The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) will have a significant impact on the activities, organization, and practices of the nationally recognized statistical rating organizations (NRSROs, or credit rating agencies). The provisions of the Act directed towards credit rating agencies reflect congressional findings that (i) credit ratings have “systemic importance” (ii) credit rating agencies play a “gatekeeper” role in the debt market that is functionally similar to securities analysts and auditors, and so warrant a similar level of oversight and accountability; (iii) certain conflicts of interest need to be carefully monitored; and, (iv) ratings on structured products were recently proven to be inaccurate, leading to mismanagement of risks by financial institutions and adverse impacts on the health of the economy during the financial crisis.

The Act addresses these conclusions by imposing new liability exposure on the credit rating agencies, mandating new internal control requirements and changes in their governance, imposing specific prohibitions to address conflicts of interest, specifying methodologies and procedures to be used in the ratings process, requiring a range of new disclosures, removing the imprimatur granted to ratings in many government regulations, and increasing SEC oversight.

NRSROs, which were not even registered as such with the SEC prior to September 2007, have gone from being lightly to highly regulated in a short period of time. In this environment, having strong procedures, compliance, internal controls, and governance will be imperative if they are to meet the demands of the new law. The Act directs the SEC to issue rules for its implementation, most of which must be completed within one year of passage – that is, by July 21, 2011.

This *A Closer Look* provides some context and perspective on the new law and its implications for NRSROs.
New liability exposure

**Private actions.** Dodd-Frank modifies the “state of mind” requirement for a private action to “knowingly or recklessly failed (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) to obtain reasonable verification of such factual elements” from a competent party independent of the issuer or underwriter.

**Liability.** Dodd-Frank amends the Securities Exchange Act of 1934 to apply to NRSRO statements the same enforcement and penalty provisions as apply to registered securities analysts and public accounting firms. It also clarifies that the ratings are not forward-looking statements for purposes of the Exchange Act’s Section 21E safe harbor.

The Act removed the protection from “expert” liability that NRSROs enjoyed under the Securities Act of 1933 when their ratings were used as part of a registration statement. This opens NRSROs up to potential liability under Section 11 of the Securities Act for material misstatements or omissions with respect to their ratings that are used in registration statements. As a result of this change, issuers will have to gain permission from NRSROs to use their ratings in a registration statement.

This increase in potential liability, which was not widely anticipated by those tracking the legislation, has already had an effect. The three major NRSROs came out right after the bill was passed and said they would not provide permission for their ratings to be used in registration statements. This in essence froze some new issuance of bonds as some types of assets — notably asset-backed securities — are required to include a rating. The SEC has temporarily addressed this issue by granting a six-month exemption that allows bond sales to proceed without ratings.

**Increased SEC enforcement tools.** Dodd-Frank also strengthens the SEC’s enforcement authority and tools with respect to NRSROs, and contains additional provisions addressing liability and penalties. For instance:

- **Prohibition on regulating substance of ratings does not preclude a fraud case.** The Act clarifies that the prohibition on the SEC from regulating the substance of ratings does not limit the SEC’s ability to bring a fraud action.

- **Failure to supervise.** The SEC may impose penalties on NRSROs and associated persons for failing to supervise.

- **Suspensions, revocations.** The SEC may suspend or revoke NRSRO registration for classes of securities if it deems an NRSRO lacks adequate financial and managerial resources to consistently produce ratings with integrity.

- **Reports will be “filed” with the SEC.** Credit rating agencies will now “file” with the SEC, as opposed to providing certain documents to it, such as registration application, financials, and annual reports. This subtle change ensures that the SEC can bring an action against a credit rating agency that files false or misleading information.

- **Duty to receive and refer tips.** NRSROs will have a duty to report to law enforcement or regulatory agencies any credible third-party information they receive that alleges that a rated issuer has committed or is committing a material violation of the law. The NRSRO need not verify the accuracy of this information. Separately, the NRSRO’s chief compliance officer (CCO) must establish procedures to receive, retain, and handle complaints regarding credit ratings, and any confidential, anonymous complaints by employees or users of ratings.

