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U.S. GOVERNMENT
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111TH CONGRESS, 2d Session | HOUSE OF REPRESENTATIVES | REPT. 111–685, Part 1

ACCOUNTABILITY AND TRANSPARENCY IN RATING AGENCIES ACT

DECEMBER 16, 2010.—Ordered to be printed

Mr. FRANK of Massachusetts, from the Committee on Financial Services, submitted the following

R E P O R T

together with

ADDITIONAL AND DISSENTING VIEWS

[To accompany H.R. 3890]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 3890) to amend the Securities Exchange Act of 1934 to enhance oversight of nationally recognized statistical rating organizations, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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AMENDMENT

The amendment is as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE.

This title may be cited as the "Accountability and Transparency in Rating Agencies Act".

SEC. 2. ENHANCED REGULATION OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS.

Section 15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7) is amended—

(1) in subsection (a)—

(A) in paragraph (1)(A), by striking "furnish to" and inserting "file with";

(B) in paragraph (2)(A), by striking "furnished to" and inserting "filed with"; and

(C) in paragraph (2)(B)(i)(II), by striking "furnished to" and inserting "filed with";

(2) in subsection (b)—

(A) in paragraph (1)(A), by striking "furnished" and inserting "filed" and by striking "furnishing" and inserting "filing";

(B) in paragraph (1)(B), by striking "furnishing" and inserting "filing"; and

(C) in the first sentence of paragraph (2), by striking "furnish to" and inserting "file with";

(3) in subsection (c)—

(A) paragraph (2)—

(i) in the second sentence by inserting "including the requirements of this section," after "Notwithstanding any other provision of law,"; and

(ii) by inserting before the period at the end of the last sentence ", provided that this paragraph does not afford a defense against any action or proceeding brought by the Commission to enforce the antifraud provision of the securities laws";

(B) by adding at the end the following new paragraph:

"(3) REVIEW OF INTERNAL PROCESSES FOR DETERMINING CREDIT RATINGS.—

"(A) IN GENERAL.—The Commission shall examine credit ratings issued by, and the policies, procedures, and methodologies employed by, each nationally recognized statistical rating organization to review whether—

"(i) the nationally recognized statistical rating organization has established and documented a system of internal controls, due diligence and implementation of methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe by rule;

"(ii) the nationally recognized statistical rating organization adheres to such system; and

"(iii) the public disclosures of the nationally recognized statistical rating organization required under this section about its credit ratings, methodologies, and procedures are consistent with such system.

"(B) MANNER AND FREQUENCY.—The Commission shall conduct reviews required by this paragraph no less frequently than annually in a manner to be determined by the Commission.

"(4) PROVISION OF INFORMATION TO THE COMMISSION.—Each nationally recognized statistical rating organization shall make available and maintain such records and information, for such a period of time, as the Commission may prescribe, by rule, as necessary for the Commission to conduct the reviews under paragraph (3).

"(5) DISCLOSURES WITH RESPECT TO STRUCTURED SECURITIES.—

"(A) REGULATIONS REQUIRED.—The rules and regulations prescribed by the Commission pursuant to this section with respect to nationally recognized statistical rating organizations shall, with respect to the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings for structured securities—

"(i) specify the information required to be disclosed to such rating organizations by the sponsor, issuers, and underwriters of such struc-

tured securities on the collateral underlying such structured securities; and

"(ii) establish and implement procedures to collect and disclose information about the processes used by such sponsor, issuers, and underwriters to assess the accuracy and integrity of their data and fraud detection.

"(B) DEFINITION.—For purposes of this paragraph, the Commission shall, by rule or regulation, define the term 'structured securities' as appropriate in the public interest and for the protection of investors.

"(6) HISTORICAL DEFAULT RATE DISCLOSURES.—The rules and regulations prescribed by the Commission pursuant to this section with respect to nationally recognized statistical rating organizations shall require each nationally recognized statistical rating organization to establish and maintain, on a publicly accessible Internet site, a facility to disclose, in a central database, the historical default rates of all classes of financial products rated by such organization."

(4) in subsection (d)—

(A) in the heading, by inserting "FINE," after "CENSURE,";

(B) by striking "shall censure" and all that follows through "revocation" and inserting the following: "shall censure, fine in accordance with section 21B(a), place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any nationally recognized statistical rating organization (or with respect to any person who is associated, who is seeking to become associated, or, at the time of the alleged misconduct, who was associated or was seeking to become associated with a nationally recognized statistical rating organization, the Commission, by order, shall censure, fine in accordance with section 21B(a), place limitations on the activities or functions of such person, suspend for a period not exceeding 12 months, or bar such person from being associated with a nationally recognized statistical rating organization), if the Commission finds, on the record after notice and opportunity for hearing, that such censure, fine, placing of limitations, bar, suspension, or revocation";

(C) in paragraph (2), by striking "furnished to" and inserting "filed with";

(D) in paragraph (4)—

(i) by striking "furnish" and inserting "file";

(ii) by striking "or" at the end;

(E) in paragraph (5), by striking the period at the end and inserting a semicolon; and

(F) by adding at the end the following:

"(6) has failed reasonably to supervise another person who commits a violation of the securities laws, the rules or regulations thereunder, or any rules of the Municipal Securities Rulemaking Board if such other person is subject to his or her supervision, except that no person shall be deemed to have failed reasonably to supervise any other person under this paragraph, if—

"(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

"(B) such person has reasonably discharged the duties and obligations incumbent upon him or her by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with; or

"(7) fails to conduct sufficient surveillance to ensure that credit ratings remain current and reliable, as applicable.";

(5) in subsection (e)—

(A) by striking paragraph (1); and

(B) in paragraph (2), by striking "(2) COMMISSION AUTHORITY.—" and moving the text of such paragraph to follow the heading of subsection (e);

(6) by amending subsection (h) to read as follows:

"(h) CORPORATE GOVERNANCE, ORGANIZATION, AND MANAGEMENT OF CONFLICTS OF INTEREST.—

"(1) BOARD OF DIRECTORS.—

"(A) IN GENERAL.—Each nationally recognized statistical rating organization or its ultimate holding company shall have a board of directors.

"(B) INDEPENDENT DIRECTORS.—At least ⅓ of such board, but no less than 2 of the members of the board of directors, shall be independent directors. In order to be considered independent for purposes of this subsection, a director of a nationally recognized statistical rating organization may not, other than in his or her capacity as a member of the board of directors or any committee thereof—

"(i) accept any consulting, advisory, or other compensatory fee from the nationally recognized statistical rating organization; or

"(ii) be a person associated with the nationally recognized statistical rating organization or with any affiliated company thereof.

"(C) COMPENSATION AND TERM.—The compensation of the independent directors shall not be linked to the business performance of the nationally recognized statistical rating organization and shall be arranged so as to ensure the independence of their judgment. The term of office of the independent directors shall be for a pre-agreed fixed period not exceeding 5 years and shall not be renewable.

"(D) DUTIES.—In addition to the overall responsibility of the board of directors, the board shall oversee—

"(i) the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings;

"(ii) the establishment, maintenance, and enforcement of policies and procedures to address, manage, and disclose any conflicts of interest;

"(iii) the effectiveness of the internal control system with respect to policies and procedures for determining credit ratings; and

"(iv) the compensation and promotion policies and practices of the nationally recognized statistical rating organization.

"(2) ORGANIZATION POLICIES AND PROCEDURES.—Each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of the nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address, manage, and disclose any conflicts of interest that can arise from such business.

"(3) COMMISSION RULES.—The Commission shall issue rules to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization, including rules regarding—

"(A) conflicts of interest relating to the manner in which a nationally recognized statistical rating organization is compensated by the obligor, or any affiliate of the obligor, for issuing credit ratings or providing related services;

"(B) conflicts of interest relating to business relationships, ownership interests, and affiliations of nationally recognized statistical rating organization board members with obligors, or any other financial or personal interests between a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, and the obligor, or any affiliate of the obligor;

"(C) conflicts of interest relating to any affiliation of a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, with any person who underwrites securities, money market instruments, or other instruments that are the subject of a credit rating;

"(D) a requirement that each nationally recognized statistical rating organization disclose on such organization's website a consolidated report at the end of each fiscal year that shows—

"(i) the percent of net revenue earned by the nationally recognized statistical rating organization or an affiliate of a nationally recognized statistical rating organization, or any person associated with a nationally recognized statistical rating organization, to the extent determined appropriate by the Commission, for that fiscal year for providing services and products other than credit rating services to each person who paid for a credit rating; and

"(ii) the relative standing of each person who paid for a credit rating that was outstanding as of the end of the fiscal year in terms of the amount of net revenue earned by the nationally recognized statistical rating organization attributable to each such person and classified by the highest 5, 10, 25, and 50 percentiles and lowest 50 and 25 percentiles;

"(E) the establishment of a system of payment for credit ratings issued by each nationally recognized statistical rating organization that requires that payments are structured in a manner designed to ensure that the nationally recognized statistical rating organization conducts accurate and reliable surveillance of credit ratings over time, as applicable, and that incentives for reliable credit ratings are in place;

"(F) a requirement that a nationally recognized statistical rating organization disclose with the publication of a credit rating the type and number

of credit ratings it has provided to the person being rated or affiliates of such person, the fees it has billed for the credit rating, and the aggregate amount of net revenue earned by the nationally recognized statistical rating organization in the preceding 2 fiscal years attributable to the person being rated and its affiliates; and

"(G) any other potential conflict of interest, as the Commission determines necessary or appropriate in the public interest or for the protection of investors.

"(4) LOOK-BACK REQUIREMENT.—

"(A) REVIEW BY THE NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION.—Each nationally recognized statistical rating organization shall establish, maintain, and enforce policies and procedures reasonably designed to ensure that, in any case in which an employee of a person subject to a credit rating of the nationally recognized statistical rating organization or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the nationally recognized statistical rating organization was employed by the nationally recognized statistical rating organization and participated in any capacity in determining credit ratings for the person or the securities or money market instruments during the 1-year period preceding the date an action was taken with respect to the credit rating, the nationally recognized statistical rating organization shall—

"(i) conduct a review to determine whether any conflicts of interest of the employee influenced the credit rating; and

"(ii) take action to revise the rating if appropriate, in accordance with such rules as the Commission shall prescribe.

"(B) REVIEW BY COMMISSION.—

"(i) IN GENERAL.—The Commission shall conduct periodic reviews of the policies described in subparagraph (A) and the implementation of the policies at each nationally recognized statistical rating organization to ensure they are reasonably designed and implemented to most effectively eliminate conflicts of interest.

"(ii) TIMING OF REVIEWS.—The Commission shall review the code of ethics and conflict of interest policy of each nationally recognized statistical rating organization—

"(I) not less frequently than annually; and

"(II) whenever such policies are materially modified or amended.

"(5) REPORT TO COMMISSION ON CERTAIN EMPLOYMENT TRANSITIONS.—

"(A) REPORT REQUIRED.—Each nationally recognized statistical rating organization shall report to the Commission any case such organization knows or can reasonably be expected to know where a person associated with such organization within the previous 5 years obtains employment with any obligor, issuer, underwriter, or sponsor of a security or money market instrument for which the organization issued a credit rating during the 12-month period prior to such employment, if such employee—

"(i) was a senior officer of such organization;

"(ii) participated in any capacity in determining credit ratings for such obligor, issuer, underwriter, or sponsor; or

"(iii) supervised an employee described in clause (ii).

"(B) PUBLIC DISCLOSURE.—Upon receiving such a report, the Commission shall make such information publicly available.";

(7) by amending subsection (j) to read as follows:

"(j) DESIGNATION OF COMPLIANCE OFFICER.—

"(1) IN GENERAL.—Each nationally recognized statistical rating organization shall designate an individual to serve as a compliance officer.

"(2) DUTIES.—The compliance officer shall—

"(A) report directly to the board of the nationally recognized statistical rating organization;

"(B) review compliance with policies and procedures to manage conflicts of interest and assess the risk that the compliance (or lack of such compliance) may compromise the integrity of the credit rating process;

"(C) review compliance with the internal control system with respect to the procedures and methodologies for determining credit ratings, including qualitative methodologies and quantitative inputs used in the rating process, and assess the risk that such internal control system is reasonably designed to ensure the integrity and quality of the credit rating process;

"(D) in consultation with the board of the nationally recognized statistical rating organization, resolve any conflicts of interest that may arise;

"(E) be responsible for administering the policies and procedures required to be established pursuant to this section;

"(F) ensure compliance with securities laws and the rules and regulations issued thereunder, including rules prescribed by the Commission pursuant to this section; and

"(G) establish procedures—

"(i) for the receipt, retention, and treatment of complaints regarding credit ratings, models, methodologies, and compliance with the securities laws and the policies and procedures required under this section;

"(ii) for the receipt, retention, and treatment of confidential, anonymous complaints by employees, obligors, issuers, and investors;

"(iii) for the remediation of non-compliance issues found during compliance office reviews, the reviews required under paragraph (7), internal or external audit findings, self-reported errors, or through validated complaints; and

"(iv) designed so that ratings that the nationally recognized statistical rating organization disseminates reflect consideration of all information in a manner generally consistent with the nationally recognized statistical rating organization's published rating methodology, including information which is provided, received, or otherwise obtained from obligor, issuer and non-issuer sources, such as investors, the media, and other interested or informed parties.

"(3) LIMITATIONS.—The compliance officer shall not, while serving in that capacity—

"(A) determine credit ratings;

"(B) participate in the establishment of the procedures and methodologies or the qualitative methodologies and quantitative inputs used to determine credit ratings;

"(C) perform marketing or sales functions; or

"(D) participate in establishing compensation levels, other than for employees working for the compliance officer.

"(4) ANNUAL REPORTS REQUIRED.—The compliance officer shall annually prepare and sign a report on the compliance of the nationally recognized statistical rating organization with the securities laws and such organization's internal policies and procedures, including its code of ethics and conflict of interest policies, in accordance with rules prescribed by the Commission. Such compliance report shall accompany the financial reports of the nationally recognized statistical rating organization that are required to be filed with the Commission pursuant to this section and shall include a certification that, under penalty of law, the report is accurate and complete.

"(5) COMPENSATION.—The compensation of the compliance officer shall not be linked to the business performance of the nationally recognized statistical rating organization and shall be arranged so as to ensure the independence of the officer's judgment.";

(8) in subsection (k)—

(A) by striking ", on a confidential basis,";

(B) by striking "furnish to" and inserting "file with";

(C) by striking "Each nationally" and inserting the following:

"(1) IN GENERAL.—Each nationally"; and

(D) by adding at the end the following new paragraph:

"(2) EXCEPTION.—The Commission may treat as confidential any information provided by a nationally recognized statistical rating organization under this section consistent with applicable Federal laws or Commission rules.";

(9) in subsection (l)(2)(A)(i), by striking "furnished" and inserting "filed";

(10) by amending subsection (p) to read as follows:

"(p) ESTABLISHMENT OF SEC OFFICE.—

"(1) IN GENERAL.—The Commission shall establish an office that administers the rules of the Commission with respect to the practices of nationally recognized statistical rating organizations.

"(2) STAFFING.—The office of the Commission established under this subsection shall be staffed sufficiently to carry out fully the requirements of this section.

"(3) RULEMAKING AUTHORITY.—The Commission shall—

"(A) establish, by rule, fines and other penalties for any nationally recognized statistical rating organization that violates the applicable requirements of this title; and

"(B) issue such rules as may be necessary to carry out this section with respect to nationally recognized statistical rating organizations."; and

(11) by adding after subsection (p) the following new subsections:

"(q) TRANSPARENCY OF RATINGS PERFORMANCE.—

"(1) RULEMAKING REQUIRED.—The Commission shall, by rule, require each nationally recognized statistical rating organization to publicly disclose information on initial ratings and subsequent changes to such ratings for the purpose of providing a gauge of the performance of ratings and allowing investors to compare performance of ratings by different nationally recognized statistical rating organizations.

"(2) CONTENT.—The rules of the Commission under this subsection shall require, at a minimum, disclosures that—

"(A) are comparable among nationally recognized statistical rating organizations, so that investors can compare rating performance across rating organizations;

"(B) are clear and informative for a wide range of investor sophistication;

"(C) include performance information over a range of years and for a variety of classes of credit ratings, as determined by the Commission;

"(D) are published and made freely available by the nationally recognized statistical rating organization, on an easily accessible portion of its website and in written form when requested by investors; and

"(E) each nationally recognized statistical rating organization include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument.

"(r) CREDIT RATINGS METHODOLOGIES.—

"(1) IN GENERAL.—The Commission shall prescribe rules, in the public interest and for the protection of investors, that require each nationally recognized statistical rating organization to establish, maintain, and enforce written procedures and methodologies and an internal control system with respect to such procedures and methodologies that are reasonably designed to—

"(A) ensure that credit ratings are determined using procedures and methodologies, including qualitative methodologies and quantitative inputs that are determined in accordance with the policies and procedures of the nationally recognized statistical rating organization for developing and modifying credit rating procedures and methodologies;

"(B) ensure that when major changes to credit rating procedures and methodologies, including to qualitative methodologies and quantitative inputs, are made, that the changes are applied consistently to all credit ratings to which the changed procedures and methodologies apply and, to the extent the changes are made to credit rating surveillance procedures and methodologies, they are applied to current credit ratings within a time period to be determined by the Commission by rule, and that the reason for the change is publicly disclosed;

"(C) notify persons who have access to the credit ratings of the nationally recognized statistical rating organization, regardless of whether they are made readily accessible for free or a reasonable fee, of the procedure or methodology, including qualitative methodologies and quantitative inputs, used with respect to a particular credit rating;

"(D) notify persons who have access to the credit ratings of the nationally recognized statistical rating organization, regardless of whether they are made readily accessible for free or a reasonable fee, when a change is made to a procedure or methodology, including to qualitative methodologies and quantitative inputs, or an error is identified in a procedure or methodology that may result in credit rating actions, and the likelihood of the change resulting in current credit ratings being subject to rating actions; and

"(E) use credit rating symbols that distinguish credit ratings for structured products from credit ratings for other products that the Commission determines appropriate or necessary in the public interest and for the protection of investors.

"(2) RATING CLARITY AND CONSISTENCY.—

"(A) COMMISSION OBLIGATION.—Subject to subparagraphs (B) and (C), the Commission shall require, by rule, each nationally recognized statistical rating organization to establish, maintain, and enforce written policies and procedures reasonably designed—

"(i) with respect to credit ratings of securities and money market instruments, to assess the risk that investors in securities and money market instruments may not receive payment in accordance with the terms of such securities and instruments;

"(ii) to define clearly any credit rating symbol used by that organization; and

"(iii) to apply such credit rating symbol in a consistent manner for all types of securities and money market instruments.

"(B) ADDITIONAL CREDIT FACTORS.—Nothing in subparagraph (A)—

"(i) prohibits a nationally recognized statistical rating organization from using additional credit factors that are documented and disclosed by the organization and that have a demonstrated impact on the risk an investor in a security or money market instrument will not receive repayment in accordance with the terms of issuance;

"(ii) prohibits a nationally recognized statistical rating organization from considering credit factors that are unique to municipal securities; or

"(iii) prohibits a nationally recognized statistical rating organization from using an additional symbol with respect to the ratings described in subparagraph (A)(i) for the purpose of distinguishing the ratings of a certain type of security or money market instrument from ratings of any other types of securities or money market instruments.

