

Draft as of March 4, 2021  
To be discussed at the March 11, 2021 Meeting of the Investor Advisory Committee

**DRAFT Recommendation of the Market Structure Subcommittee of the SEC Investor Advisory Committee regarding Credit Rating Agencies**

This recommendation concerns the annual reports released by the SEC's Office of Credit Ratings (OCR) regarding credit rating agencies registered with the SEC.

**Background**

Credit rating agencies play a significant role in credit markets, including because investors often rely on ratings to inform their investment decisions. Recognizing their important role, Congress passed the Credit Rating Agency Reform Act of 2006,<sup>1</sup> which provided the Commission the authority to establish an oversight program for credit rating agencies that are registered with the Commission as nationally recognized statistical rating organizations ("NRSROs").

Shortly after the Credit Rating Agency Reform Act became law, however, the 2007-2008 global financial crisis hit. Many commentators and policy makers concluded that credit rating agencies' failure to accurately assess the creditworthiness of various companies and financial instruments played a role in the financial crisis.<sup>2</sup> According to the Commission staff, the rating agencies' practices "raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole."<sup>3</sup>

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<sup>1</sup> Pub. L. No. 109-291, 120 Stat. 1327 (2006). In enacting this law, Congress found that credit rating agencies are of national importance, in that, among other things, the oversight of such credit rating agencies serves the compelling interest of investor protection.

<sup>2</sup> See *The U.S. Senate Permanent Subcommittee on Investigations, SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 6* (2011) [https://www.hsgac.senate.gov/imo/media/doc/PSI%20REPORT%20-%20Wall%20Street%20&%20the%20Financial%20Crisis-Anatomy%20of%20a%20Financial%20Collapse%20\(FINAL%205-10-11\).pdf](https://www.hsgac.senate.gov/imo/media/doc/PSI%20REPORT%20-%20Wall%20Street%20&%20the%20Financial%20Crisis-Anatomy%20of%20a%20Financial%20Collapse%20(FINAL%205-10-11).pdf) ("Inaccurate AAA credit ratings introduced risk into the U.S. financial system and constituted a key cause of the financial crisis."); See also SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (July 2008), <https://www.sec.gov/news/studies/2008/craexamination070808.pdf>; See also Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting Regarding Final Rules on Nationally Recognized Statistical Rating Organizations, August 27, 2017, <https://www.sec.gov/news/statement/2014-08-27-open-meeting-statement-nrsro-msp.html> ("[T]he recent financial crisis, which has been attributed in part to investor overreliance on credit ratings for structured finance products that, in hindsight, used faulty assumptions and led to a large number of downgrades.").

<sup>3</sup> SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (July 2008), <https://www.sec.gov/news/studies/2008/craexamination070808.pdf> (examining the rating agencies' activities in rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime residential mortgage-backed securities.).

In response to the financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. The Dodd-Frank Act included provisions designed to enhance the transparency and accountability of NRSROs. This included creating the Office of Credit Ratings (“OCR”) to administer Commission rules related to NRSROs for the protection of users of credit ratings and in the public interest, to promote accuracy in credit ratings by NRSROs, and to ensure that such ratings are not unduly influenced by conflicts of interest. Among other responsibilities, the OCR was tasked with conducting annual examinations of each NRSRO.<sup>4</sup>

The Dodd-Frank Act included a finding by Congress that “[i]n the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.”<sup>5</sup>

### ***OCR’s Annual Examination Reports***

The Dodd-Frank Act made a number of changes to the regulation of credit rating agencies to address the deficiencies that Congress identified. These statutory provisions specify the topic areas that each examination shall include<sup>6</sup> and require that the Commission make available to the public, in an easily understandable format, inspection reports summarizing the essential findings of the examinations, the responses by the NRSROs to any material regulatory deficiencies identified by the Commission, and whether the NRSROs have appropriately addressed the recommendations of the Commission contained in previous inspection reports.<sup>7</sup>

The Dodd-Frank Act further charged the SEC OCR with a requirement to make available to the public an annual inspection report which details the findings of the annual examination, provides the responses by the NRSRO to any finding of material regulatory deficiencies identified by the SEC, and specifies whether the NRSRO has appropriately addressed the recommendations of the Commission contained in prior examination reports.<sup>8</sup>

In implementing that section of the Dodd-Frank Act, the SEC chose to make the annual examination report confidential, despite the fact that the text of the authorizing legislation does not mention or require that the annual examination report be confidential. By contrast, when Congress intended for examination information to be confidential, as with the concept of confidential supervisory information familiar to bank regulation and examination, Congress adopted legislation

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<sup>4</sup> Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1872-83 (2010).