**Credit rating agencies will need to ensure that they have strong regulatory and compliance internal controls in place that meet or exceed legal requirements. This will help protect them from problems that can lead to litigation, and in the event of litigation, will help their defense by demonstrating that they have a strong control environment. Effective management of regulatory and litigation risk will be critical.**
New governance and internal control requirements

Boards of directors. Dodd-Frank imposes independence requirements on NRSRO boards of directors. Under the Act, at least half of the board (no fewer than two members) must be independent, and a portion (the number is not specified) must include users of ratings. NRSRO boards also now have specified oversight responsibilities for the NRSRO’s policies and procedures governing ratings methodologies, models, compliance (i.e., management of conflicts), internal controls, ratings accuracy, compensation, and promotions. To support independence, the independent directors’ compensation cannot be linked to the NRSRO’s financial performance.

Chief compliance officer. The Act also imposes certain independence requirements on an NRSRO’s chief compliance officer. The CCO cannot perform credit ratings, participate in the development of methodologies, perform marketing or sales functions, or participate in establishing compensation levels. The Act requires that the CCO submit an annual report on the NRSRO’s compliance to both the NRSRO itself and the SEC. As with independent directors, the Act also prohibits the CCO’s compensation from being linked to the financial performance of the NRSRO.

Internal controls and new CEO certification. NRSROs will have new internal controls obligations as well. The Act requires that each NRSRO “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.” In addition, the NRSRO must submit an annual report to the SEC that describes the responsibility of the NRSRO’s management in establishing and maintaining the internal control structure, and provides an assessment of its effectiveness, with an attestation by the NRSRO’s CEO.

Strong governance and internal controls are at the core of these new provisions. Dodd-Frank makes it clear that NRSRO boards, CEOs, CCOs, and senior managers play critical roles in the NRSRO’s control framework. Boards, CEOs, and CCOs will have new obligations and responsibilities. The annual internal controls and compliance reports should reflect that the NRSRO has in place an operationally robust control and compliance infrastructure.

Management of conflicts of interest

The Act contains several provisions related to conflicts of interest, including:

- **Information barriers between marketing and ratings.** The SEC is directed to issue rules to prevent an NRSRO’s sales and marketing considerations from influencing the production of its ratings. In addition, the SEC will now have explicit authority to suspend or revoke a registration for failure to adhere to such information barriers.

- **Attestation in ratings.** NRSROs must include an attestation in any credit rating issued that affirms that no part of the rating was influenced “by any other business activities,” that the rating was based solely on the merits of the instrument, and that the rating was an independent evaluation of the risks and merits of the instrument.

- **“Look-back” at employment conflicts.** The Act contains mandated timeframes and reporting requirements pertaining to employment conflicts:
  - To determine whether any employee conflicts of interest influenced its ratings, an NRSRO must review ratings of a company for one year if an employee involved in rating that company leaves the NRSRO to work for the rated issuer, underwriter, or sponsor. The SEC is required to periodically review how well rating agencies are meeting this obligation.
  - An NRSRO must report to the SEC if any designated persons (senior officers, employees involved in a rating, or their supervisors) leave the NRSRO and become employed by a rated issuer, underwriter, or sponsor for whom they provided a rating in the year prior to their change of employment. The SEC will make this information public.
The Act also includes a “Sense of Congress” that the SEC should issue rules to prevent improper conflicts of interest arising from employees of NRSROs providing services (including consulting and advisory services) to issuers that are unrelated to using credit ratings.

The Act reflects congressional concern about conflicts of interest that could impair the integrity of ratings. To address conflicts, it appears to borrow several of the measures used in the research analyst conflict of interest situation — mandating walls between analytical and other units to separate analysts from other functions, and requiring that reports contain an attestation of objectivity. Experience in implementing those measures in other contexts indicates that they must be carefully crafted and implemented in order to be compliant and effective. Implementing the employee look-back provisions will require care, as well as sound recordkeeping and tracking systems regarding movements of employees.

New and specific requirements for ratings methodologies and procedures

Dodd-Frank reaches deep into the inner workings of the NRSROs with respect to the methods they use to create and issue ratings. For example, under Dodd-Frank:

- **NRSROs must consider other sources of information.** NRSROs are required to consider issuer-related information that they have or receive from a source other than the issuer, and find “credible and potentially significant to a rating decision.”