"(C) COMPLEMENTARY RATINGS.—The Commission shall not impose any requirement under subparagraph (A) that prevents nationally recognized statistical rating organizations from establishing ratings that are complementary to the ratings described in subparagraph (A)(i) and that are created to measure a discrete aspect of the security's or instrument's risk.

"(s) TRANSPARENCY OF CREDIT RATING METHODOLOGIES AND INFORMATION REVIEWED.—

"(1) IN GENERAL.—The Commission shall require, by rule, a nationally recognized statistical rating organization to include with the publication of each credit rating regardless of whether the credit rating is made readily accessible for free or a reasonable fee a form that discloses information about the assumptions underlying the procedures and methodologies used, and the data relied on, to determine the credit rating in the format prescribed in paragraph (2) and containing the information described in paragraph (3).

"(2) FORMAT.—The Commission shall prescribe a form for use under paragraph (1) that—

"(A) is designed in a user-friendly and helpful manner for investors to understand the information contained in the report;

"(B) requires the nationally recognized statistical rating organization to provide the content, as required by paragraph (3), in a manner that is directly comparable across securities; and

"(C) the nationally recognized statistical rating organization certifies the information on the form as true and accurate.

"(3) CONTENT.—The Commission shall prescribe a form that requires a nationally recognized statistical rating organization to disclose —

"(A) the main assumptions included in constructing procedures and methodologies, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating certain structured products;

"(B) the potential shortcomings of the credit ratings, and the types of risks not measured in the credit ratings that the nationally recognized statistical rating organization is not commenting on, such as liquidity, market, and other risks;

"(C) information on the certainty of the rating, including information on the reliability, accuracy, and quality of the data relied on in determining the ultimate credit rating and a statement on the extent to which key data inputs for the credit rating were reliable or limited, including any limits on the reach of historical data, limits in accessibility to certain documents or other forms of information that would have better informed the credit rating, and the completeness of certain information considered;

"(D) whether and to what extent third party due diligence services have been utilized, and a description of the information that such third party reviewed in conducting due diligence services;

"(E) a description of relevant data about any obligor, issuer, security, or money market instrument that was used and relied on for the purpose of determining the credit rating;

"(F) a statement containing an overall assessment of the quality of information available and considered in producing a credit rating for a security in relation to the quality of information available to the nationally recognized statistical rating organization in rating similar obligors, securities, or money market instruments;

"(G) an explanation or measure of the potential volatility for the credit rating, including any factors that might lead to a change in the credit rating, and the extent of the change that might be anticipated under different conditions;

"(H) information on the content of the credit rating, including—

"(i) the expected default probability; and

"(ii) the loss given default;

"(I) information on the sensitivity of the rating to assumptions made by the nationally recognized statistical rating organization, including—

"(i) 5 assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if such assumptions were proven false or inaccurate; and

"(ii) an analysis, using concrete examples, on how each of the 5 assumptions identified under clause (i) impacts a rating.

"(J) where applicable, how the nationally recognized statistical rating organization used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating; and

"(K) such additional information as may be required by the Commission.

"(4) DUE DILIGENCE SERVICES.—

"(A) CERTIFICATION REQUIRED.—In any case in which third-party due diligence services are employed by a nationally recognized statistical rating organization or an issuer, underwriter, or sponsor in connection with the issuance of a credit rating, the firm providing the due diligence services shall provide to the nationally recognized statistical rating organization written certification of such due diligence, which shall be subject to review by the Commission, and the issuer, underwriter, or sponsor shall provide any reports issued by the provider of such due diligence services to the nationally recognized statistical rating organization.

"(B) FORMAT AND CONTENT.—The Commission shall establish the appropriate format and content for written certifications required under subparagraph (A) to ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for the nationally recognized statistical rating organization to provide an reliable rating.

"(C) DISCLOSURE OF CERTIFICATION.—The Commission shall adopt rules requiring a nationally recognized statistical rating organization to disclose to persons who have access to the credit ratings of the nationally recognized statistical rating organization regardless of whether they are made readily accessible for free or a reasonable fee the certification described in subparagraph (A) with the publication of the applicable credit rating in a manner that may permit the persons to determine the adequacy and level of due diligence services provided by the third party.

"(t) PROHIBITED ACTIVITIES.—Beginning 180 days from the date of enactment of the Accountability, Reliability, and Transparency in Rating Agencies Act, it shall be unlawful for a nationally recognized statistical rating organization, or an affiliate of a nationally recognized statistical rating organization, or any person associated with a nationally recognized statistical rating organization, that provides a credit rating for an issuer, underwriter, or placement agent of a security to provide any non-rating service, including—

"(1) risk management advisory services;

"(2) advice or consultation relating to any merger, sales, or disposition of assets of the issuer;

"(3) ancillary assistance, advice, or consulting services unrelated to any specific credit rating issuance; and

"(4) such further activities or services as the Commission may determine as necessary or appropriate in the public interest or for the protection of investors.".

SEC. 3. STANDARDS FOR PRIVATE ACTIONS.

(a) IN GENERAL.—Section 21D(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78u–4(b)(2)) is amended by inserting before the period at the end of the following: ", and in the case of an action brought under this title for money damages against a nationally recognized statistical rating organization, it shall be sufficient for purposes of pleading any required state of mind for purposes of such action that the complaint shall state with particularity facts giving rise to a strong inference that the nationally recognized statistical rating organization knowingly or recklessly violated the securities laws".

(b) PLEADING STANDARD.—Section 15E(m) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7(m)) amended to read as follows:

"(m) APPLICATION OF ENFORCEMENT PROVISIONS; PLEADING STANDARD IN PRIVATE RIGHTS OF ACTION.—Statements made by nationally recognized statistical rating organizations shall not be deemed forward looking statements for purposes of section 21E. In any private right of action commenced against a nationally recognized statistical rating organization under this title, the same pleading standards with respect to knowledge and recklessness shall apply to the nationally recognized statistical rating organization as would apply to any other person in the same or a similar private right of action against such person.".

SEC. 4. ISSUER DISCLOSURE OF PRELIMINARY RATINGS.

The Securities and Exchange Commission shall adopt rules under authority of the Securities Act of 1933 (15 U.S.C. 77a, et seq.) to require issuers to disclose preliminary credit ratings received from nationally recognized statistical rating agencies on structured products and all forms of corporate debt.

SEC. 5. CHANGE TO DESIGNATION.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are each amended by striking "nationally recognized statistical rating" each place it appears and inserting "nationally registered statistical rating".

SEC. 6. TIMELINE FOR REGULATIONS.

Unless otherwise specified in this Act, the Securities and Exchange Commission shall adopt rules and regulations, as required by the amendments made by this Act, not later than 365 days after the date of enactment.

SEC. 7. ELIMINATION OF EXEMPTION FROM FAIR DISCLOSURE RULE.

Not later than 90 days after the date of enactment of this Act, the Securities Exchange Commission shall revise Regulation FD (17 C.F.R. 243.100) to remove from such regulation the exemption for entities whose primary business is the issuance of credit ratings (17 C.F.R. 243.100(b)(2)(iii)).

SEC. 8. ADVISORY BOARD.

(a) ESTABLISHMENT.—Not later than 90 days after the date of the enactment of this Act, the Securities and Exchange Commission shall establish an advisory board to be known as the Credit Ratings Agency Advisory Board (in this section referred to as "the Board").

(b) APPOINTMENT AND TERMS OF SERVICE.—The Board shall consist of 7 members appointed by the Commission, no more than 2 of whom may be former employees of a credit rating agency. Members of the Board shall be prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the role that credit ratings play to a broad range of investors. Terms of service shall be staggered as determined by the Commission.

(c) DUTIES.—The Board shall—

(1) advise the Commission concerning the rules and regulations required by the amendments made by this Act;

(2) insure that the Commission properly and fully executes its oversight functions and responsibilities with the respect to nationally recognized statistical rating organizations and individual participants; and

(3) issue an annual report to Congress detailing its work and recommending any additional Congressional actions necessary to aid the Commission and such additional reports from time to time as appropriate when it feels that the Commission is not properly executing its oversight functions.

SEC. 9. REMOVAL OF STATUTORY REFERENCES TO CREDIT RATINGS.

(a) FEDERAL DEPOSIT INSURANCE ACT.—The Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.) is amended—

(1) in section 28(d)—

(A) in the subsection heading, by striking "NOT OF INVESTMENT GRADE";

(B) in paragraph (1), by striking "not of investment grade" and inserting "that does not meet standards of credit-worthiness as established by the Corporation";

(C) in paragraph (2), by striking "not of investment grade";

(D) by striking paragraph (3) and redesignating paragraph (4) as paragraph (3); and

(E) in paragraph (3) (as so redesignated)—

(i) by striking subparagraph (A) and redesignating subparagraphs (B) and (C) as subparagraphs (A) and (B), respectively; and

(ii) in subparagraph (B) (as so redesignated), by striking "not of investment grade" and inserting "that does not meet standards of credit-worthiness as established by the Corporation";

(2) in section 28(e)—

(A) in the subsection heading, by striking "NOT OF INVESTMENT GRADE";

(B) in paragraph (1), by striking "not of investment grade" and inserting "that does not meet standards of credit-worthiness as established by the Corporation"; and

(C) in paragraphs (2) and (3), by striking "not of investment grade" each place that it appears and inserting "that does not meet standards of credit-worthiness established by the Corporation"; and

(3) in section 7(b)(1)(E)(i), by striking "credit rating entities, and other private economic" and insert "private economic, credit,".

(b) FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992.—Section 1319 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4519) is amended—

(1) in the section heading, by striking "**BY RATING ORGANIZATION**"; and

(2) by striking "that is a nationally recognized statistical rating organization, as such term is defined in section 3(a) of the Securities Exchange Act of 1934,".

(c) INVESTMENT COMPANY ACT OF 1940.—Section 6(a)(5)(A)(iv)(I) Investment Company Act of 1940 (15 U.S.C. 80a-6(a)(5)(A)(iv)(I)) is amended by striking "is rated investment grade by not less than 1 nationally recognized statistical rating organization" and inserting "meets such standards of credit-worthiness that the Commission shall adopt".

(d) REVISED STATUTES.—Section 5136A of title LXII of the Revised Statutes of the United States (12 U.S.C. 24a) is amended—

(1) in subsection (a)(2)(E), by striking "any applicable rating" and inserting "standards of credit-worthiness established by the Comptroller of the Currency";

(2) in the heading for subsection (a)(3) by striking "RATING OR COMPARABLE REQUIREMENT" and inserting "REQUIREMENT";

(3) subsection (a)(3), by amending subparagraph (A) to read as follows:

"(A) IN GENERAL.—A national bank meets the requirements of this paragraph if the bank is one of the 100 largest insured banks and has not fewer than 1 issue of outstanding debt that meets standards of credit-worthiness or other criteria as the Secretary of the Treasury and the Board of Governors of the Federal Reserve System may jointly establish.".

(4) in the heading for subsection (f), by striking "MAINTAIN PUBLIC RATING OR" and inserting "MEET STANDARDS OF CREDIT-WORTHINESS"; and

(5) in subsection (f)(1), by striking "any applicable rating" and inserting "standards of credit-worthiness established by the Comptroller of the Currency".

(e) SECURITIES EXCHANGE ACT OF 1934.—Section 3(a) Securities Exchange Act of 1934 (15 U.S.C. 78a(3)(a)) is amended—

(1) in paragraph (41), by striking "is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization" and inserting "meets standards of credit-worthiness as defined by the Commission"; and

(2) in paragraph (53)(A), by striking "is rated in 1 of the 4 highest rating categories by at least 1 nationally recognized statistical rating organization" and inserting "meets standards of credit-worthiness as defined by the Commission".

(f) WORLD BANK DISCUSSIONS.—Section 3(a)(6) of the amendment in the nature of a substitute to the text of H.R. 4645, as ordered reported from the Committee on Banking, Finance and Urban Affairs on September 22, 1988, as enacted into law by section 555 of Public Law 100-461, (22 U.S.C. 286hh(a)(6)), is amended by striking "rating" and inserting "worthiness".

(g) EFFECTIVE DATE.—The amendments made by this section shall take effect after the end of the 6-month period beginning on the date of the enactment of this Act.

SEC. 10. REVIEW OF RELIANCE ON RATINGS.

(a) AGENCY REVIEW.—

(1) REVIEW.—Not later than 1 year after the date of the enactment of this Act, each Federal agency listed in paragraph (4) shall, to the extent applicable, review—

(A) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument, and

(B) any references to or requirements in such regulations regarding credit ratings.

(2) MODIFICATIONS REQUIRED.—Each such agency shall modify any such regulations identified by the review conducted under paragraph (1) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency

shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.

(3) REPORT.—Upon conclusion of the review required under paragraph (1), each Federal agency listed in paragraph (4) shall transmit a report to Congress containing a description of any modification of any regulation such agency made pursuant to paragraph (2).

(4) APPLICABLE AGENCIES.—The agencies required to conduct the review and report required by this subsection are—

(A) the Securities and Exchange Commission;
(B) the Federal Deposit Insurance Corporation;
(C) the Office of Thrift Supervision;
(D) the Office of the Comptroller of the Currency;
(E) the Board of Governors of the Federal Reserve;
(F) the National Credit Union Administration; and
(G) the Federal Housing Finance Agency.

(b) GAO REVIEW OF OTHER AGENCIES.—

(1) REVIEW.—The Comptroller General shall conduct a comprehensive review of the use of credit ratings by Federal agencies other than those listed in subsection (a)(3), including an analysis of the provisions of law or regulation applicable to each such agency that refer to and require the use of credit ratings by the agency, and the policies and practices of each agency with respect to credit ratings.

(2) REPORT.—Not later than 1 year after the date of the enactment of this Act, the Comptroller General shall transmit to Congress a report on the findings of the study conducted pursuant to paragraph (1), including recommendations for any legislation or rulemaking necessary or appropriate in order for such agencies to reduce their reliance on credit ratings.

SEC. 11. PUBLICATION OF RATING HISTORIES ON THE EDGAR SYSTEM.

Not later than 180 days after the date of the enactment of this Act, the Securities and Exchange Commission shall revise its rules in section 240.17g-2(a) and (d) of title 17, Code of Federal Regulations, to require that the random sample of ratings histories of credit ratings required under such rules to be disclosed on the website of a nationally recognized statistical rating organization also be provided to the Commission in a format consistent with publication by the Commission on the EDGAR system.

SEC. 12. EFFECT OF RULE 436(G).

Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect.

SEC. 13. STUDIES.

(a) GAO STUDY.—

(1) IN GENERAL.—The Comptroller General shall conduct a study of—

(A) the implementation of this Act and the amendments made by this Act by the Securities and Exchange Commission;

(B) the appropriateness of relying on ratings for use in Federal, State, and local securities and banking regulations, including for determining capital requirements; and

(C) the effect of liability in private actions arising under the Securities Exchange Act of 1934;

(D) alternative means for compensating credit rating agencies that would create incentives for accurate credit ratings and what, if any, statutory changes would be required to permit or facilitate the use of such alternative means of compensation; and

(E) alternative methodologies to assess credit risk, including market-based measures.

(2) REPORT.—Not later than 30 months after the date of enactment of this Act, the Comptroller General shall submit to Congress and the Securities Exchange Commission, a report containing the findings under the study required by subsection (a).

(b) SEC STUDY ON ASSIGNING CREDIT RATING AGENCIES ON A ROTATING BASIS.—The Securities and Exchange Commission shall undertake a study on creating a system whereby nationally recognized statistical rating organizations are assigned on a rotating basis to issuers and obligors seeking a credit rating. Not later than 1 year after the date of enactment of this Act, the Securities and Exchange Commission shall transmit to Congress a report containing the findings of the study.

(c) SEC STUDY ON EFFECT OF NEW REQUIREMENTS ON NRSRO REGISTRATION.—The Securities and Exchange Commission shall conduct a study on the effect of the amendments made by section 2 on credit rating agencies seeking to register as nationally recognized statistical rating organizations, including whether the new requirements in such amendments deter credit rating agencies from registering as nationally recognized statistical rating organizations. Not later than 1 year after the date of enactment of this Act, the Commission shall transmit to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate a report on the findings of such study.

(d) STUDY OF CREDIT RATINGS OF DIFFERENT CLASSES OF BONDS.—

(1) STUDY.—The Securities and Exchange Commission shall conduct a study of the treatment of different classes of bonds (municipal versus corporate) by the nationally recognized statistical rating organizations. Such study shall examine—

(A) whether there are fundamental differences in the treatment of different classes of bonds by such rating organizations that cause some classes of bonds to suffer from undue discrimination;

(B) if there are such differences, what are the causes of such differences and how can they be alleviated;

(C) whether there are factors other than risk of loss that are appropriate for the credit ratings agencies to consider when rating bonds, and do those factors vary across different sectors

(D) the types of financing arrangement used by municipal issuers

(E) the differing legal and regulatory regimes governing disclosures for corporate bonds and municipal bonds;

(F) the extent to which retail investors could be disadvantaged by a single ratings scale; and

(G) practices, policies, and methodologies by the nationally recognized statistical rating organizations with respect to rating municipal bonds.

(2) REPORT.—Within 6 months after the date of enactment of this Act, the Securities and Exchange Commission shall submit a report on the results of the study required by paragraph (1) to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Development of the Senate. Such report shall include as assessment of each of the issues and subjects described in subparagraphs (A) through (G) of paragraph (1).

(e) SEC STUDY ON MEANINGFUL MULTI DIGIT RATING SYMBOLS.—

(1) STUDY.—The Securities and Exchange Commission shall conduct a study on the feasibility and desirability of implementing a standardized rating system whereby ratings symbols contain multiple characters, each representing a range of default probabilities and loss expectations under standardized and increasingly severe levels of market stress. The study shall optimize the definitions of the symbols to maximize their overall usefulness for users of credit ratings.

(2) INITIAL EXAMPLE FOR GUIDANCE.—An example to provide initial guidance for the study is a ratings symbol consisting of three digits, each of which corresponds to default probabilities under different levels of market stress as follows:

(A) The first digit represents the default probability under "normal" market stress, characterized by normal economic fluctuations in addition to a 5 percent decline in asset value and 2 percent increase in unemployment.

(B) The second digit represents the default probability under more severe market stress, characterized a 20 percent decline in asset value and 5 percent increase in unemployment.

(C) The third digit represents the default probability under extreme market stress, characterized by a 50 percent decline in asset value and 10 percent increase in unemployment.

(3) REPORT.—Not later than 1 year after the date of the enactment of this Act, the Commission shall transmit to Congress a report of the study conducted pursuant to paragraph (1), including recommendations on whether the system similar to that described in paragraph (2) should be implemented and, if so, any necessary legislation required to implement such a system.

(f) SEC STUDY ON RATINGS STANDARDIZATION.—

(1) IN GENERAL.—The Securities and Exchange Commission shall undertake a study on the feasability and desirability of—

(A) standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms;

(B) standardizing the market stress conditions under which ratings are evaluated;

(C) requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and

(D) standardizing credit rating terminology across asset classes, so that named ratings shall correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.

