rating agencies seeking designation as NRSROs. Accordingly, registration under Section 15E of the Securities Exchange Act of 1934 (Exchange Act) replaced credit rating agencies' prior practice of obtaining NRSRO status through a no-action letter process. As the SEC and rating agencies were acting to implement this regime, NRSROs were responding to increased default rates for subprime residential mortgage-backed securities and collateralized debt obligations through widespread downgrades in their ratings for those instruments.[5] As a result of this process and the ensuing collapse of the market for these securities, policymakers and other observers began to call for more stringent oversight and regulation of NRSROs. In adopting the credit rating agency provisions of the Dodd-Frank Act, Congress noted the systemic importance of credit ratings to debt markets, concluding that rating agencies' status as "gatekeepers" justified a degree of oversight and accountability similar to more heavily regulated securities analysts and auditors.[6]

Rescission of Rule 436(g) and Changes to Issuer Disclosure Practices

The Dodd-Frank Act's most contentious provision with respect to NRSROs was the immediate rescission of Rule 436(g) under the Securities Act of 1933 (Securities Act). This rule, which had been subject to considerable debate in the years preceding the Dodd-Frank Act, exempted securities ratings issued by NRSROs from being deemed part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act.[7] As a result of this provision, an issuer disclosing an NRSRO's credit rating in a registration statement or prospectus was not required to obtain written consent from that NRSRO, and the NRSRO was not subject to potential liability for the rating under Section 11 of the Securities Act.[8] In rescinding Rule 436(g), which dated to 1982, Congress elected to apply the same standard of liability to NRSROs as experts other "gatekeepers" required to file consents under Rule 436, such as accountants, engineers and appraisers.[9]

In the wake of the Dodd-Frank Act's rescission of Rule 436(g), the largest NRSROs announced that they would decline issuer requests to provide consents to references to their ratings in Securities Act registration statements or prospectuses.[10] Without such consents, issuers would be unable to refer to credit ratings in registration statements or prospectuses while remaining in compliance with Section 7 of the Securities Act and Rule 436 thereunder. Although corporate issuers were able to adjust to this development by omitting disclosure of credit ratings, asset-backed issuers were confronted with SEC rules requiring that credit ratings be disclosed in offering documents for asset-backed securities.[11] The dependence of this requirement on the continued existence of Rule 436(g) exploded into view when the market for asset-backed securities ground to a halt due to NRSROs' refusal to provide consents. Only the SEC staff's suspension of the rules requiring disclosure of credit ratings for asset-backed securities led to a resumption of the market for asset-backed securities.[12]

The SEC staff published interpretive guidance to clarify circumstances that would not trigger a consent requirement.

To assist issuers in avoiding the obligation to provide NRSRO consents, the SEC staff published interpretive guidance to clarify circumstances that would not trigger a consent requirement, which include credit ratings that have been disclosed previously, ratings disclosed in free writing prospectuses or term sheets, and ratings contained in broader disclosures, such as in a liquidity discussion within Management's

Discussion and Analysis of Financial Condition and Results of Operations or disclosure of a contractual provision referencing a credit rating. Due to this guidance and the staff's no-action position for asset-backed securities offerings, the principal result of rescission of Rule 436(g) has been the avoidance of credit rating disclosure in registered offerings. As a result, issuers, including all issuers of asset-backed securities, are providing less credit rating disclosure than before the adoption of the Dodd-Frank Act.[13] Despite this effect, NRSROs' credit ratings remain widely available to investors, most notably through disclosure on NRSROs' websites and in offering term sheets, which typically are filed with the SEC as free writing prospectuses.

To avoid triggering an NRSRO consent requirement, counsel for issuers and underwriters should ensure that references to ratings in periodic reports are not incorporated by reference into a registration statement or prospectus unless they clearly satisfy the limited exceptions set forth in the SEC staff's published guidance. These references are most likely to appear in periodic reports or an underwriting agreement that is incorporated by reference into a registration statement or prospectus.[14] By adhering to these procedures, the effect of congressional repeal of Rule 436(g) should be negligible for most offerings.