- **Elimination of the exemption from Regulation FD (Fair Disclosure).** The Act directs the SEC to remove the credit rating agency exemption from Regulation Fair Disclosure within 90 days of enactment, which will result in NRSROs no longer receiving selective disclosures from issuers whose securities they rate.

- **Issuers and underwriters must disclose third-party due diligence reports; due diligence providers have new obligations.** Issuers and underwriters of asset-backed securities will have to make publicly available the findings and conclusions of any third-party due diligence report obtained. Third-party due diligence providers must also provide client NRSROs with certification that they have conducted a thorough review of data, documentation, and other relevant information necessary for the NRSRO to provide an accurate rating. The Act requires that these certifications be made public.

Taken together, these requirements, along with the greater liability exposure, place significant new pressure on due diligence. Costs to conduct adequate due diligence, whether internally or on an outsourced basis, will likely increase.

In addition, the Act requires that the SEC issue rules with respect to NRSROs’ procedures and methodologies. These rules will require:

- **Board approval.** NRSROs must issue ratings determined by procedures and methodologies (including qualitative and quantitative data and models) approved by the NRSRO’s board of directors.

- **Consistency in application and disclosure of changes.** NRSROs must apply changes to ratings procedures and methods, and changes to surveillance procedures for then-current ratings, in a consistent manner, and must disclose publicly the reasons for such changes.

- **Notification to users.** NRSROs must notify users (i) of the particular version of a procedure or methodology, including the qualitative methodology or quantitative inputs, used with respect to a particular rating; (ii) when a material change is made (and the likelihood of a material change resulting in a change in current credit ratings); and (iii) when a significant error is identified.

- **Definition and disclosure of symbols.** NRSROs must have written policies and procedures that clearly define the meaning of each ratings symbol used. They must apply such symbols consistently, and disclose each symbol’s meaning.

- **An assessment of the likelihood of default.** NRSROs must have written policies and procedures to assess the likelihood that an issuer will fail to meet the payment obligations of its security, including defaulting.
Training and testing of ratings analysts. New rules will require that ratings analysts meet “standards of training, experience, and competence necessary to produce accurate ratings” and be tested for knowledge of the credit rating process.

Taken together, and along with the new internal controls requirements and reporting described above, these requirements impose a new and more formal regime for producing ratings.

NRSROs may want to confirm that their current model governance policies and procedures are sufficient to support the consistent management of models throughout all phases of the model lifecycle — including model development, implementation, ongoing performance monitoring, and change management. Model governance policies and procedures may also need to be updated to incorporate the required disclosure of changes and notification of users, and to clearly define what is considered a material change to a methodology. Additionally, consistent with industry leading practices, model governance policies and procedures should incorporate requirements for independent model validation, both at the time of model implementation and when material model changes are made.

The newly required training and testing of ratings analysts may reflect the updated model governance process and the different technical approaches used by the NRSROs to produce models.

A range of new disclosure obligations

Dodd-Frank imposes a large number of new disclosure obligations on NRSROs — both to create and release information concerning the performance of ratings over time, as well as to provide certain information along with each individual credit rating.

Ratings performance reports. The SEC is directed to issue rules requiring each NRSRO to issue disclosure on its website, in a clear, informative, and comparable format, on the initial rating for each type of instrument and any subsequent changes to the rating, to allow users to evaluate the accuracy of ratings and compare performance among NRSROs.

New disclosures to accompany each rating. The SEC is directed to issue rules requiring each NRSRO to provide a form with each rating that discloses both qualitative and quantitative information about the rating, including the assumptions underlying the rating procedures and methodologies, the data relied upon, and, if applicable, how servicer or remittance reports were used to conduct surveillance. Among the disclosures:

- The main assumptions and principles used, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating structured products
- The potential limitations of the credit ratings, and types of risks excluded (including liquidity, market, and other risks)
- Information on the uncertainty of the credit rating (i.e., the reliability, accuracy, quality, limits on data, or accessibility of information)
- Whether and to what extent third-party due diligence services were used, a description of information that such services reviewed in conducting their due diligence, and a description of their findings or conclusions
- A description of data relied upon and an overall assessment of the quality of the information available in relation to information available about other similar issuances
- Information relating to conflicts of interest
- An explanation or measure of the potential volatility of the rating (factors that might lead to a change in the rating, the magnitude of the change under different market conditions, the historical performance of the rating, the expected probability of default, and loss in the event of default)
- Information about the sensitivity of the rating to assumptions made, along with an analysis and examples

