Dodd-Frank: Rating Agencies And The ABS Market

Law360, New York (January 24, 2011) -- It should have come as no surprise that, within the 2,300 pages of the most sweeping financial regulatory legislation since the Great Depression, there were a few unheralded provisions with significant consequences.

The Dodd-Frank Wall Street Reform and Consumer Protection Act was passed by the U.S. Congress and signed into law by President Barack Obama on July 21, 2010. The legislation introduced broad reforms to many areas of the financial markets, but one provision that garnered little attention prior to the bill becoming law paralyzed the asset-backed securities (ABS) market in the aftermath of the law's enactment.

The repeal of a rule exempting credit rating agencies from "expert" designation meant rating agencies could be held liable for material misstatements or omissions with respect to the ratings they attach to securities. Given this potential new exposure, rating agencies refused to allow issuers to include their ratings in registration statements or prospectuses, as required for new public ABS offerings. As such, issuers were briefly unable to bring new bonds to market.

The U.S. Securities and Exchange Commission immediately provided temporary relief to the market by granting a six-month reprieve from enforcement of the relevant rule. On Nov. 23, 2010, the SEC extended that reprieve indefinitely, subject of course to further Congressional action.

The Dodd-Frank Act Turns Credit Ratings into Expert Advice

In four lines on the last page of a lengthy section entitled "Improvements to the Regulation of Credit Rating Agencies," Section 939G of the Dodd-Frank Act transforms the role of rating agencies in ABS offerings by repealing Rule 436(g) under the Securities Act of 1933 (the Securities Act).

The rule provided that a credit rating from a nationally registered statistical rating organization (NRSRO) assigned to a public offering registered under the Securities Act was not considered an expert-certified part of the registration statement, as defined by Sections 7 and 11 of the Securities Act.

The rating agencies' exception from expert designation was aligned with the historically prevailing view that ratings issued by NRSROs were opinions and entitled to First Amendment protection. That view has been challenged in the last few years, and recent court decisions suggest a First Amendment defense of rating opinions may be fracturing.

On Sept. 2, 2009, Judge Shira Scheindlin of the Southern District of New York issued a decision in Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc. denying rating agencies' motions to dismiss certain claims brought by securities investors, and rejecting the argument that rating opinions were entitled to immunity under the First Amendment.[1]

Judge Scheindlin acknowledged that "it is well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an 'actual malice' exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern."[2]

However, she distinguished that generalized protection for ratings disseminated to the public at large from situations where ratings are provided only to a select group of investors, explaining that, in those narrower circumstances, the ratings do not warrant First Amendment protection.

Judge Scheindlin also rejected the argument that the ratings were nonactionable opinions. Finding that plaintiffs had sufficiently pled the rating agencies did not "genuinely or reasonably believe that the ratings they assigned to the Rated Notes were accurate and had a basis in fact," she held the ratings could be actionable misrepresentations.[3]

While Judge Scheindlin's Abu Dhabi decision was limited to New York common law fraud claims, and expressly confined to the narrow case where ratings are provided to select investors, a recent California decision is arguably more expansive. Judge Richard Kramer ruled against rating agencies on another preliminary motion in California Public Employees' Retirement Systems v. Moody's Corp. et al.[4]

The court cited the Abu Dhabi opinion, and explained: "The right to free speech allows us to give our opinions on things of public concern. The issuance of these SIV ratings is not, however, an issue of public concern. Rather, it is an economic activity designed for a limited target for the purpose of making money. That is not something that should be afforded First Amendment protection and the defendants are not akin to members of the financial press."[5]

This body of law is still developing and the ultimate resolution of these speech questions remains uncertain, but meanwhile the Dodd-Frank Act deems the assignment of ratings in public offering documents to be expert advice, not just expressions of opinions ostensibly protected by the First Amendment. But for the SEC's no-action letters, disclosure of a rating in a registration statement would now require inclusion of consent by the rating agency to be named as an expert, since Section 11 liability otherwise could attach to the rating agency.

