Credit Rating Agencies and Their Regulation

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Summary

Credit rating agencies (CRAs) are expected to provide investors with an informed and unbiased view on securities' debt risk (also referred to as credit risk), the risk that issuers will fail to make promised interest or principal payments when they are due. The agencies provide judgments ("opinions") on the creditworthiness of bonds issued by a wide spectrum of entities, including corporations, nonprofit firms, special purpose entities, sovereign nations, and state and municipal governments. They take the form of ratings that are usually displayed in a letter hierarchical format: AAA being the highest and safest, with lower grades representing an increasing scale of risk to the investor. The three dominant CRAs are Moody's, Standard & Poor's, and Fitch.

CRAs have been a fixture of securities markets since the 19th century; they predate federal regulation of the markets. The Securities and Exchange Commission (SEC) issues a designation of Nationally Recognized Statistical Rating Organization (NRSRO), which is important because a variety of laws and regulations reference their use. (For example, the amount of risk-based capital that banks must hold against a portfolio of securities is linked to ratings; and thrift institutions are not allowed to own bonds rated below investment grade.)

In recent years, many assert that the performance of the dominant rating agencies has been marked by a number of spectacular failures. Companies like Enron and WorldCom retained their high credit ratings until a few days before they filed for bankruptcy. More recently, many mortgage-backed securities initially rated AAA have defaulted or have been sharply downgraded. In both situations, investors who relied on the ratings suffered heavy losses. The SEC and other observers have criticized the three dominant CRA's ratings of mortgage-backed securities.

Between December 2008 and September 2009, the SEC adopted several reforms aimed at enhancing NRSRO disclosures, and mitigating NRSRO conflicts of interest, including a prohibition on NRSRO personnel involved in rating determination participating in fee discussions, negotiations, or arrangements; a requirement that each NRSRO and NRSRO applicant provide rating change statistics for each asset class of credit ratings for which it is registered or is seeking registration; an authorization for competing NRSROs to offer unsolicited ratings for structured finance products by granting them access to the necessary underlying data for structured products; and an elimination from federal securities regulations and laws certain references to credit ratings by NRSROs. On December 11, 2009, the House passed H.R. 4173. On March 22, 2010, the Senate Banking, Housing, and Urban Affairs Committee ordered reported out an amended version of the Restoring American Financial Stability Act of 2010, which had been released on March 15, 2010. The bill also contains rating agency reform provisions. Both H.R. 4173 and the Senate committee bill would require NRSROs to have established internal controls over the processes used to determine credit ratings, enhance the rights of entities to bring private actions against rating agencies for certain knowing or reckless failures in research with respect to rating determinations, and disclose the primary assumptions used in constructing the procedures and methodologies for arriving at credit ratings. Separately, H.R. 4173 would strike references to "not investment grade" or to "ratings" or similar language in a number of federal statutes, including the Federal Deposit Insurance Act; replace the term ''nationally recognized statistical rating'' with ''nationally registered statistical rating'' in the Securities Act of 1933 and the Securities Exchange Act of 1934; and require the removal of references by federal financial regulators and in certain federal laws. Other bills that would also provide for rating agency reforms include S. 927 (Pryor), S. 1073 (Reed), H.R. 1181 (Ackerman), H.R. 1445 (McHenry), and H.R. 2253 (Delahunt). This report will be updated as events dictate.

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Credit rating agencies (CRAs) provide investors with what is presumed to be an informed perspective on securities' debt risk (also referred to as credit risk), the risk that issuers will fail to make promised interest or principal payments when they are due. The agencies provide judgments ("opinions") on the creditworthiness of bonds issued by a wide spectrum of entities, including corporations, nations, nonprofit firms, special purpose entities, and state and municipal governments. The judgments take the form of ratings that are usually displayed in a letter hierarchical format: AAA being the highest and safest, with lower grades representing an increasing scale of risk to the investor. Globally, there are about 100 rating agencies. In terms of market share, the three dominant CRAs are Moody's,[1] Standard & Poor's (S&P, a subsidiary of McGraw-Hill), and Fitch (a subsidiary of FIMILAC, a French business services conglomerate); a number of smaller U.S.-based agencies also exist. By some accounts, the three dominant agencies have about 98% of total ratings and collect 90% of total rating revenue.

Evolution of the Issuer-Pays Model

At the beginning of the 20th century, John Moody, founder of Moody's, began the practice of selling voluminous rating manuals to bond investors, a business model known as "subscriber-pays." By the 1970s, the three dominant CRAs had changed to an "issuer-pays" model, in which a bond's issuer or arranger pays an agency or agencies for initial ratings and for ongoing ratings. The ratings are then available to the public free of charge.

Several reasons have been advanced for the business change, including (1) the advent of high-speed copying machines in the early 1970s may have sparked concerns among the CRAs that their work would be widely copied by non-payers; (2) the CRAs may have come to the realization that issuers increasingly required certain ratings to sell their bonds to regulated financial institutions and would be willing to pay for a rating; (3) the bond market upheaval brought about by the bankruptcy of the Penn-Central Railroad may have made bond issuers more willing to pay CRAs to confirm their creditworthiness;[2] and (4) the rise of asset-backed securitization in the 1970s.[3]

The subscriber-pays model, however, can still be found among a number of small CRAs. These CRAs are paid by investors or other third parties (e.g., banks, insurance funds, pension funds, large creditors) to rate their securities. Like the issuer-pays agencies, they use publicly available financial data to perform quantitative analysis. Unlike issuer-pays CRAs, they do not receive additional proprietary information from the issuers, and they do not collect qualitative data on the issuer through ongoing interviews. Thus, while issuer-pays CRAs tend to employ both quantitative and qualitative ratings reviews, subscriber-pays CRAs tend to emphasize a quantitative approach involving analytical models and software.[4]

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[1] Moody's was spun off as a public company by the financial publisher Dun & Bradstreet in 2000.