(2) REPORT.—Not later than 1 year after the date of enactment of this Act, the Securities and Exchange Commission shall transmit to Congress a report containing the findings of the study and the recommendations of the Commission.

PURPOSE AND SUMMARY

H.R. 3890, the Accountability and Transparency in Rating Agencies Act, brings comprehensive reform to the oversight and operations of the credit rating industry. The financial crisis exposed numerous problems with the credit rating agency industry, including how ratings are used by investors and regulators, as well as growing concerns about a lack of transparency and accountability in the industry, the reliability of ratings, conflicts of interest, and the provision of non-rating services, such as consulting, by credit rating agencies.

In response, H.R. 3890 gives broader powers to the U.S. Securities and Exchange Commission (SEC) to regulate nationally recognized statistical rating organizations (NRSROs). The bill also creates a new regime of enhanced corporate governance for NRSROs and addresses concerns about the integrity of the procedures and methodologies underlying credit ratings. Additionally, the legislation increases the information available to the public and investors by requiring a variety of disclosures by NRSROs.

Moreover, H.R. 3890 enhances accountability by clarifying and reforming aspects of the liability of NRSROs under the securities laws. The bill addresses the immense reliance by federal regulators on credit ratings and fosters more independent analysis by investors and users of credit ratings, too. Finally, the legislation commissions a number of studies to further investigate enhancements and reform of the industry.

BACKGROUND AND NEED FOR LEGISLATION

OVERVIEW

Credit rating agencies have assumed a central role in the global capital markets. They provide independent assessments of the creditworthiness of debt instruments, including municipal and corporate bonds, money market instruments, and structured finance debt products like mortgage-backed securities and collateralized debt obligations (CDOs). Investors, creditors and counterparties have come to rely on these credit ratings in their investment decisions not only as an assessment of an issuer's likelihood of default or the expected loss of an obligor, but as a benchmark for investment appropriateness given portfolio and business guidelines and for private contractual agreements.

Three players—Moody's Investor Services, Standard & Poor's, and Fitch Ratings—dominate the credit ratings marketplace. Together, they are responsible for more than 97 percent of the ratings

of outstanding securities across all categories reported to the SEC.[1] The dominant players have issuer-pay business models where the issuer of securities makes the payment for ratings services. An alternative model, the subscriber-pay model, has re-emerged in recent years.[2] The subscriber-pay model generates fees from users of ratings, mostly investors, who subscribe to their services. Agencies using the issuer-pay model have access to the issuer's non-public information, including access to management for discussions. Conversely, agencies using the subscriber-pay model do not have access to non-public information or management. Instead, they rely only on publicly available information when issue ratings.

Though the dominant credit rating agencies have been under fire for some years, the financial crisis exacerbated investors' loss of confidence in the agencies and the ratings they produce. In recent years, the elevated ratings of residential mortgage-backed securities (RMBS) and CDO structures and the magnitude and rapidity of subsequent downgrades erased prior confidence in the work of the dominant credit rating agencies and drove an erosion of the capital markets. Moreover, this lack of investor confidence in ratings contributed to the credit crunch and stifled access to capital for borrowers. As a result, the complex structured finance market largely shut down. In the wake of the crisis, users of credit ratings have intensified their demands for greater oversight and internal controls, accountability and accuracy of the credit rating agencies.

EVOLUTION OF NRSROS

In 1975, the SEC established the concept of an NRSRO to help broker-dealers calculate margin requirements under the newly established Net Capital Rule.[3] Securities with a higher or "investment grade rating" from an NRSRO received a lower "haircut" for capital treatment under the rule as they were deemed to be lower-risk investments. The requirement that the credit rating agency be "nationally recognized" was designed to ensure that the ratings employed were credible and reasonably relied upon by the marketplace.

Though the SEC recognized the three dominant credit rating agencies (Standard & Poor's, Moody's, and Fitch) as NRSROs at the time, it neither established a formal process for making such recognitions nor created an oversight system for NRSROs. Prior to the formal process created in the Credit Rating Agency Reform Act of 2006, eight additional firms received designation as NRSROs, but many of these firms subsequently merged with or were acquired by another NRSRO.

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[1] U.S. Securities and Exchange Commission, Annual Report on Nationally Recognized Statistical Rating Organizations, September 2009, showing that Moody's, Fitch, and Standard & Poor's collectively account for 3,039,264 of 3,123,748 (97.3 percent) ratings reported to the SEC on form NRSRO for 2008.

[2] "Historically, rating agencies were financed solely by subscriber fees paid by investors and other users of credit ratings. By the mid-1970s, however, the largest rating agencies began charging issuers for ratings, due to difficulties in limiting access to ratings information to subscribers, as well as to the demand for more comprehensive and resource-intensive analysis of issuers." U.S. Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, January 24, 2003. "Fitch and Moody's started to charge corporate issuers for ratings in 1970, and Standard and Poor's followed suit a few years later." Also, Richard Cantor & Frank Packer, The Credit Rating Industry, Federal Reserve Bank of New York Q. 1 (1994).

[3] 17 C.F.R. 240.15c3–1, Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers, Release No. 34–11497 (June 26, 1975) and 40 Federal Register 29,795 (July 16, 1975).

Congress formalized the process for NRSRO approval and oversight of the credit rating agencies in the Credit Rating Agency Reform Act of 2006.[4] The law sought to promote competition in the credit rating industry by replacing the SEC's no-action letter approach for approving NRSROs with a clear set of application criteria and a formal process for evaluating NRSRO applicants. The law also authorized the SEC to conduct oversight of NRSROs and to issue regulations to prevent or manage NRSROs' conflicts of interest.

In 2007, nine credit rating agencies formally registered under the new SEC guidelines, and today there are ten NRSROs registered with the SEC.[5] All but three of these firms operate predominantly under an issuer-pay model. The three that are predominantly subscriber-pay are Egan-Jones, LACE and Realpoint.

Since inception, the NRSRO term has become embedded in approximately a dozen federal statutes, about 100 federal regulations, roughly 200 state laws, and many state rules. For example, Federal laws with references to NRSROs include the Federal Deposit Insurance Act, the Securities Exchange Act of 1934, the Employee Retirement Income Security Act of 1974, and the Internal Revenue Code of 1986. Foreign governments and international bodies also reference credit ratings and credit rating agencies in their accords and codes. NRSRO ratings are also used as credit quality measures for the debt securities held by money market funds and pension plans, as well as in many private agreements.

THE FINANCIAL CRISIS AND THE NEED FOR FURTHER REFORM

In recent years, the dominant credit rating agencies have faced a chorus of growing criticism that reached a crescendo in the recent financial crisis. Despite the increased SEC authority post-2006, many have renewed their criticism of the timeliness and accuracy of credit ratings, especially regarding structured finance products and certain industries like bond insurers. These calls heightened the scrutiny that NRSROs have long attracted for their failures to foresee significant credit problems, despite their access to non-public information (in the case of issuer-pay NRSROs).

Earlier in this decade, for example, the dominant credit rating agencies all issued investment grade credit ratings for bonds issued by WorldCom just three months before the company declared bankruptcy. Moody's and Standard & Poor's also both gave investment grade ratings to Enron's debt and structured products until just days before that firm imploded. More recently, the rating agencies were slow to revise high ratings given to large, distressed institutions like Lehman Brothers and American International Group, and "maintained AAA ratings on thousands of nearly worthless subprime-related securities."[6] The escalation in size of the capital markets, rapid growth of new and complex products, increased liquidity in the markets, and over-reliance on credit ratings exposed the vulnerabilities in the current regulatory regime of NRSROs.

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[4] P.L. 109–291.

[5] The ten NRSROs include A.M. Best Company, Inc.; DBRS Ltd.; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; Moody's Investors Service, Inc.; Rating and Investment Information, Inc.; Standard & Poor's Ratings Services; Egan-Jones Rating Company; LACE Financial Corp.; and Realpoint LLC.

[6] Jerome S. Fons and Frank Partnoy, *Rated F for Failure,* New York Times, March 16, 2009.

ROLE OF STRUCTURED FINANCE

The financial crisis has shed light on the NRSROs' methodologies and internal controls and further differentiated the understanding between single issuer ratings (for example, corporate and municipal bonds) and structured finance ratings. Single issuer methodology has over time remained relatively static at the NRSROs, while the bull credit markets' structured finance ratings methodology has proven quite fluid. According to some critics of structured finance ratings, NRSROs were "learning-by-doing."[7]

The structured finance market—predominantly CDOs, subprime RMBS, and synthetic structured deals—also revealed the NRSROs' vulnerabilities in delivering accurate ratings, transparency, timeliness of downgrades, adequate (if any) due diligence, and inherent conflicts of interest. Rather than relying on empirical data, for these newer, more complex products NRSROs relied on statistically derived assumptions that failed investors in a fast moving marketplace.

Moreover, the SEC staff in August 2007 initiated a review of the three largest NRSROs to examine their roles in the subprime mortgage crisis. The report observed:

> The Commission staff found that these rating agencies struggled significantly with the increase in the number and complexity of subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") deals since 2002. The examinations uncovered that the procedures for rating RMBS and CDOs were not well documented. Furthermore, significant aspects of the rating process were not always disclosed or even documented by the firms and issues were identified in the management of conflicts of interest.[8]

According to the SEC, the financial crisis also revealed an inconsistency in the ratings across debt products:

> Rating agencies may employ different scales for different regions, sectors, jurisdictions or types of securities. For example, the rating scale a credit rating agency employs to assign short term obligations may differ from the rating scale it uses for long term obligations. Ratings are described by the credit rating agencies as intended to reflect only credit risk, not other valuations factors such as liquidity or currency risk."[9]

Thus, a municipal bond rated AAA did not have the same risk profile as a corporate bond rated AAA, or a similarly rated commercial mortgage-backed securities or CDOs. Furthermore, in the summer of 2007, a review of the distribution of AAA ratings across asset classes revealed a bias towards top quality ratings for structured credit; 27 sovereign bonds, 67 corporate bonds, 160 municipal

[7] Joshua Rosner, *Toward an Understanding: NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts,* Journal of Structured Finance (2009).

[8] U.S. Securities and Exchange Commission, Annual Report on Nationally Recognized Statistical Rating Organizations, September 2009.

[9] *Ibid.*

bonds, 6,822 CDOs and 8,070 RMBS all received AAA, the highest quality rating.[10]

The credit rating agencies played a significant role in the run-up of the structured market, as both advisors and validators, even when they had access to less than complete information for analysis. Conflicts of interest additionally were rife in the structured finance market as the NRSROs played a central role in the iterative process of rating structured finance transactions. Often, the NRSROs actively advised the structured finance deal originators on how to achieve optimum ratings, while the NRSROs' fees remained dependent on receipt of such rating. Even when not acting as advisors, the NRSROs' ratings validated a pool of assets due to the structural elements of the transaction (for example, the appropriate level of subordination commensurate with an identified rating outcome), not the integrity of the underlying loans. Hence, the NRSROs could deliver a high quality rating without conducting adequate analysis.

GROWING RELIANCE ON RATINGS

Many over time have come to rely on credit rating agencies. References to credit rating agencies, credit ratings, and NRSROs appear in Federal and State statutes, agency rules and regulations, as well as private contractual agreements and investment guidelines. Credit rating agencies also hold quasi-regulatory powers, and regulators presently widely depend on their work to monitor and access risk.

Users of NRSRO credit ratings also include regulators and investors around the world, too. For example, "the Basel II framework, which has been implemented by members of the European Union, relies on the ratings of credit rating agencies recognized as External Credit Assessment Institutions (ECAI) (for example, Moody's, S&P, Fitch, and DBRS) in order to calculate bank capital requirements within its standardized approach for credit risk measurement."[11]

Additionally, bank loan agreements and private contractual agreements often have what is known as "ratings triggers" whereby a credit rating downgrade of a counterparty or creditor could result in the posting of collateral or additional margin to shore up positions or exposure. Moreover, money managers—including endowments and pension funds—often view a highly rated security as safer, especially in complex products like mortgage-backed securities and synthetic CDOs where independent credit analysis is difficult for most.

The SEC has recently taken steps to reduce the reliance on ratings in the capital markets. In July 2008, the SEC proposed amendments to existing rules that rely on credit ratings.[12] These rules sought to promote independent analysis in making investment decisions. The proposals also responded to recommendations issued by the President's Working Group on Financial Markets, the Financial Stability Forum, and the Technical Committee of the International Organization of Securities Commissions. In October

[10] Josh Rosner, Graham-Fisher and Co. Weekly Report, July 26, 2007.

[11] U.S. Securities and Exchange Commission, Annual Report on Nationally Recognized Statistical Rating Organizations, September 2009.

[12] 73 Federal Register 40,124 (2008).

2009, the SEC adopted final rules that eliminated certain references to ratings by NRSROs in rules and forms under the Securities Exchange Act of 1934 and in rules under the Investment Company Act of 1940.[13]

Despite these regulatory actions, investor reliance on credit ratings has continued, and during the financial crisis, investors suffered immense losses as previously highly rated instruments soured, driving further concerns that many ratings were based upon unsatisfactory credit analysis. Quality and reliability of ratings is a chief concern for investors and users of ratings.

ACCOUNTABILITY

As noted above, both institutional and individual investors have relied on credit ratings to help determine whether to invest in a debt instrument. This massive public reliance was frustrated as the economy deteriorated beginning in 2007. As foreclosures mounted and the value of RMBS and other asset-backed securities deteriorated, credit rating agencies were forced to reevaluate their models and methodologies. They were also forced to downgrade many securities they had previously endorsed with high ratings. The flimsiness of these ratings reverberated throughout retail and institutional accounts as the value of securities eroded.

This turmoil has exposed the unreliability of credit rating agencies. Many of the users of ratings have therefore mounted criticisms that the rating agencies should be held accountable, in addition to the issuers and underwriters who are often sued for investment losses.

Credit rating agencies are subject to liability under a variety of legal theories. Credit rating agencies, like other market participants, are subject to liability under the broad anti-fraud proscription contained in the SEC's Rule 10b–5. Litigants have additionally alleged other theories under Federal securities law. Rating agencies also can be held liable under many state "blue sky" laws, which sometimes have lower pleading standards or offer broader liability than federal securities laws.[14] Further, credit rating agencies can be sued under a variety of common law and other non-securities law claims.[15]

The Credit Rating Agency Reform Act of 2006, where the formal registration process for NRSROs was created, included a prohibition on private rights of action with regard to new section 15E of the Securities Exchange Act of 1934. In the wake of the financial crisis, many have called upon Congress to remove this prohibition.

As with many securities fraud lawsuits, very few cases make it to trial. This could be for a variety of reasons, including inadequate facts in the pleading, or settlement before trial. The current *scienter* standard for bringing suit against an NRSRO has been established through case law as "knowing or reckless knowledge".

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[13] 74 Federal Register 52,358 (2009). In this rulemaking, the SEC also deferred consideration of action and reopened the comment period on other proposed amendments to remove NRSRO ratings references in rules under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

[14] *See, e.g., In re Nat'l Century Fin. Enters., Inc., Inv. Litig.,* 580 F. Supp. 2d 630, 649– 50 (S.D. Ohio 2008) (Finding rating agency liable under Ohio blue sky law, which provides for secondary liability for aiding and abetting where plaintiffs have not alleged scienter).

[15] *Id.* (rating agency can be sued for common law fraud and state negligent misrepresentation laws).

USES OF THE FIRST AMENDMENT DEFENSE

Credit rating agencies have moreover long asserted that they cannot be held liable for the content of their ratings because credit ratings are protected speech under the First Amendment of the U.S. Constitution. Here, the credit rating agencies generally make two claims: First, they claim that ratings "focus upon matters of public concern" triggering the "actual malice" test.[16] This test requires the difficult showing that the credit rating agency knew that its rating was false or issued it with reckless disregard for whether it was false or not.[17] Second, credit rating agencies claim that ratings are non-falsifiable opinions, like newspaper editorials. Such opinions are protected from liability,[18] and a number of courts have applied this protection to ratings.[19]

But this protection is far from universally accepted. Some courts accept the free speech immunity only with reservation,[20] and many others reject it altogether.[21] And "courts have suggested that credit rating agency activities associated with the structuring of a transaction, as contrasted with merely rating the transaction after issuance, are too dissimilar from ordinary journalistic activity to merit the legal protection awarded to journalists."[22]

Most recently, a Federal district court rejected a motion to dismiss brought by credit rating agencies based on First Amendment defenses, holding that free speech immunity does not apply "where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large."[23] The court also found that the ratings at issue were not protected as opinions, holding that an opinion is not protected unless the speaker genuinely and reasonably believes it or it has a basis in fact.[24] Here, the plaintiff investors had pled sufficient facts to show that the defendants knew that the credit ratings were false, and the judge moved the case to trial.[25] This decision was particularly noteworthy because it is "one of the first decisions to reject the defense in the context of ratings of mortgage backed securities."[26]

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[16] 376 U.S. 254, 280 (1964). See, *e.g., In re Enron Corp. Sec., Derv., and "ERISA" Litig.,* 511 F. Supp. 2d 742, 825 (S.D. Tx 2005) (holding that the actual malice standard applies when ratings of Enron Corp. were challenged as negligent).

[17] *New York Times Co. v. Sullivan,* 376 U.S. 254, 280 (1964).

[18] *Milkovich v. Lorain Journal Co.,* 497 U.S. 1, 20 (1990).

[19] See, *e.g., Jefferson County Sch. Dist. No. R–1 v. Moody's Investor's Servs.,* 175 F.3d 848, 856 (10th Cir. 1999) (ratings are non-falsifiable opinions).

[20] See, *e.g., In re Enron,* 511 F. Supp 2d 742 at 825 ("This Court has previously indicated that there is no blanket First Amendment protection for published credit ratings; one must examine any underlying facts, the circumstances under which the statements were made (context), the nature of the content, and the language of the statements to determine whether they are protected by the First Amendment. . . . the First Amendment protection for credit rating agencies as members of the 'financial press' performing 'traditional journalistic functions' is not universally accepted. . . .").

[21] See, *e.g., Commercial Fin. Servs., Inc. v. Arthur Andersen LLP,* 94 P.3d 106 (Okla. Civ. App. 2004) (rejecting First Amendment defense and reversing a ruling that dismissed rating agencies from action alleging a too-favorable rating); *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.*, 951 F.Supp. 1071 (S.D.N.Y. 1996) (rejecting First Amendment defense and denying rating agency's motion to dismiss claims based on its allegedly too-favorable rating).

[22] Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development,* 29 Cardozo Law Review 1553, 1690–91 (2008).

[23] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc.,* 2009 WL 2828018, 9 (S.D.N.Y. Sept. 2, 2009).

[24] *Id.* at 10.

[25] *Id.* at 11.

[26] John P. Stigi, *New York Federal District Court Rejects Credit Rating Agencies' First Amendment Defense,* Martindale.com Legal Library at *http://www.martindale.com/banking-law/article__*Sheppard-Mullin-Richter-Hampton-LLP__809518.htm (last visited November 17, 2009).

