STRENGTHENING CREDIT RATING INTEGRITY

Key Features of the SEC's New Rules for Rating Agencies

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9 November 2015

ABSTRACT: The new SEC rules for rating agencies contain three key items that should help establish a strong foundation for the ongoing value of ratings in the U.S. fixed-income market. First, the new rules firmly prohibit the influence of sales or marketing considerations on criteria development. Second, interpretive guidance for the new rules preserves the ability of ratings to serve as relative, rather than absolute, measures of credit risk. Third, the new rules require cross-sector consistency in how each rating agency uses its rating symbols. For each of the three items the SEC achieved a great result despite tough challenges. On the other hand, the SEC passed on the opportunity to repair the broken system for promoting unsolicited ratings of structured finance securities.

Keywords: credit rating, rating agency, regulation, financial crisis. NRSRO, Dodd Frank Act

JEL Classifications: G24, G28, G38, K22 G18, G01

This is an updated, post-print version of the article. The version of record appears in the *Journal of Financial Regulation and Compliance*, Volume 23, Issue 4 (2015). The journal's "green open access" policy permits posting of this post-print version on the authors' websites.

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by Mark Adelson[1] and David Jacob[2]

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Introduction

The new SEC rules for credit rating agencies, issued on August 27, 2014, represent an important milestone for the U.S. fixed-income markets (SEC, 2014b). The rules cover a broad swath of issues, but three particular items stand out as being especially important for promoting the integrity and practical utility of credit ratings. First, the rules include a clear prohibition against allowing sales or marketing considerations to influence the development of the criteria for determining ratings. Second, the rules carefully avoid forcing credit ratings to embody absolute probabilities of default. Third, the rules require each rating agency to assign consistent meanings to its rating symbols across sectors. In each case, the SEC had to navigate difficult issues to come to its final result.

The release of the new rules was somewhat overshadowed by the SEC's release on the same day of its long-awaited update to the rules for asset-backed securities (SEC, 2014c). The latter garnered disproportionate media attention because the ABS rules will materially affect the work flow of thousands of individuals in the securitization industry. By contrast, the rating agency rules have a much smaller impact on day-to-

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day workflow but a potentially far greater impact on the future of the global capital markets.

The plain text of the new rating agency rules is deceptively simple. Deeper understanding and appreciation of the rules' full import requires consideration of both the interpretive guidance provided in the adopting release and the interplay of the rules with each other as part of an integrated package.

This article is organized in six parts. The first is this brief introduction. The second examines the new prohibition against allowing sales or marketing considerations to influence the development of analytic criteria. It explores the interpretive guidance that reveals how the final version of the rule is more powerful than the original proposal. The third part considers how the new rules avoid forcing credit ratings to embody absolute probabilities of default and how the guidance supplies essential clarity that cannot be discerned merely from the rule's wording. The fourth part discusses the new rule requiring each rating agency to apply its rating symbols consistently across fixed-income sectors. The fifth part briefly discusses the system for promoting unsolicited ratings of structured finance securities, and the sixth part concludes.

Item No. 1: Prohibition against Sales or Marketing Influence on Criteria Development

The new prohibition against sales or marketing influence on criteria development is cast in terms of a prohibited conflict of interest. The prohibited conflict occurs when a person who participates in developing criteria "is influenced by sales or marketing considerations." The key language appears in clause (c)(8)(ii) of SEC Rule 17g-5 and reads as follows:

> (c) *Prohibited conflicts*. A nationally recognized statistical rating organization is prohibited from having the following conflicts of interest…:
>
> * * *
>
> (8) … where a person within the nationally recognized statistical rating organization who participates in… developing or approving procedures or methodologies used for determining the credit rating… also:
>
> (i) Participates in sales or marketing…; or
>
> (ii) Is influenced by sales or marketing considerations.[3]

The rule is notable because the explicit inclusion of criteria development ("developing or approving procedures or methodologies used for determining the credit rating") goes beyond the underlying statutory language in § 15E(h)(3)(A) of the Securities Exchange Act of 1934 (Exchange Act).[4] In addition, the interpretive guidance in the SEC's adopting release reveals that the notions of "influenced by" and "sales and marketing considerations" should be construed very broadly. Together, these elements give the new rule a very broad scope.

Until the adoption of the new rule, there was no direct regulatory prohibition against allowing commercial considerations to influence a rating agency's ratings or the development of its criteria. The closest thing was the model code of conduct for rating agencies that was promulgated by the International Organization of Securities Commissions (IOSCO). IOSCO includes the SEC and other securities regulators from around the globe. Its model code of conduct for rating agencies started with a statement

[3] See 17 C.F.R. § 240.17g-5 (2015) (effective date note), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol4/pdf/CFR-2015-title17-vol4-sec240-17g-5.pdf; Securities and Exchange Commission, *Nationally Recognized Statistical Rating Organizations*, Release No. 34-72936, 79 Fed. Reg. 55078, 55264 (15 Sep 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-09-15/pdf/2014-20890.pdf [hereinafter Adopting Release].