<sup>5</sup> See Wall Street Reform and Accountability Act, Section 931(5).

<sup>6</sup> The eight topic areas are: (i) whether the NRSRO conducts business in accordance with its policies, procedures, and rating methodologies; (ii) the management of conflicts of interest by the NRSRO; (iii) the implementation of ethics policies by the NRSRO; (iv) the internal supervisory controls of the NRSRO; (v) the governance of the NRSRO; (vi) the activities of the DCO of the NRSRO; (vii) the processing of complaints by the NRSRO; and (viii) the policies of the NRSRO governing the post-employment activities of its former staff.

<sup>7</sup> Exchange Act Section 15E(p)(3)(B).

<sup>8</sup> See Securities Exchange Act Section 15E(p)(3)(C).

with specific and extensive legislative language delineating the contours of what is protected and the consequences for revealing the information.<sup>9</sup>

When considered in light of the transparency and accountability mandates of these provisions, the SEC’s prior decision that annual examination reports will not identify the specific NRSRO whose conduct was deemed by OCR staff to be materially deficient should be reconsidered. The anonymously identified deficiencies appear to be material enough that the investor community would find them material in assessing credit rating agency performance. Instead, each regulatory deficiency is described in vague and general terms, referring to a “larger” or “smaller” NRSRO. For example, one report stated that for a “larger” NRSRO—meaning Moody’s, S&P, or Fitch—certain types of ABS transactions did not adhere to its policies and procedures concerning surveillance and data quality.<sup>10</sup> Similarly, a “smaller” NRSRO did not have policies, procedures, and internal controls for assigning and maintaining credit ratings of potentially conflicted parties.<sup>11</sup>

Deficiencies cited in the 2019 reports have included, for example, failure by the NRSRO to: properly apply or adhere to their methodologies, criteria, or policies and procedures for determining ratings; ensure that rating publications contain complete, accurate, and timely information concerning the particular rating actions or the methodologies and criteria applied to those rating actions; and separate analytical activities from sales and marketing activities and prevent analytical activities from being influenced by sales and marketing considerations.

During the most recent 2020 Exam Report, OCR identified three instances in which CRAs failed to remedy significant problems identified in the prior year’s Exam Report.<sup>12</sup> The annual exam report notes that a “smaller NRSRO” did not accurately disclose the methodologies it used to determine credit ratings. It also notes that a “smaller NRSRO” lacked a mechanism to ensure the application of its policies to its directors. It further notes that a “smaller NRSRO” lacked effective internal controls with respect to a variety of functions mandated by regulation.<sup>13</sup> Prior annual examination reports similarly detail that NRSROs often fail to address material weaknesses identified in prior examinations.

Without more detail, it is difficult for the public to know how severe the deficiencies are and therefore how concerned it should be about the NRSROs’ failures to remedy them promptly. We believe greater transparency is essential in order for the OCR’s examinations to serve their statutory purpose.

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<sup>9</sup> See Federal Reserve, Supervisory and Confidential Information, *summarized at* [https://www.federalreserve.gov/supervisionreg/topics/supervisory\\_n\\_confidential\\_info.htm](https://www.federalreserve.gov/supervisionreg/topics/supervisory_n_confidential_info.htm)

<sup>10</sup> Staff of the U.S. Securities and Exchange Commission, 2016 SUMMARY REPORT OF COMMISSION STAFF’S EXAMINATIONS OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION, As Required by Section 15E(p)(3)(C) of the Securities Exchange Act of 1934 (December 2016) <https://www.sec.gov/files/nrsro-summary-report-2016.pdf>

<sup>11</sup> Staff of the U.S. Securities and Exchange Commission, 2019 SUMMARY REPORT OF COMMISSION STAFF’S EXAMINATIONS OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION, As Required by Section 15E(p)(3)(C) of the Securities Exchange Act of 1934 (January 2020) <https://www.sec.gov/files/nrsro-summary-report-2019.pdf>

<sup>12</sup> See <https://www.sec.gov/files/nrsro-summary-report-2019.pdf> at page 10.

