

Impacts of Financial Regulatory Reform – Credit Rating Process
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FEI Summary

While many of the provisions of the Dodd-Frank Act (HR 4173) will not take effect immediately, companies should be preparing now to understand potential impacts from the legislation.

Many companies that work with rating agencies on a regular basis may start to notice differences in their working relationship. The credit rating reforms in the bill will start to take effect over the next few months and years, and the Securities Exchange Commission (SEC) will be tasked with writing the rules, which will govern the implementation of this new law. The following are some potential impacts of the legislation.

Rating Agencies Data No Longer Exempt From Regulation FD

The law requires rating agencies to comply with 'Regulation FD' and disclose any material, non-public information received from issuers during the ratings process. When it comes to companies sharing information, this provision could affect the quality of information rating agencies would be able to gather through the ratings evaluation process without first entering into a separate confidentiality agreement. This will take effect within 90 days.

Additionally, the new law requires a number of statutory references to credit rating agencies be deleted in order to reduce the public's reliance on the ratings.

The SEC will Open an Office of Credit Ratings

The office will promote accuracy in credit ratings and protect the users of ratings information as well as implement measures to limit potential conflicts of interest. The office will also conduct an annual review of all nationally recognized statistical rating organizations which will cover ethics, internal controls governance and evaluate complaints.

Rating Agencies Must Disclose All Initial Ratings Data Offered To Issuers

The SEC will adopt rules on implementing this requirement. Furthermore, rating agencies are required to consider credible information received from sources other than the issuer in making ratings decisions.

The Methodologies Used By Rating Agencies May be Standardized and Disclosed Publicly

Both qualitative and quantitative analysis methodologies must be disclosed by rating agencies to the SEC. This includes analysis on the expected analysis on risk

of default. Presumably this information would be used to standardize ratings methodology, which could hinder any competition which currently exists between rating agencies.

Rating Agencies May Face Additional Legal Liability

Rating agencies could be sued by investors if they knowingly or recklessly failed to conduct a reasonable investigation.

Lottery System for Assigning Agencies to Issuers Could be Implemented

After a two-year study, the SEC must find a way to mitigate conflicts of interests related to the fact that payments are received by the issuers they rate, and that issuers may select any rating agency they choose. If the SEC is not able find a solution to these conflicts of interest during the two-year study, then they must implement a random lottery system for assigning agencies to issuers – an idea championed by Sen. Al Franken (D-Minn.). If that system is implemented, it is unclear whether smaller rating agencies would have the opportunity to be a part of the lottery system or not.

Five Additional Studies Required By Congress

In addition to the study mentioned above, the SEC must conduct a study on the desirability of standardizing ratings terminology and market stress conditions used in evaluations. There will also be a review of additional ways to reduce the reliance of credit ratings, and a study on improving the integrity of ratings, as well as an analysis by the US Comptroller to see if there are effective alternative compensation structures for rating agencies.

The final study will require the Comptroller to evaluate whether the government should create an independent professional organization, similar to the PCAOB, which would establish minimum standards and a code of ethics for raters and be the overseer of the ratings profession.

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