[4] Securities Exchange Act of 1934 § 15E(h)(3)(A) [hereinafter "Exchange Act"], 15 U.S.C. § 78*o*-7(h)(3)(A) (2015) available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78o-7.pdf.

of principles in 2003 and then became an actual model code in 2004.[5] IOSCO updated the model code in 2008 and again in 2015.[6]

In response to the publication of IOSCO's model code in 2004, each of the major rating agencies adopted its own code of conduct covering all or nearly all the items in IOSCO's model. Moody's adopted a code of conduct in June 2005, and S&P followed suit in October of that year. IOSCO's 2004 model code specified that "[t]he determination of a credit rating should be influenced only by factors relevant to the credit assessment."[7] It also provided that a "credit rating… should not be affected by the existence of or potential for a business relationship between the [the rating agency]… and the issuer… or any other party…"[8] Such statements in a code of conduct do not have binding regulatory effect. However, if a rating agency makes such statements publicly and then acts inconsistently, it can face various other types of legal problems. That was at the heart of some of the recent rating agency litigation.[9] Somewhat ironically, one rating agency has argued that such statements in its code of

[5] International Organization of Securities Commissions, *IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf (25 Sep 2003); International Organization of Securities Commissions, *Code of Conduct Fundamentals for Credit Rating Agencies*, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf (Dec 2004) [hereinafter IOSCO 2004 Code].

[6] International Organization of Securities Commissions, *Code of Conduct Fundamentals for Credit Rating Agencies*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf (May 2008); International Organization of Securities Commissions, *Code of Conduct Fundamentals for Credit Rating Agencies – Final Report*, Report No. FR05/2015, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD482.pdf (Mar 2015).

[7] IOSCO 2004 Code, *supra* note 5, § 2.3.

[8] IOSCO 2004 Code, *supra* note 5, § 2.4.

[9] Complaint for Civil Money Penalties and Demand for Jury Trial, United States of America v. McGraw-Hill Companies, Inc., and Standard & Poor's Financial Services LLC, No. CV13-00779, C.D. CA (filed 4 Feb 2013), available at http://www.justice.gov/iso/opa/resources/849201325104924250796.PDF; *see also* Annex 1 to Settlement Agreement, United States of America v. McGraw-Hill Companies, Inc., and Standard & Poor's Financial Services LLC, No. CV13-00779, C.D. CA (2 Feb 2015), available at http://www.justice.gov/file/338701/download.

conduct were "mere puffery" and were never intended to be taken seriously.[10] The court firmly rejected that argument.[11]

Explicit Inclusion of Criteria Development

The underlying statutory requirement required the SEC to issue rules to prevent sales or marketing considerations "from influencing the production of ratings."[12] The statutory language does not specifically require the SEC to focus on criteria development. Nonetheless, the issue of criteria development was in the SEC's sights when it published the proposal for the new rules in 2011.[13]

The adopting release makes it clear that the SEC understood the significance of criteria development and how it figures into the conflict-of-interest challenges at rating agencies. Chief among those challenges is the potential conflict of interest that arises when rating agencies compete to win business by loosening their criteria for an entire sector or asset class. This practice has been termed *competitive laxity*. The credit rating industry has been particularly vulnerable to the threat of competitive laxity in areas where issuers and underwriters can engage in *rating shopping*. Rating shopping refers to the practice among issuers and underwriters of presenting their transactions to multiple rating agencies and then selecting the ones that will permit the highest leverage and still grant the desired ratings. Rating shopping by issuers and underwriters gives rating agencies an economic incentive to engage in competitive laxity.

Starting in the mid-1990s, rating shopping became a widespread practice in the structured finance segment of the fixed income market. For a time, issuers and underwriters attempted to deny that they engaged in rating shopping. They offered

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[10] Memorandum in support of Defendants' Motion to Dismiss the Complaint Pursuant to Fed. R. Civ. P. 9(b) and 12(b)(6), United States of America v. McGraw-Hill Companies, Inc., and Standard & Poor's Financial Services LLC, No. CV13-00779, C.D. CA (22 Apr 2013), available at http://ia601401.us.archive.org/27/items/gov.uscourts.cacd.553856/gov.uscourts.cacd.553856.16.1.pdf.

[11] Order Denying Defendants' Motion to Dismiss, United States of America v. McGraw-Hill Companies, Inc., and Standard & Poor's Financial Services LLC, No. CV13-00779, C.D. CA (16 Jul 2013), available at http://www.plainsite.org/dockets/download.html?id=32860908&z=4c5c1e96.

[12] Exchange Act § 15E(h)(3)(A), 15 U.S.C. § 78*o*-7(h)(3)(A) (2014) available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78o-7.pdf.

[13] Securities and Exchange Commission, *Nationally Recognized Statistical Rating Organizations*, Release No. 34-64514, 76 Fed. Reg. 33420, 33540 (8 Jun 2011) (proposed rules), available at http://www.gpo.gov/fdsys/pkg/FR-2011-06-08/pdf/2011-12659.pdf [hereinafter Proposing Release].

fabricated reasons for why particular rating agencies were selected on individual deals. By the early 2000s, rating shopping had become common knowledge. Issuers and underwriters no longer made any attempt to conceal the practice. Along the way, the rating agencies faced allegations that they were practicing competitive laxity. Actual evidence of competitive laxity was slow to emerge, but it finally did. In fact, the issue was central to many of the recent lawsuits against the rating agencies.[14]

The adopting release indicates that the explicit focus on criteria development is a response to improper behaviors like competitive laxity. It states:

> Moreover, in the Commission staff's view, sufficient steps were not taken to prevent considerations of fees, market share, or other business interests from influencing credit ratings *or rating criteria*.[15]

In a similar vein, another passage of the adopting release states:

> Further, Commission staff found as part of the examination of the activities of the three largest NRSROs in rating RMBS and CDOs linked to subprime mortgages that it appeared ''employees responsible for obtaining ratings business would notify other employees, including those responsible for criteria development, about business concerns they had related to the criteria.''[16]

Thus, the explanatory content in the adopting release makes it fully clear that the explicit inclusion of criteria development in the new rule is not accidental.

