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# Credit Rating Agencies: Opportunities for Legal and Regulatory Reform

**By Alessandro Gullo and Isaac Lustgarten**

Various market participants in the asset-backed securities markets and regulators have noted deficiencies in the performance of the credit rating agencies (CRAs). There have been attempts to regulate the CRAs as a result of their failure in various financial and corporate crises to identify problems in the credit worthiness of the securities that they rate. Some market participants blame the CRAs directly for "enabling" the current financial crisis. CRAs have been blamed for their roles in accounting scandals, the Asian crisis, the dotcom bubble and the current financial crisis, which started with problems in the securitization of subprime loans. The CRAs in turn have different views of their roles in these financial and corporate crises and over time have succeeded in avoiding regulation. The CRAs enjoy a privileged position; they are an oligopoly, endorsed by governments and regulators, and their role is embedded in the fabric of investment guidelines and requirements and the functioning of the financial markets. The CRAs view their role in the financial markets differently, and as a result they have a different view of the causes of the current financial crisis.

In general, regulators and market participants have focused on the CRAs' lack of historical data and flaws in their methodologies. The historical data, used by the CRAs, reflected favorable economic conditions with a steady growth of the housing and mortgage markets. CRAs failed to test methodologies under a broad market downturn and underestimated the underwriting standards and practices of some lenders and underwriters. Moreover, regulators have criticized the overall quality of the information provided by issuers and arrangers to the CRAs.

This article focuses on *current* and evolving regulatory requirements that present a new legal approach to the CRA business, particularly in the structured finance and asset-backed securities business. This article covers the following subjects:

- Differentiation of ratings for structured products;
- Market/volatility/systemic/macroeconomic risks;
- CRAs assessment of data on underlying assets and underlying methodology/assumptions;
- Regulatory strategies, role of an independent firm, and post-rating and monitoring process;
- Standardization of data and transparency;
- Interaction with issuers and arrangers;
- Unsolicited ratings;
- Reduced regulatory reliance on CRAs and NRSROS;
- Payment methodologies; and
- CRAs resources.

We address the debate surrounding each of the foregoing subjects, including current practices regulatory issues and tensions arising from those practices. Each section describes the advantages or disadvantages of some of the business practices and the regulatory landscape. Instead of providing a detailed overview of the current rules or proposals adopted or made by SEC, IOSCO, CESR, trade groups, the Financial Stability Forum, and the EU Commission, we integrate and elaborate on some of the concepts underlying such rules and proposals for each of the above issues, relevant for the purposes of legal and regulatory reforms applicable to CRAs. Only in the case of the EU and the SEC do we provide a brief explanation of their recent proposals or adopted rules. Our goal has been to shed light on the complex issues. As a result, when we refer to regulators in this article, we have meant to synthesize the concerns of the regulators, except for (1) a few cases where we noted unique concerns or statements by certain regulators and (2) (as mentioned above) in the brief references in each section to the status of recent EU proposals and SEC proposals and rules (we refer, in particular, to the EU Commission proposal for a regulation of the European Parliament and of the Council on

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credit rating agencies, dated November 12, 2008, and to the SEC rules and proposed rules for Nationally Recognized Statistical Rating Organizations, dated June 16, July 1, and December 3, 2008, available on the SEC Web site).

## Differentiation of Ratings for Structured Products vs. Ratings for Bonds

Because of the uniqueness of structured finance products, regulators generally agree that the CRAs should modify ratings for such products so that the rating terminology is actually different from that used for bonds or so that there is a different quality of disclosure for such products.

While a traditional bond is subject (in terms of creditworthiness) to the idiosyncratic risks of the corporate issuer, securitizations and structured finance products are more vulnerable to systemic risks. Pooling assets reduces the risk of each individual asset, and thus, under normal circumstances, the average credit performance of a pool tends to be less volatile and more predictable than the individual assets comprising the pool. Any economic event, however, that affects the creditworthiness of several of those assets at one time will have a much greater impact on the asset pool as a result of the correlations of their defaults, thereby increasing the risk of significant downgrades of the ratings. Despite these differences between traditional bonds and structured products, the CRAs have largely applied the same rating categories to both corporate bond and structured finance products.

### Methods for Differentiating Ratings of Structured Products: Different Scales vs. Greater Disclosure

Based on the fact that CRAs use processes to rate structured products different from those used to rate bonds, regulators and market participants propose special rating scales or enhanced reporting to differentiate credit ratings for structured finance products from those for bonds and are discussing two approaches: on one hand, differentiation of ratings and, on the other hand, greater disclosure.[1]

The first approach proposes differentiation of ratings for structured products. This would imply the use of a new rating scale, different symbols or modifiers to the existing scale.

The second approach proposes a greater system of disclosure, but not a system of differentiated ratings.[2] For example, CRAS could provide to the other CRAs presale rating reports, explaining the basis of rating, and enhance disclosure of collateral and credit quality characteristics reviewed by the CRAs (such as inputs to ratings, methodologies, and exceptions applied in establishing ratings, the sensitivities of ratings to key variables, loss sensitivity, structured product status, and initial collateral loss expectations for structured products).

In either case, the objective is that a competitor be given an opportunity to provide to investors information and evaluations regarding the facts underlying the differentiated ratings and the comparability of various ratings. This implies that, even if the choice of having differentiating ratings is followed, enhanced disclosure would still be necessary and form part of that regulatory strategy.

### Arguments in Favor and Against Differentiation of Ratings for Structured Products

Differentiation of ratings for structured products may be based on a variety of grounds. First, structured products' ratings are based on models and are more largely driven by underlying assumptions; the structured products rating process is driven by the desire to achieve a certain rating and the structure of the product will therefore be adapted accordingly. Moreover, structured products ratings are potentially more volatile. For rating structured products, the CRAs rely much more on non-public information about the underlying assets and in data provided by interested market players.

The CRAs, some industry representatives, and the SEC have opposed differentiation on various grounds including that it will harm the market for mortgage-backed securities by forcing asset managers and banks to sell securities into an illiquid market because of the limits imposed by laws and investment guidelines (even though it could be argued that such reform may be managed in a gradual manner).[3] For example, pension laws, capital adequacy requirements, and private contracts refer to specific ratings of permissible investments. Differentiating ratings could identify all structured finance securities as "problem" securities, including structured products that heretofore have performed well. This issue also hinges upon the need to find generally agreed criteria for equating ratings of bonds and structured finance products.

Furthermore, the proposal to differentiate ratings raises systems issues for financial firms' computer fields, which can accommodate the current ratings. Firms involved in securities issuance, underwriting, investment, and custody may not have systems capable of accepting and interpreting the new ratings that are being considered with fields wide enough to handle the extra characters that such a new, expanded rating scheme would require.

These difficulties have lead some commentators to advocate enhanced disclosure of collateral credit quality characteristics and peculiar methodologies used by the CRAs in ratings of structured finance products. This enhanced disclosure could eliminate any stigma associated with these products.

Requiring a differentiation of ratings based on increased disclaimers would allow a new market CRA entrant to provide services to evaluate the increased amount of information in the market place and also provide its own differentiation of ratings to assist investors in interpreting the true meaning of undifferentiated ratings.

One of the problems with requiring CRAS to increase disclosure and thereby facilitate investors' performing their own analysis is that there are barriers restricting access to the nonpublic information that issuers and arranger provide to the CRAs. The current proposals aimed at enhancing unsolicited ratings (providing for access to this information by other CRAs) and standardizing disclosure may address this problem. On the other hand, one can argue that enhanced reporting of assumptions and methodologies does not imply access to non public information and is not hindered by this problem.

## EU Proposal and SEC Rule

In the EU Commission's recent proposed rule and in one of SEC's recent proposals, CRAs/NRSROs would have the option to either differentiate ratings or provide more disclosure. In particular, Article 8 of the EU Commission proposal provides that CRAs would need either to use different rating categories when rating structured finance instruments or provide additional information on the different risk characteristics of these products by publishing a report with a detailed description of the rating methodology used and an explanation of how such methodology differs from the determination of other ratings. The report would also describe how the credit risk characteristics of a structured product differ from those associated with other rated entity or financial instruments.

## Market/Volatility/Systemic/ Macroeconomic Risks: Analysis and Disclosure

Credit ratings do not reflect, despite the false perception of some market participants, a judgment of the *value* of an investment; rather, they are only a judgment of the *creditworthiness* of the investment. CRAs, therefore, failed to correlate the defaults that could occur in the event of a wide market downturn both for structured products and corporate bonds. Moreover, in the monitoring process (after a rating), CRAs should be required to conduct not only mean data monitoring but also monitoring of macroeconomic expectations.

For these reasons, most market participants favor CRAs taking a more proactive approach to take into consideration a wider range of risks in issuing ratings and monitor such ratings by assessing the impact of possible future macroeconomic developments.

### Flaws in CRAs' Methodologies

Market participants have indentified flaws in CRAs' methodologies for structured products, including the increased sensitivity of a pool of assets to systemic risks and the use of limited historical data.

In terms of historical data, regulators and commentators have focused on a flaw in methodologies, including the impact of having only limited historical data in the area of subprime lending, which led to the inability to assess how a pool of assets would respond to given economic scenarios. The historical data, used by the CRAs, reflected favorable economic conditions with a steady growth of the housing and mortgage markets.

As a matter of practice, the CRAs rely heavily upon information given by others and especially by interested people (issuers, obligors). CRAs generally do not provide, nor elaborate on, information about systemic/market/macroeconomic/volatility risks, nor do they link such information with strictly related credit risks.

CRAs say that the nature of structured finance transactions leads inevitably to a delay in the response of ratings to the underlying asset pools, becoming more pronounced the further the product is from the underlying asset such that RMBS react after underlying assets default and CDOs then subsequently react.

However, the CRAs considering the impact of systemic risk on credit worthiness of structured products is especially important because pooling techniques used to package the tranches of assets in products (CDOs of ABS, RMBS, ABCP) have not only diversified away the idiosyncratic risk of each individual asset but also have enhanced the sensitivity of the structured products or pool themselves to systemic or market risks or macroeconomic factors.

### Proposed Solutions

There are several ways to integrate systemic risk considerations better in ratings and monitoring. If the CRAs provided at least their underlying assumptions and data, a competitor could provide information and analyses of the correlation risks that exist along a class of assets. Therefore, CRAs should disclose assumptions, analyses, underlying scenarios, and methodologies to the market, which should then be tested and evaluated.

A separate division of an existing CRA could assess systemic risks. Regulators could require CRAs to establish a proper system for correlating, in the ratings and monitoring process, ratings of structured products with systemic/market/macroeconomic/volatility risks. Since there is information about correlation risk among classes of securities about which the CRAs are in a unique position to know, because of their oligopoly in rating structured products, CRAs should be required to promptly correlate and review, within a specified timeframe, ratings of structured products in the event of changes of risks along the chain of different assets.

Neither the EU proposed regulation nor the adopted SEC regulations covers these macro-economic linkages directly. However, both regulators emphasize requirements for enhanced disclosure on methodologies, models, and assumptions used in the rating process. This should enable investors and market participants to be better informed about the kind of information used in rating financial instruments and the analysis involved and the limitations of such information and analyses.

The EU Commission proposal also requires CRAs to review regularly methodologies, models, and key assumptions in order to reflect changing macroeconomic or financial markets conditions in the underlying asset markets. CRAs should also disclose the scope of ratings affected by any changes in such methodologies, models, and key assumptions and should promptly review the affected credit ratings.

## Deficiencies in Underlying Methodology/Assumptions and Data on Underlying Assets

The major difficulties in determining the value of structured products involved in the subprime crisis are generally that market participants do not sufficiently understand (or have information) about the underlying methodology/assumptions of the CRAs to make their own downgrade or investment decisions. Moreover, CRAs themselves do not have sufficient high quality data about the underlying assets.

The flaws in CRAs' data and methodologies are not detected and corrected because market participants do not typically review and assess the initial and ongoing information that CRAs traditionally provide on the risk characteristics of structured products (*i.e.*, methodologies/assumptions and data on underlying assets). Market participants should assess, among other things:

1. Additional initial and ongoing information on rating stability;
2. The assumptions underlying a structured product rating and the sensitivity of the rating to changes in these assumptions;
3. Information about the loss and cash-flow analysis of structured products;
4. Standardized initial and ongoing performance reports, especially for re-securitized products to help investors deal with time delays;
5. Reviews (including due diligence) on the underlying data, quality of standards, and practices of participants in the process and information on limitations of rating analysis due to insufficient data or untested models, including rating uncertainty;

6. Reviews and reports on the quality of due diligence by the CRA; and
7. Assessments and correlation of underwriting standards of lenders and any changes in these standards with ratings of structured finance products.