[2] Lawrence J. White, "A New Law for the Bond Rating Industry," *Regulation*, spring 2007.

[3] For example, see "Testimony of Sean J. Egan Managing Director Egan-Jones Rating Co., before the House Committee on Oversight and Government Reform," October 22, 2008. Egan-Jones uses a subscriber-pays model.

[4] According to officials at Egan-Jones, a subscriber-pays firm, the CRA began downgrading Bear Stearns on January 4, 2008, and cut its rating three times before S&P, Moody's, and Fitch started downgrading the company in mid-March of the year. Egan-Jones officials also say that while the three leading issuer-pays CRAs were still giving Lehman Brothers their top ratings a day before it declared bankruptcy, it downgraded the firm to the lower tiered BBB+ rating a half a year before Lehman's bankruptcy. Officials at another subscriber-pays firm, Rapid Ratings, say the firm began (continued...)

The Nationally Recognized Statistical Rating Organization Designation and Its Potential Impact

Adopted by the Securities and Exchange Commission (SEC) in 1975, the designation of a nationally recognized statistical rating organization (NRSRO) was originally used as a part of the agency's determination of capital charges on different grades of debt securities under the SEC's net capital rule (Rule 15c3-1 under the Securities Exchange Act of 1934). Under the rule, when broker-dealers compute their net capital amounts, they must deduct from their net worth certain percentages of the market value (haircuts) of their securities positions. The agency applied reduced haircuts to the securities held by broker-dealers that were rated investment grade by a credit rating agency of national repute based on the presumption that such securities typically were more liquid and less volatile in price than securities that were less highly rated.

When it began using ratings to enforce the net capital rule in 1975, the SEC staff, in consultation with agency commissioners, made the determination that the ratings of the three dominant agencies, S&P, Moody's, and Fitch, were nationally used and should thus be considered NRSROs with respect to SEC enforcement of the net capital rule. Between 1975 and 2000, the SEC added four more NRSROs to the original three.

Over time, requiring certain NRSRO-reviewed credit ratings became an integral part of global and national rules. It also was codified in numerous federal regulations, federal statutes, and state statutes. An example of a such a federal regulation is Rule 2a-7, an amendment to the Investment Company Act of 1940, which requires that money market funds invest in debt that has been rated by an NRSRO. Also, under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA, P.L. 101-73), savings and loans could no longer purchase bonds with NRSRO-issued below investment grade ratings (i.e., junk bonds). In addition to these and other federal statutes, more than 100 state level statutes make reference to credit ratings issued by NRSROs, by some accounts. Also, under the Basel II agreement of the Basel Committee on Banking Supervision,[5] banking regulators can allow banks to use credit ratings from certain approved CRAs (technically known as External Credit Assessment Institutions), a small group of agencies dominated by Moody's, S&P, and Fitch.

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downgrading the retailers Circuit City Stores, Pilgrim's Pride, and Linens 'n Things more than a year before the retailers filed for bankruptcy protection. Officials at Rapid Ratings also say that they started downgrading various home builders in early 2006, well before the equity markets, the dominant rating agencies, and credit market indices began to see material changes in their status. Because of growing disenchantment over the performance of the dominant issuer-pays CRAs, subscriber-pays firms such as Egan-Jones and Rapid Ratings have reportedly been experiencing increased demand for their services from various money managers and large investors. Janet Morrissey, "Disillusioned Advisers Eye Smaller Ratings Firms; Interest in Subscriber-based Raters Grows at the Expense of the Big Three Agencies," *Investment News*, February16, 2009, p. 2. Beat Balzli and Frank Hornig, "Exacerbating the Crisis," *Spiegel International Online*, May 6, 2009.

[5] Basel II is the second generation of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The Basel Committee is an institution created in 1974 by central bank governors of the Group of Ten nations. The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face.

The SEC never defined the term NRSRO or specified how a CRA might become one. Its approach has been described as essentially one of "we-know-it-when-we-see-it." The resulting limited growth in the pool of NRSROs was widely believed to have helped to further entrench the three dominant CRAs.

During the past decade, various firms like the energy behemoth Enron and the telecommunications company WorldCom collapsed soon after having their investment grade ratings reconfirmed by major CRAs. This had enduring regulatory ripple effects. Congress held hearings and eventually passed the Sarbanes-Oxley Act of 2002. Among other things, the law required the SEC to issue a report on the NRSRO determination process.

In January 2003, the SEC issued its congressionally directed report, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*.[6] In June 2003, the agency also issued a concept release[7] for the purpose of soliciting public comments regarding possible CRA reform, including the possibility of abandoning the use of ratings for regulatory purposes under the federal securities laws and the desirability of a formal process for determining whose ratings should be used and what kind of oversight should be given to the CRAs.[8]

The Credit Rating Agency Reform Act of 2006[9]

On June 20, 2005, H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005, was introduced in the 109th Congress. The bill began the process of considering legislation to regulate the registration of CRAs. At the end of the legislative process, S. 3850,[10] the Credit Rating Agency Reform Act of 2006, was passed by unanimous consent by the Senate on September 22, 2006, and under suspension of the rules by the House on September 27, 2006. It was signed into law by the President on September 29, 2006, as P.L. 109-291.