COMPENSATION

In the mid-1970s, the market leading NRSROs shifted from a subscriber-pay to an issuer-pay approach. The issuer-pay model has garnered criticism as it is deemed to create conflicts of interest for the NRSROs: chiefly, that raters are encouraged to lower their standards to attract the business of issuers seeking high-quality ratings. In structured finance, it was not uncommon that an NRSRO could be paid more for a better rating outcome. This challenge is aggravated by the practice of "ratings shopping" by which an issuer solicits preliminary ratings from several NRSROs, but contracts with the NRSRO that produces the most favorable rating. Since the preliminary rating may not be released to the public, investors are unaware of the outcome of credit analysis conducted by other NRSROs.

The credit rating agencies, especially the issuer-pay model, have come under harsh criticism for inherent conflicts of interest. Under the model, the issuer of a bond (corporate, municipal or structured product) pays the credit rating agency to rate the bond upon its issuance. The issuer pays subsequent fees in the maintenance of a current rating. The credit rating agency reviews public information (mostly from SEC filings) and non-public proprietary information (such as discussions with management including the review of forecasts), as provided by the issuer, to help determine the rating. The credit rating is then made available to the public, free of charge, through the credit rating agency website. There is an additional fee for institutional investors and anyone other than the issuer to see the full ratings report and analysis behind the rating.

When obtaining a rating, an issuer's interest lies in having the highest possible rating rather than the most accurate or reliable rating. A higher rating will result in greater access to capital and a lower cost of funds for the borrower. Because the credit rating agency's revenue depends upon the issuer in the issuer-pay model, critics have argued that the credit rating agency's interest lies in higher rather than reliable ratings, which would better serve the investor.

Some credit rating agencies use a subscriber-pay business model. As described above, the top three credit rating agencies used this model until the 1970s. Under the subscriber-pay model, the credit rating agency uses only public information to issue an unsolicited rating on an investment vehicle. Potential institutional investors then purchase the rating and underlying reports, but they are not made publicly available. Institutional investors subscribe to a ratings newsletter, usually focused on a certain class of fixed-income securities.

While the subscriber-pay model can mitigate a number of conflicts of interest in the payment for the credit rating, the rating itself can be less robust because the credit rating agency only has access to public information. If all ratings were performed under this model, there is a strong chance that small issuers or less frequent issuers (e.g., municipalities) could have difficulty in finding users to pay for their rating. The result would be that such debt offerings would not get a rating and therefore either not be issued, or the issuer would have increased borrowing costs. Municipalities

generally seek a rating because it brings down their borrowing costs in issuing debt.

Additional alternatives that have been raised during debate on credit rating agency reform include creating a utility model and establishing a random assignment model. Under the utility model, an independent payment intermediary would stand between the issuer and the credit rating agency. Issuers seeking a rating would pay the intermediary who would assign a credit rating agency to the task and pay the agency a set fee for performing the rating.

One concern with the utility model is that if the intermediary is a government agency or has government officials involved in the assignment, then the rating itself would have an implied government seal of approval. Such an approval could create an implied government guarantee. There are also questions about how fees would be set and if an appropriate level of analysis would be done for complex instruments if there is not an equivalent fee for the amount of work required.

The random assignment model is similar to the utility model, whereby a panel would randomly assign a request for a rating to a credit rating agency. Issuers would pay into a pool and fees would be deducted from the pool for each rating. A concern with this alternative is that all credit rating agencies do not perform all types of ratings (for example, some credit rating agencies focus on instruments while others may focus on sectors).

There could be a situation where a credit rating agency without the expertise to perform a certain rating is assigned that rating; alternatively if the panel takes expertise into account, the panel may be left with only one or two options which would defeat the benefits of random assignment because issuers seeking those specific ratings would know which credit rating agency would be assigned to perform the rating. Additionally, the market may still demand ratings from those credit rating agencies with which they feel most comfortable and could continue to do so outside the random selection process.

Without a good substitute for the issuer-pay model, regulators have sought to mitigate the conflicts of interest arising out of that business arrangement by requiring more and greater disclosures on how credit rating agencies are paid.

HEARINGS

The Financial Services Committee's Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises has examined the issue of credit rating agencies on several occasions in recent years. For example, the Capital Markets Subcommittee held a hearing entitled *The Role of Credit Rating Agencies in the Structured Finance Market* on September 27, 2007. This hearing examined questions related to assessing the credit quality of complex financial instruments, reviewing the role of NRSROs in developing new debt products, and understanding the conflicts of interest of NRSROs, especially related to their income sources. The hearing also explored the transparency of NRSRO criteria for evaluating structured products, the implementation of the Credit Rating Agency Reform Act of 2006, and the timeliness of recent decisions by NRSROs to downgrade the ratings of many mortgage-backed securities and CDOs.

The following witnesses testified at the September 2007 hearing:

- H. Sean Mathis, Managing Director, Miller Mathis
- J. Kyle Bass, Managing Partner, Hayman Capital
- Mark Adelson, Adelson-Jacob Consulting
- Michael Kanef, Group Managing Director, Asset Finance Group, Moody's Investors Services
- Vickie Tillman, Executive Vice President, Credit Rating Services, Standard & Poor's
- Joseph Mason, Professor, LeBow School of Business, Drexel University

The Capital Markets Subcommittee held a subsequent hearing entitled *Approaches to Improving Credit Rating Agency Regulation* on May 19, 2009. At the hearing, the Subcommittee received testimony from a variety of witnesses with experience in credit ratings, investment management, and First Amendment law. The witnesses addressed credit rating agency regulation and ways to improve accountability. In particular, the rating agency witnesses expressed their desire to assist the Committee's efforts and their support for enhanced oversight, but also opposition to significantly increased liability. The following witnesses testified:

- Mr. Robert Auwaerter, Principal and Head of the Fixed Income Group, Vanguard
- Mr. Robert Dobilas, President and Chief Executive Officer, RealPoint LLC
- Mr. Eugene Volokh, Gary T. Schwartz Professor of Law, UCLA School of Law
- Mr. Stephen W. Joynt, President and Chief Executive Officer, Fitch, Inc.
- Mr. Alex J. Pollock, Resident Fellow, American Enterprise Institute
- Mr. Gregory Smith, General Counsel, Colorado Public Employees' Retirement Association

The Capital Markets Subcommittee held another hearing entitled *Reforming Credit Rating Agencies* on September 30, 2009. At the hearing, the Subcommittee received testimony regarding a legislative discussion draft released on September 25, 2009, by Capital Markets Subcommittee Chairman Paul E. Kanjorski. The discussion draft was designed to enhance the oversight, accountability, and transparency of NRSROs, and, with certain amendments, it formed the basis of the bill ultimately reported out of the Committee. The following individuals participated at the hearing:

- Mr. Daniel M. Gallagher, Co-Acting Director, Division of Trading and Markets, U.S. Securities and Exchange Commission
- Mr. Raymond McDaniel, Chairman and Chief Executive Officer, Moody's Corporation
- Mr. Devan Sharma, President, Standard & Poor's
- Mr. Stephen W. Joynt, President and Chief Executive Officer, Fitch Inc.
- Mr. Robert Dobilas, President and Chief Executive Officer, RealPoint LLC
- Mr. James H. Gellert, President and Chief Executive Officer, Rapid Ratings International Inc.
- Mr. Kurt Schacht, Managing Director, CFA Institute Centre for Financial Integrity

COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on October 27, 2009, and on October 28, 2009, ordered H.R. 3890, Accountability and Transparency in Rating Agencies Act, as amended, favorably reported to the House by a record vote of 49 yeas and 14 nays.

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. A motion by Mr. Frank to report the bill, as amended, to the House with a favorable recommendation was agreed to by a record vote of 49 yeas and 14 nays (Record vote no. FC–79). The names of Members voting for and against follow:

RECORD VOTE NO. FC–79

Representative	Aye	Nay	Present	Representative	Aye	Nay	Present
Mr. Frank	X			Mr. Bachus	X		
Mr. Kanjorski	X			Mr. Castle	X		
Ms. Waters				Mr. King (NY)	X		
Mrs. Maloney	X			Mr. Royce		X	
Mr. Gutierrez	X			Mr. Lucas		X	
Ms. Velázquez	X			Mr. Paul			
Mr. Watt	X			Mr. Manzullo		X	
Mr. Ackerman	X			Mr. Jones	X		
Mr. Sherman	X			Mrs. Biggert	X		
Mr. Meeks				Mr. Miller (CA)		X	
Mr. Moore (KS)	X			Mrs. Capito	X		
Mr. Capuano	X			Mr. Hensarling		X	
Mr. Hinojosa	X			Mr. Garrett (NJ)		X	
Mr. Clay	X			Mr. Barrett (SC)			
Mrs. McCarthy	X			Mr. Gerlach		X	
Mr. Baca				Mr. Neugebauer		X	
Mr. Lynch				Mr. Price (GA)			
Mr. Miller (NC)	X			Mr. McHenry			
Mr. Scott	X			Mr. Campbell	X		
Mr. Green	X			Mr. Putnam		X	
Mr. Cleaver	X			Mrs. Bachmann		X	
Ms. Bean	X			Mr. Marchant	X		
Ms. Moore (WI)	X			Mr. McCotter	X		
Mr. Hodes	X			Mr. McCarthy		X	
Mr. Ellison	X			Mr. Posey	X		
Mr. Klein	X			Ms. Jenkins		X	
Mr. Wilson	X			Mr. Lee		X	
Mr. Perlmutter	X			Mr. Paulsen		X	
Mr. Donnelly	X			Mr. Lance	X		
Mr. Foster	X						
Mr. Carson	X						
Ms. Speier	X						
Mr. Childers	X						
Mr. Minnick	X						
Mr. Adler	X						
Ms. Kilroy	X						
Mr. Driehaus	X						
Ms. Kosmas	X						
Mr. Grayson	X						
Mr. Himes	X						
Mr. Peters	X						
Mr. Maffei	X						

The following amendments were also considered by the Committee:

An amendment by Mr. Kanjorski (and Mr. Frank), no. 1, managers amendment, was agreed to by voice vote.

An amendment by Mr. McHenry, no. 2, disclosures with respect to structured securities, was agreed to by voice vote.

An amendment by Mr. Ackerman, no. 3, providing symbols conformity to state law requirements, was offered and withdrawn.

An amendment by Mr. Bachus, no. 4, striking differentiating rating symbols, was not agreed to by voice vote.

An amendment by Ms. Waters, no. 5, regarding compensation of compliance officer, was agreed to by voice vote.

An amendment by Mr. Bachus, no. 6, regarding change to designation, was agreed to by voice vote.

An amendment by Mr. Donnelly, no. 7, regarding Commission staffing and rulemaking authority, was agreed to by voice vote.

An amendment by Mr. McCarthy (CA), no. 8, regarding a SEC study of market barriers, was agreed to by voice vote.

An amendment by Mr. Hensarling, no. 9, regarding a study of credit ratings, was agreed to by voice vote.

An amendment by Ms. Speier, no. 10, regarding elimination of exemption from fair disclosure rule, was agreed to by voice vote.

An amendment by Mr. Garrett, no. 11, regarding pleading standard, was not agreed to by voice vote.

An amendment by Ms. Speier, no. 12, regarding a prohibition on conflicts, was agreed to by voice vote.

An amendment by Mr. Frank (and Mr. Garrett and Mr. Bachus), no. 13, regarding removal of statutory references to credit ratings, was agreed to by voice vote.

An amendment by Ms. Kilroy, no. 14, regarding publication of rating histories on the EDGAR system, was agreed to by voice vote.

An amendment by Ms. Kilroy, no. 15, regarding alternative methodologies to assess credit risk, was agreed to by voice vote.

An amendment by Ms. Kilroy, no. 16, regarding independent directors, was not agreed to by voice vote.

An amendment by Ms. Kilroy, no. 17, regarding the effect of Rules 436(g), was agreed to by voice vote.

An amendment by Mr. Meeks, no. 18, regarding assumptions made in the rating process, was agreed to, as modified, by voice vote.

Amendments by Mr. Foster, no. 19, regarding study on meaningful multi digit rating symbols and a study on ratings standardization and considered en bloc, were agreed to, as modified, by voice vote.

An amendment by Mr. Foster (and Mr. Lynch), no. 20, regarding an advisory board, was agreed to by voice vote.

An amendment by Mr. Sherman (and Mr. Lynch), no. 21, regarding initial credit rating assignments, was offered and withdrawn.

An amendment by Mr. Lynch, no. 22, regarding statistical credit rating organization attestation, was agreed to by voice vote.

An amendment by Mr. Sherman, no. 23, regarding requirement of contracts for credit ratings, was offered and withdrawn.

An amendment by Ms. Speier, no. 24, regarding requirement of contracts for credit ratings, was agreed to by voice vote.

An amendment by Mr. Sherman, no. 25, regarding requirement of contracts for credit ratings and the duty of care, was offered and withdrawn.

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the Committee has held hearings and made findings that are reflected in this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee establishes the following performance related goals and objectives for this legislation:

H.R. 3890 generally aims to improve and enhance the regulatory framework for nationally recognized statistical rating organizations, or NRSROs. H.R. 3890 specifically expands the oversight authority of the U.S. Securities and Exchange Commission over NRSROs, strengthens NRSRO corporate governance, and increases the transparency of NRSRO ratings with the goal to further protect investors. The bill also aims to reduce the reliance on credit ratings for investors, regulators and other users of credit ratings.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

COMMITTEE COST ESTIMATE

The Committee adopts as its own the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

CONGRESSIONAL BUDGET OFFICE ESTIMATE

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

DECEMBER 3, 2009.

Hon. BARNEY FRANK,
Chairman, Committee on Financial Services,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 3890, the Accountability and Transparency in Rating Agencies Act.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Susan Willie.

Sincerely,

DOUGLAS W. ELMENDORF.

Enclosure.

H.R. 3896—Accountability and Transparency in Rating Agencies Act

Summary: H.R. 3890 would expand recordkeeping and reporting requirements on credit rating agencies that are registered with the Securities and Exchange Commission (SEC). The bill also would require three federal bank regulators to establish uniform standards of creditworthiness. Finally, H.R. 3890 would require the SEC and the Government Accountability Office (GAO) to prepare several reports for the Congress related to the credit rating industry.

CBO estimates that implementing H.R. 3890 would cost $33 million over the 2010–2014 period, assuming appropriation of the necessary amounts. Further, enacting the bill could increase revenues because additional civil penalties could be imposed for violations of new regulations. CBO expects that any increase would not be significant because of the small number of violations that would probably occur. Enacting H.R. 3890 would not have a significant effect on direct spending.

H.R. 3890 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no costs on state, local, or tribal governments.

H.R. 3890 would impose private-sector mandates, as defined in UMRA, on credit rating agencies that are registered with the SEC and on issuers of certain securities. Based on information from industry sources, CBO estimates the aggregate cost to comply with the mandates in the bill would fall below the annual threshold for private-sector mandates established in UMRA ($139 million in 2009, adjusted annually for inflation).

Estimated cost to the Federal Government: The estimated budgetary impact of H.R. 3890 is shown in the following table. The costs of this legislation fall within budget function 370 (commerce and housing credit).

	By fiscal year, in millions of dollars—					
	2010	2011	2012	2013	2014	2010–2014
CHANGES IN SPENDING SUBJECT TO APPROPRIATION						
Estimated Authorization Level	3	7	8	8	8	34
Estimated Outlays	3	6	8	8	8	33

Basis of estimate: For this estimate, CBO assumes that H.R. 3890 will be enacted early in calendar year 2010, that the necessary amounts will be appropriated near the start of each fiscal year, and that spending will follow historical patterns for the SEC.

Spending subject to appropriation

Under current law, credit rating agencies that are registered with the SEC, known as nationally recognized statistical rating organizations (NRSROs), are required to follow certain recordkeeping and disclosure rules. H.R. 3890 would expand those rules and require the SEC to examine each NRSRO at least annually. The bill also would require the SEC and GAO to prepare several studies and reports for the Congress related to the credit rating industry.

Based on information from the SEC, CBO estimates that the agency would need to add 35 employees by fiscal year 2011 to un-

dertake the additional examination and oversight activities required under the bill. Assuming appropriation of the necessary amounts, CBO estimates that implementing H.R. 3890 would increase spending by $33 million over the 2010–2014 period. That amount would cover the cost of salaries and benefits, overhead, preparing reports, and upgrading information technology systems.

H.R. 3890 also would require the SEC and the Department of the Treasury to develop new standards of creditworthiness to be used when examining certain entities and transactions. CBO estimates that implementing this provision would have an insignificant effect on spending subject to appropriation.

Direct spending and revenues

H.R. 3890 would require three federal bank regulators—the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC)—to develop new standards of creditworthiness to be used when examining regulated entities. Any increase in costs to the OCC and FDIC to develop those standards would be recovered through increased fees and insurance premiums, therefore, CBO estimates that these provisions would have no significant effect on direct spending over the 2010–2019 period.

Net spending by the Federal Reserve is recorded in the federal budget as a change in revenue. Based on information from the Federal Reserve, CBO expects that the new regulatory activities would have no significant effect on the Federal Reserve's workload or budget and thus would have no significant impact on the federal budget.

Enacting H.R. 3890 also could affect revenues because additional civil penalties could be imposed for violations of new regulations, but we expect that any such increases would not be significant because of the relatively small number of violations likely to occur.

Estimated impact on State, local, and tribal governments: H.R. 3890 contains no intergovernmental mandates as defined in UMRA and would impose no costs on state, local, or tribal governments.

Estimated impact on the private sector: H.R. 3890 would impose private-sector mandates, as defined in UMRA, on credit rating agencies that are identified as NRSROs and registered with the SEC. The bill would require NRSROs to comply with several requirements to be established by the SEC with respect to:

- Disclosures to clients and to the public,
- Information to be submitted to the SEC,
- Policies that address conflicts of interest,
- Duties for compliance officers,
- Supervising employees and tracking employee transitions, and
- Services provided that are unrelated to credit-rating services.

The bill also would impose disclosure requirements on issuers of certain financial products and corporate debt. Such issuers would be required to disclose to the public any preliminary credit ratings on their products received from NRSROs. In addition, issuers of structured securities would be required to provide certain information to NRSROs.

According to the SEC, there are currently 10 NRSROs, and many of the requirements under the bill involve information that is readily available or make only incremental changes to current business practices and regulations. Based on information from the SEC and industry sources, CBO estimates that the incremental cost for credit-rating agencies and issuers to comply with the requirements established under the bill would fall below the annual threshold for private-sector mandates established in UMRA ($139 million in 2009, adjusted annually for inflation).

Estimate prepared by: Federal Costs: Susan Willie; Impact on State, Local, and Tribal Governments: Elizabeth Cove Delisle; Impact on the Private Sector: Brian Prest and Paige Piper/Bach.

Estimate approved by: Theresa Gullo, Deputy Assistant Director for Budget Analysis.

FEDERAL MANDATES STATEMENT

The Committee adopts as its own the estimate of Federal mandates prepared by the Director of the Congressional Budget Office pursuant to section 423 of the Unfunded Mandates Reform Act.

ADVISORY COMMITTEE STATEMENT

Section 8 of this legislation directs the establishment by the SEC of an advisory committee as defined by section 3 of the Federal Advisory Committee Act: the Credit Ratings Agency Advisory Board. The Committee finds pursuant to section 5 of the Federal Advisory Committee Act that none of the functions of the proposed advisory committee are being or could be performed by one or more agencies or by an advisory committee already in existence, or by enlarging the mandate of an existing advisory committee. The Committee also determines that the Credit Ratings Agency Advisory Board has a clearly defined purpose, fairly balanced membership, and meets all of the other requirements of section 5(b) of the Federal Advisory Committee Act.

