



**BIIA**

**Business Information Industry Association**  
Asia Pacific – Middle East

### **Summary of Provisions**

#### **S. 3217 – the *Restoring American Financial Stability Act* Title IX, Subtitle C – “Improvements to the Regulation of Credit Rating Agencies (excerpted from Senate Banking Committee Report)**

#### **Section 931. Findings**

This section contains Congressional findings that credit ratings are systemically important; relied upon by individual and institutional investors and regulators; and central to capital formation, investor confidence and economic efficiency. Credit rating agencies play a gatekeeper role in financial markets that justifies the same level of oversight and accountability that applies to securities analysts, auditors, and investment banks. Inaccurate ratings, generated in part by conflicts of interest in the process of rating structured financial products, contributed to the mismanagement of risk by large financial institutions and investors, which set the stage for global financial panic.

#### **Section 932. Enhanced Regulation, Accountability, and Transparency of Nationally Recognized Statistical Ratings Organizations**

##### **Enhanced Regulation**

Paragraph (1) of Section 932 provides that each NRSRO shall establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the SEC may prescribe, by rule. This provision requires an annual report containing an assessment of the effectiveness and a CEO attestation on the internal controls.

Section 932 also gives the SEC the authority to fine an NRSRO for violations of law or regulation, in addition to current law that allows the SEC to censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any NRSRO.

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Section 932 also directs the SEC to write rules preventing sales and marketing considerations from influencing the production of ratings. Violation of these rules will lead to suspension or revocation of NRSRO status if the violation affects a rating.

Section 932 addresses the role of the NRSRO compliance officer, a position created by the Credit Rating Agency Reform Act of 2006. The section prohibits NRSRO compliance officers from participating in production of ratings, the development of ratings methodologies, or the setting of compensation for NRSRO employees. The section allows the SEC to provide exemptions for small NRSROs if the SEC finds that compliance would impose an unreasonable burden.

Section 932 also directs NRSRO compliance officers to establish procedures for the receipt, retention, and treatment of complaints about the rating agency or its ratings. The section also directs the compliance officer to submit to the NRSRO an annual report to the SEC on its compliance with the securities laws, and its related policies and procedures.

Section 932 establishes the Office of Credit Ratings within the SEC. The Office shall administer the rules of the SEC with respect to NRSROs to protect investors and the public interest, to promote accuracy in credit ratings, and to prevent conflicts of interest from unduly influencing credit ratings. The Director of the Office will report to the Chairman of the SEC. The Office will be adequately staffed to fulfill its statutory role and will include persons with knowledge of and expertise in corporate, municipal, and structured debt.

The Office of Credit Ratings shall conduct annual examinations of each NRSRO. Each examination will include a review of the policies, procedures, and rating methodologies of the NRSRO and whether the NRSRO follows these; the management of conflicts of interest by the NRSRO; the implementation of ethics policies; the internal supervisory controls of the NRSRO; the governance of the NRSRO; the activities of the NRSRO compliance officer; the processing of complaints by the NRSRO; and the policies of the NRSRO governing the post-employment activities of former staff.

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The SEC will make public, in an easily understandable format, an annual report summarizing the essential findings of all NRSRO examinations that year. The report shall include the responses of NRSROs to material regulatory deficiencies identified by the SEC and to recommendations made by the SEC.

**Accountability**

Section 932 provides that the SEC may temporarily suspend or permanently revoke the registration of an NRSRO with respect to a particular class or subclass of securities, if the SEC finds, on the record after notice and opportunity for hearing, that NRSRO does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.

Subsection (q) of Paragraph 6 of Section 932 directs the SEC to require that each NRSRO publicly disclose information on the initial credit ratings published by the NRSRO for each type of obligor, security, and money market instrument and any subsequent changes to such credit ratings. The purpose of this disclosure is to allow users of credit ratings to compare the performance and accuracy of ratings issued by different NRSROs. Disclosures would be clear and informative for investors with varying levels of financial sophistication. Finally, this subsection makes accommodation for subscriber-pay NRSROs, by mandating that the disclosure be appropriate to the business model of an NRSRO.

Subsection (t) addresses corporate governance issues and requires that at least one-half the members of NRSRO boards be independent directors. Independent directors are defined as those who do not accept consulting, advisory, or other fees from the NRSRO; are not associated with the NRSRO or an affiliate; and do not participate in any deliberation involving a rating in which the independent director has a financial interest. The NRSRO board must be responsible for establishing, maintaining, and enforcing policies and procedures for determining credit ratings; preventing conflicts of interests; the internal control systems; and compensation practices. The provision authorizes the SEC to grant an exemption from independence rules for small NRSROs where compliance would present an unreasonable burden, provided that the responsibilities of the board are delegated to a committee including at least one user of NRSRO ratings.

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**Page 4****Disclosure**

Section 932 directs the SEC to prescribe rules to require each NRSRO to ensure that credit ratings are determined using procedures and methodologies that are approved by the board of directors or senior credit officer. The SEC's rules must require that material changes to ratings procedures and methodologies be applied consistently and publicly disclosed. Such changes must be applied to all credit ratings to which they apply within a reasonable time period, to be determined by the SEC.

The rules will also require each NRSRO to notify users of credit ratings when a material change is made to a procedure or methodology, and when a significant error is identified in a procedure or methodology that may result in credit rating actions.

Subsection (s) of Paragraph 6 of Section 932 directs the SEC to require NRSROs, by rule, to publish a form with each rating that discloses qualitative and quantitative information that is intended to enable investors and users of credit ratings to better understand the main principles and assumptions that underlie the rating. The disclosures shall be easy to use, directly comparable across different classes of securities, and may be provided in either paper or electronic form, as the SEC may, by rule, determine.