Numerous problems arise in the data CRAs provide regarding the performance of underlying assets and due diligence of underlying assets. It may be difficult for the CRAs to standardize the disclosure of data so that investors and other market participants can meaningfully distinguish among different products. Frequently, there *is a lack of public data available on the performance of* the underlying assets in structured finance products and the often heterogeneous nature of these products makes comparable assessments of these products by investors more problematic. Moreover, regulators have criticized the overall quality of the information provided by the issuers[4] and noted that the CRAs, in the period leading up to the current financial crisis, underestimated the *underwriting standards and practices of some lenders* and underwriters.

### Possible Solutions

The Financial Stability Forum advocates that CRAs should enhance and review the quality of data and input provided by originators, arrangers, and issuers during the due diligence to assign a rating.[5] Some regulators, like the EU, seek to assign more responsibility to CRAs, which should then presumably refuse to go further in the rating process if the quality of the information provided is insufficiently low, poor, or otherwise doubtful.

One approach to deal with understanding the underlying data is for CRAs to disclose raw data, default, and transition statistics, defaults relative to the initial ratings, procedures, and methodologies (thus not disclosing personal data).

There is regulatory consensus[6] that CRAs should, to a certain extent, review the quality of the data input and the due diligence performed by originators, arrangers, and issuers. To achieve this goal, the CRAs should take the following actions:

1. Adopt reasonable measures to ensure that the information they use is of sufficient quality to support a credible rating.
2. Establish an independent function to review the feasibility of providing a credit rating for new products materially different from those currently rated.
3. Refrain from rating a security when the complexity or structure of a new type of structured product, or the lack of robust data about underlying assets, raises serious questions as to whether CRAs can determine a credit rating.
4. Disclose what qualitative reviews CRAs perform on originators' underwriting standards and establish criteria for reviewing individual mortgage lenders, as well as the lender's origination processes. CRAs *would review and evaluate these loan originators* and disclose their evaluations on their Web sites. Such a review would satisfy the need for having a system that correlates, in the rating and monitoring process, these standards with ratings, as outlined in the preceding section, and could be particularly helpful in revolving securitizations of assets (where new assets are purchased on a periodic basis).
5. *Take into account the information on the portion* of underlying assets held by originators when rating securitized products.
6. Develop criteria for the due diligence information that is collected by investment banks on the mortgages comprising a RMBS. This solution could be more practical and feasible than a whole review of underlying data by CRA. CRAs should review and update these criteria compared to those currently used in light of any weaknesses. CRAs would receive loan level results of due diligence and review those results prior to issuing ratings. They would also disclose their due diligence criteria on their Web sites.
7. Require a series of representations and warranties from investment banks and other financially responsible parties about the loans underlying the structured finance products and the level and scope of due diligence performed.

The EU Commission proposal contains some of these measures. It does not require CRAs to verify information received, but it mentions a variety of factors to consider for determining the reliability of the sources used.[7] If a lack of reliable data or the complexity of the structure of a new product makes it seriously problematic to produce a credit rating, CRAs should refrain from issuing a credit rating or withdraw an existing credit rating. CRAs would also be required to disclose to what extent information provided by the issuer was verified.

The SEC rule requires an NRSRO applicant to disclose whether and, if so, how much verification performed on underlying assets is relied upon in determining credit ratings and how assessments of the quality of originators of structured finance play a part in the determination of the credit rating. This language seems to focus on disclosure without setting forth precise and more rigorous constraints on the quality of reviews to be carried out by CRAs. Indeed, the SEC instead emphasizes in its proposals a possible review from other CRAs. One of SEC's proposed rules requires that CRAs disclose the information provided to and used by the NRSROs so that other market participants may use the information to derive their own conclusions and review the NRSROs findings. In this two-step process (review and disclosure by CRAs of data provided by originators/issuers/arrangers and further reevaluation of such data by other market participants) other NRSROs would have the same access to non-public material information provided to the NRSRO rating the product.

### Weaknesses of Proposed Solutions

The cost-effectiveness of a complete review by the CRAs of the activity already carried out by originators, arrangers, and issuers is obviously debatable. Such duplication could also affect the pricing of the related instruments. The issue is rather to what extent CRAs are supposed to review the quality of data, what would be the degree of required due diligence for providers of such data, and to what extent such data can be standardized to ease the evaluation process. Even when another entity (other than CRAs) reviews the information and data, the issue of its impact on the pricing and liquidity of structured finance products requires further exploration. Furthermore, a legal solution based on CRAs' relying on representations and warranties (which would not significantly alter the current system) could reduce a CRA's incentive to be more proactive in reviewing and assessing data and information given by originators, issuers, and arrangers. Stronger representations and warranties when coupled with an increase of unsolicited ratings and disclosure of a small amount of information could, therefore, lead to a lower quality of assessments by CRAs and lower accuracy of data.

### Actions Taken by CRAs Regarding Review of Underlying Data

In acknowledgement of investors and regulators dissatisfaction of the CRAs treatment of underlying data, various CRAs have taken certain actions. For instance, they have enhanced the formal internal training programs for analysts and external investor education efforts, improved transparency of rating assumptions, such as the publication of a series of additional "what-if" scenarios for major asset classes, rolled out additional electronic tools to communicate surveillance and cross-transaction comparisons for structured finance ratings, and added Rating Outlooks at the tranche level across structured finance transactions in selected markets.

## Regulation Through Independent CRAs, Competing CRAs, Post Rating and Monitoring Process, and Litigation

Various mechanisms are possible to improve the effectiveness of ratings, including creating new independent or competing CRAs, enhancing the post rating monitoring process, and litigation against CRAs.

### Regulatory Approaches

To address the current deficiencies in the rating process, the US regulators and trade groups propose disclosure oriented solutions; the European approach advocates disclosure and active regulation of CRAs, with a focus also on internal governance systems.

Generally, European regulators and governments are agitating for more rigorous standards for CRAs, regulating in *some form* CRAs and expanding the scope of activities or the practices of CRAs, thus holding them more accountable for each step in the rating process. The recent proposal by the EU Commission also substantively draws upon the IOSCO code, to which the major CRAs already subscribe. The US regulators and trade groups, on the other hand, are approaching these same subjects differently by advocating self-policing and more disclosure by the CRAs to allow other market participants to observe and improve the performance of the CRAs in the origination-distribution-securitization-investment process and for market participants to make their own decisions.

### Methods to Facilitate Review of CRAs' Performance and Entrance of New Competitors

There is a regulatory demand for an entity (*e.g.*, a government agency, a competitor, a review board) to review the performance, compliance, and governance processes of the CRAs and assess the correlation between compliance/governance and the quality of ratings. In general, there is also regulatory demand for more CRAs to provide more unsolicited ratings (although difficult in the structured products area because of the lack of access to data), independent research, independent review of assets, and independent monitoring/surveillance. Given the oligopolistic nature of the CRA industry, introducing an independent firm and independent review into the ratings process may be difficult, but useful.

To enable reviews of CRA performance, regulators have suggested that CRAs disclose a record of material deviation of their ratings compared with performance of the rated securities, enhance ratings performance measurement statistics, and disclose the historical ratings activities relating to each current credit rating of a CRA.

The CRAs' new competitors could play an important role as independent firms engaged in the monitoring/surveillance (post ratings) process by reviewing the ongoing validity of methodology, data, and assumptions used and by assigning asset classes different ratings.

In this respect, the EU Commission proposal establishes a central repository gathering historical performance data of CRAs, together with additional information on past rating activities. The purpose is to allow users of ratings to be better informed about CRAs' comparative performance and make industry-wide comparisons.

The SEC's recent amendments would require an NRSRO applicant to provide enhanced disclosure and statistics on ratings transitions (*i.e.*, upgrades and downgrades) for each class of ratings for which it is registered or seeking registration. In particular, the SEC requires that the exhibits to the NRSRO forms include definitions of the credit ratings (including an explanation of each category and notch) and explanations of the performance measurement statistics, including the metrics used to derive the statistics. Separate sets of performance measurement statistics (showing ratings transitions, withdrawals and default rates) must be broken over one-, three- and 10-year periods for each class of credit rating. An NRSRO would also be required to make publicly available a random sample of 10 percent of its issuer-paid credit ratings and their histories for each class of issuer-paid credit rating for which the NRSRO is registered; an alternative proposal to such requirement, on which SEC is seeking comments, would increase such percentage to 100 percent, even though a credit rating action would not need to be disclosed until 12 months after such action is taken (this time limit is set in order to protect revenues generated from selling downloads and data feeds). The SEC is requiring similar disclosure for NRSROs that issue subscriber-paid credit ratings that do not usually make their ratings publicly available for free.

### Provision of Independent Ratings

Another approach to introducing competing information into the CRA process is to require CRAs to provide independent research in the same way that US investment banks are required to provide research by independent research firms.

The New York Attorney General created a similar model for investment banks that had conflicts of interest with their analysts' recommendations to provide independent research CRAs.

### Government and Private Sector Oversight

The United States has established a government oversight function in the auditing business that might be a model for the oversight of CRAs.

The Sarbanes-Oxley Act of 2002 established a private-sector, non-profit organization, the Public Company Accounting Oversight Board (PCAOB). The PCAOB oversees auditors of publicly traded firms with the aim of protecting the interests of investors and its powers include:

1. Registration of accounting firms. Accounting firms that are not registered with PCAOB cannot prepare or issue audit reports on US public companies.
2. Adoption of standard setting on matters such as quality control, ethics, independence, audit documentation. These standards are discussed with concerned entities and market participants and their establishment becomes effective upon approval of the SEC.
3. Conducting inspections to investigate and assess compliance with laws and professional standards. Written reports on inspections are provided to SEC and certain portions are made available to the public.

4. Enforcement of compliance and issuance of disciplinary or remedial sanctions.

In the rating business, a similar oversight board should coordinate with the SEC or IOSCO to avoid any duplication or overlapping of function.

On the other hand, certain private companies monitor and assess governance practices and risk-management processes of a vast number of companies.[8] This activity involves the analysis and verification of publicly disclosed documents. It is usually coupled with voting proxies advice and includes the provision of corporate governance ratings on the basis of a set of objectives and criteria, risk alerts and early risk detection systems, analyses of accounting policies and financial statement transparency, and other relevant economic and financial matters.

IOSCO has envisaged an international monitoring body over CRAs activity similar in purpose to the auditing standards oversight body, the Public Interest Oversight Board (whose activity, however, is limited to overseeing and advising on standard-setting activities).

### Relationships between Payment Models and Outside Oversight

The issuer pay model business which dominates the CRA industry is a serious obstacle to the introduction of competitors, surveillance companies, or other third parties. The issue becomes whether the CRAs, issuers, and/or investors should pay for such other party to monitor/survey ratings performance and provide independent research reports and to whom such an entity should be responsible (other CRAs, issuers, investors), and what would be the consequences of any such choice on liquidity of structured finance markets.[9]

Because of resource issues and independence issues, CRAs could outsource part of the monitoring/surveillance process or another party should perform such function on behalf of issuers or investors. Although these suggestions require an accepted process or infrastructure different from what currently exists, such a process would successfully implement the SEC's and other regulators' goals in introducing new participants into the CRA industry or in introducing independent non-conflicted information for the benefit of investors. On the other hand, having a government agency that centralizes this function, while it would address the problems of access to non-public information, would not realize these goals.

### Post-Rating and Monitoring Activity

After the ratings are issued, the focus of CRA performance shifts to monitoring, auditing, and surveillance. Regulators remain concerned about the ability of CRAs to react appropriately to widespread credit deterioration, in particular asset-class performance, which requires CRAs to review large numbers of ratings in a short time.

On an ongoing basis, fewer resources are dedicated to monitoring ratings than issuing initial ratings. Besides business profitability concerns, the reasons for this are that much of the initial monitoring of these transactions is carried out automatically against data performance criteria by a CRA analyst and surveillance analyst who initiate a review if the transaction does not perform as expected. Moreover, the analytical work on the particular deal structure and legal framework has already been carried out, so the monitoring/surveillance work generally takes less analyst time.

As described above, the monitoring process should be aimed also at having a proper mechanism for linking particular ratings with changing risks along the chain of different products and macroeconomic/market/volatility/systemic risks.

Regulators support the idea to establish individual separate monitoring teams within a CRA for structured-finance products, but recommend that the CRAs continue to evaluate their internal processes to ensure that they maintain their operational flexibility.

There is also regulatory demand for an independent review mechanism. A few asset managers have stressed that investors should have access to more regular information, especially the issuer report or trustee reports that the CRAs receive, and that monitoring data should be freely available to investors.

Intermediate steps by CRAs in strengthening governance and review of internal risk processes include:

1. Engaging an external firm to review their compliance and governance processes and holding periodic Audit Committee reviews of these processes;

2. Establishing risk assessment oversight committees that will assess risks to the rating process and feasibility of rating new types of securities;
3. Increasing RMBS surveillance staff to improve the surveillance process; and
4. Introducing a number of measures focusing on data integrity for structured products ratings.