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[14] *See, e.g.*, Complaint for Civil Money Penalties and Demand for Jury Trial ¶¶ 158-198, United States of America v. McGraw-Hill Companies, Inc., and Standard & Poor's Financial Services LLC, No. CV13-00779, C.D. CA (filed 4 Feb 2013), available at http://www.justice.gov/iso/opa/resources/849201325104924250796.PDF; Complaint for Treble Damages, Civil Penalties and Permanent Injunction for Violation of the California False Claims Act, Unfair Competition Law, and False Advertising Law ¶¶ 102-121, People of the State of California v. The McGraw-Hill Companies, Inc. et al., No. CGC 13 528491, Cal. Super. Ct. (County of San Francisco) (filed 5 Feb 2013), available at http://oag.ca.gov/system/files/attachments/press_releases/S%26P%20complaint.pdf. Lawsuits alleging substantially similar claims were brought by Arizona, Arkansas, Delaware, Colorado, Connecticut, Idaho, Illinois, Indiana, Iowa, Maine, Mississippi, Missouri, New Jersey, North Carolina, Pennsylvania, South Carolina, Tennessee, and Washington. The Mississippi case named both Moody's and S&P as defendants.

[15] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55083 (emphasis added).

[16] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55108 (citations omitted) (the adopting release uses the acronym NRSRO for nationally recognized statistical rating organization).

"Influencing"

The use of the word "influencing" makes the final rule significantly broader than the version proposed in 2011. The proposed version did not actually prohibit sales or marketing considerations from influencing criteria development. Instead, it would have established a prohibition against *participation* in criteria development by a person who participates in sales or marketing activities.[17]

The guidance in the adopting release interprets the term "influencing" very broadly. The guidance explains that improper influence can happen various ways, including compensation arrangements, performance appraisals, compliance systems, and direct pressure from managers. The relevant sentence in the release states (SEC, 2014b, p. 55110):

> In connection with making the evaluation necessary for the second prong of the absolute prohibition, the Commission believes there are a number of possible channels of influence that should be considered, such as compensation arrangements that may incentivize analysts to produce inflated credit ratings to increase or retain the NRSRO's market share, performance evaluation systems that reward analysts who produce inflated credit ratings to increase or retain the NRSRO's market share, compliance personnel who unduly influence credit analysts to inflate credit ratings in response to complaints by clients, clients such as rated entities who pressure analysts to produce inflated credit ratings to retain their business, or managers who are not involved in sales and marketing activities but may seek to pressure analysts to produce inflated credit ratings to increase or retain the NRSRO's market share.[18]

A second aspect of using the term "influencing" rather than "participation" is that establishes a principles-based requirement. A prohibition that covered only actual "participation" would have left open many other approaches for exerting improper influence. The end result of using the term "influencing" – and explaining it so broadly in the adopting release – is that it will be hard for a rating agency to circumvent the rule without actually violating it.

Sales or Marketing Considerations

The notion of "sales or marketing considerations" also receives a broad interpretation in the adopting release. The passages quoted above include references to fees, market share, inflated ratings, "business concerns," and "other business

[17] Proposing Release, *supra* note 13, 76 Fed. Reg. at 33540.

[18] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55110.

interests."[19] Additional guidance explains that the notion is even broader, potentially encompassing a rating agency's corporate culture:

> [T]he Commission notes that the sales and marketing prohibition is being added to a comprehensive set of existing requirements that address NRSRO conflicts… Consequently, the sales and marketing prohibition should not be viewed in isolation but rather as part of a set of requirements… pursuant to which NRSROs must disclose and manage conflicts of interest and, in some cases, avoid them altogether… *An NRSRO that permits a corporate culture in which managers seek to inappropriately influence analysts and the personnel who develop and approve rating procedures and methodologies could not be viewed as having or enforcing policies and procedures reasonably designed to address the issuer-pay conflict and, consequently, this type of conduct would violate section 15E(h)(1) of the Exchange Act and Rule 17g–5.*[20]

So, combining the explicit inclusion of criteria development with expansive interpretative guidance on "influencing" and "sales or marketing considerations" produces a rule with a very long reach.

Strictness of the Prohibition

Subject to a narrow exemption for "small" rating agencies, the prohibition against sales or marketing considerations influencing criteria development is absolute. The SEC included the new prohibition in the list of prohibited conflicts of interest rather than in the list of conflicts that a rating agency is allowed to "manage." The adopting release hammers on this point intensely, using the phrase "absolute prohibition" nearly two dozen times in reference to the subject.[21]

Another indication of the strictness of the prohibition against sales or marketing considerations influencing criteria is in the explanation that even an unsuccessful attempt to improperly influence criteria development can constitute a violation of the rule. The relevant passage from the adopting release states:

> Similarly, depending on the facts and circumstances, it would violate the rule as amended for an NRSRO to issue or maintain a credit rating that managers involved in sales and marketing activities sought to influence by pressuring or offering incentives to personnel who developed or approved the rating procedures or methodologies used to determine the credit rating to take commercial concerns into account in developing or

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[19] See quotations accompanying notes 15 ("fees, market share, or other business interests"), 16 ("business concerns"), and 18 ("market share" and "produce inflated credit ratings").

[20] Adopting Release, *supra* note 3, 76 Fed. Reg. at 55110 (emphasis added).

[21] Adopting Release, *supra* note 3, 76 Fed. Reg. at 55091, 55107-12, 55116-17, 55239, 55254.