CONSTITUTIONAL AUTHORITY STATEMENT

Pursuant to clause 3(d)(1) of rule XIII of the Rules of the House of Representatives, the Committee finds that the Constitutional Authority of Congress to enact this legislation is provided by Article 1, section 8, clause 1 (relating to the general welfare of the United States) and clause 3 (relating to the power to regulate interstate commerce).

APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of section 102(b)(3) of the Congressional Accountability Act.

EARMARK IDENTIFICATION

H.R. 3890 does not contain any congressional earmarks, limited tax benefits, or limited tariff benefits as defined in clause 9 of rule XXI.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Short title

This section establishes the short title of the bill as the "Accountability and Transparency in Rating Agencies Act".

Section 2. Enhanced regulation of nationally recognized statistical rating organizations

This section of the bill makes numerous amendments to Section 15E of the Securities Exchange Act of 1934, the relevant section of Federal securities laws concerning the regulation of nationally recognized statistical rating organizations (NRSROs).

Amendments to Exchange Act section 15E(a) on registration procedures and section 15E(b) on update of registration

Paragraphs 1 and 2 of this section use the word "file" (and variations thereof) to replace the word "furnish" (and variations thereof). Thus, documents required as part of the NRSRO registration process, or NRSRO reports, shall now be "filed" with the U.S. Securities and Exchange Commission (SEC), rather than "furnished" to it.

Information that is "furnished" to the SEC is subject to a lower standard of accuracy and liability than information "filed" with the SEC; for instance, Section 18 of the Exchange Act provides for liability for misleading statements only in documents "filed" with the SEC.

Amendments to Exchange Act section 15E(c) on accountability for ratings procedures

Numerous changes are made to Section 15E(c) of the Exchange Act. First, the legislation adds a clarification that current Section 15E(c)(2), which bars the SEC and any State from regulating the substance of credit ratings or the procedures and methodologies used to determine ratings, does not afford a defense against antifraud actions brought by the SEC.

Next, the bill adds a requirement for the SEC to review the ratings and internal policies, procedures and methodologies of an NRSRO to ensure that the NRSRO has established and documented a system of internal controls, due diligence, and implementation of ratings methodology; the NRSRO follows such system; and the NRSRO's disclosures are consistent with such system.

In this section, it is not intended that NRSROs will conduct due diligence on an instrument in the same manner and legal sense as underwriters of securities. It is also not intended for the SEC to prescribe in any way the quantitative and qualitative methodologies an NRSRO employs to determine credit ratings. Rather, it is intended that the SEC review the controls around these quantitative and qualitative methodologies that are designed, for example, to ensure that a credit analyst adheres to the NRSRO's quantitative and qualitative methodologies when performing the analysis that leads to a credit rating.

The SEC must conduct reviews of internal processes for determining ratings at least once a year. NRSROs must also maintain records and make them available to the SEC as it deems necessary to conduct the reviews.

Additionally, this section requires the SEC to issue new rules regarding NRSRO procedures and methodologies for rating structured securities. These new rules must (1) specify the information that must be disclosed to the NRSRO by the originators, issuers, and underwriters of the structured security on the security's underlying collateral, and (2) create procedures to collect and disclose information about the processes used by such originators, issuers and underwriters to assess the accuracy of their data and fraud detection. The SEC will define "structured security" in order to implement the section.

The requirement that the SEC specify the information required to be disclosed to NRSROs is intended to remove potential information barriers. The NRSROs will be free to determine whether and how to incorporate this information into their quantitative and qualitative methodologies for determining credit ratings.

The legislation also creates a new requirement that NRSROs provide, on a publicly accessible Internet site, the historical default rates of each class of financial product that they rate.

Amendments to Exchange Act Section 15E(d) on censure, fine, denial, or suspension of registration; notice and hearing

The legislation amends Exchange Act Section 15E(d) to clarify that the SEC may impose fines on NRSROs for violations of the law. The changes also clarify that the SEC may take action not only against the NRSRO itself, but also against the individuals who are associated with the NRSRO, were formerly associated with the NRSRO at the time of the alleged misconduct, or are seeking to become associated with the NRSRO.

The bill adds two new activities that give rise to SEC sanction: The first is a failure to reasonably supervise NRSRO employees. The failure to supervise is based on employees' compliance with the securities laws (including rules and regulations) and the rules of the Municipal Securities Rulemaking Board. The bill also creates a safe harbor for supervisors who establish procedures for compliance and have no reason to believe that the procedures were not being followed. The second activity is the failure to conduct sufficient surveillance to ensure that its credit ratings remain current and reliable.

Amendments to Exchange Act Section 15E(e) on termination of registration

These provisions eliminate an NRSRO's ability to voluntarily withdraw its registration as an NRSRO.

Amendments to Exchange Act Section 15E(h) on corporate governance, organization, and management of conflicts of interest

The bill makes numerous changes to Section 15E(h) of the Exchange Act. The legislation alters the title to "Management of Conflicts of Interest" to "Corporate Governance, Organization, and Management of Conflicts of Interest" to reflect the substantive amendments made by the bill.

Each NRSRO, or its parent entity, must now have a board of directors with at least one-third independent directors. The compensation for independent directors cannot be linked to the per-

formance of the NRSRO, and the terms for independent directors must be non-renewable and not exceed 5 years.

The amended subsection (h) also mandates several areas the board must oversee: (1) the establishment, maintenance and enforcement of processes for determining ratings; (2) the establishment, maintenance and enforcement of policies addressing conflicts of interest; (3) the effectiveness of the internal control system with respect to policies and procedures for determining credit ratings; and (4) the compensation and promotion policies and practices of the NRSRO.

Each NRSRO must also establish, maintain and enforce written policies and procedures to address, manage and disclose conflicts of interest, consistent with SEC rulemakings required under both current and amended subsection (h).

These SEC rulemakings, in the amended subsection (h), prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by an NRSRO. The amended section maintains several rules required under current law, including rules concerning:

- Conflicts arising from how the NRSRO is paid for ratings; and
- Conflicts arising from any affiliations of NRSROs with any person that underwrites investment vehicles that are the subject of a credit rating.

Amended section (h) also includes several new rules concerning conflicts of interest:

- Conflicts relating to the business relationships, ownership interests, any affiliations of NRSRO board members with obligors, and other financial or personal interests of the NRSRO board members or the NRSRO with a rating obligor or obligor affiliate (the amended law amplifies the current rule to include the affiliations of NRSRO board members with obligors);
- Disclosure of information about (1) the net revenue of the NRSRO attributable to each entity that paid for a credit rating, and (2) the relative standing of such entities in terms of net revenue earned by the NRSRO attributable to each such entity;
- Establishment of a performance-based payment system for ratings to incentivize accurate and reliable issuance and surveillance of credit ratings; and
- Disclosure with each rating of the fees associated with the rating and information about the number and type of ratings provided for the entity being rated and its affiliates, and the revenue earned by the NRSRO in the preceding two fiscal years attributable to the person being rated or its affiliates.

Also, the amended section (h) maintains that the SEC must issue rules regarding any other potential conflict of interest, as it deems necessary or appropriate in the public interest or for the protection of investors.

The amended subsection (h) further imposes a new requirement for NRSROs to conduct a one-year look-back review when an NRSRO employee goes to work for an obligor or underwriter of a security or money market instrument subject to a rating by that NRSRO. If the employee participated in any capacity in determining the rating of the issuer during the year before the NRSRO took a ratings action, the NRSRO must conduct a review to determine whether any conflicts of interest of the employee influenced

the rating, and if appropriate, revise the rating. This new paragraph further requires the SEC to conduct periodic reviews of an NRSRO's policies and procedures for conducting the look-back reviews and their implementation.

Amended subsection (h) also requires periodic SEC reviews of an NRSRO's code of ethics and conflict of interest procedures. These reviews must occur at least once annually and whenever such policies are materially modified or amended.

Additionally, NRSROs must now report to the SEC when certain employees of the NRSRO go to work for an entity that the NRSRO has rated in the previous twelve months. The SEC shall make such reports publicly available.

Amendments to Exchange Act section 15E(j) on designation of compliance officer

The law's existing NRSRO compliance officer requirements are expanded and modified. The compliance officer will report directly to the board of directors and review specific aspects of internal control and conflict of interest policies. For instance, the compliance officer must establish procedures designed to ensure that ratings take into account all information obtained by the NRSRO to help determine that rating. The compliance officer must also establish procedures for receiving complaints about conflicts of interest, including anonymous complaints by employees, issuers and investors.

The bill prohibits a compliance officer from determining credit ratings, performing marketing or sales functions, or participating in the establishment of rating models and methodologies and employee compensation levels (other than for employees working for the compliance office). These amendments require the compliance officer to annually prepare and certify a report on the compliance of the NRSRO with the securities laws and the NRSRO's internal policies and procedures. Finally, the compensation of the compliance officer must be arranged to ensure the officer's independence, and may not be linked to the NRSRO's business performance.

Amendments to Exchange Act section 15E(k) on statements of financial condition

This section amends the current law to provide that when NRSROs provide financial information to the SEC, it is no longer on a confidential basis. However, the SEC may treat as confidential any information provided under this section consistent with Federal law and SEC rules.

Amendments to Exchange Act section 15E(p) on establishment SEC Office

This bill expands the rulemaking authority of the SEC regarding NRSROs. It requires the SEC to establish an office with sufficient staff to coordinate NRSRO regulation. Also, the legislation instructs the SEC to issue rules (1) providing for fines and other penalties for NRSRO violations of the law, and (2) as necessary to carry out the new NRSRO regulatory regime.

New Exchange Act section 15E(q) on transparency of ratings performance

This section adds a new subsection (q) to Section 15E. This new subsection requires the SEC to write rules mandating NRSROs to publicly disclose information to allow investors to better gauge the performance of ratings and, thus, the NRSROs. This requirement applies to both initial ratings and subsequent changes to ratings. It is intended that this applies to existing ratings and not merely new issues. The form of disclosure must be comparable among NRSROs, so investors can compare ratings performance across NRSROs. The information presented must also be clear and informative for a wide range of investor sophistication, describe long-term performance for a variety of classes of ratings, and be published and made easily accessible. Each NRSRO rating further must include an attestation that the rating was not influenced by other business activities, was based solely on the merits of the instruments being rated, and that the rating was an independent evaluation of the risks and merits of the instrument.

New Exchange Act section 15E(r) on credit ratings methodologies

This section adds to a new subsection (r) to Section 15E of the Exchange Act to require the SEC to issue rules to ensure that NRSROs establish, maintain and enforce written procedures and methodologies designed to ensure that credit ratings are determined based on the NRSRO's procedures and methodologies. These rules must also ensure that changes to rating procedures and methodologies are consistently applied and that users of credit ratings are notified of a change of procedure or methodology in a timely fashion.

Also, the SEC must adopt ratings symbols that distinguish between structured finance products, like mortgage-backed securities and collateralized debt obligations, and non-structured products, like corporate and municipal bonds.

The SEC shall also require each NRSRO to establish, maintain and enforce written policies and procedures designed to produce credit ratings that reflect the risk of non-repayment, and to ensure that ratings symbols are clearly defined and consistent for all types of securities and money market instruments. These rules shall not prohibit an NRSRO from using additional factors to determine a rating (such as credit factors that are unique to municipal securities) or an additional symbol to distinguish ratings for difference types of securities.

While additional credit factors may be considered by the NRSROs, nothing in the bill should be interpreted as inconsistent with the general intent that uniform ratings methodologies be adopted across different types of securities and reflect the risk of non-repayment.

New Exchange Act section 15E(s) on transparency of credit rating methodologies and information reviewed

This section adds to Exchange Act Section 15E a new subsection (s) to require NRSROs to provide information to help investors better understand ratings, using a form established by the SEC. This includes information about:

- the assumptions and information used in developing ratings procedures and methodology;
- potential shortcomings of the ratings, including what types of risks the rating does not take into account;
- how certain the rating is, including the reliability and quality of information used in making the rating;
- whether third-party due diligence services were used, in the instance of rating a structured product;
- what information about any obligor, issuer, security, or money market instrument was used to determine the rating;
- the overall quality of the rating;
- the volatility of the rating;
- the content of the rating;
- the sensitivity of the rating to assumptions made by the NRSRO; and
- how the NRSRO used servicer and remittance reports for ratings surveillance (where applicable).

The NRSRO must also certify that the information provided on the form is true and accurate. Additionally, the form will be made public to provide optimal transparency to investors and users of credit ratings.

To further support the quality of ratings for structured finance products, especially mortgage-backed securities, this new subsection requires third-party firms that provide due diligence, for example on pools of loans, to certify their work to the NRSRO. This change ensures that the due diligence firm will execute a thorough review of data, documentation, and other relevant information necessary for the NRSRO to provide a reliable rating. The SEC will establish the appropriate format for this certification, but it is not intended that the SEC will determine what is considered an appropriate level of due diligence. The NRSRO must disclose the certification to those who have access to its ratings.

New Exchange Act section 15E(t) on prohibited activities

To bolster efforts to mitigate conflicts of interest, a new subsection (t) bars NRSROs from providing risk management advisory services; advice or consultation relating to any merger, sale, or disposition of assets of an issuer; ancillary assistance, advice or consulting unrelated to a credit rating; and other activities as defined by the SEC. This subsection takes effect 180 days after the bill is enacted.

Section 3. Standards for private actions

Section 3 clarifies that the scienter requirement for cases brought against NRSROs is "knowing or reckless" violation of the anti-fraud provisions of the securities laws.

The bill also amends Section 15E(m) of the Exchange Act by deleting the rules of construction instituted by the Credit Rating Agency Reform Act of 2006. It now provides that statements made by NRSROs shall not be deemed forward-looking statements for purposes of the safe-harbor in Section 21E of the Exchange Act.

The legislation further requires that the scienter requirement of "knowing or reckless knowledge" be applied to NRSROs in the same manner as it is applied to other defendants in the same or similar lawsuits under the securities laws.

Section 4. Issuer disclosure of preliminary ratings

To address the concern of "ratings shopping" by issuers, this section instructs the SEC to adopt rules that require issuers to disclose the preliminary credit ratings they receive from an NRSRO on structured finance products and all forms of corporate debt.

Section 5. Change to designation

This section amends the Securities Act of 1933 and the Exchange Act to change all references of "nationally recognized statistical rating" to "nationally registered statistical rating."

Section 6. Timeline for regulations

Unless otherwise provided in the bill, the SEC must issue final rules and regulations to implement the bill within 365 days of enactment.

Section 7. Elimination of exemption from Fair Disclosure Rule

This section requires the SEC, within 90 days of enactment, to eliminate the exemption in Regulation Fair Disclosure, commonly known as Reg FD, for NRSROs.

Section 8. Advisory board

This section requires the SEC, within 90 days of this bill's enactment, to establish the Credit Ratings Agency Advisory Board. The Board will have seven members appointed by the SEC, no more than two of whom may be former employees of a credit rating agency. Members of the Board must display integrity and an understanding of the role of credit rating agencies in the marketplace. The Board shall advise the SEC regarding the rules and regulations required by this bill; ensure that the SEC properly exercises its NRSRO oversight functions; and issue an annual report to Congress detailing this work and any recommendations.

Section 9. Removal of statutory references to credit ratings

In order to reduce reliance on NRSROs, this bill amends several statutes to remove references to credit ratings, credit rating agencies and NRSROs. The affected laws include the Federal Deposit Insurance Act; the Federal Housing Enterprises Financial Safety and Soundness Act; the Investment Company Act of 1940; Section 5136A of title LXII of the Revised Statutes of the United States; the Securities Exchange Act of 1934; and Section 3(a)(6) of the amendment in the nature of a substitute to the text of H.R. 4645, as ordered reported from the Committee on Banking, Finance and Urban Affairs on September 22, 1988, as enacted into law by Section 555 of Public Law 100–461. These amendments shall take effect six months after enactment.

Section 10. Review of reliance on ratings, rating agencies, and NRSROs

This section requires certain Federal agencies to review their regulations, policies and practices that reference credit ratings, credit rating agencies, and NRSROs. After identifying where the agency relies on or makes these references, the agencies shall modify their regulations by striking these references and substituting a standard of creditworthiness to be established by the agencies.

The relevant agencies, all of which are under the jurisdiction of the House Committee on Financial Services, are the SEC, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the National Credit Union Administration, and the Federal Housing Finance Authority.

Where feasible, the agencies should seek to develop uniform standards of creditworthiness to ensure a level playing field for evaluating counterparties, creditors, securities and financial products. This is most critical for banking institutions as they set standards. Agencies must complete this review within one year of enactment and report modifications to Congress.

This section also requires the Government Accountability Office (GAO) within one year of enactment to conduct a comprehensive review of the use of and reliance on credit ratings by Federal agencies in laws and regulations. The GAO shall make recommendations for modifying legislation or rulemaking in order for these agencies to reduce their reliance on ratings.

Section 11. Publication of rating histories on the EDGAR System

Within 180 days of enactment, the SEC must revise its rules in Section 240.17g–2(a) and (d) of Title 17, Code of Federal Regulations, to require that the random sample of ratings histories of credit ratings currently required to be disclosed on NRSRO websites must also be provided to the SEC for publication on the EDGAR system.

Section 12. Effect of Rule 436(g)

This bill nullifies Rule 436(g) promulgated under the Securities Act of 1933. This rule currently provides an exemption for credit ratings provided by NRSROs from being considered a part of the registration statement prepared or certified by a person under the "expert liability" regime of Section 7 and Section 11 of the Securities Act of 1933.[27] It does not apply to ratings provided by credit rating agencies that are not NRSROs.

Section 13. Studies

Finally, this bill orders a number of studies, including:

- A study by the Comptroller General of the implementation of this Act, the effect of liability in private actions arising under the Exchange Act, alternative compensation structures, and alternative methodologies for assessing credit risk (this study shall be submitted to Congress within 30 months of enactment);
- A study by the SEC on creating a system whereby NRSROs are assigned on a rotating basis to issuers (this study shall be transmitted to Congress within one year of enactment);
- A study by the SEC of the effect of the amendments made in section 2 of this bill on the registration process for NRSROs,

[27] Section 7 of the Securities Act requires issuers to obtain the written consent of persons, whose profession gives their statements authority, who are named as having prepared or certified a report or valuation in connection with the registration statement. 15 U.S.C. 77g. Section 11 of the Securities Act holds these persons liable if sections made under their authority contain material misstatements or omissions. 15 U.S.C. 77k.

and whether the new requirements of this bill will be a barrier to registering as an NRSRO (this study shall be transmitted to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs within one year of enactment);

• A study by the SEC of the treatment of different classes of bonds (municipal versus corporate) by the NRSROs, including (1) where there are fundamental differences in the treatment of different classes of bonds by rating organizations that cause some classes of bonds to suffer from undue discrimination; (2) if there are such differences, what causes them and how can they be alleviated; (3) whether there are factors other than risk of loss that are appropriate for the credit rating agencies to consider when rating bonds, and do those factors vary across sectors; (4) the types of financing arrangement used by municipal issuers; (5) the differing legal and regulatory regimes governing disclosures for corporate and municipal bonds; (6) the extent to which retail investors would be disadvantaged by a single ratings scale; and (7) practices, policies, and methodologies by the NRSRO with respect to municipal bonds (this study shall be submitted to the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs within six months of enactment);

• A study by the SEC of a standardized rating symbol system whereby rating symbols contain multiple characters, each letter representing a range of default probabilities and loss expectations (this study shall be transmitted to Congress within one year of enactment); and

• A study by the SEC of the feasibility and desirability of ratings standardization (this study shall be transmitted to Congress within one year of enactment).