<sup>13</sup> See <https://www.sec.gov/files/nrsro-summary-report-2019.pdf> at 10.

The anonymized nature of OCR’s annual examination report, which merely identifies firms as a “smaller NRSRO” or a “larger NRSRO” does not allow public investors or issuers to assess the reliability or credibility of NRSROs. It is further unclear whether the multiple instances of multi-year infractions occur at a single firm or multiple firms.

### ***Concerns about Lack of Transparency in Annual Examination Reports***

Concerns about the transparency of OCR’s annual examination reports previously have been raised with the Commission, without resolution. In October 2017, University of California Berkeley School of Law Professor Frank Partnoy published an article highlighting concerns regarding the annual reports’ failure to identify particular NRSROs, in addition to expressing broader concerns about the continued overreliance on credit ratings, a lack of oversight and accountability, and primitive methodologies used by rating agencies since congressional and regulatory reforms were enacted.<sup>14</sup> Specifically, Professor Partnoy requested that the Commission provide the identities of the rating agencies in the OCR’s reports under the Freedom of Information Act (FOIA), but the Commission’s FOIA office denied his request.<sup>15</sup>

As discussed above, the OCR’s approach of withholding the identities of the NRSROs whose activities are deemed by OCR staff to be deficient is inconsistent with congressional intent to increase the transparency and accountability of rating agency practices. It is also, according to Professor Partnoy, “contrary to the SEC’s own 2014 release implementing its new NRSRO rules, where it repeatedly emphasized the importance of making information about each agency easily accessible.”<sup>16</sup>

In addition, this approach precludes investors and third parties from adequately assessing the reliability of particular rating agencies’ policies and procedures and comparing the practices of different NRSROs. In so doing, withholding the identities of NRSROs in annual examination reports hampers investors’ ability to make fully informed decisions about whether to rely on their ratings. Such an outcome is likely to perpetuate a system of over-reliance on credit ratings, including on ratings that may not be reliable or accurate.

### ***Analogy to the PCAOB’s annual public inspection reports***

A closely analogous regime which might better inform the SEC’s annual examination and annual report of examinations for NRSROs is the Public Company Accounting Oversight Board’s annual inspection process for accounting firms that audit more than 100 issuers. For those firms, the PCAOB conducts annual inspections and provides public reports of those inspections. The public versions of the annual examination report contain more limited information than what is contained in the full PCAOB inspection report, but are nevertheless quite extensive compared to the OCR’s annual exam reports. This regime for reporting inspection results recently underwent a substantial reform to increase the level of information provided to the public.

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<sup>14</sup> Frank Partnoy, What’s (Still) Wrong with Credit Ratings, 92 Wash. L. Rev. 1407, Oct. 3, 2017, <http://bit.ly/2izCTMY>.

<sup>15</sup> Id. at 1429, note 107.

<sup>16</sup> Partnoy at 1431.

The PCAOB's public inspection reports do not identify the specific clients whose audits are inspected. They do, however, provide copious information to assess the auditor's performance, including graphic representations of the percentage of total audits inspected at that audit firm that contained material deficiencies. The material deficiencies are categorized by type of account or transaction affected and are each described in multi-paragraph narrative format.

The public annual reports of each auditor inspected contain roughly 20 pages of information about an auditor who is identified by name, including information about the method of inspection and the results of the inspection. The PCAOB's annual reports also provide the audit firm an opportunity to respond that is listed as an appendix to the report.

### **Recommendation**

The IAC believes investors would benefit, credit rating agencies would be more accountable, and market transparency would be aided if the SEC were to enhance the transparency of its annual inspection reports. Toward that end, the IAC recommends that OCR identify in its reports the specific NRSRO whose conduct was deemed by OCR staff to be materially deficient. The format of OCR's annual examination reports should be remodeled to conform to the approach utilized in the PCAOB's annual public inspection reports.

This recommendation would be faithful to Congress' goals of increasing the transparency and accountability of credit rating agencies. It would also enable users of credit ratings to more adequately assess the reliability of particular rating agencies' policies and procedures and compare the practices of different NRSROs. In so doing, it would increase users' ability to make more informed decisions about whether to rely on particular rating agencies' ratings. In addition, providing the market with information that will enable more informed decisions about whether to rely on particular rating agencies' ratings can potentially reduce reliance on unreliable and inaccurate ratings.