

**Revised Discussion Draft of the  
Accountability and Transparency in Rating Agencies Act  
Section-by-Section Analysis  
October 16, 2009**

**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 makes numerous changes to Section 15E of the Securities Exchange Act of 1934, the section of the securities laws that concerns the regulation of Nationally Recognized Statistical Rating Organizations (NRSROs).

***Changes to Subsection (a) on Registration Procedures and Subsection (b) on Update of Registration***

Documents required as part of the NRSRO registration process, shall now be “filed” with the U.S. Securities and Exchange Commission (SEC), rather than “furnished” to the SEC.

***Changes to Subsection (c) on Accountability for Ratings Procedures***

Changes to this subsection include a clarification that the limitation on the SEC or any State not to regulate the substance of credit ratings or the procedures and methodologies to determine ratings does not afford a defense against anti-fraud actions brought by the SEC.

**Review of Internal Processes for Determining Credit Ratings**

The changes to subsection (c) also insert a new requirement that the SEC review ratings, and the internal policies, procedures and methodologies of NRSROs to ensure that the NRSRO has established and documented a system of internal controls, including due diligence for determining ratings; that the NRSRO follows such systems; and that the NRSRO’s disclosures are consistent with such systems. The SEC must conduct such reviews no less than once a year.

**Provision of Information to the Commission**

Subsection (c) also creates a new requirement that NRSROs maintain records and make them available so the SEC may conduct reviews of the internal processes for determining credit ratings.

***Changes to Subsection (d) on Censure, Fine, Denial, or Suspension of Registration; Notice and Hearing***

The changes made to subsection (d) clarify that “fines” are a sanction available to the SEC for violations of the law by an NRSRO. The refinements 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 associated with the NRSRO, or are seeking to become associated with the NRSRO.

Subsection (d) further adds a provision to the law to require NRSRO supervisors to supervise their employees and permits the SEC to sanction supervisors who fail to do so reasonably. The failure to supervise is based on compliance with the securities laws (including rules and regulations) and the rules of the Municipal Securities Rulemaking Board. A safe harbor is provided for a supervisor who establishes procedures for compliance and has no reason to believe that the procedures were not being followed.

The changes to subsection (d) also clarify that the SEC has the ability to apply fines if sufficient surveillance by the NRSRO to ensure that credit ratings remain current, accurate and reliable is not conducted.

### ***Changes to Subsection (e) on Termination of Registration***

The bill removes the current paragraph in subsection (e) that permits the SEC to establish rules to permit an NRSRO to withdraw its registration voluntarily.

### ***Changes to Subsection (h) on Corporate Governance, Organization, and Management of Conflicts of Interest***

As noted in the above header, the bill alters the present title of subsection (h) from “Management of Conflicts of Interest” to better reflect the provisions now contained within the subsection.

#### **Board of Directors**

Under the revised subsection (h), each NRSRO, or its parent entity, must have a Board of Directors with at least one-third independent directors. The compensation for independent directors cannot be linked to the performance of the NRSRO, and the terms for independent directors shall be non-renewable and not exceed 5 years.

Subsection (h) also requires independent directors to oversee the establishment, maintenance and enforcement of processes for determining ratings and addressing conflicts of interest. Independent directors must also oversee the effectiveness of the NRSRO’s internal control systems, as well as the compensation and promotion policies of the employees at the NRSRO.

#### **Organization Policies and Procedures**

Under subsection (h), each NRSRO must establish, maintain and enforce written policies and procedures to address, manage and disclose conflicts of interest, consistent with SEC rules described immediately below.

#### **Commission Rules**

Subsection (h) requires the SEC to issue rules to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by an NRSRO, including:

- Conflicts of interest arising from how the NRSRO is paid for ratings;
- Conflicts of interest arising from consulting, advisory or other services;

- Disclosure of business relationships that present conflicts of interest;
- Disclosure of any affiliations of NRSROs with any person that underwrites investment vehicles that are the subject of a credit rating;
- Disclosure of information about the net revenue of the NRSRO attributable to each entity who paid for a credit rating;
- Establishment of performance-based payment system for the ratings;
- Disclosure of the fees associated with a rating and the fees associated with any ratings provided to the same obligor or underwriter and their affiliates in the preceding 2 year period; and
- Any other regulations as deemed necessary or appropriate by the SEC.

#### Look-Back Requirement

A new paragraph in subsection (h) requires NRSROs to conduct a 1-year look-back review when an NRSRO employee goes to work for an obligor or underwriter to ensure that methodologies and procedures to prevent conflicts of interest were properly followed with respect to the issuance of ratings involving the former employee. This paragraph further requires the SEC to conduct periodic reviews of the NRSRO's look-back assessments.

The SEC must also conduct periodic reviews of an NRSRO's code of ethics and conflict of interest procedures and make the code of ethics and conflict of interest procedures publicly available. The SEC shall conduct these reviews no less frequently than annually and whenever such policies are materially modified or amended.

#### Report to Commission on Certain Employment Transitions

A new paragraph in subsection (h) requires NRSROs to report to the SEC when certain employees of the NRSRO go to work for an entity that the NRSRO rated in the previous 12 months. The SEC shall make such reports publicly available.