The EU Commission proposal focuses on the enhancement of monitoring indirectly by requiring CRAs to constantly review their methodologies, models and assumptions. Besides, it generally states that CRAs should allocate a sufficient number of human and financial resources to the monitoring and updating of credit ratings.

The SEC requires an NRSRO applicant to provide more detailed information on the surveillance process and on how different models are used for surveillance than for initial ratings; an NRSRO must disclose the frequency of its surveillance efforts and how changes to its quantitative and qualitative rating models are incorporated into the surveillance process.

### Litigation against CRAs

US litigation has been an ineffective method of influencing the performance of CRAs.

In the United States, claims against CRAs have ranged from lack of due diligence, negligent misrepresentation, and unfair trade practices to the assignment of undeservedly higher ratings to impaired and risky instruments and the failure to change ratings before a bankruptcy or crisis occurred.

Civil suits against CRAs by investors have largely been unsuccessful, as the courts have found that the role of CRAs is akin to that of members of the press and that information gathered during the rating process and the analysis of such information has First Amendment protection.[10] The courts have also suggested that investors are not intended third-party beneficiaries of the contract between the CRA and the issuer.[11] Additionally, the First Amendment protection enjoyed by CRAs has been reinforced by cases in which these agencies have successfully resisted third-party discovery. The courts have also found that that rating agencies enjoy the same privileges as journalists.[12]

An exception is found in *In re Fitch*[13] where the court held that information gathered by the rating agency in question was not protected by the journalist's privilege because the rating agency played an active role in restructuring the transaction, a role it considered "inconsistent with traditional journalism." The court also found in that case that Fitch's rating had been based on the "client needs."

With respect to the subprime meltdown, one of the latest claims against CRAs is a securities class action lawsuit filed by the New Jersey Carpenter's Vacation Fund[14] against a number of participants associated with Harbor View Mortgage Loan Trusts. The complaint alleges that the rating agency defendants "failed to conduct due diligence and willingly assigned the highest ratings to such impaired instruments since they received substantial fees from the issuer."[15] The complaint also alleges that the rating agencies "issued the ratings based on an outdated methodology designed in about 2002." The rating agencies later downgraded the mortgage-backed securities, and their admission that they had not used an appropriate rating methodology resulted in a substantial decline in the value of the bonds. This case is yet to be decided.

Legal commentators agree that the subprime crisis and the extent of involvement of the rating agencies with the issuers in structuring and packaging products will test the limits of the privilege claimed by CRAs. They may be exposed to charges of self-dealing, conflicts of interests, and material omissions where they have not revealed the extent of their relationships with the issuers. Also, the courts have stated that the fact that CRA rates unsolicited transactions is not a primary consideration for the application or non-application of the privilege,[16] so it is likely that S&P may not benefit from that argument.

### Standardization of Data, Methodology, and Transparency

There is a regulatory trend toward asking the CRAs to provide standardization of methodology, data, and transparency regarding components of the ratings process.

A standardized, publicly available format would support market participants in reaching their investment decisions, allow for clear communications regarding the characteristics and limitations of the ratings of structured finance products, and provide information on critical model assumptions to facilitate a greater understanding by market participants and clear labels identifying which methodology and version have been used. If standardized information is disclosed, a competitor or investor may evaluate such information for investors, for whom the standardization may mask the underlying work.

The CRAs resist standardization on the grounds that each CRA is singular and provides unique reports: Standardization has its limits due to a higher grade of complexity and the differences between the transactions.

### Alternatives to Full Standardization

If full standardization is not accomplished, regulators have advocated having at least certain specified information in each rating opinion. This is the solution underlying the recent EU Commission proposal, which does not aim to create a single format for presentation of credit ratings but requires elements that users of ratings may expect to find in a rating opinion.[17]

The SEC is less insistent on standardization. In this context, one market participant proposes restricting CRAs in receiving non-public information based on the argument that either information is crucial for risk assessment and thus should be publicly available or, if not, should not be made available to CRAs. Thus, the SEC and CRAs prefer full disclosure rather than a standardized approach.

If standardized information were not produced, there might be a need for a competitor CRA to provide standardized reports to allow for comparison among the various CRAs. In that case, the competitor itself would create standardized data. A competitor could also construct a publicly available independent database to collect consolidated information.

### Transparency of Data and Methodology CRAs Used to Assist Investors in Interpreting Ratings

Transparency is a key, recurring requirement under recent regulatory proposals or reforms. The purpose is to improve CRAs' performance through enhanced market discipline and better information in favor of users of ratings. In the case of the SEC approach, transparency is also aimed at encouraging unsolicited ratings activities.

As noted, regulators have been focusing on disclosure of methodologies, model assumptions, weightings of key parameters, and correlations underlying structured finance ratings and their impact on the ratings to enable investors to make better use of structured-finance ratings in their investment decisions and risk-assessment procedures.

This transparency should be feasible because CRAs require the issuer to provide comprehensive disclosure in a standardized manner about the characteristics of each asset in the asset pool, the validation process used to verify the quality of information provided, all pertinent representations and warranties, and servicer and trustee reports.

The idea of removing registration features from CRAs' Web sites also goes toward this transparency-oriented approach.

The EU Commission proposed regulation provides for the publication of an annual transparency report (including a series of general matters on CRAs internal governance, compliance, and financial information on CRAs' clients) and for detailed, ongoing disclosure obligations (dealing also with staff issues, compensation arrangements, ancillary services, conflicts of interest).

As noted in previous sections, the SEC bases its regulatory focus on transparency and disclosure requirements with regard to procedures and methodologies, surveillance process, and review of quality of originators.

The SEC's emphasis on disclosure and transparency aims also at increasing the number of unsolicited ratings.

## Interaction with Issuers and Arrangers and Related Conflicts of Interests

The nature of structured finance means that the rating process tends to involve a more continual and repetitive interaction between the CRAs and the issuer/arranger that may result in CRAs playing an advisory role in the structuring of a securitization vehicle.[18] Typically, the issuer/arranger will bring a proposed structure to the CRA, and the CRA will carry out its modeling and assessment of the underlying asset pool(s). This assessment will highlight the relative strengths and weaknesses of the structure, asset pool(s), and credit-enhancement levels of the proposed product, as well as provide an indicative rating. The issuer/arranger can then accept the initial rating proposed as a result of this assessment or choose to restructure the product in a number of ways to improve this rating. The CRAs state that this is achieved, for example, by altering the underlying asset pool(s) or improving credit-enhancement levels, according to decisions left to the issuer/arranger. The CRA will perform a new assessment on any amended structure.

One reason for this peculiar interaction is that issuers of structured finance have more flexibility to alter the composition of their security than a corporate issuer would have to amend its finances. The CRAs say that this interaction is beneficial in allowing them to gain a clear understanding of the proposed structure of the deal and thus produce a better-informed rating. The risk is that the CRAs' interaction with issuers/arrangers has become advisory in nature, presenting a heightened possibility that conflicts of interest will negatively impact the objectiveness of their rating opinions.

The CRAs generally do not view their interaction with issuers/arrangers of structured finance products as advisory in nature. They state that they may provide feedback on credit-enhancement levels, but only in line with their publicly available methodologies, and they do not provide advice on how to structure any deals. Therefore, they do not consider themselves providers of an advisory service or believe that their activity creates additional unmanageable conflicts of interest.

Of course, the concern is the line between illegitimate recommendations and legitimate information and feedback provided by a CRA regarding the relationship between model outputs on the one hand and the CRA's decisions with respect to necessary credit enhancement levels to support a particular rating on the other. The distinction between feedback and an implicit recommendation is quite subtle, and the peculiar interaction and the close relationship with issuers/arrangers could arguably be handled by strong monitoring tools and appropriate and transparent payment methodologies.*

### Positions Taken by Regulators and Monitoring Tools

Regulators maintain that the level of interaction between the CRAs and issuers of structured finance products creates additional conflicts of interest for the CRAs that the CRAs are not managing properly. Thus, CRAs should ensure that they are fully transparent with regard to the exact nature of their interaction with issuers/arrangers of structured finance products. CRAs should also have strong policies and procedures in place to monitor and control this interaction and ensure it reflects their public position.

The SEC requires that NRSROs stop advisory activities or recommendations to the issuers/obligors. The SEC allows feedback for NRSROs regarding the issue but prohibits recommendations.

Likewise, the EU Commission proposal prohibits providing advisory services or recommendations regarding the design of structured-finance instruments. It also establishes disclosure requirements to manage and eliminate any potential or actual conflict of interest. Specified cases of conflict of interest, mainly related to financial relationships with clients, are subject to disclosure.

### Possible Solutions

Besides limiting or prohibiting advisory activities and having disclosure requirements as noted in the preceding paragraph, regulators are considering the following measures to deal with conflicts raised by the interaction of CRAs with structured-products issuers (with the EU proposal especially focusing on internal governance related measures):

1. A rotation of analysts who cannot work with a certain client for longer than a specific period;
2. Having a number of independent directors in the board whose remuneration cannot depend on the business performance of the CRA in charge of verifying compliance with internal control systems;
3. The creation of an internal function to review the quality of the ratings, which reports to the independent directors;
4. Determining compensation arrangements for employees involved in the rating process not on the basis of the revenue generated by the rated entities;
5. Prohibiting CRAs (including affiliates) from issuing a credit rating with respect to an obligor or security when the CRA made recommendations to the obligor or the issuer, underwriter, or sponsor of the security (that is, the parties responsible for structuring the security) about the corporate or legal structure, assets,

liabilities, or activities of the obligor or issuer of the security (especially about how to obtain a desired credit rating during the rating process).

An additional interesting solution could be to insert a competitor as an intermediary. Since regulators would like to see the connection between the product analyst and the arranger weakened, broken, or supervised and seek to limit or prohibit a CRA from recommending structures to an issuer, a competitor could insert itself as an intermediary. Such intermediary could play a role in the structuring process, advising or recommending a certain structure. In that case, the trilateral relationship between the arrangers/issuer, the CRA, and the intermediary (*e.g.*, competing CRA) should be further assessed in order to avoid the recurrence of the same problems arising from a too close interaction. Arguably, the intermediary should maintain a relationship only with, and be accountable only towards, the issuer/arrangers.

## Unsolicited Ratings

The SEC argues that transparency and disclosure by CRAs would result in an increase in unsolicited ratings to contribute to enhancing the quality and credibility of solicited ratings. However, unsolicited ratings may contribute to unintended adverse consequences for ratings in general and raise certain practical obstacles.

The SEC proposes requiring NRSROs to disclose more information. Such disclosure would facilitate unsolicited ratings, thereby increasing competition, policing the NRSROs, and allowing for the entry and development of new ones.

The SEC considers that the following information should be disclosed:

1. All information provided to the NRSRO that is used in determining the initial credit rating for the security, including information about the characteristics of the assets underlying or referenced by the security and the legal structure of the security;
2. All information provided to the NRSRO that is used in undertaking credit rating surveillance on the security or money market instrument, including information about the characteristics and performance of the assets underlying or referenced by the security or money market instrument, like trustee reports about the underlying assets.

The SEC expects the rules to increase the transparency of the ratings process and thereby making it more apparent when an NRSRO may be allowing business considerations to impair its objectivity and enhance competition by creating the opportunity for NRSROs that are not hired to rate structured products to determine, nonetheless, credit ratings and establish track records for rating these products.

One of SEC the proposed rules would require that, as a condition to the NRSRO's being permitted to rate a structured finance product, the information provided to the NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed through a means designed to provide reasonably broad dissemination of the information. The procedures and timing for disclosure would differ based on whether an offering is public or private.

The SEC proposes that an NRSRO should obtain a representation from the arranger (or other parties) that the necessary information be disclosed to other NRSROs, which in turn would furnish the SEC an annual certification that they are accessing the information solely to determine credit ratings and will determine a minimum number of credit ratings using the information. Moreover, NRSROs hired by arrangers (issuers, underwriters, and sponsors) to perform credit ratings for structured finance products would need to disclose to other NRSROs, on a password-protected Web Site, the deals for which they were in the process of determining such credit ratings. The arrangers would need to provide the NRSROS that they hire with a representation that they will provide information given to the hired NRSROs to other NRSROs and NRSROs seeking to access information maintained by the NRSROs and the arrangers would need to furnish the SEC an annual certification that they are accessing the information solely to determine credit ratings and will determine a minimum number of credit ratings using the information. The arranger would be required to provide information to determine or monitor the credit rating, must tag the information to indicate whether it is current, to provide the components of the information including information about the characteristics of the assets underlying or referenced by the security or money market instrument and the legal structure of the security or money market instrument, performance data regarding the underlying assets probably obtained from the trustee, loan tapes, and legal documents. The goal is to allow the other NRSROs to more actively participate in the ratings process and to follow the progression of changes that lead to the final information upon which the credit rating should be based. These proposals would also require amending Regulation FD regarding the fair and timely disclosure to all of material nonpublic information.