Removal of References to Credit Ratings from Federal Regulations

The regulatory use of credit ratings, which dates to Depression-era banking regulations, accelerated rapidly following the SEC's 1975 amendment to its broker-dealer net capital rule, Exchange Act Rule 15c3-1, which defined the term NRSRO for the purpose of prescribing capital charges to broker-dealers for different types of debt securities.[15] NRSRO credit ratings subsequently were incorporated into other SEC rulemakings, federal and state legislation, banking regulation and private contracts. Over time, regulatory dependence on credit ratings came to be cited as a principal cause of undue reliance on such ratings among investors, regulators and other market participants, particularly with respect to ratings of structured finance products.[16]

The SEC first publicly examined the regulatory use of NRSROs in a 1994 Concept Release and reconsidered the use of credit ratings in regulation after the passage of the Sarbanes-Oxley Act, but did not take action in either instance.[17] In the midst of the 2007-2008 financial crisis, however, policymakers began to consider structural changes in oversight and regulation of financial markets, including the potential removal of credit ratings from regulation.[18] In the midst of the crisis, the SEC proposed a series of rulemakings that would have removed references to NRSROs and credit ratings from its rules and forms, soliciting comment on the question of whether such usage "'placed an official seal of approval' on ratings that could adversely affect the quality of due diligence and investment analysis."[19] In response to these proposals, the SEC took limited action to remove some references to credit ratings from its regulations, but this effort was relatively discrete.[20]

The SEC reconsidered the use of credit ratings in regulation after the passage of the Sarbanes-Oxley Act.

Passage of the Dodd-Frank Act precipitated a comprehensive approach to the removal of ratings from SEC regulations. In response to the perceived over-reliance on credit ratings, the Dodd-Frank Act: (1) deleted assorted statutory references to credit ratings and NRSROs; (2) ordered federal agencies to review their regulations within one year and to substitute alternative standards of creditworthiness for all references to credit ratings; and (3) required each agency to prepare a report describing resulting modifications to its regulations.[21]

In contrast to the SEC's embrace of this directive, which is supported by the largest NRSROs,[22] banking regulators have noted problems developing suitable alternative standards of creditworthiness for regulatory capital purposes and only recently released proposals to implement this mandate.[23] The contrasting difficulties faced by the SEC and other financial regulators underscore this tension between concern over investor overreliance on credit ratings and the utility of credit ratings to prudential financial regulation.

The SEC began implementing the Dodd-Frank Act requirement in July 2011 by revising eligibility standards for the use of Forms S-3 and F-3 to remove eligibility for certain issuers of investment grade non-convertible securities (other than common equity) and substituting eligibility criteria focused primarily on the amount and frequency of registered debt issuance.[24] In response to concerns from certain issuers of public debt, primarily public utilities and certain insurance companies, the final rules provide short form eligibility for wholly owned subsidiaries of well-known seasoned issuers, as well as a grandfather provision permitting previously eligible issuers to remain eligible until 2014. The inclusion of these criteria effectively addressed concerns that the initial proposal would strip a large number of issuers with a broad market following of eligibility to use Forms S-3 and F-3. In addition to modifying criteria for short-form registration eligibility, this rulemaking also removed NRSRO credit ratings as permissible disclosure in communications deemed not to involve a prospectus or free writing prospectus pursuant to Rule 134 under the Securities Act.

Revised eligibility criteria for Forms S-3 and F-3 are likely to have a negligible effect on capital markets transactions. The SEC's July rulemaking may permit some new frequent, non-investment grade issuers to conduct offerings on Forms S-3 or F-3, or, once the grandfather period expires, could preclude certain infrequent, investment grade issuers from doing so, but these circumstances will arise only at the margins. Issuers contemplating offerings of non-convertible securities, other than common equity, pursuant to General Instruction I.B.2 of Form S-3 and Form F-3 should determine the applicability of these modified criteria. If an issuer is relying on the grandfather provision, it must disclose that it has a reasonable belief that it would have been eligible under the prior rules, as well as the basis for such belief. In addition, although including an NRSRO's credit rating in a communication will not automatically result in the document being deemed a prospectus, the loss of the safe harbor provided by Rule 134 and the ability to publish a credit rating in a free writing prospectus will likely result in the omission of credit ratings from materials published in reliance on Rule 134.