The qualitative content of the form shall include the credit ratings produced; the main assumptions and principles used in constructing procedures and methodologies (including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across obligors used in rating structured products); the potential limitations of the credit ratings and the types of risks excluded from the credit ratings that the NRSRO does not comment on; information on the uncertainty of the credit rating including information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; a statement on the reliability and limitations of the data relied upon and any other data accessibility limitations; and whether and to what extent third party due diligence services have been used by the NRSRO, including a description of the information that such third party reviewed in conducting due diligence services and a description of the findings or conclusions of such third party.

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The form shall include an overall assessment of the quality of information available and considered in producing a rating in relation to the quality of information available to the NRSRO in rating similar issuances; information relating to conflicts of interest of the nationally recognized statistical rating organization; and such additional information as the SEC may require.

The quantitative content will include an explanation or measure of the potential volatility of the credit rating (including any factors that might lead to a change in the credit ratings), information on the sensitivity of the rating to assumptions made by the NRSRO, and the extent of the change that a user can expect under different market conditions. In addition, the disclosures will include information on the historical performance of the rating and the expected probability of default and the expected loss in the event of default.

Subsection (s) provides the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter of an asset-backed security shall be made public, in a format to be determined by the SEC. The disclosures shall be in a manner that allows the public to determine the adequacy and level of due diligence services provided by a third party

**Section 933. State of Mind in Private Actions**

Section 933 provides that the enforcement and penalty provisions applicable to statements made by a credit rating agency shall apply in the same manner and to the same extent as to statements made by a registered public accounting firm or a securities analyst, and such statements shall not be deemed forward looking statements.

In actions for money damages brought against a credit rating agency or a controlling person, it shall be sufficient for pleading any required state of mind in relation to such action, that the complaint state facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed to conduct a reasonable investigation of the factual elements of the rated security, or failed to obtain reasonable verification of such factual elements from independent sources that it considered to be competent.

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Section 933 specifies that, for purposes of passing the pleading test of the Private Securities Litigation Reform Act, plaintiffs need not plead that the CRA "knowingly or recklessly" engaged in a deceptive misrepresentation or omission in communicating with investors, but instead requires only that they plead that the CRA "knowingly or recklessly failed ... to conduct a reasonable investigation ... with respect to ... factual elements ... or to obtain reasonable verification of such ... elements..." The Section permits plaintiffs to more easily pass the motion to dismiss stage of litigation. It does not change the ultimate standard used by a fact-finder in determining whether the basic elements of 10b-5 have been met.

**934. Referring Tips to Law Enforcement or Regulatory Authorities**

Section 934 provides that each NRSRO will refer to the appropriate law enforcement or regulatory authorities any information that the NRSRO receives and finds credible that alleges that an issuer of securities rated by the NRSRO has committed or is committing a violation of law that has not been adjudicated by a Federal or State court. This is in effect a mandatory whistle-blowing provision, and exceptions could be created to cover circumstances when the compliance officer concluded that the information was false or unreliable. This provision requires the NRSRO to determine whether it feels the information is credible, but does not require the NRSRO to undertake extensive fact finding or analysis or to determine whether a violation of law has occurred.

**Section 935. Consideration of Information from Sources Other Than the Issuer in Rating Decisions**

Section 935 provides that NRSROs must consider information about an issuer that the NRSRO has, or receives from a source other than the issuer, that the NRSRO finds credible and potentially significant to a rating decision. The Section does not require an NRSRO to initiate a search for such information. The information is expected to be evaluated on its own merits as to whether it indeed should affect the rating.

**Section 936. Qualification Standards for Credit Rating Analysts**

Section 936 directs the SEC to issue rules reasonably designed to ensure that any person employed by an NRSRO to perform credit ratings meets standards of training, experience, and competence necessary to produce accurate ratings; and is tested for knowledge of the credit rating process.

**Section 937. Timing of Regulations**

Section 937 directs the SEC to issue final regulations within 1 year of the date of enactment of the Act.

**Section 938. Universal Ratings Symbols**

Section 938 requires NRSROs to clearly define any symbols used to denote a credit rating, and apply any such symbols in a consistent manner to all types of securities and money market instruments to which they are applied.

**Section 939. Government Accountability Office Study and Federal Agency Review of Required Uses of Nationally Recognized Statistical Rating Organization Ratings**

Section 939 directs the GAO to study the scope of Federal and State laws and regulations with respect to the regulation of securities markets, banking, insurance, and other areas that require the use of ratings issued by NRSROs.

**Section 939A. Securities and Exchange Commission Study on Strengthening Credit Rating Agency Independence**

Section 939A directs the SEC to conduct a study of the independence of NRSROs, evaluate the management of conflicts of interest by NRSROs, and evaluate the potential impact of rules prohibiting an NRSRO that provided a rating to an issuer from providing other services to the issuer.

**Section 939B. Government Accountability Office Study on Alternative Business Models**

Section 939B directs the GAO to conduct a study on alternative means of compensating NRSROs in order to create incentives for NRSROs to provide more accurate ratings and any statutory changes that would be required to facilitate these changes. The GAO will submit this report, with recommendations, within one year of passage of the Act.

**Section 939C. Government Accountability Office Study on the Creation of an Independent Professional Analysts Organization**

Section 939C directs the GAO to conduct a study on the feasibility and merits of creating an independent professional organization for NRSRO rating analysts that would establish independent standards for governing the rating analyst profession, establishing a code of ethical conduct, and overseeing the rating analyst profession. The GAO shall submit a report to the relevant congressional committees within one year of passage of the Act.

***Source: Member contributions, BIIA research***

The link to the Committee report is  
here: <http://banking.senate.gov/public/files/RAFSAPostedCommitteeReport.pdf>.