The SEC would not require disclosure of the following:

1. Information about collateral pools (*i.e.*, loan tapes) provided by the arranger containing a mix of assets that is different from the composition of the final collateral pool upon which the credit rating is based; and
2. Communications between the NRSRO and the issuer, underwriter, sponsor, depositor, or trustee to the extent that the communications do not contain information necessary for the NRSRO to determine an initial credit rating or perform surveillance on an existing credit rating.

The SEC proposes the pricing date as the time of the first disclosures, or the earliest date upon which the asset pool and legal structure of the trust are settled on.However, such disclosure should be coordinated with the timing need for other NRSROs to issue unsolicited ratings.

The SEC's proposal expects disclosure of the characteristics of the assets (not personal identifying information) in the pool underlying the structured finance product and the legal documentation setting forth the capital structure of the trust, payment priorities with respect to the tranche securities issued by the trust (the waterfall), and all applicable covenants regarding the activities of the trust, a loan tape (identifying each loan in the pool and its characteristics such as type of loan, principal amount, loan-to-value ratio, borrower's FICO score, and geographic location of the property) and the credit-enhancement levels for the tranche securities to be issued by the trust.

## Possible Concerns Regarding Unsolicited Ratings

The risk of the foregoing proposal of disclosing certain information to facilitate unsolicited ratings is that arrangers would prefer to have a CRA use relatively little information to generate solicited credit ratings to minimize the amount of information the NRSRO must disclose. There could be a race to the bottom, in which CRAs using a small amount of information and lower accuracy of data would be favored. However, enhanced disclosure and transparency requirements and obligations to carry out certain assessments and not to issue ratings in case of lack of information, as described under preceding sections, might address these concerns.

On the other hand, if the disclosure of certain information is not required, a competing CRA might not have sufficient data to deliver a useful unsolicited rating.

The issue could also be the enforceability of any representations and warranties by issuers/originators/arrangers to disclose relevant information and their liability also vis-à-vis other NRSROs.

Finally, and perhaps most importantly, there is the issue of who would pay for unsolicited ratings and whether such ratings would be public (allowing for free riders).

Some of the above concerns about unsolicited ratings are implicit in the proposed EU regulation, which, unlike SEC, does not enhance the importance of unsolicited ratings but takes a rather cautious approach. The risk is that ratings may be based on less comprehensive information. Accordingly, the EU proposed regulation merely provides for disclosure of CRAs policies on unsolicited ratings, with the aim of alerting investors that the CRA did not have access to the issuers' internal documents. It also requires unsolicited ratings to have a different rating category.

## Legal Questions to Consider

In light of the above and as noted in SEC's proposals, the following legal issues should be considered in relation to disclosure of information, interactions with interested parties, and enhancement of unsolicited ratings:

1. Would the proposed information be sufficient or inadequate to permit the determination of an unsolicited credit rating?

2. Are there other entities that are providing information to CRAs that should be covered?
3. Should regulators provide a safe harbor whereby a CRA that obtained a representation from one or more parties to a transaction to disclose the required information would not be held in violation of the rule if the party did not fulfill its disclosure obligations under the representation?
4. Should regulators also require the disclosure of information about any steps that were taken to verify information about the assets underlying or referenced by the security or money market instrument, or, if no such steps were taken, a disclosure of that fact?
5. Would the disclosure of the initial information provide enough time for other CRAs to determine unsolicited ratings before the securities were sold to investors and what would be the impact of any change of the underlying information or the structured product on the unsolicited ratings? Should there be any requirement to update the unsolicited rating?
6. For CRAs that obtain information about the underlying assets of structured products from third parties such as vendors, would it be necessary to require the disclosure of this information as proposed?
7. Does and could the information provided to CR As by issuers, underwriters, sponsors, depositors, or trustees about assets underlying structured products commonly include personal identifying information?
8. Does any of the information provided to CRAs about assets underlying structured products contain proprietary information? Is this type of conflict one that could be addressed through disclosure and procedures to manage it instead of prohibiting it?
9. Would there be practical difficulties for a CRA that is part of a large conglomerate to comply with the proposed requirement?
10. Should regulators specify the type of interactions between a CRA and the person seeking the rating that would or would not constitute recommendations for the purposes of this rule?

## Payment Methodologies

Regulators are scrutinizing the various methods by which the CRAs are paid and whether such methods pose conflicts of interests and damage the integrity, value, or quality of the information provided to or by the CRAs. In discussing the various payment methods, this article covers solicited and unsolicited ratings, the issuer-pays model, the fee-for-service model (which requires that an issuer pay CRAs regardless of whether it ultimately rates the securities), *ex post* (or post-ratings) services, ancillary services, notching, and remuneration of analysts.[19]

The fee-for-service model and the provision of *ex post* services and ancillary services present opportunities in which a competitor could play a role, not only in the direct issuance of the rating but also in related services, like structuring a structured finance vehicle or providing post-rating and ancillary services. These areas would benefit from an independent participant that, because the participant is not involved in the issuance of the rating (or, in case of the fee-for-service model, is paid regardless of the ultimate issue of a rating) would prove valuable to an investor for services that the CRAs currently provide but which place the CRAs in a conflicted position.

Fees as percentage of the nominal value of the transaction are 2 to 3 times higher for structured products than for traditional rating activity. The main principles that CRAs publish in their own codes of conduct provide only generic information about fees and payment methods. However, some of the CRAs make more specific fee information available on their Web sites.

### Pre-1975 Debt Securities

The investor paid the CRAs because the system had no or low conflict of interests due to the lower volume and/or frequency of each issuance. On the other hand, free riders were able to benefit by the dissemination of information paid for by a specific investor.

### Current Payment Methodologies and Issues

***Solicited Debt Securities***: Issuers and/or underwriters pay a "success fee" or use an issuer-pays model in which the issuer pays based on a percentage of the total issuance value and on the complexity of deal and/or asset class. There are possible floors and ceilings limits and additional fees for monitoring the security through its lifetime. The CRAs also impose break-up fees in case of "rating shopping." This system raises conflicts of interest and allows for the dissemination of information to free riders. Rating shopping may also create the risk of encouraging CRAs to issue high ratings with low quality standards for the purposes of maintaining market shares without a proper counter-mechanism that renders CRAs more accountable (due to the freedom-of-speech defense).

Moreover, the investors-pay model may raise conflicts of interest, as investors could have certain interests in purchasing specific securities having certain ratings for a variety of purposes (*e.g.*, capital adequacy requirements under Basel II).

***Unsolicited:*** Issuers and/or underwriters typically do not pay for unsolicited ratings. However, market participants express concern that unsolicited ratings may encourage issuers to hire a CRA in other deals because the issuers believe the unsolicited rating to be high quality or because they wish to influence the outcome of unsolicited ratings. With respect to unsolicited ratings, some issuers also allege that CRAs may have used strong-arm tactics to induce payment for a rating that an issuer did not request (*i.e.*, sending a bill for an unsolicited rating or sending a fee schedule and "encouraging" payment). In order to improve market understanding of structured finance ratings and rating changes, regulators should review the transparency of these methodologies and the ways that they are applied.

***Solicited Only Structured Securities Due to the Complexity of Each Deal***: The issuer or underwriter pays "success fees" or issuer-pays model fee based on the percentage of total issuance value and the complexity of deal and/or class asset. There are possible floors and ceilings limits and additional fees for monitoring the transaction through its lifetime. The CRAs may also impose break-up fees in case the issuer engages in "rating shopping." Additional revenues may be derived from ancillary and consultant activities. Ancillary activities are services not linked to rating activity, such as advisory activity on the capital structure of the issuer vehicle.[20]

This payment model introduces more conflicts of interests because:

- Issuer-pays model may press CRAs to issue ratings that are pleasing to the issuer/arranger/underwriter.
- There is a greater connection between core rating and ancillary activities.
- Analysts are involved in fee negotiations. (CESR particularly criticized the role of analysts in fee negotiation although CRAs said that for structured product this consultative activity is necessary in order to price the service correctly.)

***Complex Transactions***: Higher fees apply to more complex transactions.

***Disclosure***: Market participants have suggested that a certain percentage of CRAs annual revenues derive from investors rather than exclusively from issuers or to require, for a particular product that is to be rated by at least two CRAs, that a rating is issued also by a company not compensated by the issuer.

Market participants' disclosures might include:

- Whether any issuer, originator, arranger, subscriber, or other client and its affiliates make up more than 10 percent of a CRA's annual revenue;
- All cases of rating shopping on a periodic basis; and
- General nature and quota of CRAs' compensation (*i.e.*, revenues for core rating activity and revenues for other ancillary activities).

***Fee for Service Model/RBMS***: This payment model requires the issuer to pay the CRAs for services provided, regardless of whether a rating is actually issued.[21]

This model could avoid rating shopping and races to the bottom towards having more complacent ratings. However, the fee-for-service model also arguably entrenches the existing CRAs since the existing ones will be paid.

***Ex Post Services/Structured Products and Ancillary Services***: The issuer pays the CRAs. Ancillary services are services not linked to a rating activity, such as advisory activity on the capital structure of the issuer vehicle.[22]

***Remuneration of Analysts/Structured Products***: According to some observers, credit analysts' remuneration policies should be linked solely to quality criteria and managed so as to eliminate potential conflicts of interest. Generally, regulators are concerned that analysts not be involved in fee negotiations with issuers' clients—the SEC new rules prohibit analysts, model developers, and others involved in the ratings determination process to participate in fee discussion—and that the analysts' compensation not be linked to number, size, or complexity of deals. Such linkage risks providing the analyst with an incentive to approve or relax standards with respect to more deals. Some respondents to CESR consultation support public disclosure of remuneration policies but others express doubts.

***Notching***: Notching is the practice of downgrading by one or more notches the rating of an underlying asset attributed by a competitor. Commentators allege that these practices are anticompetitive and allow dominant position by engaging in certain aggressive competitive practices.[23]

### Positions Taken by Regulators

The EU Commission proposal does not prefer a particular methodology, as it deems that any may present conflicts of interest. It focuses on structuring employees' compensation arrangements on the quality of ratings (whose internal control system is monitored by independent members of the board) rather than on revenues, also requiring separate channels between the rating function and business lines.

The SEC rules mainly deal with payment methodologies in the provisions covering conflicts of interest, which hinge upon disclosure requirements and prohibiting certain acts and practices. Its recent rules and proposals include and reinforce a clear separation between fee negotiations and credit analysts' activity and introduce additional conflicts of interest, such as those relating to repeatedly being paid by certain arrangers to rate securities. The SEC is also proposing the application of a disclosure requirement on subscriber paid credit ratings.

## Reduced Regulatory Recognition of Reliance on CRAs and Opening Up to Competitors

Many regulations refer to ratings and permit activities by, for example, banks, pension funds, countries, and cities based on such ratings. Regulators have noted that regulatory reliance on CRA ratings may have reduced the investors' own dependence on such ratings without proper due diligence. Reliance on CRAs' ratings occurs in financial legislation, pension rules, Department of Education regulations, national and municipal government rules on permissible investments, fiduciary standards, the BIS risk-based capital accords, contracts, and covenants in triggers of various securities issuances.

Current over-reliance may also justify a delay in the downgrading process, due to the severe consequences that this will cause in the financial markets.

Clearly, by reducing regulators reliance on ratings, underwriters, investment managers, investors, and other participants must strengthen their monitoring and risk processes.

### Advantages of Reducing Regulatory Reliance on Ratings

The SEC's proposal, if adopted, would eliminate requirements that:

1. Certain investment companies must invest in certain NRSRO-rated securities to exempt the investment companies from certain disclosure and other requirements;
2. Broker-dealers and consolidated supervised entities (broker-dealers that have reduced their capital requirements by giving broader access to, and more information about, affiliates) maintain their net capital by investing in certain NRSRO securities;
3. Certain issuers of NRSRO-rated securities qualify for certain exemptions.

If the SEC proposal to reduce regulatory recognition and reliance on the ratings of NRSROs were adopted, investment companies, broker-dealers, issuers, and their counterparties will be able to substitute their own judgment regarding the creditworthiness of certain securities and therefore also shop for third-party advisors to assist in or confirm their judgments.

Reduced regulatory reliance on CRAs' ratings may thus open up more specific opportunities for a competitor.

## CRAs Resources

The subprime situation and the nature of the securitization process have shown that the CRA resources can be strained. For example, deterioration in credit quality across an asset class can lead to the need for a CRA to review a large number of ratings within a short time, including possibilities that the CRAs must review products that are at another stage along the securitization chain from the underlying asset (CDOs of RMBS for example). Thus, the CRA could suffer a significant strain on analyst and rating committee resources in terms of processing a large number of rating reviews concurrently if a CRA determined that an asset class is behaving differently from expectations. Under such circumstances, the CRA would have to review its methodology, reassessing specific ratings or groups of ratings, where they evaluate whether the underlying assets are performing outside initial expectations.