In addition, within 180 days of enactment, the SEC is directed to require NRSROs to include in any report accompanying a credit rating for an asset-backed security offering a description of the representations,
warranties, and enforcement mechanisms available to investors, and how they differ from the representations, warranties, and enforcement mechanisms in issuances of similar securities.

These new disclosures appear to be intended to provide information to users of ratings to allow them to better understand the basis for the rating, as well as to develop a deeper understanding of the limitations of the credit rating, and to evaluate the quality of credit ratings among the various NRSROs. It will be critical for NRSROs to establish programs and procedures to adequately capture and accurately present the information in the form.

References to credit ratings are to be removed from federal laws

Dodd-Frank mandates the striking of references to credit ratings from many federal laws by July 2012. The statutes and agencies affected include:

Securities Exchange Act of 1934. The SEC will now have to create standards that do not rely on credit ratings for determining if a security qualifies as a mortgage-related or small-business-related security.

Investment Company Act of 1940. One of the requirements for a state-regulated investment company to rely on an exemption from the Investment Company Act has been that certain debt securities must be rated investment grade by an NRSRO or, in the case of an investment in an open-end investment company, 65% of the open-ended investment company’s assets must be deemed investment grade by an NRSRO. The SEC will now have to come up with an alternative standard of creditworthiness.

National Bank Act. Dodd-Frank removes references to NRSRO ratings from the standards applicable to the 100 largest banks owning a financial subsidiary. Now these banks will have to have at least one debt instrument issued that meets creditworthiness standards promulgated by the Department of the Treasury and Federal Reserve Board.

Federal Deposit Insurance Act. Savings associations’ corporate debt holdings will now have to meet standards of creditworthiness established by the FDIC, instead of being rated investment grade by an NRSRO. In addition, credit ratings agencies are no longer a source the FDIC may use when considering the soundness of a depository institution. The term “credit rating agencies” was replaced by “credit analysts.”

Federal Housing Enterprises Financial Safety and Soundness Act of 1992. The director of the Federal Housing Finance Agency can engage any entity — not just an NRSRO — to review the credit quality of Freddie Mac, Fannie Mae, or the Federal Home Loan Banks.

World Bank/International Bank for Reconstruction and Development (IBRD). Under Dodd-Frank, the United States executive director of the IBRD, under the direction of the Secretary of the Treasury, shall support voluntary market-based programs to reduce sovereign debt and sustain economic development and would only allow lending if the IBRD’s creditworthiness is not lowered. Prior to Dodd-Frank, the IBRD’s credit rating had to be preserved.

The goal of the removal of statutory references is to remove the statutory imprimatur given to credit ratings issued by credit rating agencies, and to substitute standards to be developed by the administering agency. On August 10, 2010, the federal banking regulators (the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation) jointly issued an advance notice of rulemaking regarding alternatives to the use of credit ratings in the regulatory capital guidelines. It seeks comment on a range of potential approaches. Other regulators will issue similar requests for comment and solicit input in developing alternative standards for determining creditworthiness.

SEC oversight is enhanced

Dodd-Frank also mandates that the SEC create an Office of Credit Ratings, with a director who reports to the SEC chairman. The Office of Credit Ratings is to administer the rules with respect to credit rating agencies for
the protection of users of ratings, to promote accuracy in ratings, and to ensure that ratings are not unduly influenced by conflicts of interest.

**Inspection regime mandated.** The staff of the office is directed to conduct annual examinations of compliance, management of conflicts of interest, implementation of ethics policies, internal supervisory controls, governance, the activities of the CCO, the processing of complaints, and policies governing the post-employment activities of departing staff (new obligations for departing staff are described above). The SEC must make public its summaries of essential findings of the examinations, along with the NRSRO’s responses and whether the NRSRO has appropriately addressed the recommendations. The SEC is also directed to issue rules establishing fines and other penalties for violations of these requirements.