> approving the procedures or methodologies. Moreover, depending on the facts and circumstances, because the rule is an absolute prohibition, *this conduct would violate the rule, even if a manager did not successfully influence any credit rating or the rating procedures or methodologies used to determine the credit rating*.[22]

Enforcement Mechanisms

Another interesting feature of the prohibition against sales or marketing influence on criteria development is that it has a special enforcement mechanism. The first prong of the enforcement mechanism is a new attestation requirement. Under the requirement, the person responsible for a credit rating must attest that (i) no part of the rating was influenced by any other business activity, (ii) the rating is based solely on the merits of the subject issuer or obligation, and (iii) the rating is an independent evaluation of the credit risk of the subject issuer or obligation.[23] The attestation requirement does two things. First, it requires that each rating must have a designated individual who takes responsibility for the rating's integrity. Second, it creates a paper trail pointing directly to that individual. The individual responsible for making the attestation could not truthfully do so if he or she knew that the development of the criteria used for the rating had been influenced by sales or marketing considerations.

Something absent from the new rules, however, is a parallel attestation requirement for newly issued or revised criteria. The new rules do not require any individual to attest that a new criteria article is free from influence by sales or marketing considerations. Perhaps a future version of the rules might someday require such an attestation.

The second prong of the enforcement mechanism is a new rule that provides for suspending or revoking a rating agency's registration with the SEC for violating the new conflict of interest prohibitions. However, those penalties apply only if the violation actually affects a credit rating.[24]

Of course, in addition to the special enforcement provisions, the standard penalties under Section 32(a) of the Exchange Act could apply to violations of the new

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[22] Adopting Release, *supra* note 3, 76 Fed. Reg. at 55109 (emphasis added).

[23] Adopting Release, *supra* note 3, 76 Fed. Reg. at 55266 (adopting SEC Rule 17g-7(a)(1)(iii)). *See also* Exchange Act § 15E(q)(2)(F), 15 U.S.C. § 78*o*-7(q)(2)(F) (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78o-7.pdf.

[24] Adopting Release, *supra* note 3, 76 Fed. Reg. at 55264.

rules.[25] For an individual, the potential penalties are fines of up to $5 million and prison time of up to 20 years. For an entity other than a natural person, the fines can be up to $25 million.

Practical Challenges for Enforcement

Notwithstanding the new attestation requirement and the potential for severe penalties, the SEC may face some practical challenges in enforcing the prohibition against sales and marketing influence on criteria development. The two key challenges are (i) detecting possible violations and (ii) proving them to the necessary standard of proof ("preponderance of the evidence" in a civil action and "beyond a reasonable doubt" in a criminal case).

For detecting possible violations, the SEC should focus on criteria changes that have the effect of increasing the agency's market share by making criteria more lenient (*i.e.*, easier for a security to attain a high rating). Relevant signals may occur when issuers (especially structured finance issuers) switch rating agencies shortly after a change in criteria.

In addition, the SEC should consider whether the article containing or announcing a criteria change includes a convincing analytic reason for the change. The SEC should examine whether the article describes how the change maintains or improves the criteria's calibration (*i.e.*, how it maintains or improves the consistency of ratings within and across sectors). A criteria article that lacks such content may signal that the change was not done for legitimate analytic reasons. If that is the case, an investigation into the real reasons may bear fruit.

For proving violations, the SEC will have to use its traditional investigative tools. Naturally, in the course of its annual examination of a rating agency, the SEC has access to the company's books and records. The SEC's new whistleblower rules[26] may also provide incentives for rating agency staff to come forward individually when they have knowledge of a violation.

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[25] 15 U.S.C. § 78ff(a) (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78ff.pdf.

[26] 17 C.F.R. §§ 240.21F-1 to 240.21F-17 (2015); Securities Exchange Commission, *Securities Whistleblower Incentives and Protections*, Release No. 34-64545, 76 Fed. Reg. 34300 (13 Jun 2011), available at http://www.gpo.gov/fdsys/pkg/FR-2011-06-13/pdf/2011-13382.pdf; Exchange Act § 21F, 15 U.S.C. §§ 78u-6 and 78u-7 (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78u-6.pdf.

As currently configured, the SEC's examination and enforcement mechanism does not provide a way to harness private-sector resources and expertise for detecting and proving violations of the prohibition. Perhaps, in the future, the SEC might use third-party, independent audits of a rating agency's criteria as a screen for monitoring compliance. Such use would be conceptually like third-party, independent audits of company financial statements. It would be a further evolutionary step in the regulatory use of private-sector resources to address conflicts of interest. A somewhat analogous example appears in the concept of an "operating advisor" in the rules for credit risk retention in securitizations.[27] Another example appears in the "asset reviewer" provision the SEC's disclosure rules for securitizations.[28]

It would have been beyond the scope of the rating agency rules for the SEC to have adopted a complementary rule that applied to issuers and underwriters. Perhaps someday there may be a rule that prohibits such entities from rating shopping or otherwise attempting to improperly influence a rating agency's criteria development or its analysis of any obligor or security.

The bottom line on the prohibition against sales or marketing influence on criteria development is that (i) it is an absolute prohibition, (ii) it has long reach through the expansive interpretive guidance provided in the adopting release, and (iii) it has a strong enforcement mechanism backing it up. Although some practical enforcement challenges may remain, the rule has a chance to make a big difference. It has a chance to reduce – or perhaps even eliminate – the types of conduct that undermined the integrity of certain credit ratings, produced inflated ratings on certain structured finance securities, made investors mistrust ratings, and ultimately produced a tidal wave of litigation.

The SEC and its staff deserve kudos for getting this portion of the new rules nearly perfect.

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[27] *See, e.g.*, 12 C.F.R. § 43.7 (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title12-vol1/pdf/CFR-2015-title12-vol1-sec43-7.pdf; OCC, Federal Reserve System, FDIC, Federal Housing Finance Agency (FHFA), SEC, and Dept. of Housing and Urban Development (HUD), *Credit Risk Retention*, 79 Fed. Reg. 77602, 77645-47 (24 Dec 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-29256.pdf.