Regulators are generally advising that CRAs dedicate sufficient resources to their monitoring/surveillance functions and ensure that their rating methodologies are sufficiently reviewed often, especially in light of any change in the risk characteristics of underlying assets. The CRAs have tried to increase their surveillance resources for structured-finance transactions, including the establishment of specific monitoring teams for certain assets and products. CRAs have indicated that there are sufficient analysts and committee resources for working on new issuances and for reviewing ratings, either against new methodologies or due to a decline in asset performance.

## Conclusion

The current financial crisis and its supposed origins with problems in asset-backed securities and subprime loans have identified many weaknesses in the performance and the lack of appropriate regulatory oversight over CRAs. The interconnectedness of markets, products, and asset classes highlights the need for framing credit ratings into a broader picture where market and systemic risks have to be taken into account. Compartmentalized credit ratings, which ignore the correlations of products to a chain of assets, amplify the risks posed by a wide market downturn.

The diverse approaches of the regulators can be integrated to develop a constructive regulatory framework for CRAs. The EU proposed regulation seems to be too cautious and does not stimulate the opportunities to facilitate unsolicited ratings, independent research, and review, providing evaluation mechanisms of credit ratings. The SEC emphasizes disclosure obligations as a tool for enhancing unsolicited ratings and providing for a market-oriented verification of credit ratings. However, if disclosure is not accompanied by effective monitoring tools and the substantial enhancement of CRAs methodologies and procedures, CRAs would not improve the quality and accuracy of their assessments. Legal and regulatory reforms should be shaped in a coherent and comprehensive framework, in consideration of the significance of each of these aspects.

For these reasons, we favor future legal and regulatory strategies that integrate regulation and oversight over the rating agencies (particularly if they are allowed to continue to maintain their privileges of endorsement by state rules, an oligopoly, and free speech protections) with competition. Removing the issuer-pays model will not eliminate all conflicts and other deficiencies. Improving the quality and effectiveness of credit ratings requires a variety of measures: more disclosure in terms of the meaning of the actual rating, probably with a method that combines differentiation of ratings for structured products with increased information; requiring the CRAs to integrate into their ratings systemic and economic risks and demonstrating the method for doing so; enhancing independent evaluation and introducing better monitoring tools; improving internal governance and compliance processes; establishing disclosure and reporting requirements that can help introduce more competitors into the markets; having regulatory reliance of credit ratings only in the presence of appropriate oversight mechanisms; and creating a data base of ratings related information.

## Notes

* A recent proposal attempts to severe this interaction, by creating a centralized clearing platform for ratings agencies, where the centralized clearing platform chooses which agency will rate the debt, based on some degree of excellence. See "Repairing the US Financial Architecture", an Independent View from New York University Stern School of Business.

1. The recent declaration of the G-20 provides, among the immediate actions to be taken by March 31, 2009, that "regulators should take steps to ensure that credit rating agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, *and differentiate ratings for complex products*."
2. Such system of greater disclosure (and some of the information to be provided by CRAs) should be considered also in relation to non-structured finance products.
3. A survey recently made by Moody's on differentiating structured products ratings concludes that market participants overwhelmingly rejected the idea of a separate rating scale but agreed to a greater disclosure. Moody's said that it will introduce two risk measures to enhance transparency on its structured finance ratings, the Assumption Volatility Scores and the Loss Sensitivities.
4. The responsibility for providing adequate and timely information on the underlying assets lies with the issuers, originators, and arrangers of the structures.

5. *See* Report on Enhancing Market and Institutional Resilience, April and October 2008.
6. This practice was required by the NY Attorney General in his 2008 settlement with the CRAs.
7. These include: independently audited financial statements and public disclosures; verification by reputable third-party services; random sampling examination by the credit rating agency of the information received; or contractual provisions clearly stipulating liability for the rated entity or its related third parties, if the information provided under the contract is knowingly materially false or misleading or if the rated entity or its related third parties fail to conduct reasonable due diligence regarding the accuracy of the information as specified under the terms of the contract.
8. The major companies in this field are Risk Metrics, Glass Lewis, Proxy Governance, and Egan-Jones, and in Europe, Manifest and European Corporate Governance Service, a network of independent local market experts. Rating agencies are often assessed by these companies. On the other hand, S&P itself offers corporate governance ratings services.
9. A recurring and underpinning issue in the opening of the market to new participants is to assess whether competitors would or should act in a different segment or process of the rating activity and to whom they should be accountable. Given the current oligopoly, the risks currently underlined of a reciprocal connivance (or of antagonism towards new participants) could be still relevant.
10. County of Orange v. McGraw Hill Companies; In re Enron Corp. Securities, Derivative & ERISA Litigation.
11. Quinn v.The McGraw-Hill Companies, Inc., 168 F.3D 331 (7th Cir. 1999). In the past, CRAs typically rated debt transactions on an unsolicited basis and sold subscriptions to their ratings to investors. In the 1970s, CRAs began charging issuers to rate each specific transaction. S&P continues to rate unsolicited transactions, Moody's and Fitch had virtually abandoned the practice by 2000.
12. In re Pam Am Corp., 161 B.R. 577, 581-583 (S.D.N.Y. 1993); In re Scott Paper Co. Sec. Litig., 145 F.R.D. 366, 370 (E.D. Pa. 1992).
13. In re Fitch, 330 F.2d 104, 111 (2d Cir. 2003).
14. 2008 WL 4369840 (S.D.N.Y. Sept. 24, 2008).
15. This is as a result of ratings shopping where a bank that is displeased with the rating it received from one agency could simply try another rating agency. In June 2008, in a bid to avoid litigation, the three major rating agencies reached an agreement with the Attorney General of New York regarding their fee structure for rating RMBS aimed partly at ending ratings shopping and ending competition among the agencies for fees.
16. *See* Compuware v. Moody's, 324 F. Supp. 2d 860 (E.D. Mich. 2004).
17. Such elements are (i) name and job title of the lead analyst, (ii) indication of material sources for the rating opinion, (iii) information, whether draft rating was disclosed to the issuer and changed following dialogue with the issuer, (iv) information on methodologies used, (v) explanation of risks involved, sensitivity analysis of the assumptions made, worst-case and best-case scenario ratings, (vi) date of issue and last update of the rating, (vii) any limitations of the rating, and (viii) extent to which information provided by the issuer and used in the rating process was verified.
18. The SEC proposed rule for NRSROs, dated June 16, 2008, contains a comprehensive description of the interaction between the major NRSROs and arrangers during the RMBS and CDO rating process and outlines the role played by analysts and rating committees. The SEC proposed rule for NRSROs, dated June 16, 2008, contains a comprehensive description of the interaction between the major NRSROs and arrangers during the RMBS and CDO rating process and outlines the role played by analysts and rating committees.
19. In 2007, structured finance ratings still represented 40 percent of CRAs' revenues. In a recent congressional hearing, a former S&P managing director pointed out that the RMBS group enjoyed the largest ratings market share among the three major rating agencies (reaching even 92 percent); such business revenues discouraged S& P from updating and keeping current the statistically based model to estimate the defaults and losses of individual loans and pools, developed in 1995.
20. In this context, the IOSCO code requires operational and legal separation of the credit rating business from any other business undertaken by CRAs that may present a conflict of interest.
21. The NY Attorney General Landmark Reform Agreement on Residential Mortgages Backed Securities (RMBS) requires CRAs to establish a fee-for-service structure in which they will be compensated regardless of whether the investment bank ultimately selects them to rate a RMBS.
22. DBRS said that it does not engage in ancillary business, although it may provide an impact assessment of the effect on the rating of potential transactions or situations at an issuer's request. DBRS views this work as an extension of its existing relationship with the issuer and not as a separate business line. Fitch offers no advisory services and offers only one ancillary service: a CDS consensus pricing service—Valuespread—which is relevant to both structured finance and corporate finance products. While Valuespread is a division within the Fitch operations, the revenue derived from the sale of this product is not included within the structured finance rating revenues. If Fitch would include it, it would have represented less than 0.6 percent of its structured finance rating revenues. Moody's Investor Services said that it does not offer any non-rating "ex-post" services related to structured finance products. S&P Rating Services does offer services related to structured finance products in addition to credit ratings, such as models allowing market participants to evaluate and optimize potential securitization structures with the same tools used by S&P Rating Services' analysts and products providing an insight into S&P Rating Services' surveillance process.
23. Fitch complained that S&P and Moody's were attempting to squeeze them out of certain structured products by engaging in the practices of "notching," refusing to rate securities issued by certain pools (*i.e.*, collateralized debt obligations), unless a substantial portion of the assets within those pools were also rated by them.

# THE MONITOR

The Monitor is an agenda of matters of interest to the financial services industry. The Monitor includes: (1) regulatory and related matters on which comment periods are open; (2) important regulatory initiatives that are still pending and under active consideration; (3) recent regulatory matters of continued urgency to the financial services community; and (4) cases pending before the US Supreme Court and other federal and state courts. All cases are listed by subject. Unless otherwise noted, this issue of The Monitor covers developments during the period January 17, 2009, through February 12, 2009.

## BANK REGULATION/ THRIFT REGULATION

### Treasury Announces Financial Stability Plan

On February 10, the Department of the Treasury, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) announced a comprehensive set of measures to restore confidence in the strength of US financial institutions and restart the critical flow of credit to households and businesses. The program intends to lay the groundwork for restoring the flows of credit necessary to support recovery.

The core program elements include:

- A new Capital Assistance Program to help ensure that US banking institutions have sufficient capital to withstand the challenges ahead, paired with a supervisory process to produce a more consistent and forward-looking assessment of the risks on banks' balance sheets and their potential capital needs.
- A new Public-Private Investment Fund on an initial scale of up to $500 billion, with the potential to expand up to $1 trillion, to catalyze the removal of legacy assets from the balance sheets of financial institutions. The fund will combine public and private capital with government financing to help free up capital to support new lending.
- A new Treasury and Federal Reserve initiative to dramatically expand—up to $1 trillion—the existing Term Asset-Backed Securities Lending Facility (TALF) in order to reduce credit spreads and restart the securitized credit markets that in recent years supported a substantial portion of lending to households, students, small businesses, and others.
- An extension of the FDIC's Temporary Liquidity Guarantee Program to October 31, 2009.
- A new framework of governance and oversight to help ensure that banks receiving funds are held responsible for appropriate use of those funds through stronger conditions on lending, dividends, and executive compensation along with enhanced reporting to the public.

Alongside this program, the Obama administration will launch a comprehensive program to help address the housing crisis.

Treasury has begun a process of consultation designed to solicit further input from key public and private stakeholders. Details on all programs will be posted on *FinancialStability.gov*.

#### *New Financial Stability Trust*

The program will consist of three elements:

1. A forward-looking assessment of the risks on bank balance sheets and their capital needs;
2. A capital program to help banks establish an additional buffer that strengthens both the amount and quality of the capital; and
3. Efforts to improve the disclosure of exposures on bank balance sheets.

In conducting these exercises, supervisors have indicated that they recognize the need not to adopt an overly conservative posture or take steps that could inappropriately constrain lending.

#### *Capital Assistance Program (CAP)*

The supervisory agencies will undertake a coordinated and consistent capital planning exercise with each of the major US banking institutions. As part of this process, supervisors will conduct a special forward-looking "stress" assessment of the losses that could occur across a range of economic scenarios, including conditions more severe than currently anticipated or than are typically used in the capital planning process.

This stress testing exercise will allow supervisors to determine whether an additional buffer, particularly one that strengthens the composition of capital, is needed for the bank to comfortably absorb losses and continue lending, even in a more adverse environment. Banks will be encouraged to access private markets to raise any additional capital needed to establish this buffer. However, in light of the current challenging market environment, the Treasury will make a new capital facility generally available to eligible banking institutions as a bridge to private capital until market conditions normalize.

This additional capital buffer is designed to help absorb larger than expected future losses and to support lending to creditworthy borrowers during an economic downturn.

The expectation is that the capital provided under the CAP will be in the form of a preferred security that is convertible into common equity, with a dividend rate to be specified and a conversion price set at a modest discount from the prevailing level of the institution's stock price up to February 9, 2009. This security would serve as a source of contingent common equity, convertible solely at the issuer's option for an extended period of time.

The instrument will be designed to give banks the incentive to replace USG-provided capital with private capital or to redeem the USG capital when conditions permit. In addition, with supervisory approval, banks will be allowed to apply to exchange the existing CPP preferred stock for the new CAP instrument.