Section 2 of P.L. 109-291 sets forth the congressional findings leading to the need for regulation of CRAs. This section, referencing Section 702 of the Sarbanes-Oxley Act and commenting on the SEC's concept releases and proposed rules, states the finding that "credit rating agencies are of national importance." Among the reasons provided for the need for legislation to regulate CRAs are that the two largest CRAs [Moody's and Standard & Poor's] serve most of the market and that additional competition is in the public interest and that the SEC has stated that it needs statutory authority to oversee the credit rating industry.

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[6] Available at http://www.sec.gov/news/studies/credratingreport0103.pdf.

[7] U.S. Securities and Exchange Commission, Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws," June 4, 2003, available at http://www.sec.gov/rules/concept/33-8236.htm.

[8] For example, see CRS Report RS22215, *Credit Rating Agencies: Current Federal Oversight and Congressional Concerns*, by (name redacted).

[9] Michael Seitzinger wrote this section.

[10] On February 8, 2005, the Senate Committee on Banking, Housing, and Urban Affairs held a hearing titled "Examining the Role of Credit Rating Agencies in the Capital Markets." On March 7, 2006, the committee held a hearing titled "Assessing the Current Oversight and Operations of Credit Rating Agencies." The committee on August 2, 2006, ordered an original measure to be reported. On September 6, 2006, the original measure, with written report No. 109-326, was reported to the Senate.

Section 3 adds five new definitions to the Securities Exchange Act of 1934:[11] credit rating, credit rating agency, nationally recognized statistical rating organization, person associated with a nationally recognized statistical rating organization, and qualified institutional buyer.[12] The definition of "nationally recognized statistical rating organization" would appear to resolve uncertainty which might have existed concerning the SEC's somewhat informal recognition of such an organization. Under the new statute a "nationally recognized statistical rating organization" is a credit rating agency that has been in business as a credit rating agency for at least the three consecutive years immediately preceding the date of its application for registration as an NRSRO and which issues credit ratings certified by qualified institutional buyers concerning financial institutions, brokers, or dealers; insurance companies; corporate issuers; issuers of asset-backed securities; issuers of government securities, municipal securities, or securities issued by foreign governments; or a combination of one or more categories of obligors described in any of the aforementioned categories.

To be deemed by the SEC as a nationally recognized statistical rating organization, a credit rating agency must submit in its application to the SEC detailed information, such as the following: (1) credit ratings performance measurement statistics over short-term, mid-term, and long-term periods; (2) the procedures and methodologies that the applicant uses in determining credit ratings; (3) policies or procedures adopted and implemented by the applicant to prevent the misuse of material, nonpublic information; (4) its organizational structure; (5) whether it has in effect a code of ethics and, if not, why not; (6) any conflict of interest relating to its issuance of credit ratings; (7) on a confidential basis a list of the twenty largest issuers and subscribers that use its credit rating services by amount of net revenues received in the fiscal year immediately preceding the date of submission of the application; and (8) any other information and documents which the SEC may by rule prescribe as necessary or appropriate in the public interest or for the protection of investors.[13] The SEC is required to follow a specific time frame and procedure in determining whether to grant the application for treatment as a nationally recognized statistical rating organization.

The legislation makes it unlawful for any nationally recognized statistical rating organization to represent or imply that it has been designated, sponsored, recommended, or approved by the United States or by any U.S. agency, officer, or employee. The legislation requires each nationally recognized statistical rating organization to establish, maintain, and enforce written policies and procedures reasonably designed to address and manage any conflicts of interest that might arise.

P.L. 109-291 fits within the general philosophy of all of the major federal securities laws. This philosophy is premised upon the belief that, so long as there is full and accurate disclosure of all material information by a covered company, the investing public will have sufficient information upon which to make its investment decisions. The Credit Rating Agency Reform Act of 2006 requires a credit agency wishing to have the status of a nationally recognized statistical rating organization to disclose to the SEC significant information about its business and its methods for issuing credit ratings so that the investing public will have information to help determine the likely accuracy of credit ratings that the agency has assigned.

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[11] 15 U.S.C. §§ 78a *et seq*.

[12] Adding sections 3(a)(60)-(64) to the Securities Exchange Act of 1934.

[13] Section 4 of P.L. 109-291, adding section 15E to the Securities Exchange Act of 1934.

The law took effect in June 2007, with the SEC issuing its first round of final implementation rules that same month. In September 2007, Moody's, S&P, and Fitch were formally registered as NRSROs under the new regime. Currently, there are 10 NRSROs: two are headquartered in Japan; one is based in Canada; and one, A.M. Best, specializes in insurance companies' issues. The others consist of the three dominant and three smaller CRAs. According to the agency's report, the SEC did not grant any new entrants NRSRO designation for the year ended June 25, 2009. There was only one application for NRSRO registration in the period covered by the report, and this was subsequently withdrawn. Accordingly, there are still only 10 agencies registered as NRSROs.