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In addition to this rulemaking, the SEC has responded to the Dodd-Frank Act's mandate to strip its regulations of all references to credit ratings by proposing to remove references to ratings from certain rules under the Investment Company Act of 1940. The most significant proposal would substitute the determination of a money market fund's board of directors with respect to creditworthiness for a standard predicated on an NRSRO's credit rating.[25] The SEC also has proposed removing references to ratings from rules promulgated under the Exchange Act, including the net capital rule.[26]

Provisions to Increase Transparency and Reduce Conflicts in the Rating Process

In May 2011, the SEC proposed rules to implement provisions of the Dodd-Frank Act affecting credit ratings (NRSRO Proposal).[27] If adopted, these rules would expand significantly the SEC's oversight of NRSRO policies and procedures relating to the production of credit ratings by imposing a series of procedures designed to increase transparency and strengthen the integrity of credit ratings. If adopted as proposed, these regulations will result in increased disclosure regarding the procedures and methodology used to determine a credit rating and will quite possibly increase the time and expense associated with obtaining a credit rating.

The NRSRO Proposal would require the following:

- disclosures to provide users of credit ratings with information regarding NRSROs' rating methodologies, accuracy of previously issued ratings, compensation, and rating symbols;
- publication of due diligence reports of third-party diligence providers in offerings of asset-backed securities; and
- procedural steps for NRSROs designed to limit conflicts of interest and promote ratings quality.

The NRSRO Proposal is largely shaped by the statutory language of the Dodd-Frank Act, which was derived from criticisms of NRSROs that emerged during the subprime mortgage crisis. Although these criticisms focused on the structured finance market, the Dodd-Frank Act and the NRSRO Proposal address NRSRO conduct and procedures generally. As a result, implementation of the NRSRO Proposal will affect the production and publication of all credit ratings.

New NRSRO Disclosure Requirements to Promote Ratings Transparency

The NRSRO Proposal contains a number of measures designed to assist users of credit ratings in better understanding a rating, as well as the considerations and processes used to determine such rating. The NRSRO Proposal would implement an Dodd-Frank Act provision mandating publication of qualitative and quantitative information regarding a credit rating by requiring NRSROs to prepare and publish a report to accompany any "rating action."[28] This report would include the rating, methodology, and assumptions used in determining the rating and the limitations and uncertainties regarding the rating.[29] In addition, the individual responsible for the rating action will be required to attest to his or her responsibility for the independence of the rating process. NRSROs will be required to "publicly disclose" this information by making it "readily available to any users of credit ratings," which will likely involve NRSROs posting these reports on their websites.[30]

Other aspects of the NRSRO Proposal will require expanded disclosure of past ratings performance, historical credit ratings, and disclosure of NRSROs' changes to their procedures and methodologies. This last item will include mandatory disclosure of any "significant errors" identified with respect to a procedure or methodology. The NRSRO Proposal will also require NRSROs to clearly define and consistently apply ratings symbols and disclose whether a rating is paid for by the "sell-side," the "buy-side" or is unsolicited.

Increased transparency in the rating process is designed to facilitate independent analysis of credit risk using information reported by NRSROs. However, the new reporting requirement may result in increased delays and costs associated with the production and publication of credit ratings. These changes also may result in a rating process that is more regimented and less adaptable to market exigencies. In addition, NRSRO reporting obligations imposed in the interest of enhanced transparency may chill the exchange of information between issuers and rating agencies. How NRSROs and issuers grapple with implementation of the NRSRO Proposal, particularly in its early stages, will bear watching to determine whether these factors impair the utility of ratings to investors and other market participants.