By reassuring investors, creditors, and counterparties of financial institutions, as well as the institutions themselves, that there is a sufficient amount and quality of capital to withstand even a considerably weaker-than-expected economic environment, the CAP instrument should improve confidence and increase the willingness of financial institutions to lend.

Any capital investments made by Treasury under the CAP will be placed in a separate entity set up to manage the government's investments in US financial institutions.

Eligible US banking institutions with assets in excess of $100 billion on a consolidated basis will be required to participate in the coordinated supervisory review process and may access the CAP as a means to establish any necessary additional buffer. Eligible US banking institutions with consolidated assets below $100 billion may also obtain capital from the CAP. Eligibility will be consistent with the criteria and deliberative process established for identifying Qualifying Financial Institutions (QFIs) in the existing Capital Purchase Program (CPP).

*Enhancing Public Disclosure*

Treasury will work with bank regulatory agencies and the Securities and Exchange Commission (SEC) and accounting standard setters in their efforts to improve public disclosure by banks. This process aims to increase the publicly available information about the range of exposures on bank balance sheets.

*New Public-Private Investment Fund (PPIF)*

As a complement to the CAP, the Treasury, working with the Federal Reserve, FDIC, and private investors, will create a new Public-Private Investment Fund (PPIF) to acquire real-estate-related legacy assets. By selling to PPIF, financial institutions will be able to reduce balance sheet risk, support new lending, and help improve overall market functioning. The PPIF facility will be sized up to $500 billion and with a proposed expansion of the program to up to $1 trillion over time.

This PPIF will combine a mix of government and private capital with financing supported by the Federal Reserve and the FDIC.

*Expansion of the Term Asset-Backed Securities Lending Facility (TALF)*

The Term Asset-Backed Securities Lending Facility (TALF) combines capital provided by the TARP with funding from the Federal Reserve in order to promote lending by increasing investor demand for securitized loans. The TALF aims to significantly expand the availability and reduce the cost of term financing for investors in asset-backed securities (ABS), and in turn stimulate demand for ABS, thereby allowing originators of securitized loans to lower the cost and increase the availability of credit to consumers and businesses.

The Treasury and Federal Reserve have agreed to dramatically increase the size of the TALF from

$200 billion to as much as $1 trillion and to expand the eligible asset classes from the current newly issued AAA rated ABS collateralized by credit card, auto, student, and Small Business Administration loans to include newly issued AAA commercial mortgage-backed securities (CMBS). In addition, the Treasury will continue to consult with the Federal Reserve regarding possible further expansion of the TALF program to include other asset classes, such as non-agency residential mortgage-backed securities (RMBS) and assets collateralized by corporate debt.

This facility is designed in a way that gradually reduces its attractiveness and scale as the economy and financial conditions recover.

*Ongoing Mortgage-Backed Securities (MBS) and Agency Debt Purchases*

The Federal Reserve plans to continue its current purchase program of agency debt and mortgage-backed securities (MBS) on a total scale of at least $600 billion. The Federal Reserve and the Treasury remain ready to expand their MBS purchase programs as conditions warrant. These purchase programs are intended to stimulate economic activity by reducing mortgage rates, thereby improving housing affordability and the demand for houses, as well as reducing interest payments and freeing up funds for households that refinance.

*Additional Tools for the Federal Reserve*

In order for the Federal Reserve to manage monetary policy over time in a way consistent with maximum sustainable employment and price stability, it must be able to manage its balance sheet and in particular to control the amount of reserves that the Fed provides to the banking system. The amount of reserves is the key determinant of the interest rate that the Federal Reserve uses to pursue its monetary policy objectives. Treasury and the Federal Reserve will seek legislation to give the Federal Reserve the additional tools to enable it to manage more effectively the level of reserves.

*Extension of Temporary Liquidity Guarantee Program (TLGP)*

The FDIC's Temporary Liquidity Guarantee Program has contributed importantly to the gradual easing of liquidity strains on US financial institutions. Though funding conditions have eased somewhat, this temporary program will be extended for an additional four months to provide liquidity to banks as part of the overall strategy to move the economy forward.

With that in mind, for an additional premium, the FDIC will extend the TLGP program through October 2009.

*Stronger Conditions on Lending, Executive Compensation, and Reporting*

Going forward, the Financial Stability Plan will call for a new level of transparency, accountability, and conditionality with tougher standards for firms receiving exceptional assistance. These stronger conditions were informed by recommendations made by formal oversight groups—the Congressional Oversight Panel, the Special Inspector General, and the Government Accountability Office—as well as congressional banking oversight leaders.

Recipients of capital provided under the CAP will be required to submit a plan for how they intend to use this capital to preserve and strengthen their lending capacity; specifically, they will commit to increase lending activities above levels relative to what would have been possible without government support. This plan will be submitted during the application process, and the Treasury Department will make these plans public upon distribution of the capital investment to the firm.

These firms must submit to Treasury monthly or quarterly reports on their lending by category. This report will also include a comparison to estimates of what their lending would have been in the absence of government support. For public companies, similar reports will be filed on an 8K simultaneous with the filing of their 10Q and 10K reports. All these reports will be put on the Treasury Web site *FinancialStability.gov*.

*Taxpayers' Right to Know*

Information disclosed or reported to Treasury by recipients pursuant to the conditions and requirements will be posted on *FinancialStability.gov*.

All recipients of CAP funds will commit to participate in mortgage foreclosure mitigation programs consistent with guidelines that the Treasury will release on industry standard best practices.

Limiting dividends, stock repurchases, and acquisitions provides assurance to taxpayers that all of the capital invested by the government under the CAP goes to improving banks' capital bases and promoting lending. Until an institution repays all funds provided to it under the CAP, it shall be:

- Restricted from paying quarterly common stock dividend payments in excess of $0.01 per share unless approved by Treasury and the primary regulator as consistent with the firm reaching its capital planning objectives.
- Restricted from repurchasing shares. Special approval for share repurchases may be granted by the Treasury Department and the banking institution's primary regulator.
- Restricted from pursuing acquisitions. Banking institutions that receive CAP funds are restricted from pursuing cash acquisitions of healthy firms until the government investment is repaid. Exceptions will be made for regulator-approved restructuring plans.

Further explanation of the Financial Stability Plan can be accessed at *http://www.financialstability.gov/*.

## Agencies Guide on Risks from Remote Deposit Capture

Although remote deposit capture systems can be beneficial both for financial institutions and for their customers, they also can expose institutions to additional risk, according to guidance published by the federal bank and thrift regulatory agencies. The Federal Reserve Board, FDIC, OCC, and OTS have issued interagency guidance addressing how institutions should manage that risk, particularly in the case of remote deposit capture (RDC) systems that are deployed at a customer's location. RDC allows a financial institution to receive digital information from deposit documents at remote locations such as automated teller machines, branches, or customer locations.

RDC is a new delivery system, not just a new service, the guidance said. Implementation requires that management understand all of the associated risks, including especially risks to the security and confidentiality of information.

Risk management policies should address risk tolerance levels, internal procedures and controls, risk transfer mechanisms, and third-party contracts, according to the interagency guidance. Not all customers will be appropriate for RDC, it was noted, and information generated by an institution's Bank Secrecy Act/anti-money laundering program may be useful in determining whether a particular customer is suitable. A customer's business activities, risk-management processes, location, and customer base would be relevant considerations, and personal visits could be called for in some cases.

The guidance also noted the importance of:

- Determining the suitability of third-party vendors;
- Training customers;
- Drafting strong contracts with vendors and customers; and
- Implementing business continuity plans.

The interagency guidance can be accessed at http://www.occ.treas.gov/ftp/bulletin/2009-4a.pdf.

## Fed Discusses Market Risk Rule Applicability

The Federal Reserve Board has issued enhanced guidance on its market risk rule (MRR), which establishes regulatory capital requirements for bank holding companies and state member banks that have significant exposure to certain defined market risks: those with gross trading assets and liabilities of at least $1 billion or 10 percent of total consolidated assets. The guidance reiterates some of the rule's core requirements, clarifies technical aspects, and addresses several issues where additional guidance was needed. The agency warned, however, that compliance with the rule will not alone ensure adequate market-risk management.

The MRR requires affected banks to determine a capital charge for their exposure to general market risk based on all of their covered positions by using a Fed-approved internal value-at-risk model. Capital charges for specific risks also must be calculated. The MRR also imposes qualitative requirements such as stress testing, back testing of models, independent annual system reviews, and the establishment of an independent risk-control unit.

The Fed noted that some institutions have not properly incorporated all covered positions. Covered positions include all positions in an institution's trading account and all foreign-exchange and commodities positions, whether on- or off-balance sheet. Whether a position is considered to be a trading-book position or a banking-book position must be determined based on documented, objective, consistently applied procedures.

An institution's model must capture all significant price risks, the Fed said, including both basis risks and directional market risks. Formal prohibitions or strict limits on positions types or risk exposures may help an institution reduce the complexity of its model. All trading positions must be incorporated in daily model back testing, the Fed continued. Models should be updated at least quarterly and, if called for by an institution's specific activities or the market conditions, as often as daily. An annual independent review also is required.

The guidance outlined stress-testing requirements for an institution's covered positions. Seven characteristics were noted specifically, such as including all covered positions, considering the possible need to liquidate covered positions during a time of reduced liquidity in the market, and the need to consider stresses that apply to positions underlying structured or leveraged positions.

The guidance can be accessed at *http://www.federalreserve.gov.*

### Treasury Releases TARP Terms for S Corp Financial Institutions

The Treasury Department has issued a term sheet and released answers to frequently asked questions (FAQs) addressing how it will provide relief under the Troubled Asset Relief Program (TARP) to qualified financial institutions that are S Corporations. Unlike previous terms under the TARP, the Treasury will use debt instruments, rather than preferred stock, to assist struggling S Corp financial institutions. This is intended to end concern that S Corp banks, which are typically small community banks, would not share in the relief available to the rest of the financial industry.

The terms of the TARP program for S Corps require the Treasury to acquire subordinated debentures from a qualified financial institution, with each note having a principal amount of $1,000. According to the FAQs, debt (rather than preferred stock) was chosen to provide relief to these entities because S Corps under the Tax Code can have only one class of stock (§ 1361(b)(1)(D)). The Treasury could not own preferred stock in these entities without disqualifying them from S Corp status.

The interest rate on subordinated debt owed by S Corp institutions will be 7.7 percent for each of the first five years of the program (versus 5 percent for preferred stock) and 13.8 percent afterwards (versus 9 percent for preferred stock). In the FAQs, the Treasury stated that this rate is higher than the dividend rate imposed on preferred stock in other participating qualified financial institutions in order to establish equal treatment among taxpayers. The use of debt instead of preferred stock for S Corporations allows the participants to claim a tax deduction for interest payments that would otherwise reduce the net tax effectively paid to the Treasury.

As consideration for this debt, the financial institution is required to grant warrants to the Treasury for the purchase of additional debentures equal to 5 percent of the amount originally purchased, with an exercise price of $0.01. These warrants are entitled to the same rights, preferences, privileges, and voting rights as the debentures, with interest rates of 13.8 percent per year.

According to the Treasury, S Corps will have until Feb. 13, 2009, to apply to their federal banking agency using forms on the Treasury's TARP Web site at *http://www.treas.gov/initiatives/eesa/.*

### House Passes TARP Reform Bill

The House of Representatives passed a bill intended to increase the effectiveness of and accountability under the Troubled Asset Relief Program on Jan. 21, 2009, by a vote of 260 to 166. The TARP Reform and Accountability Act of 2009 (H.R. 384) would impose a number of requirements and restrictions on financial institutions that receive TARP funds and require the Treasury Department to take stronger action to reduce mortgage foreclosures. It was introduced by Financial Services Committee Chairman Barney Frank, D-Mass., but considered by the entire House as a Committee of the Whole rather than by his committee.

The bill would require institutions, other than some small community institutions, that receive TARP money to negotiate an agreement with the Treasury and their primary federal regulator on how the money is to be used. The agreement would include benchmarks to be met by the institution. An institution receiving TARP money could acquire another financial institution only if the Treasury first certified either that the acquisition reduced risk to taxpayers or that the acquisition could have been accomplished without the TARP funds.

Disclosure and reporting duties also would be imposed. Institutions that have received TARP funds would be obligated to make reports on at least a quarterly basis about how the funds have been used. Insured depository institutions would be required to report on the amount their lending activity had increased or, at least, on the reduction in the decrease of their lending activity.

An amendment would require the Federal Reserve Board to disclose the details of its program to purchase illiquid mortgage-backed securities from troubled financial institutions. The Fed hired four investment firms to manage the program, but according to amendment sponsor Patrick Murphy, D-Pa., it has refused to release information on how the firms were chosen, how much they are being paid, what conflicts of interest provisions are in place, or who will manage the purchases.