The SEC's *Annual Report on Nationally Recognized Statistical Rating Organizations* released in September 2009, reported the following: (1) seven of the 10 NRSROs operate primarily under the issuer-pays model and three operate largely under the subscriber-pays model; (2) NRSROs operating under the issuer-pays model have about 99% of the total outstanding credit ratings issued by NRSROs; (3) S&P, Moody's, and Fitch issue 97% of ratings across the different categories of reported ratings, and more than 99% of the ratings for some categories (i.e., government securities); (4) S&P, Moody's, and Fitch were responsible for all but 17,019 of the more than 400,000 outstanding ratings issued for asset-backed securities; and (5) the SEC was unable to determine the impact of NRSRO registration on the demand for the provision of credit ratings for several reasons, including that the SEC's relatively new NRSRO registration and oversight program that requires disclosure of information about outstanding ratings for NRSROs is less than two years old, and that the credit crisis has reduced debt issuance in a number of sectors, making it hard to evaluate the relationship between being registered as an NRSRO and obtaining additional business.

The Rating Agencies and Structured Finance

The provision of investment grade ratings by the dominant CRAs was a critical part of the process of structuring the residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs) that held subprime housing mortgages. Basically, the CRAs evaluated the probabilities of default for individual mortgages, analyzed the correlations between individual loans, used this to assess the probability of default for the securitized products, and then rated the different tranches[14] of the structured products[15] accordingly.

Moody's, S&P, and Fitch were all active participants in rating the various structured securities backed by mortgages. However, Moody's structured-finance unit dominated the practice: the unit accounted for about 28% of the firm's revenues in 1998. By 2006, the group was responsible for about 43% of total revenues, a year in which Moody's earned more revenue ($881million) from structured finance than all of its revenues in 2001. By 2007, the company was reportedly rating about 94% of the $190 billion in mortgage-related and other structured-finance CDOs issued in 2007.[16]

[14] A tranche is a "slice," or portion, of a securitized credit portfolio. Tranches are typically organized into classes based on risk (e.g., Class A, Class B). Investors buy portions of a securities portfolio and are paid based on the hierarchy of tranches.

[15] These are securities products that are derived from or based on a single security or securities, a basket of stocks, an index, a commodity, debt issuance or a foreign currency, etc.

[16] Aaron Lucchetti, "Rating Game: As Housing Boomed, Moody's Opened Up," *Wall Street Journal*, April 11, 2008, p. (continued...)

Many believe that the three dominant CRAs fundamentally failed in their rating processes when it came to judging the likelihood of a decline in housing prices, the proper weight to be attached to the effect of falling house prices on loan default rates, and the inter-relationship between loan defaults and the prospect of further defaults. In 2006, after several years of the "housing bubble," the subprime mortgage sector began a precipitous collapse, an implosion that helped engender the financial crisis. During the housing boom cycle, the CRAs often gave top tier AAA ratings to many structured securities, only to downgrade many of them later to levels often below investment grade status.

In June 2008, the SEC observed:

> The scope and magnitude of these downgrades has caused a loss of confidence among investors in the reliability of RMBS [residential mortgage-backed securities] and CDO [collateralized debt obligations] credit ratings issued by the NRSROs. This lack of confidence in the accuracy of NRSRO ratings has been a factor in the broader dislocation in the credit markets. For example, the complexity of assessing the risk of structured finance products and the lack of commonly accepted methods for measuring the risk has caused investors to leave the market, including the market for AAA instruments, particularly investors that had relied primarily on NRSRO credit ratings in assessing whether to purchase these instruments. This has had a significant impact on the liquidity of the market for these instruments. In the wake of these events, the NRSROs that rated subprime RMBS and CDOs have come under intense criticism and scrutiny….[17]

A number of key reasons for the CRAs' perceived failings have been advanced. They include

- *Business Model Bias.* The issuer-pays business model is said to create a potential bias toward providing overly favorable ratings and is also said to encourage "ratings shopping." That in turn is said to engender "a race to the bottom" among the competing dominant agencies.[18]

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A1. Some would argue that the dominant CRAs' willingness to sacrifice quality ratings for the enormous amount of structured finance profits may have been illustrated by the following rating agency quotations, which were cited during an October 22, 2008 House Oversight and Government Reform hearing on the rating agencies:

> "... In the September 2007 e-mail made public today, the Moody's employee said that it 'seems to me that we had blinders on and never questioned the information we were given,' according to the congressional investigators. 'It is our job to think of the worst-case scenarios and model them.' The e-mail continued: "Combined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue." '[then House Oversight and Government Reform Chairman Henry] Waxman also cited a transcript of a September 2007 meeting in which Raymond W. McDaniel, chairman and CEO of Moody's Corp. described as a slippery slope of events. 'What happened in '04 and '05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade, McDaniel said in the meeting. 'We tried to alert the market. We said 'we're not rating it. This stuff isn't investment grade. No one cared because the machine just kept going....' In one document, an S&P employee in the structured finance division wrote: 'It could be structured by cows and we would rate it.'"

Lorraine Woellert and Dawn Kopecki "Moody's, S&P Employees Doubted Ratings," *Bloomberg*, October 22, 2008.

[17] SEC Proposed Rules, *Federal Register*, June 25, 2008, pp. 36211-36252.

[18] A key response to this kind of concern by issuer-pays CRAs is that they have had to maintain the integrity of their reputational capital to ensure continued demand for their services. The CRAs have also claimed that they have had the proper administrative checks such as (1) ensuring that rating decisions are made by rating committees and not by individual analysts; (2) prohibiting analysts from holding fee discussions with or owning securities in the institutions that they rate (excluding through diversified mutual funds); and (3) not evaluating or compensating analysts on the (continued...)