Third-Party Due Diligence Reports in Asset-Backed Securities Offerings

The Dodd-Frank Act requires the issuer or underwriter of any asset-backed security to disclose the findings and conclusions of any third-party due diligence report obtained in connection with an offering of asset-backed securities.[31] The Dodd-Frank Act further requires the person providing the due diligence services to give a written certification to any NRSRO that produces a credit rating to which such services relate.[32]

> ***The individual responsible for the rating action will be required to attest to his or her responsibility for the independence of the rating process.***

The NRSRO Proposal would require the issuer or underwriter of any asset-backed security, including exempted securities and securities issued in unregistered offerings, to furnish the findings and conclusions of any third-party due diligence report electronically on new Form ABS-15G.[33] This form would require the signature of either the senior officer in charge of securitization of the depositor or a duly authorized officer of the underwriter and would be due at least five days before the first sale in any asset-backed securities offering.[34] Alternatively, if the NRSRO represents that it will make the required disclosure publicly available in the report it will be required to issue in connection with a rating action at least five business days before the first sale, and the issuer or underwriter determines that such representation can be reasonably relied upon, the issuer or underwriter would not be required to furnish Form ABS-15G. If the NRSRO does not fulfill its representation, the issuer or underwriter then would be required to furnish Form ABS-15G at least two business days before the first sale in the offering.

The SEC is soliciting comment on a number of aspects of these proposals, most significantly including whether the proposed rules should apply to unregistered offerings and offerings of exempted securities under Section 3(a)(12) of the Exchange Act.[35] Application of the proposed rule to these offerings does not seem to be clearly required by the Dodd-Frank Act and is problematic because it may result in the unintended narrowing of private offering exemptions under the Securities Act.[36] If the SEC determines that these requirements will apply to unregistered offerings and offerings of exempted securities, counsel for issuers and underwriters engaged in such offerings will need to consider how filing Form ABS-15G might affect compliance with registration exemptions.

Procedural Requirements to Limit Conflicts of Interest and Promote Ratings Quality

The Dodd-Frank Act requires the SEC to adopt rules to prevent NRSRO sales and marketing considerations from influencing the production of credit ratings. The NRSRO Proposal would implement this requirement by revising Exchange Act Rule 17g-5 to prohibit NRSRO employees who participate in the sale or marketing of a product or service from also participating in determining or monitoring a credit rating, or from developing or approving procedures or methodologies used to determine a rating.[37] In addition, the Dodd-Frank Act mandates that NRSROs establish policies and procedures to determine whether prior rating decisions were affected by a conflict of interest. The NRSRO Proposal would implement this provision through proposed Rule 17g-8(c), which would require NRSROs to publicize the existence of a conflict of interest and place an affected rating under review if a conflict is discovered in the course of this "look back" review. Together, these measures are intended to reduce actual and apparent conflicts of interest and therefore increase the reliability of credit ratings. In furtherance of this objective, the look-back provisions should motivate issuers to avoid conflicts of interest in the ratings process, as a conflict may give rise to an untimely rating review and resultant negative publicity.

The NRSRO Proposal also would require NRSROs to establish, maintain, and enforce standards of training, experience, and competence for credit rating analysts that are designed to result in the production of accurate credit ratings.[38] As proposed, these standards must include the knowledge necessary to evaluate and analyze information relevant to an assessment of creditworthiness and technical expertise necessary to understand any models and model inputs used in an NRSRO's quantitative analysis. The NRSRO Proposal would require participation in the determination of any credit rating of at least one analyst with a minimum of three years of credit analysis experience. In addition, NRSROs will be required to periodically test their credit rating analysts regarding knowledge of their procedures and methodologies. These requirements are focused on NRSROs and will affect market participants only indirectly, likely by imposing increased costs and delays in the rating process, but they also may improve market confidence in the reliability of credit ratings.

Assigned Credit Ratings for Asset-Backed Securities Offerings

The Dodd-Frank Act requires a number of studies relating to rating agencies, most significantly a study under Section 939F by the SEC by July 21, 2012, regarding the potential assignment of credit rating agencies to rate structured finance products.[39] This study must address: (1) the credit rating process for structured finance products and conflicts of interest associated with the issuer-pay and subscriber-pay models of NRSRO compensation; (2) the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings for structured finance products;[40] (3) the range of metrics that could be used to determine the accuracy of credit ratings for structured finance products; and (4) alternative means for compensating NRSROs that would create incentives for accurate credit ratings for structured finance products.