The Repeal of Rule 436(g) was Largely Unanticipated, Despite an Ongoing SEC Review

The challenges presented to rating agencies and the ABS market by the Dodd-Frank Act did not garner media and industry attention in the weeks leading up to the legislation's finalization. Analysts did acknowledge the liberalized pleading standards, mentioning the potentially heightened litigation costs associated with new standards, but there was no mention of Rule 436(g) repeal in the press leading up to the bill's passage.

However, the repeal of Rule 436(g) actually had been contemplated for some time. The SEC sought input from industry actors in September 2009 about whether it should propose rescinding the expert exemption from credit ratings in securities registration statements. The ratings agencies submitted letters in December opposing the contemplated rescission, and met with the SEC to discuss the issue in early 2010.

After intense lobbying, it appeared that the rating agencies had successfully fended off the repeal, but the small clause reappeared in the bill late in the reconciliation process. The line was inserted into the Dodd-Frank Act by congresswoman Mary Jo Kilroy, a Democrat from Ohio whose stated goal was to increase the potential liability for credit rating agencies — her amendment to the conference committee bill was passed on June 16th while the House and Senate versions were being reconciled.

Perhaps the repeal of Rule 436(g) went unremarked because the focal point for analysts was the potential shift in the entire NRSRO business model, a system that was under attack as the legislation was drafted but ultimately left untouched. Indeed, analysts concluded that the law's consequences for rating agencies were mild, particularly in contrast with the harsher impact they had anticipated.

One typical article ran the headline: "Raters seen unscathed by financial reform bill" and explained as follows: "Credit rating agencies have emerged relatively unscathed in the final version of the U.S. financial reform bill, with their business model intact and only minor threats to profits, boosting their near-term prospects, analysts say."[6]

The article explained that the rating agencies' core business model, where banks select and compensate rating agencies to rate their issuances, was left intact by the legislation. Senator Al Franken had led an effort to change that model, championing conflict-of-interest rules that provided for the random assignment of rating agencies to debt issuances.

Franken won bipartisan support to include his amendment in the Senate version of the legislation, but House and Senate negotiators voted to remove the conflict of interest rules during reconciliation, replacing them with a two-year study to evaluate and address issues surrounding the independence of NRSROs.[7]

Rating Agencies Initially Seek to Avoid Section 11 Expert Liability, Freezing ABS Market

Against the backdrop of evolving First Amendment law, and in response to the Dodd-Frank Act's repeal of Rule 436(g), Fitch Ratings, Standard & Poor's Ratings Services, Moody's Investor Service and DBRS Inc. all indicated they would not allow their organizations to be named as experts in ABS registration documents filed with the SEC.

Typifying the NRSROs' response, Fitch issued a comprehensive statement explaining its view that ratings are forward-looking and "embody assumptions and predictions about future events that by their nature cannot be verified as facts," thereby justifying the historical treatment of credit rating agencies as not experts under the Securities Act.[8]

Despite this position, NRSROs announced intentions to avoid exposure to expert liability under Section 11 following the Dodd-Frank Act: Fitch and other NRSROs indicated they would continue to publish credit ratings and research, but would not consent to include ratings in prospectuses and registration statements until they fully understand the attendant liability issues.

Given the NRSROs' reaction, the ABS new issue market froze, because Items 1103(a)(9) and 1120 of Regulation AB require ratings to be incorporated in a public registration statement or prospectus for ABS offerings. Issuers must disclose the rating and identity of the rating agency if an issuance or sale of any class of offered asset-backed securities is conditioned on the assignment of a rating by one or more NRSROs.[9] Without the consent of the ratings agencies, such disclosures were impossible, and new ABS issuances could not proceed.

Ford Deal Prompts the SEC to Suspend Enforcement, Reviving ABS Market

A plan by Ford Motor Company's financing arm, Ford Motor Credit Company LLC, to issue $1.08 billion in new debt backed by packages of auto loans was the first offering to falter in the wake of the Dodd-Frank Act. The day after the legislation was signed, the Ford deal stalled because the company was unable to use credit ratings in its offering documents.