- *The Existence of a Quasi-Regulatory License.* The existence of the aforementioned series of statutes and regulations requiring specific levels of NRSRO ratings is said to further protect and reinforce a rating industry oligopoly in which there is little real competition.[19]
- *Flawed Models and Assumptions.* The agencies used inappropriate models for rating structured finance products. While some observers concede that the modeling exercises posed formidable inherent challenges, CRA models for structured products were reportedly calibrated based on short spans of data over a benign period of economic moderation in financial markets and rising house prices. Scenarios with economic turbulence or falling house prices were not used to gauge the models' reliability under such circumstances. A related issue, noted above, is that they may have failed to (1) correctly calculate underlying house loan defaults because they attached the wrong weights to the effect of falling house prices on loan default rates; and (2) understand the interdependence among loan defaults, and the likelihood of falling house prices occurring.[20]

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basis of the revenue associated with the entities they rate. The issuer-pays CRAs have also argued that the subscriber-pays model has its own potential shortcomings, including the fact that investors could press for lower initial ratings because such securities pay higher yields, and possible instances in which short sellers could be motivated to encourage an unexpected negative rating action to the benefit their financial interests. Ultimately, officials at one issuer-pays CRA say that the real issue is not what model one uses, but how transparent its practitioners are regarding their use of models. "S&P Offers Mea Culpa on Ratings," The Bond Buyer, March 5, 2009. Jesse Westbrook, "S&P, Moody's Defend Pay Model Faulted by Regulators," *Bloomberg*, April 14, 2009.

[19] The power of this quasi-regulatory license may be undercut by the fact that S&P and Moody's market domination preceded 1975, the start of NRSRO designation. Interestingly, for years, Moody's has reportedly argued for rescinding the NRSRO designation, claiming that this would allow it to prove that its market dominance is solely related to its expertise. But Jonathan Macey of the Yale School of Finance reportedly thinks that the frequently more accurate subscriber-pays CRA, Egan-Jones, would be equally accurate in an issuer-pays CRA. He reportedly believes that this is because Egan is a relatively new NRSRO and people historically did not hire it for regulatory reasons, but hired it strictly for the quality of its ratings. Chris Nolter, "Redefining the Blob," the Deal.com, December 12, 2008. On the broad issue of federal actions that may help to reinforce the leading CRAs' formidable market share, some have raised concerns that the Federal Reserve's (Fed's) financial firm assistance programs like its commercial-paper facility and the Term Asset-Backed Securities Loan Facility (TALF) accept only collateral that has been appraised by a "major" rating agency, that of one of the three dominant CRAs. They say that this selectivity is a potential setback for the seven other rating firms that have also earned NRSRO status. The Fed has reportedly spoken of reconsidering expanding the list of eligible raters. In response to an inquiry by the Hon. Keith Ellison, Federal Reserve Chairman Ben Bernanke indicated that the CRAs' role in the current financial crisis has "... led to CRAs to tighten underwriting standards and establish stricter ratings criteria.... [And that] Federal Reserve economists have carefully reviewed the methodologies that the rating agencies are employing to analyze the types of ABS [asset backed securities] that are eligible to be financed in the TALF program.... " Richard Blumenthal, Attorney General for Connecticut, launched an antitrust probe in which the Fed is accused of "rewarding the same companies that helped burn down the house." "The Wages of Sin," *The Economist*, April 23, 2009. "Letter to the Hon. Keith Ellison from Ben S. Bernanke, Chairman of the Federal Reserve System," May 12, 2009. On December 4, 2009, the Fed announced that it had adopted a final rule that would establish a process by which the New York Fed may determine the eligibility of credit rating agencies for TALF under criteria for determining the eligibility of entities to issue credit ratings on asset-backed securities, other than those backed by commercial real estate, to be accepted as collateral for the TALF. According to the Fed, the new rule's intent is to promote competition among NRSROs and ensure appropriate protection against credit risk for the U.S. taxpayer. Newly eligible NRSROs will become eligible under the new criteria starting in February 2010. "Federal Reserve Board Release" December 4, 2009, available at http://www.federalreserve.gov/newsevents/press/monetary/20091204a.htm.

[20] For example, see Paul Mizen, "The Credit Crunch of 2007-2008: A Discussion of the Background, Market Reactions, and Policy Responses," Federal Reserve Bank of St. Louis Review, September-October 2008, p. 531. In addition, others contend that unlike the traditional rating processes for single-named issuers, which primarily relied on empirical analysis, structured-finance rating analysis was basically driven by statistical models. Another criticism is (continued...)

- *An Inability to Handle a Voluminous Amount of Structured Securities Business.* There are a number of observations that the three CRAs were too undermanned to effectively accommodate the overwhelming volume of structured finance business.[21]
- *Challenges from High Levels of Fraud and Lax Mortgage Underwriting.* A number of observers, including officials of the three top CRAs, have pointed to lax underwriting and outright underwriting fraud for many of the mortgages that backed the structured securities. The pervasiveness of such practices is said to have undermined the integrity of the rating process for the securities.[22]
- *Insufficient CRA Regulation.* As described below, the financial and credit crisis has resulted in an array of newly adopted and proposed rating agency regulations, evidence of a widely held view that the previous regulations were inadequate.
- *The Potential Conflicts of Interest Involved in CRAs both Rating and Helping to Design the Same Securities.* The CRAs were often involved both in rating and providing advice on how to structure the same securities to fetch superior ratings. There are concerns that such a dual role represents a conflict of interest that may have undermined the objectivity of the rating process.
- *The Potential Conflicts of Interest in the CRAs' Provision of Ancillary Services to the Issuers Whose Securities They Rate.* CRAs often charge issuers for advice, which can include pre-rating assessments (providing issuers with a preview of what ratings they are likely to receive under various scenarios) and risk-management consulting. There are concerns that these additional commercial relationships with issuers can undermine their ability to provide unbiased ratings.[23]
- *Limited Liability under the First Amendment.* When CRAs publish ratings for the investing public at large, they often are characterized as having First Amendment

