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Rating Agency Regulation: The SEC Strikes a Balance

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The SEC and its staff deserve kudos for their handling of the controversial "notching" issue in their new rating agency regulations.¹ New Rule 17g-6(a)(4) prohibits notching only when it is done "for an anticompetitive purpose." In our opinion, the intent-based standard is exactly the right approach. The new rule combines the intent-based standard with a documentation and record retention requirement under new Rule 17g-2(b)(8). The retained documentation and records should help the SEC determine intent for purposes of enforcing Rule 17g-6(a)(4).

The "Inner Capitalist" within most financial professionals loves to hate regulation. Much of the time, criticism of regulations and of regulators is warranted. On the other hand, sometimes regulators tackle a tough issue and figure out exactly the right way to regulate. That is just what happened with the notching issue.

The adopting release for the new regulations² notes that the SEC received more comments on the proposed treatment of notching than on any other issue. The final rule is markedly different than the original proposal.³ The original proposal included a prohibition on

[i]ssuing or threatening to issue a lower credit rating, or lowering or threatening to lower an existing credit rating, or refusing to issue a credit rating or withdrawing a credit rating ... of any asset-backed or mortgage-backed securities transaction, unless a portion of the assets which comprise the asset pool or the asset-backed or mortgage-backed securities also are rated by the rating organization.

However, the original proposal also provided a partial exception:

The prohibitions on refusing to issue a credit rating or withdrawing a credit rating shall not apply if the rating organization has rated less than 85% of the market value of the assets underlying the asset pool or the asset-backed or mortgage-backed securities.

The comments received by the SEC in response to the proposal were divided on the notching issue. Both Fitch and DBRS supported the proposed prohibition. They, along with many other commenters, proposed making the prohibition even more stringent. They recommended narrowing the exception by lowering the 85% threshold to 66%.⁴ Many supporters of the prohibition expressed the view that notching is "unfair" and reduces competition among rating agencies.

¹ Notching occurs when a rating agency *estimates what rating it would have assigned to a security based on the ratings actually assigned by other rating agencies*. Some rating agencies employ notching as part of their process for rating CDOs. Notching is one of several ways for a rating agency to handle underlying securities that it did not rate. Naturally, the most obvious approach for handling such securities would be to rate them. However, rating agencies have to charge significant fees for doing so and must have access to the relevant information. Notching is an alternative that the rating agencies make available to CDO issuers.

² Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55,857, 72 Fed. Reg. _____ (___ Jun 2007).

³ Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 55,231, 72 Fed. Reg. 6377 (9 Feb 2007).

⁴ *Id.*, n. 423.

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Other commenters, including S&P and Moody's, opposed the proposed prohibition. They argued that forcing rating agencies to accept and rely on each others' opinions would reduce competition by constraining their ability to perform independent credit analysis and to express their independent views. Moody's and S&P asked the SEC to strike the prohibition entirely. However, each suggested a variety of other alternatives as well. One of Moody's suggested alternatives was an "intent" standard and one of S&P's was a record retention requirement. In the end, the SEC chose a combination of the Moody's and S&P suggestions.

The SEC's choice of an intent-based approach under Rule 17g-6(a)(4) follows meaningful examples from other areas of the law. For example, under the federal securities laws, a plaintiff pursuing a securities fraud claim under 1933 Act § 10(b) must prove that the defendant acted with "scienter" — deliberately or knowingly. Likewise, in the area of freedom of speech, liability for defamation depends on intent in certain contexts. In *New York Times v. Sullivan*,⁵ the Supreme Court decided that a public official cannot recover damages for libel unless he can show that the defendant acted with "actual malice." The Court stated:

The constitutional guarantees require, we think, a federal rule that prohibits a public official from recovering damages for a defamatory falsehood relating to his official conduct unless he proves that the statement was made with "actual malice" — that is, with knowledge that it was false or with reckless disregard of whether it was false or not.⁶

Perhaps the most interesting aspect of Rule 17g-6(a)(4) is that it seems to have less to do with securities regulation than with antitrust law. The Department of Justice and the Federal Trade Commission are the entities primarily responsible for administering and enforcing the federal antitrust laws. Traditionally, the SEC has not had a major role in the antitrust arena. Left to itself, the SEC probably would not have embraced such a role. However, Congress forced the issue by enacting the Credit Rating Agency Reform Act of 2006.⁷ That law contains a Congressional finding that "the 2 largest credit rating agencies serve the vast majority of the market, and additional competition is in the public interest." Other provisions of the law effectively designate the SEC as the regulator of the credit rating industry. Accordingly, the SEC had to tackle the issue of competition within the industry.⁸

The adopting release for the new regulations does not refer to the federal antitrust laws. In particular, the discussion of the intent-based approach in Rule 17g-6(a)(4) does not mention the antitrust laws. Arguably it should have. According to the Supreme Court's decision in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*,⁹ intent is the key element of actions under section 2 of the Sherman Antitrust Act.¹⁰ The intent aspects of antitrust law have been deeply explored and extensively discussed.¹¹ Thus, perhaps even without realizing that it was doing so, the SEC constructed its new intent-based structure on strong, deep, and wide foundations.

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⁵ 376 U.S. 254 (1964)

⁶ *Id.* at 279-80

⁷ Pub. Law No. 109-291, 120 Stat. 1327.

⁸ Significantly, the subsection of the law that addresses prohibited acts and practices provides it must not be construed to "modify, impair, or supersede" the operation of the main federal antitrust laws.

⁹ 472 U.S. 585 (1985).

¹⁰ 15 U.S.C. § 2, July 2, 1890, ch. 647, 26 Stat. 209.

¹¹ See e.g., Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 S. CAL. L. REV. 657 (2001).

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