[28] 17 C.F.R. § 239.45(b)(1)(ii) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol3/pdf/CFR-2015-title17-vol3-sec239-45.pdf; Securities and Exchange Commission, *Asset-Backed Securities Disclosure and Registration*, Release Nos. 33-9638, 34-72982, 79 Fed. Reg. 57184, 57190, 57275-82, 57337-38 (24 Sep. 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-21375.pdf.

Item No. 2: Not Forcing Credit Ratings to Embody Absolute Default Probabilities or Expected Losses

At first blush, the plain language of the new rules seems to require every rating to embody an "expected probability of default" and an "expected loss in the event of default" with respect to the subject issuer or obligation.[29] That result would force nearly all rating agencies to redefine the meanings of their ratings, which would be difficult or impossible for most. Fortunately, the adopting release includes a clarifying explanation that avoids such a result.

The key language in the new rule is nearly identical to the underlying statutory language. In both settings, the language is part of a list of disclosure items that a rating agency must publish along with every rating action that it takes. One of the required items is "[i]nformation on the content of the rating, including … [t]he expected probability of default and the expected loss in the event of default." The wording appears to presume that every credit rating embodies a specific "default probability" and a specific "expected loss." However, such a presumption would be contrary to the facts. The credit ratings from most of the major rating agencies do not embody either specific default probabilities or specific expected losses. Rather, they provide indications of *relative risk*. Within the rating systems of the major rating agencies, the observed frequency of defaults for issuers and securities within each rating category rises and falls over time through the peaks and troughs of economic cycles. The same is true of observed losses. Absolute default probabilities and absolute loss expectations simply do not exist within the rating systems of the major rating agencies.

The adopting release saves the day with interpretive guidance. It explains that the new rules do not require rating agencies to change what their ratings mean. Instead, a rating agency can use appropriate historical default and loss statistics for complying with the disclosure requirement. The key passage in the adopting release states:

> The Commission recognizes that credit ratings generally are intended to indicate the relative degree of credit risk of an obligor or debt instrument rather than reflect a measure of a specific default probability or loss expectation. The Commission does not expect NRSROs to alter the meanings of their credit ratings or rating procedures and methodologies to conform to the disclosure requirement. Rather, the Commission expects NRSROs to provide ''information'' to the extent it is consistent with their procedures and methodologies for determining credit ratings, on the expected probability of default and

[29] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55264 (adopting SEC Rule 17g-7(a)(1)(ii)(L)(2)). *See also* Exchange Act § 15E(s)(3)(B)(ii)(II), 15 U.S.C. § 78*o*-7(s)(3)(B)(ii)(II) (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78o-7.pdf.

> expected loss in the event of default. This information could consist of, for example, historical default and loss statistics, respectively, for the class or subclass of the credit rating.[30]

That would be the end of the story but for second provision in the new rules. The second provision requires a rating agency to have "policies and procedures that are reasonably designed to… [a]ssess the probability that an issuer… will default…"[31] Fortunately, there are three factors that prevent an incorrect interpretation that would require each credit rating to embody a specific probability of default.

First, the requirement in the second provision to "assess the probability" is not the same thing as requiring the "information content" of a rating to include a specific probability of default. Nearly every rating agency would agree that it "assesses the probability" of an issuer's default as part of its analysis. In that context, the word "probability" is best understood with the nuance of "propensity" or "likelihood," rather than as a specific number.

Second, the interpretive guidance for the second provision includes an explicit discussion of the statutory provision that prohibits the SEC from regulating the substance of ratings or rating criteria.[32] It seems likely that the SEC included that discussion to signal that it did not intend to compel rating agencies to redefine their ratings.

Third, the interpretive guidance also discusses the coordination of the second provision with the first one.[33] It states that a rating agency's required policies regarding assessments of an issuer's default probability (*i.e.*, the requirement of the second provision) will help it comply with the provision for including information on default probability and expected loss on the required disclosure form (*i.e.*, the first provision).

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[30] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55175.

[31] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55268 (adopting SEC Rule 17g-8(b)(1)). *See also* 15 U.S.C. § 78*o*-8(a)(1) (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78o-8.pdf.

[32] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55209 (discussing Exchange Act § 15E(c)(2), 15 U.S.C. § 78*o*-7(c)(2) (2014), available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78o-7.pdf).

[33] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55209 (discussing the interplay of new SEC Rule 17g-8(b)(1) with new SEC Rule 17g-7(a)(1)(ii)(L)(2)).

Thus, the overall thrust of the second provision is to support rather than contradict the earlier guidance allowing rating agencies to keep their existing rating definitions.[34]

The issue of not forcing credit ratings to embody absolute default probabilities or expected losses was an extremely important one. The potential for misinterpreting the relevant statutory language and producing a damaging regulatory result was real. As with the prohibition against sales or marketing considerations influencing criteria development, the SEC and its staff deserve credit for coming to the right result. In addition, the focus on the issue appears to have emerged only after the publication of the proposed rules in 2011. By coming to the right result between the proposal and the final release, the SEC and its staff really came through in the clutch.

Item No. 3: Consistent Meaning of Rating Symbols across Sectors

The new rules require each rating agency to have "policies and procedures that are reasonably designed to… [a]pply any symbol… in a manner that is consistent for all types of obligors, securities, and money market instruments for which the symbol… is used."[35] Thus, when a rating agency uses a given symbol, the symbol must mean the same thing for all kinds of securities to which it is applied. However, the rule does not require that the same symbol must mean the same thing at different rating agencies.