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that the data that the agencies used to evaluate mortgage-backed securities, including those backed by subprime mortgages, were significantly biased by an over reliance on conventional 30-year fixed prime mortgage loans, whose behavior would prove to be quite different from the subprime loans. Joseph R. Mason and Josh Rosner, "Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions," May 3, 2007, available at http://ssrn.com/abstract=1027475. It has, however, been argued that the CRA's modeling failings did not exist in isolation: many others, including various central bankers, commercial and investment bank analysts, and various financial risk management units also failed to foresee the dramatic housing market price collapse.

[21] In July 2008, the SEC released a study, "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies." Based on a 10-month examination of S&P, Moody's, and Fitch, among the report's findings were (1) the agencies became overwhelmed by the volume and complexity of the structured securities; (2) instances that suggested that there were no attempts to shield analysts from e-mails and other communications that spoke of fees and revenue from individual issuers; (3) the agencies considered adjusting ratings criteria to enhance their competitiveness; and (4) cases in which the CRAs did not adequately document aspects of their ratings criteria. The study is available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

[22] For example, in late 2007, analysis by Fitch found that "the extraordinarily high level of defaults encountered" by the pool of 2006 subprime mortgages could not be explained only by home price declines but that lax loan underwriting and high instances of fraud also appeared to be significant factors in the declines. "Fitch: Underwriting & Fraud Significant Drivers of Subprime Defaults; New Originator Reviews," *Business Wire*, November 28, 2007.

[23] An argument that has been frequently used to address this charge is that the ancillary services tend to account for a very small portion of CRA revenue.

> privileges similar to those of journalists,[24] which can mean that they are immune from liability absent actual malice; below, this issue is examined in greater detail.

First Amendment Issues and the Rating Agencies[25]

A credit rating agency engaged in the business of publishing ratings concerning the creditworthiness of public companies appears to have limited protection under the First Amendment's guarantee that "Congress shall make no law ... abridging the freedom of speech, or of the press...."

Although no U.S. Supreme Court case was found directly on point, the case *Lowe v. Securities and Exchange Commission*,[26] which concerned an exception to the definition of "investment adviser" as stated in the Investment Advisers Act,[27] stated that publications containing factual information about financial transactions, market trends, and general market conditions were entitled to First Amendment protections.

> The dangers of fraud, deception, or overreaching that motivated the enactment of the statute are present in personalized communications but are not replicated in publications that are advertised and sold in an open market. To the extent that the chart service contains factual information about past transactions and market trends, and the newsletters contain commentary on general market conditions, there can be no doubt about the protected character of the communications, a matter that concerned Congress when the exclusion was drafted. The content of the publications and the audience to which they are directed in this case reveal the specific limits of the exclusion. As long as the communications between petitioners and their subscribers remain entirely impersonal and do not develop into the kind of fiduciary, person-to-person relationships that were discussed at length in the legislative history of the Act and that are characteristic of investment adviser-client relationships, we believe the publications are, at least presumptively, within the exclusion and thus not subject to registration under the Act.[28]

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[24] For example, Floyd Abrams, a visiting professor of First Amendment issues at Columbia University's Graduate School of Journalism and a partner at Cahill Gordon & Reindel LLP who has represented S&P, observed that "What credit rating agencies do in analyzing debt and assessing the likelihood of repayment of the debt and then putting a sort of shorthand label [like triple-A] on it is very similar to what recognized journalists do in covering the market.… As a result, there is a substantial body of law that has developed concluding that rating agencies are protected by the First Amendment in what they do." Lynn Hume, "Can Raters Be Regulated? Lawyer, Cases Cite First Amendment Protection," *The Bond Buyer*, March 30, 2005. By contrast, Richard Blumenthal, the Connecticut attorney general, has indicated that "the very nature of [rating firms'] so-called speech is very different from the classic First Amendment-protected expression …. It's much more akin to an advertisement that misstates the price of an item on sale than a political candidate on a soapbox." Attorney General Blumenthal has a lawsuit pending over some S&P ratings of non-mortgage-backed securities. Ashby Jones, "A First Amendment Defense for the Rating Agencies*,"The Wall Street Journal*, April 21, 2009.

[25] Michael Seitzinger wrote this section.

[26] 472 U.S. 181 (1985).

[27] 15 U.S.C. § 80b-2(a)(11). The act defines "investment adviser" in pertinent part as:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include ... (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation....

[28] Lowe v. Securities and Exchange Commission, 472 U.S. 181, 210 (1985)(footnotes omitted).

In a more recent case involving Enron litigation, in which CRAs were widely criticized for giving Enron a solid rating until close to the time of the declaration of bankruptcy, a federal district court[29] concluded that, although there is no absolute First Amendment protection for credit rating reports, the courts in general have not precluded First Amendment protection for negligence.