Following completion of the study, the Dodd-Frank Act requires the SEC to "by rule, as [it] determines is necessary or appropriate in the public interest for the protection of investors, establish a system for the assignment of [NRSROs] to determine the initial credit ratings of structured finance products . . . ."[41] While the Dodd-Frank Act is less than clear regarding whether the SEC is required to take action, in issuing any rule the SEC must give "thorough consideration" to the system described in an amendment proposed by Senator Al Franken (D-Minn.) in an earlier version of the Dodd-Frank Act that the Senate approved on May 20, 2010 (Franken Amendment), unless it determines that an alternative system would better serve the public interest and the protection of investors.[42] If adopted, the Franken Amendment would require the SEC to establish a Credit Rating Agency Board, a self-regulatory organization that would be responsible for designating NRSROs as "qualified" and selecting such entities to provide the initial credit rating for any structured financial product.

On May 10, 2011, the SEC issued a solicitation of public comment to assist in its study on assigned credit ratings.[43] The solicitation requests that interested persons provide comments using a framework developed by the U.S. Government Accountability Office (GAO) for use in evaluating or crafting alternative compensation models for NRSROs.[44] The GAO framework provides useful guidance to commenters and the SEC for the recommendation of possible alternatives to the system contemplated by the Franken Amendment. The comments the SEC receives in response to its solicitation are likely to affect the contours of the any proposed assignment system, as well as to inform its view regarding its study regarding NRSRO independence and the long-time viability of the subscriber-pays model for both asset-backed and corporate issuers.

There is significant uncertainty about what is likely to come from this study (or the others mandated by the Dodd-Frank Act) and from any SEC action to establish a system for the mandatory assignment of NRSROs to determine the initial credit rating of structured finance products. The statute is open-ended in terms of implementing any findings from the SEC's report and analysis and, in all likelihood, the SEC lacks statutory authority, to say nothing of budgetary resources, sufficient to implement a mandatory rating assignment system. Nonetheless, much about the legislation is quite directive and will hang over the SEC with considerable weight should ratings, rating agencies or the debt markets become the subject of further crisis-ridden skepticism and scrutiny. While no immediate changes in market practice are imminent in this area, it is an area that participants in the asset-backed securities market should monitor closely, as a mandatory assignment system would fundamentally alter the means through which NRSROs are selected and ratings determined for structured finance products.

Conclusion

Implementation of the credit rating agency provisions of the Dodd-Frank Act is roughly at its midpoint, as the SEC weighs comments on the NRSRO Proposal and its study of assigned credit ratings, and the cumulative effect of these provisions remains to be seen. The rescission of Rule 436(g) and the potential imposition of a rating assignment system for structured financial products stand out as measures that may fundamentally affect the manner in which credit ratings are determined and used. The long process of removing references to credit ratings, detailed disclosure in NRSRO reports accompanying credit ratings and third-party due diligence reports for offerings of asset backed securities also may have a broad impact on the development and use of credit ratings, but will generally be manageable by one-time changes to compliance protocols for most market participants. Finally, regulations focused on NRSRO conduct, such as provisions to limit conflicts of interest and require analyst training, are likely to produce subtle effects, such as marginal improvements in ratings reliability and incremental increases in the time and expense of obtaining a credit rating. As implementation of the Dodd-Frank Act's provisions relating to credit ratings continues, market participants should be mindful of these reforms and be ready to adjust policies and procedures to accommodate new rules.

Notes

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Title IX, Subtitle C—Improvements to the Regulation of Credit Rating Agencies, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2. Sarbanes-Oxley Act of 2002 § 702, Pub. L. No. 107-204, 116 Stat. 745 (2002).

3. *See* U.S. Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (Jan. 2003), available at http://www.sec.gov/news/studies/credratingreport0103.pdf; Ratings Agencies and the Use of Credit Ratings under the Federal Securities Laws, SEC Rel. No. IC-26066 (June 4, 2003), available at http://www.sec.gov/rules/concept/33-8236.htm.

4. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (Sept. 29, 2006).

5. *See generally* Fin. Crisis Inquiry Comm'n, *The Financial Crisis Inquiry Report* 221-30 (2011), *available at* http://www.gpoaccess.gov/fcic/fcic.pdf (describing the effect of ratings downgrades in 2007-2008); Staff of S. Permanent Subcomm. on Investigations, *Report on Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* 263-67 (2011), *available at* http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf (same).

6. Dodd-Frank Act § 931.

7. To reduce the regulatory advantage of NRSRO registration and increase competition in the industry, the SEC in 2008 proposed expanding Rule 436(g) to apply to ratings issued by any credit rating agency and, in a diametrically opposed concept release, in 2009 suggested rescission of Rule 436(g). *See Security Ratings*, SEC Rel. No. 33-8940 (July 1, 2008), *available at* http://www.sec.gov/rules/proposed/2008/33-8940.pdf; *see also Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933*, SEC Rel. No. 33-9071 (Oct. 7, 2009), *available at*

http://www.sec.gov/rules/concept/2009/33-9071.pdf.

8. Section 11 provides a right of action against, *inter alia*, "any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement . . . ." Securities Act § 11(a)(4).

9. *See* Dodd-Frank Act § 931(3) (noting the congressional finding that credit rating agencies "should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers").

10. *See, e.g.*, Press Release, Fitch Ratings, Fitch Comments on U.S. Financial Reform Act's Implication for Credit Rating Agencies (July 19, 2010).

11. *See* Regulation AB, Items 1103(a)(9) and 1120.

12. The disclosure requirement was initially suspended for six months. *See* Ford Motor Credit Company LLC, SEC No-Action Letter (July 22, 2010). On November 23, 2010, the staff extended this position indefinitely in order to permit the completion of rulemaking implementing the Dodd-Frank Act. *See* Ford Motor Credit Company LLC, SEC No-Action Letter (Nov. 23, 2010), *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm.

13. In addition, the SEC seems unlikely to act on its 2009 proposal to require corporate issuers to disclose credit ratings in registration statements. *See Credit Ratings Disclosure*, SEC Rel. No. 33-9070 (Oct. 7, 2009), *available at* http://www.sec.gov/rules/proposed/2009/33-9070.pdf.

14. A stand-alone term sheet that includes a credit rating should be filed as an issuer free writing prospectus, which will: (1) provide an avenue for disclosure not requiring an NRSRO consent; and (2) ensure that the rating qualifies as previously filed issuer information so that a subsequent underwriter free writing prospectus, such as a Bloomberg Screen, need not be filed with the SEC.

15. Frank Partnoy, *The Paradox of Credit Ratings*, *in* Ratings, Rating Agencies and the Global Financial System 65, 70-72, 74 (Richard M. Levich et al., eds., 2002); *see also Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations*, SEC Rel. No. 34-55857 (June 5, 2007), *available at* http://www.sec.gov/rules/final/2007/34-55857.pdf.

16. Partnoy*, supra* note 15, at 73; *see also* Fin. Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* 37-39 (2008), *available at* http://www.financialstabilityboard.org/publications/r_0804.pdf; Christopher M. Bruner & Rawi Abdelal, *To Judge Leviathan: Sovereign Credit Ratings, National Law, and the World Economy*, 25 J. Pub. Pol. 191 (2005).

17. *See* Nationally Recognized Statistical Rating Organizations, SEC Rel. No. 34-34616 (Aug. 31, 1994); *see also* U.S. Securities and Exchange Commission, *supra* note 3; Ratings Agencies and the Use of Credit Ratings under the Federal Securities Laws, *supra* note 3.

18. President's Working Group on Fin. Mkts., *Policy Statement on Financial Market Developments* (2008), *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf (urging regulators to review the use of ratings in regulation and supervisory rules); Fin. Stability Forum, *supra* note 16, at 38-39.