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECURITIES EXCHANGE ACT OF 1934

TITLE I—REGULATION OF SECURITIES EXCHANGES

* * * * * * *

DEFINITIONS AND APPLICATION OF TITLE

SEC. 3. (a) When used in this title, unless the context otherwise requires—

(1) * * *

* * * * * * *

(41) The term "mortgage related security" means a security that [is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization]

meets standards of credit-worthiness as defined by the Commission, and either:

(A) * * *

* * * * * * *

(53)(A) The term "small business related security" means a security that [is rated in 1 of the 4 highest rating categories by at least 1 nationally recognized statistical rating organization] *meets standards of credit-worthiness as defined by the Commission*, and either—

(i) * * *

* * * * * * *

(62) NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION.—The term "[nationally recognized statistical rating] *nationally registered statistical rating* organization" means a credit rating agency that—

(A) * * *

* * * * * * *

(63) PERSON ASSOCIATED WITH A NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION.—The term "person associated with" a [nationally recognized statistical rating] *nationally registered statistical rating* organization means any partner, officer, director, or branch manager of a [nationally recognized statistical rating] *nationally registered statistical rating* organization (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with a [nationally recognized statistical rating] *nationally registered statistical rating* organization, or any employee of a [nationally recognized statistical rating] *nationally registered statistical rating* organization.

* * * * * * *

REGISTRATION AND REGULATION OF BROKERS AND DEALERS

SEC. 15. (a) * * *

(b)(1) * * *

* * * * * * *

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

(A) * * *

(B) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction which the Commission finds—

(i) * * *

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, investment adviser, bank, insurance company, fiduciary, transfer agent, [nationally recognized statistical rating] *nationally registered statistical rating* organization, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act (7 U.S.C. 1 et seq.) or any substantially equivalent foreign statute or regulation;

* * * * * * *

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, [nationally recognized statistical rating] *nationally registered statistical rating* organization, foreign person performing a function substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation, or as an affiliated person or employee of any investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

* * * * * * *

SEC. 15E. REGISTRATION OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS.

(a) REGISTRATION PROCEDURES.—

(1) APPLICATION FOR REGISTRATION.—

(A) IN GENERAL.—A credit rating agency that elects to be treated as a [nationally recognized statistical rating] *nationally registered statistical rating* organization for purposes of this title (in this section referred to as the "applicant"), shall [furnish to] *file with* the Commission an application for registration, in such form as the Commission shall require, by rule or regulation issued in accordance with subsection (n), and containing the information described in subparagraph (B).

* * * * * * *

(2) REVIEW OF APPLICATION.—

(A) INITIAL DETERMINATION.—Not later than 90 days after the date on which the application for registration is [furnished to] *filed with* the Commission under paragraph (1) (or within such longer period as to which the applicant consents) the Commission shall—

(i) * * *

* * * * * * *

(B) CONDUCT OF PROCEEDINGS.—

(i) CONTENT.—Proceedings referred to in subparagraph (A)(ii) shall—

(I) * * *

(II) be concluded not later than 120 days after the date on which the application for registration is [furnished to] *filed with* the Commission under paragraph (1).

* * * * * * *

(D) EXEMPTION FROM CERTIFICATION REQUIREMENT.—A written certification under subparagraph (B)(ix) is not required with respect to any credit rating agency which has received, or been the subject of, a no-action letter from the staff of the Commission prior to August 2, 2006, stating that such staff would not recommend enforcement action against any broker or dealer that considers credit ratings issued by such credit rating agency to be ratings from a [nationally recognized statistical rating] *nationally registered statistical rating* organization.

* * * * * * *

(3) PUBLIC AVAILABILITY OF INFORMATION.—Subject to section 24, the Commission shall, by rule, require a [nationally recognized statistical rating] *nationally registered statistical rating* organization, upon the granting of registration under this section, to make the information and documents submitted to the Commission in its completed application for registration, or in any amendment submitted under paragraph (1) or (2) of subsection (b), publicly available on its website, or through another comparable, readily accessible means, except as provided in clauses (viii) and (ix) of paragraph (1)(B).

(b) UPDATE OF REGISTRATION.—

(1) UPDATE.—Each [nationally recognized statistical rating] *nationally registered statistical rating* organization shall promptly amend its application for registration under this section if any information or document provided therein becomes materially inaccurate, except that a [nationally recognized statistical rating] *nationally registered statistical rating* organization is not required to amend—

(A) the information required to be [furnished] *filed* under subsection (a)(1)(B)(i) by [furnishing] *filing* information under this paragraph, but shall amend such information in the annual submission of the organization under paragraph (2) of this subsection; or

(B) the certifications required to be provided under subsection (a)(1)(B)(ix) by [furnishing] *filing* information under this paragraph.

(2) CERTIFICATION.—Not later than 90 days after the end of each calendar year, each [nationally recognized statistical rating] *nationally registered statistical rating* organization shall [furnish to] *file with* the Commission an amendment to its registration, in such form as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors—

(A) certifying that the information and documents in the application for registration of such [nationally recognized

statistical rating] *nationally registered statistical rating* organization (other than the certifications required under subsection (a)(1)(B)(ix)) continue to be accurate; and

* * * * * * *

(c) ACCOUNTABILITY FOR RATINGS PROCEDURES.—

(1) AUTHORITY.—The Commission shall have exclusive authority to enforce the provisions of this section in accordance with this title with respect to any [nationally recognized statistical rating] *nationally registered statistical rating* organization, if such [nationally recognized statistical rating] *nationally registered statistical rating* organization issues credit ratings in material contravention of those procedures relating to such [nationally recognized statistical rating] *nationally registered statistical rating* organization, including procedures relating to the prevention of misuse of nonpublic information and conflicts of interest, that such [nationally recognized statistical rating] *nationally registered statistical rating* organization—

(A) * * *

* * * * * * *

(2) LIMITATION.—The rules and regulations that the Commission may prescribe pursuant to this title, as they apply to [nationally recognized statistical rating] *nationally registered statistical rating* organizations, shall be narrowly tailored to meet the requirements of this title applicable to [nationally recognized statistical rating] *nationally registered statistical rating* organizations. Notwithstanding any other provision of law, *including the requirements of this section,* neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any [nationally recognized statistical rating] *nationally registered statistical rating* organization determines credit ratings*, provided that this paragraph does not afford a defense against any action or proceeding brought by the Commission to enforce the antifraud provision of the securities laws*.

(3) REVIEW OF INTERNAL PROCESSES FOR DETERMINING CREDIT RATINGS.—

(A) IN GENERAL.—The Commission shall examine credit ratings issued by, and the policies, procedures, and methodologies employed by, each nationally recognized statistical rating organization to review whether—

(i) the nationally recognized statistical rating organization has established and documented a system of internal controls, due diligence and implementation of methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe by rule;

(ii) the nationally recognized statistical rating organization adheres to such system; and

(iii) the public disclosures of the nationally recognized statistical rating organization required under this section about its credit ratings, methodologies, and procedures are consistent with such system.

(B) MANNER AND FREQUENCY.—The Commission shall conduct reviews required by this paragraph no less frequently than annually in a manner to be determined by the Commission.

(4) PROVISION OF INFORMATION TO THE COMMISSION.—Each nationally recognized statistical rating organization shall make available and maintain such records and information, for such a period of time, as the Commission may prescribe, by rule, as necessary for the Commission to conduct the reviews under paragraph (3).

(5) DISCLOSURES WITH RESPECT TO STRUCTURED SECURITIES.—

(A) REGULATIONS REQUIRED.—The rules and regulations prescribed by the Commission pursuant to this section with respect to nationally recognized statistical rating organizations shall, with respect to the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings for structured securities—

(i) specify the information required to be disclosed to such rating organizations by the sponsor, issuers, and underwriters of such structured securities on the collateral underlying such structured securities; and

(ii) establish and implement procedures to collect and disclose information about the processes used by such sponsor, issuers, and underwriters to assess the accuracy and integrity of their data and fraud detection.

(B) DEFINITION.—For purposes of this paragraph, the Commission shall, by rule or regulation, define the term "structured securities" as appropriate in the public interest and for the protection of investors.

(6) HISTORICAL DEFAULT RATE DISCLOSURES.—The rules and regulations prescribed by the Commission pursuant to this section with respect to nationally recognized statistical rating organizations shall require each nationally recognized statistical rating organization to establish and maintain, on a publicly accessible Internet site, a facility to disclose, in a central database, the historical default rates of all classes of financial products rated by such organization.

(d) CENSURE, *FINE,* DENIAL, OR SUSPENSION OF REGISTRATION; NOTICE AND HEARING.—The Commission, by order, ❚shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any nationally recognized statistical rating organization if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation❚ *shall censure, fine in accordance with section 21B(a), place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any nationally registered statistical rating organization (or with respect to any person who is associated, who is seeking to become associated, or, at the time of the alleged misconduct, who was associated or was seeking to become associated with a nationally recognized statistical rating organization, the Commission, by order,*

shall censure, fine in accordance with section 21B(a), place limitations on the activities or functions of such person, suspend for a period not exceeding 12 months, or bar such person from being associated with a nationally recognized statistical rating organization), if the Commission finds, on the record after notice and opportunity for hearing, that such censure, fine, placing of limitations, bar, suspension, or revocation is necessary for the protection of investors and in the public interest and that such nationally recognized statistical rating organization, or any person associated with such an organization, whether prior to or subsequent to becoming so associated—

(1) * * *

(2) has been convicted during the 10-year period preceding the date on which an application for registration is [furnished to] *filed with* the Commission under this section, or at any time thereafter, of—

(A) * * *

* * * * * * *

(3) is subject to any order of the Commission barring or suspending the right of the person to be associated with a [nationally recognized statistical rating] *nationally registered statistical rating* organization;

(4) fails to [furnish] *file* the certifications required under subsection (b)(2); [or]

(5) fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity[.]*;*

(6) has failed reasonably to supervise another person who commits a violation of the securities laws, the rules or regulations thereunder, or any rules of the Municipal Securities Rulemaking Board if such other person is subject to his or her supervision, except that no person shall be deemed to have failed reasonably to supervise any other person under this paragraph, if—

(A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(B) such person has reasonably discharged the duties and obligations incumbent upon him or her by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with; or

(7) fails to conduct sufficient surveillance to ensure that credit ratings remain current and reliable, as applicable.

(e) TERMINATION OF REGISTRATION.—

[(1) VOLUNTARY WITHDRAWAL.—A nationally recognized statistical rating organization may, upon such terms and conditions as the Commission may establish as necessary in the public interest or for the protection of investors, withdraw from registration by furnishing a written notice of withdrawal to the Commission.

[(2) COMMISSION AUTHORITY.—]In addition to any other authority of the Commission under this title, if the Commission finds that a [nationally recognized statistical rating] *nationally registered statistical rating* organization is no longer in ex-

istence or has ceased to do business as a credit rating agency, the Commission, by order, shall cancel the registration under this section of such [nationally recognized statistical rating] *nationally registered statistical rating* organization.

(f) REPRESENTATIONS.—

(1) BAN ON REPRESENTATIONS OF SPONSORSHIP BY UNITED STATES OR AGENCY THEREOF.—It shall be unlawful for any [nationally recognized statistical rating] *nationally registered statistical rating* organization to represent or imply in any manner whatsoever that such [nationally recognized statistical rating] *nationally registered statistical rating* organization has been designated, sponsored, recommended, or approved, or that the abilities or qualifications thereof have in any respect been passed upon, by the United States or any agency, officer, or employee thereof.

(2) BAN ON REPRESENTATION AS NRSRO OF UNREGISTERED CREDIT RATING AGENCIES.—It shall be unlawful for any credit rating agency that is not registered under this section as a [nationally recognized statistical rating] *nationally registered statistical rating* organization to state that such credit rating agency is a [nationally recognized statistical rating] *nationally registered statistical rating organization registered under this title.*

(3) STATEMENT OF REGISTRATION UNDER SECURITIES EXCHANGE ACT OF 1934 PROVISIONS.—No provision of paragraph (1) shall be construed to prohibit a statement that a [nationally recognized statistical rating] *nationally registered statistical rating* organization is a [nationally recognized statistical rating] *nationally registered statistical rating* organization under this title, if such statement is true in fact and if the effect of such registration is not misrepresented.

(g) PREVENTION OF MISUSE OF NONPUBLIC INFORMATION.—

(1) ORGANIZATION POLICIES AND PROCEDURES.—Each [nationally recognized statistical rating] *nationally registered statistical rating* organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such [nationally recognized statistical rating] *nationally registered statistical rating* organization, to prevent the misuse in violation of this title, or the rules or regulations hereunder, of material, nonpublic information by such [nationally recognized statistical rating] *nationally registered statistical rating* organization or any person associated with such [nationally recognized statistical rating] *nationally registered statistical rating* organization.

* * * * * * *

[(h) MANAGEMENT OF CONFLICTS OF INTEREST.—

[(1) ORGANIZATION POLICIES AND PROCEDURES.—Each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business.

[(2) COMMISSION AUTHORITY.—The Commission shall issue final rules in accordance with subsection (n) to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization, including, without limitation, conflicts of interest relating to—

[(A) the manner in which a nationally recognized statistical rating organization is compensated by the obligor, or any affiliate of the obligor, for issuing credit ratings or providing related services;

[(B) the provision of consulting, advisory, or other services by a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, to the obligor, or any affiliate of the obligor;

[(C) business relationships, ownership interests, or any other financial or personal interests between a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, and the obligor, or any affiliate of the obligor;

[(D) any affiliation of a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, with any person that underwrites the securities or money market instruments that are the subject of a credit rating; and

[(E) any other potential conflict of interest, as the Commission deems necessary or appropriate in the public interest or for the protection of investors.]

(h) CORPORATE GOVERNANCE, ORGANIZATION, AND MANAGEMENT OF CONFLICTS OF INTEREST.—

(1) BOARD OF DIRECTORS.—

(A) IN GENERAL.—Each nationally recognized statistical rating organization or its ultimate holding company shall have a board of directors.

(B) INDEPENDENT DIRECTORS.—At least 1/3 of such board, but no less than 2 of the members of the board of directors, shall be independent directors. In order to be considered independent for purposes of this subsection, a director of a nationally recognized statistical rating organization may not, other than in his or her capacity as a member of the board of directors or any committee thereof—

(i) accept any consulting, advisory, or other compensatory fee from the nationally recognized statistical rating organization; or

(ii) be a person associated with the nationally recognized statistical rating organization or with any affiliated company thereof.

(C) COMPENSATION AND TERM.—The compensation of the independent directors shall not be linked to the business performance of the nationally recognized statistical rating organization and shall be arranged so as to ensure the independence of their judgment. The term of office of the independent directors shall be for a pre-agreed fixed period not exceeding 5 years and shall not be renewable.

(D) DUTIES.—In addition to the overall responsibility of the board of directors, the board shall oversee—

(i) the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings;

(ii) the establishment, maintenance, and enforcement of policies and procedures to address, manage, and disclose any conflicts of interest;

(iii) the effectiveness of the internal control system with respect to policies and procedures for determining credit ratings; and

(iv) the compensation and promotion policies and practices of the nationally recognized statistical rating organization.

(2) ORGANIZATION POLICIES AND PROCEDURES.—Each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of the nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address, manage, and disclose any conflicts of interest that can arise from such business.

(3) COMMISSION RULES.—The Commission shall issue rules to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization, including rules regarding—

(A) conflicts of interest relating to the manner in which a nationally recognized statistical rating organization is compensated by the obligor, or any affiliate of the obligor, for issuing credit ratings or providing related services;

(B) conflicts of interest relating to business relationships, ownership interests, and affiliations of nationally recognized statistical rating organization board members with obligors, or any other financial or personal interests between a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, and the obligor, or any affiliate of the obligor;

(C) conflicts of interest relating to any affiliation of a nationally recognized statistical rating organization, or any person associated with such nationally recognized statistical rating organization, with any person who underwrites securities, money market instruments, or other instruments that are the subject of a credit rating;

(D) a requirement that each nationally recognized statistical rating organization disclose on such organization's website a consolidated report at the end of each fiscal year that shows—

(i) the percent of net revenue earned by the nationally recognized statistical rating organization or an affiliate of a nationally recognized statistical rating organization, or any person associated with a nationally recognized statistical rating organization, to the extent determined appropriate by the Commission, for that fis-

cal year for providing services and products other than credit rating services to each person who paid for a credit rating; and

(ii) the relative standing of each person who paid for a credit rating that was outstanding as of the end of the fiscal year in terms of the amount of net revenue earned by the nationally recognized statistical rating organization attributable to each such person and classified by the highest 5, 10, 25, and 50 percentiles and lowest 50 and 25 percentiles;

(E) the establishment of a system of payment for credit ratings issued by each nationally recognized statistical rating organization that requires that payments are structured in a manner designed to ensure that the nationally recognized statistical rating organization conducts accurate and reliable surveillance of credit ratings over time, as applicable, and that incentives for reliable credit ratings are in place;

(F) a requirement that a nationally recognized statistical rating organization disclose with the publication of a credit rating the type and number of credit ratings it has provided to the person being rated or affiliates of such person, the fees it has billed for the credit rating, and the aggregate amount of net revenue earned by the nationally recognized statistical rating organization in the preceding 2 fiscal years attributable to the person being rated and its affiliates; and

(G) any other potential conflict of interest, as the Commission determines necessary or appropriate in the public interest or for the protection of investors.

(4) LOOK-BACK REQUIREMENT.—

(A) REVIEW BY THE NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION.—Each nationally recognized statistical rating organization shall establish, maintain, and enforce policies and procedures reasonably designed to ensure that, in any case in which an employee of a person subject to a credit rating of the nationally recognized statistical rating organization or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the nationally recognized statistical rating organization was employed by the nationally recognized statistical rating organization and participated in any capacity in determining credit ratings for the person or the securities or money market instruments during the 1-year period preceding the date an action was taken with respect to the credit rating, the nationally recognized statistical rating organization shall—

(i) conduct a review to determine whether any conflicts of interest of the employee influenced the credit rating; and

(ii) take action to revise the rating if appropriate, in accordance with such rules as the Commission shall prescribe.

(B) REVIEW BY COMMISSION.—

(i) IN GENERAL.—The Commission shall conduct periodic reviews of the policies described in subparagraph (A) and the implementation of the policies at each nationally recognized statistical rating organization to ensure they are reasonably designed and implemented to most effectively eliminate conflicts of interest.

(ii) TIMING OF REVIEWS.—The Commission shall review the code of ethics and conflict of interest policy of each nationally recognized statistical rating organization—

(I) not less frequently than annually; and

(II) whenever such policies are materially modified or amended.