> [W]hile there is no automatic, blanket, absolute *First Amendment* protection for reports from the credit rating agencies based on their status as credit rating agencies, the courts generally have shielded them from liability for allegedly negligent ratings for various reasons.
>
> The United States Supreme Court has opined, "The liberty of the press is not confined to newspapers and periodicals.... The press in its historic connotation comprehends every sort of publication which affords a vehicle of information and periodicals." As noted by the Rating Agencies, they have been accorded special protections by a few courts when they are characterized as publishers or journalists.[30]

The court goes on to discuss that, nevertheless, the Supreme Court has held that publishers are not entitled to automatic protection under the First Amendment for general violations of laws. However, in the instant case the court found that the credit rating reports concerning Enron were protected by the First Amendment and stated its reasoning as follows:

> The credit rating reports regarding Enron by national credit rating agencies were not private or confidential, but distributed "to the world" and were related to the creditworthiness of a powerful public corporation that operated internationally. While not making a per se rule about the level of *First Amendment* protection that should be accorded to such speech, in dicta in *Lowe v. SEC*, the Supreme Court noted that it had previously "held that expression of opinion about a commercial product such as a loudspeaker is protected by the *First Amendment*" and stated, "It is difficult to see why the expression of opinion about a marketable security should not also be protected" [citation omitted]. As noted, credit rating agencies do not profit from the sale of the bonds of any company that they rate for creditworthiness and they perform an essential service for economy and efficiency for the capital markets.[31]

However, it should be noted that, if a credit rating agency issued an opinion with actual malice,[32] the qualified First Amendment protection would likely not be applicable. "Thus a publisher may be liable for a statement of opinion if that statement reasonably implies false facts or relies on stated facts that are provably false."[33]

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[29] Newby v. Enron Corp., 511 F. Supp. 2d 742 (S.D. Tex. 2005).

[30] *Id.*, at 817-818 (citations omitted).

[31] *Id.*, at 206-207 (citation and quotations omitted).

[32] "Actual malice" has been defined by the Supreme Court as "with knowledge that the statement was false or with reckless disregard for whether or not it was true." Hustler Magazine v. Falwell, 485 U.S. 46, 56 (1988).

[33] Newby v. Enron Corp., at 822, using the reasoning in Milkovich v. Lorain Journal, 497 U.S. 1, 20 (1990).

Various Responses to the Perceived Rating Agency Failings

There have been a variety of responses to the perceived failings of the rating agencies with respect to structured mortgage-backed securities. Several important responses are discussed below.

The July 2008 SEC Study on Moody's, S&P, and Fitch

In July 2008, the SEC released a study, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*.[34] Based on a 10-month examination of S&P, Moody's, and Fitch, the report concluded that

- the agencies became overwhelmed by the increase in volume and sophistication of the structured securities they were paid to review, forcing their analysts to short cut the customary and expected due diligence;
- while it was the historical convention for their analysts to be unaware of any of their CRAs' business interests with the arrangers and issuers of the products they rated, the SEC found evidence of instances in which there was no attempt to shield them from e-mails and other communications that spoke of fees and revenue from individual issuers;
- there appeared to be instances in which the CRAs considered adjusting their ratings criteria to make them more competitive; and
- there were instances in which the CRAs did not adequately disclose or document modifications to their ratings criteria.

Voluntary Reforms Adopted by the Rating Agencies

The largest CRAs have acknowledged some failings in their rating of structured securities. For example, S&P has conceded that many of its subprime mortgage-backed structured securities ratings between 2005 and 2007 have "not held up."[35] Also, Raymond W. McDaniel Jr., Moody's chief executive officer, has said that "in hindsight, it is pretty clear that there was a failure in some key assumptions that were supporting our analytics and our models."[36] Likewise, an official at Fitch observed that it was "... clear that many of our structured finance rating opinions have not performed well and have been too volatile. We did not foresee the magnitude or velocity of the decline in the U.S. housing market, nor the dramatic shift in borrower behavior brought on by the changing practices in the market...."[37]

[34] Available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

[35] S&P Official Offers Mea Culpa on Ratings," *The Bond Buyer*, March 5, 2009.

[36] Floyd Norris, "Moody's Official Concedes Failures in Some Ratings," *New York Times*, January 26, 2008.

[37] Lorraine Woellert and Dawn Kopecki, "Moody's, S&P Employees Doubted Ratings," *Bloomberg*, October 22, 2008.

In response to such perceived failings (and as some argue, also perhaps to mitigate the prospect of unwanted regulation), the three top CRAs have instituted a number of internal reforms. These include

- reforming the review of the due diligence process conducted by originators and underwriters;
- improving the effectiveness of their analytical methodologies;
- providing more clarity about the credit characteristics of structured finance ratings;
- promoting objective measurement of ratings performance;
- adopting measures to improve investors' understanding of the attributes and limitations of credit ratings;
- rotating their analysts; and
- establishing an ombudsman to help manage potential conflicts of interest.

The Settlement with the New York Attorney General

In June 2008, after beginning an investigation into S&P's, Moody's, and Fitch's role in the mortgage market failure, New York Attorney General Andrew Cuomo reached a settlement with all three CRAs, agreements that do not appear to be court enforced. Its major provisions are as follows:

- Each agency will establish a fee-for-service structure under which they will be compensated regardless of whether the investment bank ultimately selects them to rate an RMBS. The New York Attorney General's Office explained that the agencies had been paid no fees during their initial reviews of the loan pools underlying the residential mortgage-backed securities or during their discussions and negotiations with the investment banks about the structuring of the loan pools, allowing investment banks to get free previews of assessments of residential mortgage-backed securities from multiple CRAs. This was said to have enabled the investment banks to hire the agency that provided the best rating.
- Each agency will establish criteria for reviewing individual mortgage lenders, as well as the lender's origination processes.
- Each agency will disclose information about all securitizations submitted for their initial review. This Attorney General has said that this will enable investors to determine whether issuers sought, but subsequently decided not to use, ratings from a credit rating agency.
- Each agency will develop criteria for the due diligence information that is collected by investment banks on the mortgages comprising residential mortgage-backed securities. The Attorney General had previously found that the three CRAs were not always privy to pertinent due diligence information that investment banks had about the mortgages underlying the loan pools.
- Each agency will perform an annual review of its residential mortgage-backed securities businesses to identify practices that could compromise its independent

ratings. The CRAs will remediate any practices that they find could compromise independence.