#### ***Changes to Subsection (j) on Designation of Compliance Officer***

The bill expands the compliance officer requirements in subsection (j) by mandating that the compliance officer to report directly to the Board of Directors. The subsection also identifies specific aspects of internal control and conflict of interest policies that the compliance officer should review, including a requirement that the compliance officer establish procedures designed to ensure that ratings take into account all information presented to the NRSRO. The compliance officer must also establish procedures for receiving complaints about conflicts of interest, including anonymous complaints by employees, issuers and investors.

Subsection (h) also prohibits the compliance officer from determining credit ratings, participating in the establishment of models and methodologies, taking part in marketing or sales functions, or participating in establishing compensation levels (other than for employees under direct supervision). Finally, subsection (h) requires the compliance officer to annually prepare and certify a report that the NRSRO is in compliance with the securities laws and the NRSRO's internal policies and procedures.

### ***Changes to Subsection (k) on Statements of Financial Condition***

The bill removes a provision of current law regarding maintaining the confidentiality of financial statements provided by an NRSRO to the SEC. The bill does, however, create an exception for information whose release the SEC determines would harm the NRSRO.

### ***Changes to Subsection (p) on Establishment SEC Office***

The legislation revises the existing subsection (p) to instead require the SEC to establish an office to coordinate NRSRO regulation.

### ***New Subsection (q) on Transparency of Ratings Performance***

The bill creates a new subsection (q) under Section 15E of the Securities Exchange Act to require the SEC to write rules mandating the public disclosure of information to allow investors to gauge the performance of ratings and compare the performance of NRSROs. This requirement applies to both initial ratings and subsequent changes to the ratings. The disclosures must be clear and informative, describe long-term performance for a variety of classes of ratings, be published, and made easily accessible.

### ***New Subsection (r) on Credit Ratings Methodologies***

The legislation includes a new subsection (r) under Section 15E of the Securities 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 the procedures and methodologies are consistently applied and notify users of credit ratings which version of a procedure or methodology is used and when a change is made to the procedures and methodologies.

Also, the SEC must adopt ratings symbols that distinguish between structured products and non-structured products. The SEC shall additionally require each NRSRO to establish, maintain and enforce written policies and procedures designed to assess the risk that investors may not receive payment, and to ensure that ratings symbols be consistent for all types of securities and money market instruments. These rules shall neither prohibit an NRSRO from using additional factors to determine a rating nor from using an additional symbol to distinguish ratings for difference types of securities.

### ***New Subsection (s) on Transparency of Credit Rating Methodologies and Information Reviewed***

The bill additionally inserts a new subsection (s) under Section 15E of the Securities Exchange Act to require NRSROs, using a form established by the SEC, to provide information to help investors understand ratings, such as information about assumptions used in developing the ratings; how the NRSRO used servicer and remittance reports for ratings surveillance (where applicable); potential shortcomings of ratings, including what risks the rating does not take into account; information on the

reliability and quality of information reviewed for the rating; whether third party due diligence services were used; and the potential volatility of the rating. The NRSRO must also certify that the information provided on the form is true and accurate. Additionally, the form will be made public so others can understand the ratings.

Finally, this new subsection requires third-party firms that provide due diligence to certify their work to the NRSRO to ensure thorough review of such data.

### ***New Subsection (t) on Prohibited Activities***

Beginning 180 days after the date of enactment, the new subsection (t) under Section 15E of the Securities Exchange Act bars NRSROs from providing risk management advisory services; advice or consultation relating to any merger, sales, 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. On a case-by-case basis, the SEC may provide exemptions to this prohibition.

*Note: Because of a clerical error, the legislation does not include a Section 3.*

### **Section 4. Standards for Private Actions**

To promote greater accountability by NRSROs, the legislation codifies the current pleading standard for cases brought against NRSROs as “knowingly or recklessly.” The bill also amends Section 15E(m) of the Securities Exchange Act by clarifying that NRSROs are liable and can be sued under private rights of action. The legislation additionally contains a provision providing that statements made by NRSROs shall not be deemed forward-looking statements for purposes of the safe-harbor in Section 21E of the Securities Exchange Act. The legislation further ensures that the pleading standard of “knowingly or recklessly” shall be applied to NRSROs in the same manner as it is applied to other defendants in a lawsuit.

### **Section 5. Issuer Disclosure of Preliminary Ratings**

Under the revised discussion draft, the SEC must adopt rules that require issuers to disclose the preliminary credit ratings they receive from an NRSRO on structured products and all forms of corporate debt. This reform seeks to end the practice of ratings shopping, whereby obligors go to several NRSROs and only release the best ratings they obtain.

### **Section 6. Timeline for Regulations**

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

### **Section 7. Federal Agency Review of Reliance on Ratings**

In order to reduce reliance on the work of NRSROs, the bill requires Federal agencies to review their regulations, policies and practices which reference credit ratings to determine if another measure of creditworthiness would be appropriate. Agencies must complete this review within 1 year after the date of enactment and report to Congress after the review.

## **Sec. 8. Studies and Reports**

The bill requires the Government Accountability Office, not later than 30 months of enactment of the bill, to conduct a study of:

- The implementation of this Act;
- The appropriateness of relying on ratings in Federal, State and local securities and banking regulations;
- The effect of liability in private actions arising under the Securities Exchange Act of 1934; and
- Alternative means for compensating credit rating agencies to create incentives for more accurate ratings.

Within 1 year of enactment, the SEC must also undertake a study on creating a system whereby NRSROs are assigned to issuers seeking a credit rating on a rotating basis.