(5) REPORT TO COMMISSION ON CERTAIN EMPLOYMENT TRANSITIONS.—

(A) REPORT REQUIRED.—Each nationally recognized statistical rating organization shall report to the Commission any case such organization knows or can reasonably be expected to know where a person associated with such organization within the previous 5 years obtains employment with any obligor, issuer, underwriter, or sponsor of a security or money market instrument for which the organization issued a credit rating during the 12-month period prior to such employment, if such employee—

(i) was a senior officer of such organization;

(ii) participated in any capacity in determining credit ratings for such obligor, issuer, underwriter, or sponsor; or

(iii) supervised an employee described in clause (ii).

(B) PUBLIC DISCLOSURE.—Upon receiving such a report, the Commission shall make such information publicly available.

(i) PROHIBITED CONDUCT.—

(1) PROHIBITED ACTS AND PRACTICES.—The Commission shall issue final rules in accordance with subsection (n) to prohibit any act or practice relating to the issuance of credit ratings by a [nationally recognized statistical rating] *nationally registered statistical rating* organization that the Commission determines to be unfair, coercive, or abusive, including any act or practice relating to—

(A) conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor or an affiliate thereof of other services or products, including pre-credit rating assessment products, of the [nationally recognized statistical rating] *nationally registered statistical rating* organization or any person associated with such [nationally recognized statistical rating] *nationally registered statistical rating* organization;

(B) lowering or threatening to lower a credit rating on, or refusing to rate, securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets within such pool or part of such transaction, as applicable, also is rated by the [nationally

recognized statistical rating] *nationally registered statistical rating* organization; or

(C) modifying or threatening to modify a credit rating or otherwise departing from its adopted systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases or will purchase the credit rating or any other service or product of the [nationally recognized statistical rating] *nationally registered statistical rating* organization or any person associated with such organization.

* * * * * * *

[(j) DESIGNATION OF COMPLIANCE OFFICER.—Each nationally recognized statistical rating organization shall designate an individual responsible for administering the policies and procedures that are required to be established pursuant to subsections (g) and (h), and for ensuring compliance with the securities laws and the rules and regulations thereunder, including those promulgated by the Commission pursuant to this section.]

(j) DESIGNATION OF COMPLIANCE OFFICER.—

(1) IN GENERAL.—Each nationally recognized statistical rating organization shall designate an individual to serve as a compliance officer.

(2) DUTIES.—The compliance officer shall—

(A) report directly to the board of the nationally recognized statistical rating organization;

(B) review compliance with policies and procedures to manage conflicts of interest and assess the risk that the compliance (or lack of such compliance) may compromise the integrity of the credit rating process;

(C) review compliance with the internal control system with respect to the procedures and methodologies for determining credit ratings, including quantitative methodologies and quantitative inputs used in the rating process, and assess the risk that such internal control system is reasonably designed to ensure the integrity and quality of the credit rating process;

(D) in consultation with the board of the nationally recognized statistical rating organization, resolve any conflicts of interest that may arise;

(E) be responsible for administering the policies and procedures required to be established pursuant to this section;

(F) ensure compliance with securities laws and the rules and regulations issued thereunder, including rules prescribed by the Commission pursuant to this section; and

(G) establish procedures—

(i) for the receipt, retention, and treatment of complaints regarding credit ratings, models, methodologies, and compliance with the securities laws and the policies and procedures required under this section;

(ii) for the receipt, retention, and treatment of confidential, anonymous complaints by employees, obligors, issuers, and investors;

(iii) for the remediation of non-compliance issues found during compliance office reviews, the reviews required under paragraph (7), internal or external audit

findings, self-reported errors, or through validated complaints; and

(iv) designed so that ratings that the nationally recognized statistical rating organization disseminates reflect consideration of all information in a manner generally consistent with the nationally recognized statistical rating organization's published rating methodology, including information which is provided, received, or otherwise obtained from obligor, issuer and non-issuer sources, such as investors, the media, and other interested or informed parties.

(3) LIMITATIONS.—The compliance officer shall not, while serving in that capacity—

(A) determine credit ratings;

(B) participate in the establishment of the procedures and methodologies or the qualitative methodologies and quantitative inputs used to determine credit ratings;

(C) perform marketing or sales functions; or

(D) participate in establishing compensation levels, other than for employees working for the compliance officer.

(4) ANNUAL REPORTS REQUIRED.—The compliance officer shall annually prepare and sign a report on the compliance of the nationally recognized statistical rating organization with the securities laws and such organization's internal policies and procedures, including its code of ethics and conflict of interest policies, in accordance with rules prescribed by the Commission. Such compliance report shall accompany the financial reports of the nationally recognized statistical rating organization that are required to be filed with the Commission pursuant to this section and shall include a certification that, under penalty of law, the report is accurate and complete.

(5) COMPENSATION.—The compensation of the compliance officer shall not be linked to the business performance of the nationally recognized statistical rating organization and shall be arranged so as to ensure the independence of the officer's judgment.

(k) STATEMENTS OF FINANCIAL CONDITION.—**[**Each nationally recognized statistical rating**]**

(1) IN GENERAL.—Each nationally registered statistical rating organization shall**[**, on a confidential basis, furnish to**]** *file with* the Commission, at intervals determined by the Commission, such financial statements, certified (if required by the rules or regulations of the Commission) by an independent public accountant, and information concerning its financial condition, as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(2) EXCEPTION.—The Commission may treat as confidential any information provided by a nationally recognized statistical rating organization under this section consistent with applicable Federal laws or Commission rules.

(l) SOLE METHOD OF REGISTRATION.—

(1) IN GENERAL.—On and after the effective date of this section, a credit rating agency may only be registered as a **[**nationally recognized statistical rating**]** *nationally registered sta-*

tistical rating organization for any purpose in accordance with this section.

(2) PROHIBITION ON RELIANCE ON NO-ACTION RELIEF.—On and after the effective date of this section—

(A) an entity that, before that date, received advice, approval, or a no-action letter from the Commission or staff thereof to be treated as a [nationally recognized statistical rating] *nationally registered statistical rating* organization pursuant to the Commission rule at section 240.15c3–1 of title 17, Code of Federal Regulations, may represent itself or act as a [nationally recognized statistical rating] *nationally registered statistical rating* organization only—

(i) during Commission consideration of the application, if such entity has [furnished] *filed* an application for registration under this section; and

* * * * * * *

(3) NOTICE TO OTHER AGENCIES.—Not later than 30 days after the date of enactment of this section, the Commission shall give notice of the actions undertaken pursuant to this section to each Federal agency which employs in its rules and regulations the term "[nationally recognized statistical rating] *nationally registered statistical rating* organization" (as that term is used under Commission rule 15c3–1 (17 C.F.R. 240.15c3–1), as in effect on the date of enactment of this section).

[(m) RULES OF CONSTRUCTION.—

[(1) NO WAIVER OF RIGHTS, PRIVILEGES, OR DEFENSES.—Registration under and compliance with this section does not constitute a waiver of, or otherwise diminish, any right, privilege, or defense that a nationally recognized statistical rating organization may otherwise have under any provision of State or Federal law, including any rule, regulation, or order thereunder.

[(2) NO PRIVATE RIGHT OF ACTION.—Nothing in this section may be construed as creating any private right of action, and no report furnished by a nationally recognized statistical rating organization in accordance with this section or section 17 shall create a private right of action under section 18 or any other provision of law.]

(m) APPLICATION OF ENFORCEMENT PROVISIONS; PLEADING STANDARD IN PRIVATE RIGHTS OF ACTION.—Statements made by nationally recognized statistical rating organizations shall not be deemed forward looking statements for purposes of section 21E. In any private right of action commenced against a nationally recognized statistical rating organization under this title, the same pleading standards with respect to knowledge and recklessness shall apply to the nationally recognized statistical rating organization as would apply to any other person in the same or a similar private right of action against such person.

(n) REGULATIONS.—

(1) * * *

(2) REVIEW OF EXISTING REGULATIONS.—Not later than 270 days after the date of enactment of this section, the Commission shall—

(A) review its existing rules and regulations which employ the term "[nationally recognized statistical rating] *nationally registered statistical rating* organization" or "NRSRO"; and

* * * * * * *

(o) NRSROs SUBJECT TO COMMISSION AUTHORITY.—

(1) IN GENERAL.—No provision of the laws of any State or political subdivision thereof requiring the registration, licensing, or qualification as a credit rating agency or a [nationally recognized statistical rating] *nationally registered statistical rating* organization shall apply to any [nationally recognized statistical rating] *nationally registered statistical rating* organization or person employed by or working under the control of a [nationally recognized statistical rating] *nationally registered statistical rating* organization.

(2) LIMITATION.—Nothing in this subsection prohibits the securities commission (or any agency or office performing like functions) of any State from investigating and bringing an enforcement action with respect to fraud or deceit against any [nationally recognized statistical rating] *nationally registered statistical rating* organization or person associated with a [nationally recognized statistical rating] *nationally registered statistical rating* organization.

[(p) APPLICABILITY.—This section, other than subsection (n), which shall apply on the date of enactment of this section, shall apply on the earlier of—

[(1) the date on which regulations are issued in final form under subsection (n)(1); or

[(2) 270 days after the date of enactment of this section.]

(p) ESTABLISHMENT OF SEC OFFICE.—

(1) IN GENERAL.—The Commission shall establish an office that administers the rules of the Commission with respect to the practices of nationally recognized statistical rating organizations.

(2) STAFFING.—The office of the Commission established under this subsection shall be staffed sufficiently to carry out fully the requirements of this section.

(3) RULEMAKING AUTHORITY.—The Commission shall—

(A) establish, by rule, fines and other penalties for any nationally recognized statistical rating organization that violates the applicable requirements of this title; and

(B) issue such rules as may be necessary to carry out this section with respect to nationally recognized statistical rating organizations.

(q) TRANSPARENCY OF RATINGS PERFORMANCE.—

(1) RULEMAKING REQUIRED.—The Commission shall, by rule, require each nationally recognized statistical rating organization to publicly disclose information on initial ratings and subsequent changes to such ratings for the purpose of providing a gauge of the performance of ratings and allowing investors to compare performance of ratings by different nationally recognized statistical rating organizations.

(2) CONTENT.—The rules of the Commission under this subsection shall require, at a minimum, disclosures that—

(A) are comparable among nationally recognized statistical rating organizations, so that investors can compare rating performance across rating organizations;

(B) are clear and informative for a wide range of investor sophistication;

(C) include performance information over a range of years and for a variety of classes of credit ratings, as determined by the Commission;

(D) are published and made freely available by the nationally recognized statistical rating organization, on an easily accessible portion of its website and in written form when requested by investors; and

(E) each nationally recognized statistical rating organization include an attestation with any credit rating it issues affirming that no part of the rating was influenced by any other business activities, that the rating was based solely on the merits of the instruments being rated, and that such rating was an independent evaluation of the risks and merits of the instrument.

(r) CREDIT RATINGS METHODOLOGIES.—

(1) IN GENERAL.—The Commission shall prescribe rules, in the public interest and for the protection of investors, that require each nationally recognized statistical rating organization to establish, maintain, and enforce written procedures and methodologies and an internal control system with respect to such procedures and methodologies that are reasonably designed to—

(A) ensure that credit ratings are determined using procedures and methodologies, including qualitative methodologies and quantitative inputs that are determined in accordance with the policies and procedures of the nationally recognized statistical rating organization for developing and modifying credit rating procedures and methodologies;

(B) ensure that when major changes to credit rating procedures and methodologies, including to qualitative methodologies and quantitative inputs, are made, that the changes are applied consistently to all credit ratings to which the changed procedures and methodologies apply and, to the extent the changes are made to credit rating surveillance procedures and methodologies, they are applied to current credit ratings within a time period to be determined by the Commission by rule, and that the reason for the change is publicly disclosed;

(C) notify persons who have access to the credit ratings of the nationally recognized statistical rating organization, regardless of whether they are made readily accessible for free or a reasonable fee, of the procedure or methodology, including qualitative methodologies and quantitative inputs, used with respect to a particular credit rating;

(D) notify persons who have access to the credit ratings of the nationally recognized statistical rating organization, regardless of whether they are made readily accessible for free or a reasonable fee, when a change is made to a procedure or methodology, including to qualitative methodologies and quantitative inputs, or an error is identified in a

procedure or methodology that may result in credit rating actions, and the likelihood of the change resulting in current credit ratings being subject to rating actions; and

(E) use credit rating symbols that distinguish credit ratings for structured products from credit ratings for other products that the Commission determines appropriate or necessary in the public interest and for the protection of investors.

(2) RATING CLARITY AND CONSISTENCY.—

(A) COMMISSION OBLIGATION.—Subject to subparagraphs (B) and (C), the Commission shall require, by rule, each nationally recognized statistical rating organization to establish, maintain, and enforce written policies and procedures reasonably designed—

(i) with respect to credit ratings of securities and money market instruments, to assess the risk that investors in securities and money market instruments may not receive payment in accordance with the terms of such securities and instruments;

(ii) to define clearly any credit rating symbol used by that organization; and

(iii) to apply such credit rating symbol in a consistent manner for all types of securities and money market instruments.

(B) ADDITIONAL CREDIT FACTORS.—Nothing in subparagraph (A)—

(i) prohibits a nationally recognized statistical rating organization from using additional credit factors that are documented and disclosed by the organization and that have a demonstrated impact on the risk an investor in a security or money market instrument will not receive repayment in accordance with the terms of issuance;

(ii) prohibits a nationally recognized statistical rating organization from considering credit factors that are unique to municipal securities; or

(iii) prohibits a nationally recognized statistical rating organization from using an additional symbol with respect to the ratings described in subparagraph (A)(i) for the purpose of distinguishing the ratings of a certain type of security or money market instrument from ratings of any other types of securities or money market instruments.

(C) COMPLEMENTARY RATINGS.—The Commission shall not impose any requirement under subparagraph (A) that prevents nationally recognized statistical rating organizations from establishing ratings that are complementary to the ratings described in subparagraph (A)(i) and that are created to measure a discrete aspect of the security's or instrument's risk.

(s) TRANSPARENCY OF CREDIT RATING METHODOLOGIES AND INFORMATION REVIEWED.—

(1) IN GENERAL.—The Commission shall require, by rule, a nationally recognized statistical rating organization to include with the publication of each credit rating regardless of whether

the credit rating is made readily accessible for free or a reasonable fee a form that discloses information about the assumptions underlying the procedures and methodologies used, and the data relied on, to determine the credit rating in the format prescribed in paragraph (2) and containing the information described in paragraph (3).

(2) FORMAT.—The Commission shall prescribe a form for use under paragraph (1) that—

(A) is designed in a user-friendly and helpful manner for investors to understand the information contained in the report;

(B) requires the nationally recognized statistical rating organization to provide the content, as required by paragraph (3), in a manner that is directly comparable across securities; and

(C) the nationally recognized statistical rating organization certifies the information on the form as true and accurate.

(3) CONTENT.—The Commission shall prescribe a form that requires a nationally recognized statistical rating organization to disclose—

(A) the main assumptions included in constructing procedures and methodologies, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating certain structured products;

(B) the potential shortcomings of the credit ratings, and the types of risks not measured in the credit ratings that the nationally recognized statistical rating organization is not commenting on, such as liquidity, market, and other risks;

(C) information on the certainty of the rating, including information on the reliability, accuracy, and quality of the data relied on in determining the ultimate credit rating and a statement on the extent to which key data inputs for the credit rating were reliable or limited, including any limits on the reach of historical data, limits in accessibility to certain documents or other forms of information that would have better informed the credit rating, and the completeness of certain information considered;

(D) whether and to what extent third party due diligence services have been utilized, and a description of the information that such third party reviewed in conducting due diligence services;

(E) a description of relevant data about any obligor, issuer, security, or money market instrument that was used and relied on for the purpose of determining the credit rating;

(F) a statement containing an overall assessment of the quality of information available and considered in producing a credit rating for a security in relation to the quality of information available to the nationally recognized statistical rating organization in rating similar obligors, securities, or money market instruments;

(G) an explanation or measure of the potential volatility for the credit rating, including any factors that might lead to a change in the credit rating, and the extent of the change that might be anticipated under different conditions;

(H) information on the content of the credit rating, including—

(i) the expected default probability; and

(ii) the loss given default;

(I) information on the sensitivity of the rating to assumptions made by the nationally recognized statistical rating organization, including—

(i) 5 assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if such assumptions were proven false or inaccurate; and

(ii) an analysis, using concrete examples, on how each of the 5 assumptions identified under clause (i) impacts a rating.

(J) where applicable, how the nationally recognized statistical rating organization used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating; and

(K) such additional information as may be required by the Commission.

(4) DUE DILIGENCE SERVICES.—

(A) CERTIFICATION REQUIRED.—In any case in which third-party due diligence services are employed by a nationally recognized statistical rating organization or an issuer, underwriter, or sponsor in connection with the issuance of a credit rating, the firm providing the due diligence services shall provide to the nationally recognized statistical rating organization written certification of such due diligence, which shall be subject to review by the Commission, and the issuer, underwriter, or sponsor shall provide any reports issued by the provider of such due diligence services to the nationally recognized statistical rating organization.

(B) FORMAT AND CONTENT.—The Commission shall establish the appropriate format and content for written certifications required under subparagraph (A) to ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary for the nationally recognized statistical rating organization to provide an reliable rating.

(C) DISCLOSURE OF CERTIFICATION.—The Commission shall adopt rules requiring a nationally recognized statistical rating organization to disclose to persons who have access to the credit ratings of the nationally recognized statistical rating organization regardless of whether they are made readily accessible for free or a reasonable fee the certification described in subparagraph (A) with the publication of the applicable credit rating in a manner that may permit the persons to determine the adequacy and level of due diligence services provided by the third party.

(t) PROHIBITED ACTIVITIES.—Beginning 180 days from the date of enactment of the Accountability, Reliability, and Transparency in Rating Agencies Act, it shall be unlawful for a nationally recognized statistical rating organization, or an affiliate of a nationally recognized statistical rating organization, or any person associated with a nationally recognized statistical rating organization, that provides a credit rating for an issuer, underwriter, or placement agent of a security to provide any non-rating service, including—

(1) risk management advisory services;

(2) advice or consultation relating to any merger, sales, or disposition of assets of the issuer;

(3) ancillary assistance, advice, or consulting services unrelated to any specific credit rating issuance; and

(4) such further activities or services as the Commission may determine as necessary or appropriate in the public interest or for the protection of investors.

* * * * * * *

ACCOUNTS AND RECORDS, EXAMINATIONS OF EXCHANGES, MEMBERS, AND OTHERS

SEC. 17. (a)(1) Every national securities exchange, member thereof, broker or dealer who transacts a business in securities through the medium of any such member, registered securities association, registered broker or dealer, registered municipal securities dealer, registered securities information processor, registered transfer agent, [nationally recognized statistical rating] *nationally registered statistical rating* organization, and registered clearing agency and the Municipal Securities Rulemaking Board shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title. Any report that a [nationally recognized statistical rating] *nationally registered statistical rating* organization is required by Commission rules under this paragraph to make and disseminate to the Commission shall be deemed furnished to the Commission.

* * * * * * *

SEC. 21D. PRIVATE SECURITIES LITIGATION.