Ratings Comparability vs. Rating Standardization

The idea that a rating agency's symbols should mean the same thing across sectors is often referred to as "ratings comparability." The idea that the meaning of rating symbols should be the same for all rating agencies is referred to as "rating standardization." The new rule addresses ratings comparability but not rating standardization.

Ratings comparability makes ratings useful for managing risk across fixed-income sectors. Ratings comparability, for example, allows a firm's chief investment officer to use a given rating agency's ratings as part of his or her toolkit for defining the

[34] See quotation accompanying note 30.

[35] 17 C.F.R. § 240.17g-8(b)(3) (2015), available at http://www.gpo.gov/fdsys/pkg/CFR-2015-title17-vol4/pdf/CFR-2015-title17-vol4-sec240-17g-8.pdf; *see also* 15 U.S.C. § 78*o*-8(a)(3) (2014), available at available at http://www.gpo.gov/fdsys/pkg/USCODE-2014-title15/pdf/USCODE-2014-title15-chap2B-sec78o-8.pdf.

firm's overall, fixed-income investment policy. It helps the chief investment officer to assess the balance of risk and return across sectors and thereby contributes to sector allocation decisions. Likewise, ratings comparability helps a firm's chief risk officer to gauge credit risk across sectors and to assess whether the firm is over- or under-risked relative to its risk appetite and risk tolerance.

In the past, regulators and other market participants seemed to presume that rating symbols had standardized meanings across rating agencies. The Basel III guidelines for risk-based capital standards for banks are a vivid example. Rating standardization does not actually exist. Congress directed the SEC to conduct a study of credit rating standardization and to report its findings.[36] The study found that rating definitions are not standardized across rating agencies and it recommended increasing transparency rather than mandating standardization.[37]

The SEC study also found that although ratings comparability is a stated goal of several rating agencies, their effectiveness in achieving it was questionable. Not surprisingly, the issue of ratings comparability was in the spotlight during the throes of the financial crisis, when large numbers of highly rated securities defaulted and the defaults were concentrated in just a few sub-sectors. The major rating agencies suffered damage to their reputations. Several reacted, in part, by publicly reaffirming their commitments to ratings comparability.

Evolution of Views on Ratings Comparability

Standard & Poor's was the first to react. In May 2008 and June 2009 it published articles firmly embracing a commitment to ratings comparability.[38] S&P uses one set of rating definitions for all asset classes. Also, S&P clearly states that the "sf" identifier that

[36] Dodd-Frank Wall Street Reform and Consumer Protection Act § 939(h), Pub. Law No. 111-203, 124 Stat. 1376 (2010) available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf. Congress also directed federal agencies to remove rating agency credit ratings from their regulations. Dodd-Frank Act § 939A(b).

[37] Securities and Exchange Commission, *Report to Congress – Credit Rating Standardization Study* (Sep 2012), https://www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf.

[38] Griep, C.M., Hessol, G.I., and Wong, C.R., *Standard & Poor's Reaffirms Its Commitment to the Goal of Comparable Ratings Across Sectors and Outlines Related Actions*, Standard & Poor's research report (6 May 2008); Adelson, M., Ravimohan, R., Griep, C.M., Jacob, D., Coughlin, P., Bukspan, N., and Wyss, D., *Understanding Standard & Poor's Rating Definitions*, Standard & Poor's criteria report (3 Jun 2009).

it attaches to ratings on structured finance securities to comply with legal requirements in certain countries does not change the meaning of the ratings.[39]

Even before the financial crisis, in the early 2000s, S&P voiced a commitment to cross-sector consistency.[40] Then, a few years later, it appeared to waver. Although the rating agency never openly renounced the idea of cross-sector consistency, different teams within the firm's analytic ranks seemed to apply conflicting definitions in practice. In late 2005, the firm's CDO rating team published a report stating that in its CDO rating model it would use different default rates for bonds from different sectors that carried identical ratings.[41] Also, with the benefit of hindsight, it now appears clear that, at least until the early 2000s, although S&P used the same long-term rating symbols for U.S. municipal bonds as for other securities, each symbol corresponded to a higher level of creditworthiness when applied to a U.S. municipal bond. In contrast to the other major rating agencies, when S&P eventually recalibrated its municipal ratings, it did so without any formal announcement.

Fitch published a report announcing its commitment to ratings comparability in June 2010.[42] It explained that it had recently completed a "recalibration initiative" for its ratings on U.S. municipal bonds, hinting, perhaps, that the rating definitions might not have been consistent in the past. Notwithstanding the 2010 article, Fitch's commitment to ratings comparability seems only halfhearted: the rating agency has different definitions for (i) corporate finance obligations and (ii) structured finance, project finance, and public finance obligations. Both sets of definitions use the same symbols (*i.e.*, AAA, AA, A, BBB, BB, B, etc.), but the former are phrased in terms of "credit risk" while the latter refer to "default risk."[43]

The evolution of Moody's thinking is somewhat more interesting because it was the most transparent on this issue. In the mid-1990s, statements by one of Moody's top

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[39] *Standard & Poor's Rating Definitions* ¶ 98 (22 Sep 2014).

[40] Griep, C., *Risk Management Applications Put New Focus on Ratings Criteria*, S&P special report (13 Jun 2001).

[41] Gilkes, K., Jobst, N. and Watson, B., *CDO Evaluator Version 3.0: Technical Document*, S&P criteria report, Appendix A (19 Dec 2005); Adelson, M., *Bond Rating Confusion*, J. Structured Finance, vol. 12, no. 4, pp. 41-48 (Winter 2007).

[42] Olert, J.S., Linnell, I., Stroker, N., Prescott, C., and Buckley, K.M., *Ratings Comparability*, FitchRatings special report (21 Jun 2010).