> Annual examinations, coupled with new SEC authority to fine NRSROs for violations, will mean the NRSROs will not only need to have strong internal controls, but ensure they have the procedures and staff resources to manage near continuous regulatory reviews and recommendations that may result.

**New studies are mandated**

In addition to the specific new obligations outlined above, Dodd-Frank also mandates that both the SEC and General Accounting Office (GAO) conduct a number of studies that may, among other things, result in additional rulemaking in the future. The Act mandates specific timeframes for the completion of these studies.

**SEC studies:**

- **Standardizing terminology and inputs.** Study the feasibility of standardizing terminology across credit rating agencies and ratings classes, and whether standardized stress testing and default probabilities should be used (within one year).

- **Assigned credit ratings.** Study the credit rating process for structured finance products and conflicts of interest associated with both the issuer-pay and subscriber-pay models, and assess the feasibility of any alternative models, such as establishing a public or private utility or self-regulating organization to assign NRSROs to determine ratings (within two years). The SEC is also given rulemaking authority to establish a system for the assignment of ratings of structured finance products to prevent the issuer from selecting the NRSRO.

- **Strengthening credit rating agency independence.** Study the independence of NRSROs, management of conflicts of interest raised when NRSROs provide other services, and the potential impact of prohibiting NRSROs from providing other services (within three years).

**GAO studies:**

- **Independent professional analyst organization.** Study the feasibility of creating an independent organization of NRSRO ratings analysts that would set standards for governing the profession of rating analysts, establish an ethical code of conduct, and oversee the profession (within one year).

- **Alternative business models.** Study alternative means for compensating NRSROs in order to create incentives for NRSROs to provide more accurate credit ratings (within 18 months).

> Until these studies are complete, we can’t know whether they will result in recommendations for further action, either legislative action or SEC rulemaking. This adds a degree of uncertainty to the regulatory environment as the NRSROs adjust to Dodd-Frank and the related current rulemaking.
While Dodd-Frank will have significant impact on credit rating agencies, many implementation issues are currently unclear and are subject to the SEC and other agencies’ rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

Additional information

If you would like additional information on Dodd-Frank or about PwC’s Financial Services Regulatory practice, please contact:

Dan Ryan  
FS Regulatory Practice Chairman  
646-471-8488  
daniel.ryan@us.pwc.com

Gary Meltzer  
FS Regulatory Practice Managing Partner  
646-471-8763  
gary.c.meltzer@us.pwc.com

John Garvey  
FS Advisory Leader  
646-471-2422  
john.garvey@us.pwc.com

PwC’s Financial Services Regulatory Practice Leaders

Kenneth Albertazzi  
617-530-6237  
kenneth.albertazzi@us.pwc.com

A. Duer Meehan  
703-918-6191  
a.duer.meehan@us.pwc.com

David Sapin  
646-471-8481  
david.sapin@us.pwc.com

Gary Welsh  
703-918-1432  
gary.welsh@us.pwc.com

David Albright  
703-918-1364  
david.albright@us.pwc.com

Robert Nisi  
646-471-4027  
robert.nisi@us.pwc.com

Ellen Walsh  
646-471-7274  
ellen.walsh@us.pwc.com

Ric Pace  
703-918-1385  
ric.pace@us.pwc.com

Dan Weiss  
703-918-1431  
dan.weiss@us.pwc.com

Thomas Biolsi  
646-471-2056  
thomas.biolsi@us.pwc.com

Richard Paulson  
646-471-2519  
richard.paulson@us.pwc.com

Gary Welsh  
703-918-1432  
gary.welsh@us.pwc.com

John Campbell  
646-471-7120  
john.w.campbell@us.pwc.com

Jeff Lavine  
703-918-1379  
jeff.lavine@us.pwc.com

Lori Richards  
703-610-7513  
lori.richards@us.pwc.com

www.pwcregulatory.com

© 2010 PricewaterhouseCoopers LLP. All rights reserved. “PricewaterhouseCoopers” refers to PricewaterhouseCoopers LLP, a Delaware limited liability partnership, or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity. This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.