(a) * * *

(b) REQUIREMENTS FOR SECURITIES FRAUD ACTIONS.—

(1) * * *

(2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind*, and in the case of an action brought under this title for money damages against a nationally recognized statistical rating organization, it shall be sufficient for purposes of pleading any required state of mind for purposes of such action that the complaint shall state with par-*

ticularity facts giving rise to a strong inference that the nationally registered statistical rating organization knowingly or recklessly violated the securities laws..

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FEDERAL DEPOSIT INSURANCE ACT

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SEC. 7. (a) * * *

(b) ASSESSMENTS.—

(1) RISK-BASED ASSESSMENT SYSTEM.—

(A) * * *

* * * * * * *

(E) INFORMATION CONCERNING RISK OF LOSS AND ECONOMIC CONDITIONS.—

(i) SOURCES OF INFORMATION.—For purposes of determining risk of losses at insured depository institutions and economic conditions generally affecting depository institutions, the Corporation shall collect information, as appropriate, from all sources the Board of Directors considers appropriate, such as reports of condition, inspection reports, and other information from all Federal banking agencies, any information available from State bank supervisors, State insurance and securities regulators, the Securities and Exchange Commission (including information described in section 35), the Secretary of the Treasury, the Commodity Futures Trading Commission, the Farm Credit Administration, the Federal Trade Commission, any Federal reserve bank or Federal home loan bank, and other regulators of financial institutions, and any information available from [credit rating entities, and other private economic] *private economic, credit,* or business analysts.

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SEC. 28. ACTIVITIES OF SAVINGS ASSOCIATIONS.

(a) * * *

* * * * * * *

(d) CORPORATE DEBT SECURITIES [NOT OF INVESTMENT GRADE].—

(1) IN GENERAL.—No savings association may, directly or through a subsidiary, acquire or retain any corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness as established by the Corporation*.

(2) EXCEPTION FOR SECURITIES HELD BY QUALIFIED AFFILIATE.—Paragraph (1) shall not apply with respect to any corporate debt security [not of investment grade] which is acquired and retained by any qualified affiliate of a savings association.

[(3) TRANSITION RULE.—

[(A) IN GENERAL.—The Corporation shall require any savings association or any subsidiary of any savings association to divest any corporate debt security not of investment grade the retention of which is not permissible under paragraph (1) as quickly as can be prudently done, and in any event not later than July 1, 1994.

[(B) TREATMENT OF NONCOMPLIANCE DURING DIVESTMENT.—With respect to any corporate debt security not of investment grade held by any savings association or subsidiary on the date of enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, the savings association or subsidiary shall be deemed not to be in violation of the prohibition in paragraph (1) on retaining such investment so long as the association or subsidiary complies with any applicable requirement established by the Corporation pursuant to subparagraph (A) for divesting such securities.]

[(4)] *(3)* DEFINITIONS.—For purposes of this section—

[(A) INVESTMENT GRADE.—Any corporate debt security is not of "investment grade" unless that security, when acquired by the savings association or subsidiary, was rated in one of the 4 highest rating categories by at least one nationally recognized statistical rating organization.]

[(B)] *(A)* QUALIFIED AFFILIATE.—The term "qualified affiliate" means—

(i) * * *

* * * * * * *

[(C)] *(B)* CERTAIN SECURITIES NOT INCLUDED.—The term "corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness as established by the Corporation*" does not include any obligation issued or guaranteed by a corporation that may be held by a Federal savings association without limitation as to percentage of assets under subparagraph (D), (E), or (F) of section 5(c)(1) of the Home Owners' Loan Act.

(e) TRANSFER OF CORPORATE DEBT SECURITY [NOT OF INVESTMENT GRADE] IN EXCHANGE FOR A QUALIFIED NOTE.—

(1) ACQUISITION OF NOTE.—Notwithstanding subsections (a), (b), and (c) of section 5 of the Home Owners' Loan Act and any other provision of Federal or State law governing extensions of credit by savings associations, any insured savings association, and any subsidiary of any insured savings association, that, on the date of the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, holds any corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness as established by the Corporation* may acquire a qualified note in exchange for the transfer of such security to—

(A) * * *

* * * * * * *

if the conditions of paragraph (2) are met.

(2) CONDITIONS FOR EXCHANGE OF SECURITY FOR QUALIFIED NOTE.—The conditions of this paragraph are met if—

(A) * * *

(B) the company to which the corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness established by the Corporation* is transferred is not a bank holding company, an insured savings association, or a direct or indirect subsidiary of such holding company or insured savings association;

(C) before the end of the 90-day period beginning on the date of the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, the insured savings association notifies the Director of the Office of Thrift Supervision of such association's intention to transfer the corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness established by the Corporation* to the savings and loan holding company or the subsidiary of such holding company;

(D) the transfer of the corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness established by the Corporation* is completed—

(i) * * *

* * * * * * *

(E) the insured savings association receives in exchange for the corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness established by the Corporation* the fair market value of such security;

(F) the Director of the Office of Thrift Supervision has—

(i) * * *

(ii) determined that the transfer represents a complete and effective divestiture of the corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness established by the Corporation* and is in compliance with the provisions of this subsection; and

(G) any gain on the sale of the corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness established by the Corporation* is recognized, and included for applicable regulatory capital requirements, by the insured savings association only at such time and to the extent that the insured savings association receives payment of principal on the note in cash in excess of the fair market value of the transferred corporate debt security not of investment grade as carried on the accounts of the insured savings association immediately prior to the transfer.

(3) QUALIFIED NOTE DEFINED.—The term "qualified note" means any note that—

(A) is at all times fully secured by the corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness established by the Corporation* transferred in exchange for the note, or by other collateral of at least equivalent value that is acceptable to the Director of the Office of Thrift Supervision;

(B) contains provisions acceptable to the Director of the Office of Thrift Supervision that would—

(i) * * *

(ii) allow the sale of the corporate debt security [not of investment grade] *that does not meet standards of credit-worthiness established by the Corporation* if the proceeds of the sale are reinvested in assets of equivalent value;

* * * * * * *

FEDERAL HOUSING ENTERPRISES FINANCIAL SAFETY AND SOUNDNESS ACT OF 1992

TITLE XIII—GOVERNMENT SPONSORED ENTERPRISES

* * * * * * *

Subtitle A—Supervision and Regulation of Enterprises

PART 1—FINANCIAL SAFETY AND SOUNDNESS REGULATOR

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SEC. 1319. AUTHORITY TO PROVIDE FOR REVIEW OF REGULATED ENTITIES.

The Director may, on such terms and conditions as the Director deems appropriate, contract with any entity [that is a nationally recognized statistical rating organization, as such term is defined in section 3(a) of the Securities Exchange Act of 1934,] to conduct a review of the regulated entities.

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INVESTMENT COMPANY ACT OF 1940

TITLE I—INVESTMENT COMPANIES

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EXEMPTIONS

SEC. 6. (a) The following investment companies are exempt from the provisions of this title:

(1) * * *

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(5)(A) Any company that is not engaged in the business of issuing redeemable securities, the operations of which are subject to regulation by the State in which the company is organized under a statute governing entities that provide financial or managerial assistance to enterprises doing business, or proposing to do business, in that State if—

(i) * * *

* * * * * * *

(iv) the company does not purchase any security issued by an investment company or by any company that would be an investment company except for the exclusions from the definition of the term "investment company" under paragraph (1) or (7) of section 3(c), other than—

(I) any debt security that [is rated investment grade by not less than 1 nationally recognized statistical rating organization] *meets such standards of credit-worthiness that the Commission shall adopt*; or

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SECTION 5136A OF TITLE LXII OF THE REVISED STATUTES OF THE UNITED STATES

SEC. 5136A. FINANCIAL SUBSIDIARIES OF NATIONAL BANKS.

(a) AUTHORIZATION TO CONDUCT IN SUBSIDIARIES CERTAIN ACTIVITIES THAT ARE FINANCIAL IN NATURE.—

(1) * * *

(2) CONDITIONS AND REQUIREMENTS.—A national bank may control a financial subsidiary, or hold an interest in a financial subsidiary, only if—

(A) * * *

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(E) except as provided in paragraph (4), the national bank meets [any applicable rating] *standards of credit-worthiness established by the Comptroller of the Currency* or other requirement set forth in paragraph (3); and

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(3) [RATING OR COMPARABLE REQUIREMENT] *REQUIREMENT.*—

[(A) IN GENERAL.—A national bank meets the requirements of this paragraph if—

[(i) the bank is 1 of the 50 largest insured banks and has not fewer than 1 issue of outstanding eligible debt that is currently rated within the 3 highest investment grade rating categories by a nationally recognized statistical rating organization; or

[(ii) the bank is 1 of the second 50 largest insured banks and meets the criteria set forth in clause (i) or such other criteria as the Secretary of the Treasury and the Board of Governors of the Federal Reserve System may jointly establish by regulation and determine to be comparable to and consistent with the purposes of the rating required in clause (i).]

(A) IN GENERAL.—A national bank meets the requirements of this paragraph if the bank is one of the 100 largest insured banks and has not fewer than 1 issue of outstanding debt that meets standards of credit-worthiness or other criteria as the Secretary of the Treasury and the

Board of Governors of the Federal Reserve System may jointly establish.

* * * * * * *

(f) FAILURE TO [MAINTAIN PUBLIC RATING OR] *MEET STANDARDS OF CREDIT-WORTHINESS OR* MEET APPLICABLE CRITERIA.—

(1) IN GENERAL.—A national bank that does not continue to meet [any applicable rating] *standards of credit-worthiness established by the Comptroller of the Currency* or other requirement of subsection (a)(2)(E) after acquiring or establishing a financial subsidiary shall not, directly or through a subsidiary, purchase or acquire any additional equity capital of any financial subsidiary until the bank meets such requirements.

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ACT OF OCTOBER 1, 1988

(H.R. 4645, as ordered reported from the Committee on Banking, Finance and Urban Affairs on September 22, 1988, and enacted into law by section 555 of Public Law 100–461)

An Act Providing for participation by the United States in a capital stock increase ot the International Bank for Reconstruction and Development and a replenishment of the African Development Fund, and for other purposes.

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SEC. 3. POLICY BASED LENDING FOR DEBT REDUCTION.

(a) CRITERIA.—The Secretary of the Treasury shall instruct the United States Executive Director of the International Bank for Reconstruction and Development to initiate discussions with other directors of such bank and to advocate and support the facilitation of voluntary market-based programs for the reduction of sovereign debt and the promotion of sustainable economic development, which, if implemented, would—

(1) * * *

* * * * * * *

(6) involve such bank in lending for purposes of debt reduction and conversion only where such involvement would not lower the credit [rating] *-worthiness* of such bank;

* * * * * * *

ADDITIONAL VIEWS

The recent global financial crisis exposed serious deficiencies in the performance of the Nationally Recognized Statistical Ratings Organizations (NRSROs). As a result, for the second time this decade, the Financial Services Committee has favorably reported legislation to the House that will significantly reform the credit rating agency industry.

Credit ratings—which are assessments of the risk that a specific debt instrument will default—should be one component of an investor's analysis in deciding whether to buy that debt instrument for their portfolio, however, these ratings should not be the *only* component of the analysis. Investors must be incentivized to perform their own due diligence and risk assessments rather than placing blind faith in the ratings assigned by the NRSROs. H.R. 3890, the Accountability and Transparency in Rating Agencies Act, appropriately subjects rating agencies to enhanced scrutiny as a way of promoting greater transparency and accountability to the capital markets.

Committee Republicans believe that the blind reliance on ratings supplied by the major credit rating agencies undermines market discipline and discourages investor due diligence. Chairman Frank joined an amendment offered by Representatives Garrett and Bachus during the markup of H.R. 3890 that would (1) remove references to ratings from Federal statutes within the jurisdiction of the Financial Services Committee, (2) direct the Federal financial regulatory agencies within the Committee's jurisdiction to remove references to ratings from Federal regulations and (3) have the GAO study the use of ratings by all other Federal agencies and report to Congress within one year on the need for modifications. This amendment promotes independent investor analysis, removes the government "Good Housekeeping" seal of approval, increases competition among rating agencies and lessens the reliance on ratings by investors.

While H.R. 3890 includes many constructive reforms, Committee Republicans have significant concerns regarding the adoption of an amendment offered by Representative Kilroy during the markup that would create a new standard of liability for NRSROs by repealing Securities and Exchange Commission Rule 436(g). Rule 436(g) currently exempts NRSROs from liability under sections 7 and 11 of the Securities Act of 1933, which govern security registration statements and create civil penalties for inclusion of false information within such statements. By repealing this exemption, the amendment would subject NRSROs to unlimited potential civil litigation. The inclusion of the Kilroy amendment presents a significant barrier to continued Republican support for the legislation if it is not amended or removed from the bill prior to being considered by the House.

Furthermore, a repeal of Rule 436(g) would likely result in the removal of ratings from offering statements, as well as more homogenized ratings among the various NRSROs. Homogenized ratings would mean a narrower range of opinions being available to the market—precisely the opposite of what investors need to properly use ratings in their investment evaluations. Repealing Rule 436(g) also raises Constitutional concerns. According to federal precedent governing opinions protected by the First Amendment, credit rating agencies are subject to liability for their ratings if they issue false statements knowingly or recklessly, but not for mere negligence. By eliminating the protection offered by Rule 436(g), the Kilroy amendment would subject NRSROs to liability for mere negligence—a consequence that Committee Republicans reject.

Additionally, an amendment offered and withdrawn by Representative Sherman during the markup would also give Committee Republicans significant concern if the Majority attempts to add this troubling provision to the legislation as the process moves forward. The amendment would require NRSROs, when contracting to provide a credit rating, to extend a "duty of care" to investors in the debt instrument they are rating. Imposition of this new and undefined "duty of care" would have a chilling effect on the ratings industry to the detriment of investors. The amendment also would not provide NRSROs with any notice as to the number of parties that may make a claim against them. This proposal has the potential to expose NRSROs to unknown civil liability and a virtually unlimited number of claims. The Sherman amendment may increase the cost of capital for issuers of debt securities, prompt current NRSROs to leave the business, and discourage new entrants, in contravention of one of the central goals of the 2006 Credit Rating Agency Reform Act. Committee Republicans strongly oppose inclusion of the Sherman amendment in the final version of this legislation.

Credit rating agency reform should not be treated as an opportunity to create new, burdensome, and costly liability standards that result in a windfall for the trial bar while doing little to benefit investors. Regulation by litigation is not reform. Instead, reforms should reduce or eliminate barriers to entry by new market participants, provide the SEC with the regulatory authority it requires to effectively examine and discipline NRSROs, require rating agencies to disclose all relevant information used to create the rating, and ensure that the Federal government does not place a stamp of approval on the rating agencies' work product that undermines market discipline. A bill that achieves those objectives without promoting needless litigation will enjoy our support on the House floor.

SPENCER BACHUS.
RANDY NEUGEBAUER.
ADAM H. PUTNAM.
JUDY BIGGERT.

DISSENTING VIEWS

We agree that the credit rating agencies and the ratings process are in need of significant reform. The thrust of this reform should center on three key elements: (1) Reducing investor reliance on ratings; (2) Encouraging investor due diligence; and (3) Increasing competition between credit rating agencies. While H.R. 3890, the *Accountability and Transparency in Rating Agencies Act,* makes some significant steps in that regard, it unfortunately includes several provisions that will exacerbate the current problems within the industry and make it more difficult for investors to receive useful information.

Frank-Garrett-Bachus NRSRO Reference Removal Amendment

One specific provision we fully support and believe will accomplish the two objectives laid out above is an amendment by Chairman Frank, Rep. Scott Garrett and Ranking Member Spencer Bachus added during the Committee consideration of the bill that will remove all Nationally Recognized Statistical Rating Organization (NRSRO) references from all statutes under the committee's jurisdiction. The amendment also directs the regulators to review all of the regulations under their purview and remove those designations as well.

Credit ratings are only one piece of the puzzle in determining creditworthiness. Investors must be encouraged to do their proper due diligence in evaluating issuer credit quality. By removing the NRSRO reference from statute and regulation, we further delink the government from the rating and reduce the investor perception that the government endorses the rating. We believe this amendment is a significant step forward and one that will lead to a more constructive ratings process in the future.

Section 15E(m) of the Securities Exchange Act of 1934 (15 U.S.C. 780–7(m))

As reported by the Committee, this section of the bill would repeal two important provisions of the Credit Rating Agency Reform Act of 2006 that ensure there is no waiver of rights for credit rating agencies seeking designation as a nationally registered statistical rating organization. These provisions do not make NRSROs immune from private suit, nor do they create any new defenses. Repeal of these recently enacted provisions may well have an unintended consequence that may prove detrimental to the markets and investors. Repeal of current section (m) will likely lead to fewer credit rating agencies participating or remaining as NRSROs, thus reducing competition and depriving investors of greater choice in the ratings opinions they use.

Section 9, Effect of Rule 436(g)

Section 9 of the Act repeals SEC Rule 436(g), which encourages the disclosure of ratings by providing NRSROs with an exemption from liability under Section 7 and Section 11 of the Securities Act of 1933 when their ratings are included as part of the registration statements filed under that Act. Without the exemption, issuers would have to obtain the consent of an NRSRO before including those ratings. Obtaining such consent could increase dramatically the time and cost involved with raising capital, and thus make it more difficult for issuers to do so. Moreover, some NRSROs may refuse consent, with the result being less information available to investors as they evaluate securities in a registration statement. Alternatively, NRSROs might scale back the scope of their coverage, with the most profound impact felt by newer and smaller issuers, including those in emerging sectors critical to the future growth of our markets and economy.

The reasoning behind Rule 436(g)—to encourage greater availability of NRSRO rating opinions—is as sound today as it was when first adopted in 1982 and as beneficial to investors who want and need as much information as possible regarding a security offering. Moreover, many market participants who commented on the rule at the time the rule was proposed were concerned that requiring consent and subjecting NRSROs to Section 11 liability could affect their independence, and thus the quality of their ratings, by making them more active "participants" in the offering. In addition, expanding the potential for litigation against NRSROs would create incentives for NRSROs to narrow the scope of their rating analysis in order, again, to minimize the areas for liability based on after-the-fact second-guessing.

Ratings would thus become more backward-looking and, as a consequence, less geared towards their primary purpose: an assessment of likely credit quality on a going forward basis. Finally, as noted by the SEC when it proposed the Rule, NRSROs remain subject to liability under the antifraud provisions of the securities laws. NRSROs are also subject to regulation by the Commission under the Credit Rating Agency Reform Act of 2006. These accountability measures—and others to which NRSROs are currently subject, or would be subject under other provisions of H.R. 3890—serve to provide investors with necessary, substantive protections. Increased liability would discourage new entrants into the ratings industry, thus undermining the important goal of increasing competition.

Conclusion

In the aftermath of the financial crisis, we must ensure that we put in place a framework of rating debt and equities that reduces investor reliance on ratings, encourages investor due diligence, and increases competition between credit rating agencies. Because of the changes in liability and the opposite effect those changes will have on our stated goals as well as the negative consequences the provisions will have on investors and the marketplace, we are unable to support the legislation in its current form.

SCOTT GARRETT.

ERIK PAULSEN.
ED ROYCE.
JEB HENSARLING.
RANDY NEUGEBAUER.
RON PAUL.

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