Stricter executive compensation limits would be applied to institutions that receive any new or additional TARP distributions. These would be a combination of the strictest limits imposed by the Treasury to date plus the limits imposed on US automobile manufacturers:

- Incentive compensation that encouraged taking excessive risks would be prohibited;
- Compensation based on materially inaccurate financial statements would be recovered (or clawed back);
- Golden parachutes would be prohibited until the TARP investment was fully repaid;
- Incentive compensation could not be paid to the institution's 25 most highly compensated employees; and
- Compensation plans that would encourage manipulation of earnings would be prohibited.

Moreover, the bill would give the Treasury the authority to impose these requirements on institutions that already have received TARP funds.

The Treasury would be required to use at least $40 billion, and permitted to use as much as $100 billion, of the second $350 billion installment of TARP funding for a comprehensive foreclosure mitigation plan. Under the bill, the plan would be available only for mortgages on owner-occupied property and would need to satisfy at least one of these alternatives:

1. Establish a guarantee program for qualifying loan modifications under a systematic plan;
2. Reduce costs for Hope for Homeowners loans;
3. Pay down second-lien mortgages that interfere with the refinancing of first-lien mortgages;
4. Make incentive payments to loan servicers; or
5. Purchase whole loans in order to modify or refinance them.

The bill would create a safe harbor from liability for loan servicers that modify loans as long as the modification was consistent with standards previously established in the Homeowner Emergency Relief Act. Also, in an effort to discourage suits against loan servicers, an unsuccessful plaintiff would be required to pay the servicer's court costs and attorney fees.

Additionally, the bill would reduce costs for the Hope for Homeowners plan in an effort to make it more attractive. Changes would include:

- Eliminating the 3 percent up-front premium;
- Reducing the maximum permitted loan-to-value ratio;
- Eliminating the government profit sharing in the appreciation over market value of a home when a loan later is refinanced (but retaining the government declining share in equity created by the refinancing); and
- Permitting incentive payments to loan servicers.

The bill includes several other significant provisions. One would require the Treasury to create a program independent of TARP that would encourage home purchases in order to reduce the existing inventory of residential properties. Another would make permanent the increase in deposit insurance coverage to $250,000, as well as implement an inflation adjustment mechanism.

Frank noted that Senate Banking Committee Chairman Christopher Dodd, D-Conn., has indicated that he does not plan to act on the bill. However, "I regard this as a very important vote . . . to strengthen our hand in making sure that Treasury does what we think is necessary, even if it doesn't become law," Frank said.

House Speaker Nancy Pelosi, D-Calif., said that the legislation would ensure that TARP "functions as Congress originally intended." She added that Congress and the new administration "will ensure that TARP funds are used for lending to American workers and small businesses—so we can lift our economy out of recession—and not for the enrichment of a privileged few."

## Treasury Department Sets New Executive Pay Limits

The Treasury Department has issued new restrictions on the executive compensation that can be paid by financial institutions that have received targeted assistance, assistance to institutions such as AIG, Bank of America, and Citibank that made individual agreements with the federal government. Similar restrictions have been proposed for all financial institutions receiving cash infusions under general capital access programs, programs that are open to all qualifying institutions on the same terms. The Treasury also plans to develop and impose long-term model compensation strategies for all public financial institutions, even those not receiving government assistance. These strategies will apply to all employees, not just top executives, and will seek to encourage proper management of risk and an emphasis on long-term value and growth through long-term stock awards.

"The measures are designed to ensure that the compensation of top executives is closely aligned not only with the interests of shareholders and financial institutions, but with the taxpayers providing assistance to those companies," Treasury stated in a press release. "The standards today mark the beginning of a long-term effort to examine both the degree that executive compensation structures at financial institutions contributed to our current financial crisis and how corporate governance and compensation rules can be reformed to better promote long-term value . . . and to prevent such financial crises from occurring again."

For companies receiving targeted assistance, the restrictions limit to $500,000 the total of compensation other than restricted stock that may be paid to senior executives. Any compensation above $500,000 must be made in restricted stock or similar long-term incentives. Executives will be able to cash in the restricted stock only after the government investment has been repaid and all dividends due to the government have been paid or after the completion of a specified period that was linked to repayments, protecting taxpayer interests, or meeting lending and stability standards. The company's compensation pay strategy must be disclosed and submitted to a non-binding say-on-pay shareholder resolution.

Another provision of the rules requires a company's board of directors to adopt and disclose a policy on the payment of luxury expenditures such as airplane flights, office renovations, parties, and conferences and events. The company's chief executive will have to certify any spending that is potentially excessive or luxurious. Also, the provision for a company to recover, or clawback, bonuses and incentive compensation that resulted from deceptive practices will be extended from the top five senior executives of a company to the top 25 senior executives. The existing ban on golden parachutes paid to the top five executives of a company will be expanded to the top 10 executives, and the next 25 senior executives will be limited to receiving payments of no more than one year's compensation.

The Treasury Department is proposing similar standards for companies receiving assistance under generally available capital access programs. The $500,000 restriction on compensation other than restricted stock compensation could be waived if the company discloses the compensation and submits it to a nonbinding say-on-pay shareholder resolution. Golden parachutes will be limited to one year of compensation for the top five executives, instead of the three years allowed currently. The same claw-back and luxury spending requirements that apply to companies that receive targeted assistance will be imposed on companies that participate in the general capital assistance programs. However, these standards will not apply retroactively to existing investments or, according to the Treasury's press release, to existing programs such as the Capital Purchase Program.

President Obama said that the new Treasury guidelines are the beginning of a long-term effort to restore trust in the financial system and ensure that taxpayers are not subsidizing excessive compensation on Wall Street. "We're going to be taking a look at broader reforms so that executives are compensated for sound risk management and rewarded for growth measured over years, not just days or weeks," Obama said at a White House event announcing the new rules. "We all need to take responsibility. And this includes executives at major financial firms who turned to the American people, hat in hand, when they were in trouble, even as they paid themselves their customary lavish bonuses," the president asserted.

Treasury Secretary Timothy F. Geithner also announced that the Obama administration would outline a comprehensive program for financial recovery during the week of Feb. 9, 2009. Geithner noted the strong sentiment across the country that those who were not responsible for the economic crisis are bearing a greater burden than those who were responsible. The policies limiting executive compensation are "designed to strengthen the public trust," he said.

### Additional Guidance on Executive Compensation Limits Issued

The Treasury Department has released further guidance on the executive compensation limits that apply to financial institutions that are receiving funds through programs that the Treasury has established under the Emergency Economic Stabilization Act (EESA). Two separate documents have been issued: revised guidelines for institutions receiving assistance under the program for systemically significant failing institutions and frequently asked questions under the Capital Purchase Program (CPP).

The program to assist systemically significant failing institutions permits these institutions to sell troubled assets to the Treasury for purchase with funds from the Troubled Asset Relief Program (TARP). EESA imposes limits on the compensation that participating institutions may pay to senior executive officers. These include limits on incentive compensation and, in some cases, prohibitions on golden parachutes.

The guidelines address:

- The institutions and officers that are covered;
- What institutions must do to comply with the restrictions;
- The certification and reporting requirements that must be met;
- What golden parachutes are prohibited; and
- The effect of a merger, acquisition or reorganization.

The FAQs apply to institutions in which the Treasury is investing funds through the CPP in exchange for preferred stock and warrants or, in the case of S corporations, debt instruments. They apply as long as the Treasury holds any interest in the institution. The FAQs cover:

- What officers are affected;
- What certification and reporting requirements must be met;
- When an institution must seek to recover incentive previously-paid compensation; and
- Which golden parachutes are prohibited.

The guidance and FAQ can be accessed at *http://www.ustreas.gov/*

## SECURITIES/SECTION 20/ BROKER-DEALER

### Senators Introduce Hedge Fund Registration Bill

Sen. Carl Levin and Sen. Charles Grassley have introduced a bill requiring hedge funds to register with the SEC. The Hedge Fund Transparency Act would make hedge funds subject to SEC regulation and oversight by requiring them to register with the SEC, file an annual public disclosure form with basic information, maintain books and records required by the SEC, and cooperate with any SEC information request or examination. The measure also would require hedge funds to establish anti-money laundering programs and to report suspicious transactions, thereby clarifying that hedge funds have the same obligations under US money laundering statutes as other financial institutions.

The information to be made available to the public under the bill would include, at a minimum, the names of the companies and natural individuals who are the beneficial owners of the hedge fund and an explanation of the ownership structure, the names of any financial institutions with which the hedge fund is affiliated, the minimum investment commitment required from an investor, the total number of investors in the fund, the name of the fund's primary accountant and broker, and the current value of the fund's assets and assets under management. The bill would also authorize the SEC to require additional information that it deems appropriate.

The bill would impose a set of basic disclosure obligations on hedge funds and makes clear that they are subject to full SEC oversight, while exempting them from many of the obligations that the Investment Company Act imposes on other types of investment companies, such as mutual funds, which are open for investment by all members of the public. The bill would impose a more limited set of obligations on hedge funds in recognition of the fact that they are generally confined to wealthy investors. The bill also would give the SEC the authority to impose additional regulatory obligations and exercise the level of oversight that it sees fit over hedge funds to protect investors, other financial institutions and the US financial system as a whole.

Hedge funds generally rely on Investment Company Act § 3 (c)(1) and (7) for exemptions. The bill would apply to all entities that rely on § 3(c)(1) or (7) to avoid compliance with the full set of the Investment Company Act requirements. Many entities invoke those sections to avoid those requirements and SEC oversight. These entities refer to themselves by a wide variety of terms, including hedge funds, private equity funds, venture capitalists, and small investment banks. Rather than attempting to define the specific set of companies covered by the bill and invite future claims by parties that they are outside the definitions and the SEC's authority, the bill applies to any investment company that has at least $50 million in assets or assets under its management and relies on § 3(c)(1) or (7) to avoid compliance with the full set of Investment Company Act requirements. The bill also moves paragraphs (c)(1) and (7) from the part of the act that defines "investment company" to the part that exempts certain investment companies from the act's full set of requirements. This revision clarifies that hedge funds are investment companies and that they are not excluded from the coverage of the act.

These entities currently enjoy an exemption from many of the law's requirements because they are investment companies that have voluntarily limited themselves to 100 or fewer beneficial owners and accept funds only from investors of means. Under current law, the two paragraphs allow hedge funds to claim that they are excluded from the act, that they are not investment companies and are outside of the SEC's reach. Under the bill, the hedge funds would qualify as investment companies, which Congress believes they plainly are, but would qualify for exemptions from many of the Investment Company Act's requirements by meeting certain criteria.

### Senate Banking Committee Reviews Madoff Scandal

The Senate banking committee opened a hearing on the Madoff securities fraud to consider regulatory and oversight concerns and the need for reform. The Madoff fraud is noteworthy for both its size and its duration, according to Committee Chair Christopher Dodd. The committee explored how the SEC may have failed to detect the fraud with so many warning signs. Sen. Dodd noted that former SEC Chair Christopher Cox acknowledged that credible allegations were presented to the SEC staff but were never brought to the Commission. Chairman Dodd requested that the SEC and the Financial Industry Regulatory Authority update the committee every three months with respect to the steps that they are taking in response to the failure to detect a fraud of historic proportions.

John C. Coffee, Jr., a law professor at Columbia University, observed that Ponzi schemes are hard to detect once they've begun. They are not rare and are increasing in number, he said. Prof. Coffee presented ideas for preventing Ponzi schemes. He noted that no mutual fund has failed because of a Ponzi scheme and attributed that record to the requirement that funds have independent custodians that hold the funds in a separate account. The investment adviser does not have access to the funds.

Prof. Coffee also attributed the SEC's failure to detect the Madoff scheme partly to the extension of exemptions for unregistered broker-dealers from a requirement to use auditors registered with the Public Company Accounting Oversight Board. If Mr. Madoff had been required to use a registered auditor, Prof. Coffee said he could not have gotten away with his scheme. That issue has now been resolved since the SEC did not extend the exemption when it expired at the end of the year.

Prof. Coffee said that the SEC's Office of Compliance Inspections and Examinations is cost constrained and must use risk adjusted criteria to determine which firms to inspect. He does not believe that the staff used the right criteria for Mr. Madoff. Once Mr. Madoff was required to register as an investment adviser, Prof. Coffee said that he should have been asked about the custodian he was using given the size of the accounts under management. Mr. Madoff served as his own custodian.

Lori Richards, the director of OCIE, reported that the staff expects to identify areas to improve inspections and oversight. She noted that there are more than 11,000 registered investment advisers, a number larger than the staff is able to inspect regularly. The staff is thinking expansively about the changes that could be implemented to increase the likelihood of detecting fraud, she said.

Linda Chatman Thomsen, the director of the SEC's Enforcement Division, advised that her office receives hundreds of thousands of tips and complaints each year and cannot fully investigate all of them. Every day, the division must make difficult decisions about which matters to pursue, she said. The division is looking at ways to identify emerging trends for investigations. With more resources, the division could do more, she added.