19. *Security Ratings*, SEC Rel. No. 33-8940 (July 1, 2008), *available at* http://www.sec.gov/rules/proposed/2008/33-8940.pdf; *see also References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Rel. No. 34-58070 (July 1, 2008), *available at* http://www.sec.gov/rules/proposed/2008/34-58070.pdf; *References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Rel. No. IC-28327 (July 1, 2008), *available at* http://www.sec.gov/rules/proposed/2008/ic-28327.pdf.

20. *See Money Market Fund Reform*, SEC Rel. No. 34-29132 (Feb. 23, 2010), *available at* http://www.sec.gov/rules/final/2010/ic-29132.pdf (removing a requirement that money market funds must invest in rated asset-backed securities, but retaining other references to credit ratings); *References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Rel. No. 34-60789 (Oct. 5, 2009), *available at* http://www.sec.gov/rules/final/2009/34-60789.pdf.

21. Dodd-Frank Act §§ 939-939A.

22. *See, e.g.*, Deven Sharma, President, Standard & Poor's, *Policymakers Must Reduce Reliance on Credit Ratings*, Fin'l Times (July 25, 2011) (arguing that removal of regulatory requirements to use credit ratings would "reduce their impact on markets and on public policy" and "free rating firms to compete entirely on quality").

23. *See* Department of the Treasury, Office of the Comptroller of the Currency et al., Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions (Dec. 7, 2011), *available at* http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-ia-2011-143a.pdf; Department of the Treasury, Office of the Comptroller of the Currency, Alternatives to the Use of External Credit Ratings in the Regulations of the OCC (Nov. 18, 2011), *available at* http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-140a.pdf. For discussion of the difficulties financial regulators confronted in developing these standards, *see Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act: A Progress Report by the Regulators at the Half-Year Mark Before the S. Comm. on Banking, Housing and Urban Affairs* (statements of Sheila Bair, Chairman, Federal Deposit Insurance Corporation, and John Walsh, Acting Comptroller of the Currency).

24. *Security Ratings*, SEC Rel. No. 33-9245 (July 27, 2011), *available at* http://www.sec.gov/rules/final/2011/33-9245.pdf. As adopted, an issuer would satisfy the eligibility criteria of General Instruction I.B.2 of Form S-3 and Form F-3 if it: (1) issued at least $1 billion in non-convertible securities, other than common equity, in primary registered offerings for cash within the preceding three years; (2) had outstanding at least $750 million of non-convertible securities, other than common equity, issued in primary registered offerings for cash; (3) is the wholly-owned subsidiary of a well-known seasoned issuer, as defined in Rule 405 under the Securities Act; or (4) is a majority-owned operating partnership of a real estate investment trust that qualifies as a well-known seasoned issuer.

25. *See* References to Credit Ratings in Certain Investment Company Act Rules and Forms, SEC Rel. No. 33-9193 (Mar. 3, 2011), *available at* http://www.sec.gov/rules/proposed/2011/33-9193.pdf.

26. *See* Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, SEC Rel. no. 34-64352 (Apr. 27, 2011), *available at* http://www.sec.gov/rules/proposed/2011/34-64352.pdf.

27. *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, SEC Rel. No. 34-64514 (June 8, 2011), *available at* http://www.sec.gov/rules/proposed/2011/34-64514.pdf.

28. Proposed amendments to Exchange Act Rule 17g-7 would define "rating action" to encompass: (1) publication of an expected or preliminary credit rating before publication of the initial credit rating; (2) an initial credit rating; (3) an upgrade or downgrade of an existing credit rating; (4) the placement of an existing rating on credit watch or review; (5) an affirmation of an existing credit rating; or (6) withdrawal of an existing rating. *Id.* at 458-59.

29. As proposed, the form submitted by an NRSRO also must contain information regarding diligence practices, an assessment of the quality of information available, information regarding potential conflicts of interest and a detailed sensitivity analysis of variables influencing the rating. *Id.* at 459-63.

30. *See id.* at 182 n.534.

31. *See* Exchange Act § 15E(s)(4)(A).