[43] *Definitions of Ratings and Other Forms of Opinions*, FitchRatings (Jan 2014) (compare definitions in Part A.1.1.2 with those in Part A.1.1.3).

executives indicated a very strong commitment to ratings comparability.[44] A subsequent article from 1999 reaffirmed ratings comparability as a goal, but also explained that in practice, ratings might have different meanings across sectors.[45] The following year, however, Moody's published an article emphasizing that it was trying to be "globally" consistent in its ratings across different geographic regions.[46] Then, in 2002, Moody's explained that it applied a distinct rating scale for rating U.S. municipal bonds.[47] Four years later, Moody's started to reverse its earlier stance on municipal bonds. It requested comment on a proposal to map its municipal bond rating scale onto its corporate rating scale.[48] It did so the following year.[49] In early 2010, Moody's announced that it would "recalibrate" its long-term U.S. municipal ratings to its global rating scale.[50] On the other hand, Moody's made a slight move in the opposite direction in how it describes the meaning of the "(sf)" identifier for ratings on structured finance securities. Although the rating agency uses one "global" rating scale and aspires to the goal of comparability, it cautions users of ratings that they should not expect structured finance securities to necessarily display the same performance as non-structured finance securities that carry the same rating.[51]

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[44] McGuire, T.J., "The Credit Rating Process a Global Perspective," Address at The Chase Manhattan Bank, International Advisory Committee (31 Oct 1994) (transcribed in Creating Efficiency in the Taxable Fixed Income Markets –Thomas J. McGuire's Legacy to Moody's Investors Service, at 136).

[45] Cantor, R., Fons, J.S., Mahoney, C.T., Watson, D, and Pinkes, K., *The Evolving Meaning of Moody's Bond Ratings*, Moody's rating methodology report (Aug 1999).

[46] Murray, C., Cantor, R., Collins, T., Hu, C.M., Keenan, S., Nayar, S., Ray, R., Ruttan, R., and Zarin, F., *Promoting Global Consistency for Moody's Ratings*, Moody's rating methodology report (May 2000).

[47] Washburn, L., Boicourt, R., Cantor, R., Farrell, D., Fons, J.S., Hamilton, D.T., Kurtz, K., Lipnick, L.H., Nelson, J., and Sussman, G., *Moody's US Municipal Bond Rating Scale*, Moody's special comment (Nov 2002).

[48] Richman, N., Oosterveld, B., Nelson, J., Washburn, L., Sussman, G., Robinson, C., and Kurtz, K., *Mapping of Moody's U.S. Municipal Bond Rating Scale to Moody's Corporate Rating Scale and Assignment of Corporate Equivalent Ratings to Municipal Obligations*, Moody's special comment (Jun 2006) (request for comment).

[49] Richman, N., Oosterveld, B., Nelson, J., Washburn, L., Kurtter, R., Sussman, G., and Kurtz, K., *The U.S. Municipal Bond Rating Scale: Mapping to the Global Rating Scale and Assigning Global Scale Ratings to Municipal Obligations*, Moody's rating methodology report (Mar 2007)

[50] Sussman, G., Dorer, J., Hu, C.M., Kurtter, R., and Nelson, J., *Recalibration of Moody's U.S. Municipal Ratings to its Global Rating Scale*, Moody's rating methodology report (Mar 2010).

[51] *Rating Symbols and Definitions* at 4, Moody's (Aug 2014).

Engineering a Workable Rule on Ratings Comparability

Although there now seems to be a rough consensus that ratings comparability is a worthwhile goal, actually achieving it might be impossible in practice. The reality of the financial world is that episodes of stress may affect different sectors differently. Different sectors may have peaks and troughs of credit performance at different times. The new SEC rules recognize that the principle of ratings comparability is more useful as an aspiration than as an expectation. The rules require a rating agency to have "policies and procedures" that aim for the result while not actually requiring the rating agency to achieve it.

The adopting release offers guidance explaining that, in enforcing the new rule, the SEC will consider whether the rating agency is working to achieve a consistent meaning of rating symbols across sectors, and not just whether it succeeds. The relevant passage from the adopting release states:

> Consequently, in enforcing the rule, the Commission will consider whether the NRSRO is achieving the objective through the use of established procedures and methodologies that are reasonably designed. In response to the commenters, the Commission agrees that the performance of credit ratings… will be relevant to considering whether the objective of consistency is being met. If the Commission staff believes the objective of consistency is not being met, the staff will need to consider whether the NRSRO has established… policies and procedures… designed to achieve this objective before making a recommendation to the Commission that the Commission institute an enforcement action.[52]

The SEC study on credit rating standardization laid important groundwork for avoiding confusion between ratings comparability across sectors (within a single rating agency) and rating standardization across different rating agencies. Avoiding the confusion was essential in order to avoid producing a mandate for standardization that could never have been achieved in practice

Non-standardization and Competition

Because there is no statutory or regulatory requirement for rating standardization, one of the ways in which rating agencies can compete is in how they define their ratings. This introduces at least two avenues for competition. First, rating agencies can have differing definitions of creditworthiness (*i.e.*, the thing that ratings purport to measure). For example, S&P primarily emphasizes *relative likelihood of default*

[52] Adopting Release, *supra* note 3, 79 Fed. Reg. at 55211 (footnote omitted).

in its rating system. However, it also considers payment priority, recovery, and credit stability as secondary factors of creditworthiness. By contrast, Moody's emphasizes *relative expected credit loss*.

A second avenue along which a rating agency can compete is the stringency of its rating scale. The rating agency can make its top rating easier or harder to achieve compared to the top ratings of other agencies. For example, if two rating agencies define their rating scales in terms of stress scenarios, one might link its top rating to the Great Depression while the second might link its top rating to an episode of lesser severity. In that case, the top rating on the first agency's scale would represent a higher standard of creditworthiness.