Sen. Dodd asked about Prof. Coffee's recommendations and whether they have been considered by the SEC. Director Richards agreed that an independent custodian is a strong internal control. As many as 1,000 registered investment advisers are using affiliated custodians, she said. She agreed that, unless the custodian is truly independent, it may give rise to the possibility of fraud. The downside to requiring independent custodians would be the cost, but she agreed that the SEC should consider the recommendation.

Sen. Dodd said that the committee expects more than a study. It wants to see actions very quickly. Many of the committee members repeatedly questioned why the SEC did not take seriously detailed reports about the possible existence of a Ponzi scheme by the Madoff firm. Ms. Thomsen advised that she could not address any specifics of the case since it is the subject of an SEC and a criminal investigation. She advised, however, that the SEC receives thousands of tips and leads, many as detailed as the allegations submitted about the Madoff firm. Red flags do not necessarily mean that there is a fraud, she said. Director Thomsen also assured the committee that the SEC's inspector general has the same questions as those posed by the members and he is conducting an internal investigation.

Sen. Mark Warner asked Ms. Richards to submit to the committee the protocol that it uses in its risk assessments to determine which firms will be reviewed. In response to his line of questioning, she said that the custodial arrangement is one area that the staff looks at, but the auditing firm is not. The fee structure is also a factor, she said, but the fund's performance is not. She agreed that information about performance could be useful.

Sen. Jack Reed asked about the "feeder funds" that were soliciting investments for the Madoff firm. Many people did not realize that they were investing with Mr. Madoff, he noted. Prof. Coffee said that the feeder funds posed a legitimate concern. A number of actions have been filed against some of these feeder funds for material misstatements and omissions. Prof. Coffee said that the committee may want to look at the feeder funds because they may represent an area where this investigation should go. He said an investigation may find that Mr. Madoff and his employees were making payoffs to these funds. In the last year or two, Mr. Madoff had to be desperate, the professor said, so he may have had to pay the feeder funds "under the table."

Sen. Robert Menendez noted that some Madoff family members worked for the firm and asked whether family relationships were a cause for concern. Prof. Coffee said that the chief compliance officer has much to answer for about the business that the firm was conducting. There may have been false statements within the scope of federal criminal law, the professor said.

When asked whether he had any additional recommendations, Prof. Coffee noted that many are discussing whether the jurisdiction of FINRA should be expanded to give it authority over investment advisers, or whether investment advisers should have their own self-regulatory organization. Those options should be on the table, in his view. Another idea is whether the Securities Investor Protection Corp. should behave more like the Federal Deposit Insurance Corp. and be assigned some regulatory responsibilities and whether the premiums should relate to the relevant risks rather than imposing a flat rate. He added that to use SIPC as more of a deterrence would be controversial.

Sen. Dodd asked Directors Richards and Thomsen to convey back to SEC Chair Mary Schapiro the committee's interest in her view on the need for additional staffing and resources.

## COURT DEVELOPMENTS

### Supreme Court to Hear Preemption Case

The Supreme Court has granted a request that it consider whether New York could enforce against national banks a state law prohibiting housing discrimination. According to the Second Circuit, the National Bank Act and regulations adopted by the Office of the Comptroller of the Currency vested exclusive visitorial authority over national banks in the OCC.

The case arose in 2005 when the New York Attorney General attempted to investigate whether minority mortgage loan borrowers were significantly more likely to receive high-interest loans than were white borrowers, as was suggested by data collected under the Home Mortgage Disclosure Act. The state official sent "letters of inquiry" to a number of lenders, including national banks and their operating subsidiaries, seeking information about their mortgage loan policies and property-related loans in the state. The letters were said to ask that the information be produced voluntarily. Shortly thereafter, the OCC and The Clearing House Association, a group of national banks that included some who had received letters of inquiry, separately sued for injunctions against the state investigation. Both claimed that the attorney general's investigation was an attempt to exert visitorial authority over national banks, which was prohibited by federal law.

The appeal is *Cuomo v. The Clearing House Assn.*

### Undisclosed Plan to Increase Interest Rate Did Not Violate TILA

A credit card lender's undisclosed intent to rely on a universal default clause to increase a consumer's interest rate after the consumer accepted a balance transfer offer would not have made the lender's disclosures inaccurate under the Truth-in-Lending Act (TILA) or Reg. Z—Truth in Lending (12 CFR 226), according to the Ninth Circuit. However, state laws on unfair business practices and false advertising could have been violated, the court said, and the consumer should have the opportunity to pursue those claims.

The consumer said that he had opened a credit card account in 2003 and that, about 16 months later, he was given the opportunity to transfer balances from other accounts to the credit card account at a preferential interest rate. However, that lower rate would be lost if the consumer had made a late payment to any creditor. The consumer had, in fact, made a late payment in June of that year. The consumer accepted the balance transfer offer in October; however, when he received his November statement, it reflected the increased interest rate, not the promotional rate that he had expected. The credit card company claimed to have looked at his credit report in August and September and not to have found a report of the late payment, making him eligible for the balance transfer offer.

The consumer sued, asserting that the credit card company knew of the late payment before he accepted the balance transfer offer and waited until he accepted the offer to apply the higher interest rate. This undisclosed intent to increase the interest rate made the TILA disclosures inaccurate, the consumer claimed.

TILA and Reg. Z imposed only disclosure requirements and did not regulate the terms of credit, the court said. They required only that the disclosures accurately reflect the legal relationship at the time that they were made. An undisclosed intent to change those terms at a later date was irrelevant to whether the disclosures were accurate when they were made, according to the court. Therefore, the disclosures did not violate the law or regulation.

Moreover, the credit card company would have no liability under the state laws for claims based on the adequacy of its disclosures. The state law created a safe harbor for conduct that was authorized by other laws, and the disclosures complied with the TILA and Reg. Z.

State law claims that did not relate to the adequacy of the disclosures could continue, the court said. If the credit card company knew or should have known of the late payments when it made its disclosures and had an intent to raise the consumer's interest rate after he transferred his balance, the state laws could have been violated. TILA and Reg. Z governed the adequacy of the disclosures, but they did not give the credit card lender a right subsequently to take actions that were inconsistent with those disclosures.

The consumer had presented evidence that the credit card lender had violated the state laws, the court continued. A consumer reporting agency employee testified that the credit card company had been told of the late payments before the disclosures were made, and other evidence implied that the agency reported such information as soon as it was received. Additionally, evidence about the operation of the creditor's computer system could be interpreted to support the consumer's claim. [*Hauk v. JPMorgan Chase Bank* (9th Cir.).]

### Consumers Could Assert RESPA Violation Even if Not Overcharged

Consumers could sue for a violation of the Real Estate Settlement Procedures Act (RESPA) prohibition on unearned fees and kickbacks even if they were not overcharged as a result of the violation, the Sixth Circuit has determined. RESPA created a legal right and the consumers would have suffered an injury that resulted from the violation of that right, the court said. A dismissal of the consumers' suit was reversed.

The consumers claimed that their realty agency referred them to a title company when they purchased a home. The title company and the realty agency both were owned by the same two companies. According to the consumers, this combination allowed the companies to compensate each other for referrals and to pay each other kickbacks or fee splits in violation of RESPA. However, the consumers did not claim that they were overcharged in their transaction.

RESPA prohibits kickbacks, fee splitting, and unearned fees and says that a violator is liable to anyone who is charged for a settlement service for "three times the amount of any charge paid for such settlement service." The first issue the court addressed was the meaning of "any charge paid." That phrase referred to more than just any overcharge, the court decided; it referred to any settlement charge at all. Thus, RESPA made a violator liable to anyone who had paid any settlement charge, regardless of whether there was an overcharge.

The second issue was whether the consumers had constitutional standing to sue, which was determined by whether they had suffered a personal and individualized injury. The court decided that the consumers met this test. The right to sue for a RESPA violation was not given to the public at large, but was restricted to those who had paid settlement fees. Also, they had a personal right to receive referrals that were not based on illegal payments, and that right would have been violated. [*Carter v. Welles-Bowen Realty, Inc.* (6th Cir.).]

### Credit Card Company Properly Investigated Dispute

A consumer's claim that a credit card issuer that furnished information to a consumer reporting agency had failed adequately to investigate his claims that the information was inaccurate has been rejected by the Ninth Circuit. However, the consumer will be given a chance to prove that the credit card company had failed to report the dispute to consumer reporting agencies and that it violated California state law.

The dispute arose from a problem in the consumer's credit card purchase of a satellite television system. The consumer was dissatisfied with the equipment and filed a dispute over payment with the credit card company. However, the card issuer resolved the dispute in favor of the equipment provider and refused to remove the charge from the consumer's account. When the consumer continued to refuse to pay the bill, the card issuer reported the overdue amount to various consumer reporting agencies. The consumer then several times disputed the accuracy of the reported information with those agencies, which passed the dispute back to the card issuer for investigation as required by the Fair Credit Reporting Act (FCRA). When he was dissatisfied with the results of these investigations, the consumer sued the credit card company.

The court began by agreeing with the consumer that the FCRA required the credit card issuer to perform a reasonable investigation of the dispute after notice by the reporting agencies. A cursory or unreasonable investigation would not be adequate, the court said. The meaning of the word "investigation" implied a detailed or careful inquiry, and the purpose of the FCRA—allowing consumers to correct inaccurate information—argued in favor of the same interpretation.

However, the company's three different investigations of the disputes all were adequate, the court decided. The sufficiency of the credit card issuer's investigation of the disputes over the accuracy of information it had furnished to the consumer reporting agencies was to be measured against the information that it received from the agencies, the court noted. The first dispute report said simply that the consumer claimed that the card issuer had agreed to change the report. This required the card issuer only to check its files to determine whether such an agreement had been made. The second dispute was almost as vague, being a claim of fraud with no details. It was enough for the company to compare the identifying information and also confirm that it had never received a claim of fraud directly from the consumer.

The third dispute was more detailed, the court agreed. However, it did not include any reason for the card issuer to conclude that the results of the two previous investigations were incorrect. It was reasonable for the card issuer to rely on its previous investigations.

The consumer also asserted that the card issuer had violated the FCRA by reporting the overdue account to consumer reporting agencies without notice that he had disputed the debt. The consumer could not sue the card issuer for failing to include a report of the disputes he had made directly with the company, the court said. If the company had a duty to report those disputes to the consumer reporting agencies, it was a duty that could be enforced only by state or federal authorities under the FCRA.

However, the consumer could sue for the card company's failure to include in information it sent to consumer reporting agencies that the consumer had disputed the accuracy of information in the consumer reports. The FCRA created a private right of action for such a failure, as the omission of a bona fide dispute would result in the consumer report being inaccurate.

The court went on to say that the consumer had presented at least some evidence that the card issuer had failed to include the dispute in its information. The consumer could testify that the dispute was not noted on his consumer reports, and the forms returned by the company to the reporting agencies stated that the information was accurate as it had been reported, even though the company's files showed the dispute.

The consumer's claim that reporting the inaccurate information constitutes libel was found to have been preempted by the FCRA. Although the FCRA allowed a consumer to sue for libel if there was evidence that the company either knew the debt was false or acted with reckless disregard as to the validity of the debt, no such evidence had presented, the court said.

On the other hand, a California statute prohibiting the reporting of information the company knew or should have known to be false was not preempted, the court determined. The FCRA specifically exempted the law from preemption. The court rejected the credit card company's claim that the state law should be considered to have been preempted because the FCRA did not list the state law provisions on enforcement, ruling that specification of the section that established the right was what mattered. [*Gorman v. Wolpoff & Abramson* (9th Cir.).]

### No Willful Violation if Law Arguably Allowed Credit Report Sale

A consumer reporting agency that sold a consumer report to a credit card issuer for use in reviewing a consumer's closed account did not willfully violate the Fair Credit Reporting Act (FCRA), the Eleventh Circuit has decided. The court affirmed a pretrial judgment in favor of the agency.

The consumer had once had an account with the credit card issuer but paid the full account balance and closed the account in 1998. In 2001, the card issuer started a semi-annual account review program that required purchasing consumer reports from the agency. As part of the sale arrangements, the issuer told the agency that all of the requests were for reports on current customers. However, reports on the consumer were sold to the card issuer twice in 2002, well after his account had been closed.

The consumer sued the agency, asserting that the issuer had no permissible purpose in obtaining the consumer report and that the agency willfully violated the FCRA by not maintaining procedures to ensure that it sold reports only for proper purposes.

The FCRA permitted the sale of a consumer report for use in reviewing an account, the court began, but did not make clear whether that included reviewing a closed account. As a result, interpreting the FCRA to include allowing the review of closed accounts was not unreasonable and could not have resulted in a willful violation, the court said. [*Levine v. World Financial Network National Bank* (11th Cir.).]