32. *See id.* § 15E(s)(4)(B). The NRSRO proposal would require such certifications to be made on proposed Form ABS Due Diligence-15E and included by an NRSRO in its report issued in connection with a rating action. *See* Proposed Rules 17g-10(a), 17g-7(a)(2).

33. *See Proposed Rules for Nationally Recognized Statistical Rating Organizations*, *supra* note 27. The SEC proposes to define a third-party diligence report as any report containing findings and conclusions of any "due diligence services" performed by a third party for the issuer or underwriter of an asset-backed security. Pursuant to proposed Exchange Act Rule 17g-10, "due diligence services" would constitute a review of the assets underlying an asset-backed security for the purposes of making findings relevant to the production of a credit rating regarding: (1) quality or integrity of the information provided by the securitizer or originator; (2) whether the origination of the assets conformed to established underwriting guidelines; (3) the value of collateral securing such assets; (4) whether the originator complied with applicable law; or (5) any other factor that may have a material effect on the likelihood the issuer will pay interest and principal. A NRSRO receiving certifications on this form would be required to include the certifications in its report under Rule 17g-7.

34. *See* Proposed Form ABS-15G. For municipal asset-backed securities offerings, the municipal issuer or underwriter could instead furnish Form ABS-15G through the Electronic Municipal Market Access System of the Municipal Securities Rulemaking Board.

35. Section 3(a)(12) of the Exchange Act defines exempted securities as including, *inter alia*, government securities and municipal securities.

36. As added by the Dodd-Frank Act, Exchange Act Section 15E(s)(4) addresses "any asset-backed security," but also refers repeatedly to "underwriter," a term that is normally indicative of a public offering. *See* Letter from Jeffrey W. Rubin, Chair, Federal Regulation of Securities Committee, Business Law Section of the American Bar Association, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission 6-10 (Aug. 19, 2011), *available at* http://www.sec.gov/comments/s7-18-11/s71811-56.pdf (also noting that the public filing requirement for Form ABS-15G could cast doubt on the validity of unregistered offering exemptions and safe harbors conditioned on the absence of a general solicitation).

37. Rule 17g-5, as presently in effect, specifies various relationships that constitute conflicts of interest of NRSROs, as well as seven prohibited conflicts of interest for NRSROs. *See* Exchange Act Rule 17g-5(b)-(c).

38. *See* Proposed Exchange Act Rule 17g-9 (implementing Section 936 of the Dodd-Frank Act).

39. The Dodd-Frank Act also requires SEC studies regarding standardization of credit rating terminology and NRSRO independence and studies by the Government Accountability Office of alternative means for compensating NRSROs and the establishment of a professional organization for rating analysts employed by NRSROs. *See* Dodd Frank Act §§ 939(h), 939C-939E.

40. *See id.* § 939F(b). This portion of the study must include: (1) an assessment of potential mechanisms for determining fees; (2) appropriate methods for paying fees; (3) the extent to which such a system would create moral hazard; and (4) any constitutional or other concerns regarding the establishment of such a system. *See id.*

41. *Id.* § 939(d).

42. H.R. 4173 (111th Cong.) § 939D (proposed Section 15(w) of the Securities Exchange Act of 1934).

43. *See Solicitation of Comment to Assist in Study on Assigned Credit Ratings*, SEC Rel. No. 34-64456 (May 10, 2011), *available at* http://www.

sec.gov/rules/other/2011/34-64456.pdf. The text of the Franken Amendment is included in the appendix to the request. *Id.* at 49.

44. *See* U.S. Gov't Accountability Office, GAO Report No. 10- 782, Securities and Exchange Commission: Action Needed to Improve Rating Agency Registration Program and Performance Related Disclosures 79-93 (2010), *available at* http://www.gao.gov/new.items/d10782.pdf. The framework consists of the following factors: (1) independence, focusing on mitigation of conflicts between the entity paying for the rating and the NRSRO; (2) NRSRO accountability for the accuracy and timeliness of ratings; (3) competition and incentives for improved ratings quality; (4) transparency; (5) feasibility; (6) market acceptance and choice; and (7) oversight. *Id.* at 85-93.