That day, July 22, 2010, Ford wrote to the SEC's Division of Corporation Finance asking the division not to recommend enforcement action if Ford did not include ratings in a prospectus relating to an offering completed during a "specified, temporary period of time."[10]

The SEC responded immediately, issuing a no-action letter indicating that, given the rating agencies' refusal to be named experts, the Division of Corporation Finance would not recommend enforcement action if an issuer omits the ratings disclosure required by Items 1103 (a)(9) and 1120 of Regulation AB during a six-month grace period.[11]

The SEC's no-action position was set to expire with respect to any registered offerings of asset-backed securities with initial bona fide offers on or after Jan. 24, 2011,[12] but was recently extended indefinitely.[13]

In addition to granting Ford Motor Credit Company's request for an enforcement delay, the SEC staff also published five compliance and disclosure interpretations (C&DIs) for corporate debt issuers addressing related issues — essentially, they allow the status quo issuance process to continue.[14]

Notably, the C&DIs clarify that the consent of rating agencies is required if ratings information is included in a Securities Act registration statement or prospectus, but is not required if the rating information is included only for the purpose of satisfying disclosure requirements (e.g., if the disclosure is related to changes to a credit rating, the liquidity of the registrant, the cost of funds for a registrant or the terms of agreements that refer to credit ratings).

Typical examples of scenarios where companies would not need NRSRO consent would be to mention ratings in the context of a risk factor discussion about the failure to maintain a certain rating, or to acknowledge the potential impact of a change in credit rating on a company.

The Dodd-Frank Act Has Other Consequences for Rating Agencies

The repeal of Rule 436(g) has had the most obvious immediate impact on the rating agencies and the ABS market, but other provisions of the Dodd-Frank Act have ramifications for the NRSROs as well.

Importantly, Section 933 of the Dodd-Frank Act changed the pleading standards for a private action brought against rating agencies under the Securities Exchange Act of 1934 (the "Exchange Act").

For securities fraud lawsuits, it is now sufficient for a complaint to plead that a ratings agency "knowingly or recklessly failed to conduct a reasonable investigation" of facts about the deal it rated, or knowingly or recklessly failed to obtain reasonable verification that such an investigation was done by a source independent of the issuer or underwriter.

Looking Ahead

The SEC's no-action position with regard to the repeal of Rule 436(g) offers relief to the multibillion market for bonds backed by consumer loans, but the SEC has indicated that further changes may be on the horizon.[15] The new no-action letter explains that the SEC's position was driven in part by a need to "allow adequate time to complete the regulatory actions required by the Dodd-Frank Act."[16]

The SEC's approach will permit registered asset-backed securities offerings "to continue without interruption" while the SEC continues its ongoing evaluation of "whether and, if so, how [the Dodd-Frank Act's] final regulatory actions should affect the commission's disclosure requirements regarding credit ratings for asset-backed securities offerings."[17] A final resolution for the ABS market is still yet to come.

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[1] 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

[2] Id. at 175-76.

[3] Id. at 176.

[4] Superior Court of California, San Francisco County, No. 09-490241 (May 24, 2010).

[5] Id. at 8.

[6] John Parry, Raters seen unscathed by financial reform bill, Reuters, Jun 30, 2010.

[7] See Section 939C of the Dodd-Frank Act.

[8] Press Release, Fitch Ratings, Fitch Comments on U.S. Financial Reform Act's Implication for Credit Rating Agencies, July 19, 2010.

[9] Item 1120 also requires a description of any arrangements to have such ratings monitored

while the asset-backed securities are outstanding.

[10] Letter from S. Thomas, Ford Motor Credit Company LLC, to K. Hsu, Securities and Exchange Commission, Division of Corporation Finance (July 22, 2010).

[11] Ford Motor Credit Company LLC, SEC No-Action Letter (July 22, 2010).

[12] Id.

[13] Ford Motor Credit Company LLC, SEC No-Action Letter (November 23, 2010).

[14] Securities Act Rules, SEC Compliance & Disclosure Interpretations: New Question 233.04, New Question 233.05, New Question 233.06, New Question 233.07, New Question 233.8 (July 27, 2010).

[15] Ford Motor Credit Company LLC, SEC No-Action Letter (November 23, 2010).

[16] Id.

[17] Id.