For a rating agency that generates most of its revenue from issuers, lowering its standards by re-defining its rating scale can be a form of competitive laxity that does not violate the prohibition against allowing sales or marketing considerations to influence criteria development. An agency's rating scale is not part of its criteria. Rather, an agency's rating scale transcends its criteria. The rating scale establishes the target levels of creditworthiness associated with each rating symbol. Criteria explain the methodology and assumptions for mapping issuers and securities to the symbols. The prohibition does not restrict where a rating agency places the targets. It simply requires that the criteria for every sector actually aim for the targets and not be influenced by sales or marketing considerations to aim lower.

It may be difficult for an established rating agency to practice competitive laxity across the board by redefining its rating scale. Such an action not only requires firm-wide coordination but also may damage the agency's credibility with a broad base of investors, leading to a loss of market share and revenue in the long run. By contrast, prior to the introduction of the new rules, it was comparatively easy for a rating agency to practice competitive laxity in an isolated sector; all it had to do was adopt new criteria for the sector.

So, careful reading reveals that there is actually an important interplay among the different provisions of the new rules. Although it might not be readily evident at first blush, the new rule on ratings comparability is conceptually connected to the prohibition against allowing sales or marketing considerations to influence criteria development. Moreover, the fact that the rules do not require rating standardization represents implicit recognition that how an agency defines its rating scale is fundamentally a competitive business decision and not an analytic one.

Item No. 4: System to Encourage Unsolicited Ratings of Structured Finance Securities Remains Broken

In 2009, the SEC released a rule amendment establishing a system intended to facilitate the production of unsolicited credit ratings on structured finance securities. An unsolicited rating is one by a rating agency that was not hired to rate the subject security.[53] According to the rule, a rating agency can accept an engagement to rate a structured finance security only if the issuer agrees that it will make all the information provided to that rating agency available to all other rating agencies. The information does not get filed with the SEC and investors do not have access to it.

The original purpose of the system was to encourage unsolicited ratings that would counter the effects of rating shopping and competitive laxity.[54] In principle, a rating agency that practiced competitive laxity would be exposed by unsolicited ratings from its competitors. Its credibility would suffer and its position would decline relative to the competitors.

A rating agency's decision to publish an unsolicited rating is a business decision with competitive motivations. One possible motivation is to discredit a competitor's analysis by presenting a superior alternative viewpoint. Another is to establish or expand the rating agency's presence in sectors, geographic regions, or asset classes by showcasing its analytical capabilities.[55]

Despite the best intentions, the system for encouraging unsolicited credit ratings has not actually worked. It has produced very few unsolicited ratings. The few that have occurred have been concentrated in surveillance ratings on outstanding securities. The landscape of unsolicited ratings on new structured finance issues has been barren.

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[53] SEC Rule 17g-5(a)(3), 17 C.F.R. § 240.17g-5(a)(3) (2014).

[54] Securities and Exchange Commission, *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, Release No. 34-57967, 73 Fed. Reg. 36212, 36243 (25 Jun 2008); Securities and Exchange Commission, *Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations*, Release No. 34-59343, 74 Fed. Reg. 6485, 6493, 6506 (9 Feb 2009); Securities and Exchange Commission, *Amendments to Rules for Nationally Recognized Statistical Rating Organizations*, Release No. 34-61050, 74 Fed. Reg. 63832, 63843-45, 63857, 63861 (4 Dec 2009).

[55] Issuers have sometimes accused rating agencies of publishing unsolicited ratings to punish an issuer for not having hired the rating agency to rate the subject securities. The accusation implies that the subject rating agency gave a lower rating than it otherwise would have out of spite. The market should easily be able to discern whether a rating agency is guilty of such conduct by considering whether the published analysis accompanying an unsolicited rating describes a proper application of the rating agency's criteria.

With the release of the latest rules, the SEC had the chance to replace the broken system. For example, it might have decreed that all information provided to any hired rating agency must be filed with the SEC and made available to investors. Instead, it left the ineffective and under-utilized system in place. In the end, however, it might not matter. The other features of the new rules – particularly the new prohibition against allowing sales or marketing considerations to influence criteria development – might be enough to address the challenge of competitive laxity.

Conclusion

Key items in the SEC's new rules for rating agencies are essential for allowing credit ratings to contribute toward enhancing the efficiency of the fixed-income markets. Keeping sales or marketing influence out of criteria development is such a basic idea that it should not need to be the subject of a rule. However, real-world events show that it does. Now it is. Likewise, recognizing that most ratings indicate *relative* risk rather than *absolute* risk is simply acknowledging the facts. Yet, because of awkward statutory language, the SEC had to draft guidance to prevent misinterpretation. Also, the potential for confusion between the ideas of ratings comparability (within a single rating agency) and rating standardization (across different rating agencies) was substantial because the Dodd-Frank Act addresses both. The SEC's final rules avoid confusion and provide clarity.

In contrast to the three new items, for which the SEC produced excellent results, it passed on the opportunity to correct the broken system for promoting unsolicited ratings on structured financings. This is a slight disappointment, but the new prohibition against sales or marketing influence on criteria may be enough to address the issue of sector-specific competitive laxity.

The new rules recognize that rating agencies are commercial enterprises that exist to generate profits for shareholders. While the new rules restrict rating agencies from competing by means of laxity in their criteria, the rules do not restrict other modes of competition. They can compete on the quality and utility of their published analyses. They may use unsolicited ratings as a part of their competitive strategies. In addition, rating agencies retain the ability to practice competitive laxity by redefining their rating scales.

— END —