- Each agency will require a series of representations and warranties from investment banks and other financially responsible parties about the loans underlying the residential mortgage-backed securities.[38]

At the announcement of the agreement, the New York Attorney General observed: "By increasing the independence of the rating agencies, ensuring they get adequate information to make their ratings, and increasing industry-wide transparency, these reforms will address one of the central causes of that collapse."[39]

However, Lawrence White, a professor of economics at New York University who has written extensively on CRAS and has testified before Congress about them, had far less praise for the pact. He observed that "this feels cosmetic to me. Getting paid for just showing up doesn't strike me as a good model or incentive structure." He said that the critical problem is that investors are compelled by a bevy of government regulators to heed the CRAs' ratings.[40]

Reforms Adopted by the SEC

In December 2008, the SEC began a process of adopting a number of NRSRO reforms it had proposed earlier in the year. The process continued with the adoption of various reforms in February 2009. According to the agency, the reforms are meant to "address concerns about the integrity of the process by which NRSROs rate structured finance products, particularly mortgage related securities...." More specifically, the rules, most of which went into effect in April 2009, are intended to (1) increase the transparency of the NRSROs' rating methodologies; (2) strengthen the NRSROs' disclosure of ratings performance; (3) prohibit the NRSROs from engaging in certain practices that create conflicts of interest; and (4) enhance the NRSROs' recordkeeping and reporting requirements obligations for the purpose of aiding the SEC in the performance of its oversight role.[41]

As a group, the reforms generally subject NRSROs to additional disclosure requirements, amend Rule 17g-5 of the Securities and Exchange Act of 1934 with respect to NRSRO conflict of interest prohibitions, and amend Rule 17g-2 under the Exchange Act with respect to NRSRO recordkeeping requirements. The key reforms[42]

- prohibit an NRSRO from issuing or maintaining a credit rating if (1) the NRSRO made recommendations to the entity being rated or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the entity being rated or issuer of the security; or (2) the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO

[38] This section derives from: "Attorney General Cuomo Announces Landmark Reform Agreements with the Nation's Principal Credit Rating Agencies," *Release from the Office of the Attorney General, State of New York*, June 5, 2008.

[39] Ibid.

[40] Lawrence White, quoted in: Aaron Elstein "Cuomo Reaches Deal with Ratings Agencies," *Crain's New York Business*, June 5, 2008.

[41] "Amendments to Rules for Nationally Recognized Statistical Rating Organizations," *Federal Register*, vol. 74, no. 25, February 9, 2009, p. 6456.

[42] Ibid.

who has responsibility for participating in determining or approving credit ratings, or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models. In its explanation of this "no-advice rule," the SEC explained that it was motivated by its concern that NRSROs occasionally make structural recommendations to securities arrangers and then rate the resulting securities, which the agency described as the NRSROs basically rating their own work. It however, also conceded that the distinction between providing feedback during the rating process and making recommendations could be a potential gray area;

- require an NRSRO or NRSRO applicant to provide rating change statistics for each asset class of credit ratings for which it is registered or is seeking registration, broken out over 1, 3, and 10 year periods;
- require an NRSRO to provide all rating change statistics (upgrades as well as downgrades) and disclose default statistics relative to the initial rating, including defaults that occur after a credit rating is withdrawn;
- require an NRSRO to provide enhanced disclosure in three areas: (1) whether (and, if so, how much) verification performed on assets underlying or referenced by the structured finance transaction is relied on in determining credit ratings; (2) whether (and, if so, how) assessments of the quality of originators of structured finance transactions play a part in the determination of the credit ratings; and (3) more detailed information on the surveillance process, including whether different models or criteria are used for ratings surveillance than for determining initial ratings;
- prohibit a person within an NRSRO who has responsibility in determining credit ratings or for developing or approving procedures or methodologies used for determining credit ratings from participating in any fee discussions, negotiations, or arrangements;
- prohibit an NRSRO from allowing a credit analyst who has participated in determining or monitoring the credit rating to receive gifts, including entertainment, from the obligor being rated or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities, such as meetings, that have an aggregate value of no more than $25;
- require an NRSRO to make publicly available on its corporate website a random sample of 10% of its issuer-paid credit ratings and their histories for each class of issuer-paid credit rating for which it is registered and has issued 500 or more ratings;
- require an NRSRO to keep records of all rating actions related to a current rating from the initial rating to the current rating. If a quantitative model is a substantial component of the credit rating process for a structured finance product, a rating agency must keep a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued. The agency is to retain records of any complaints regarding the performance of a credit analyst in determining, maintaining, monitoring, changing, or withdrawing a credit rating; and

- require an NRSRO to disclose ratings history information for 100% of current credit ratings determined after June 26, 2007, in an XBRL format (extensible business reporting language, a computer language for the transmission of business and financial data aimed at standardizing the automation of business intelligence).[43]

The aforementioned adopted SEC rules include most of the earlier 2008 SEC NRSRO reform proposals, but two such proposals have not been adopted: (1) a requirement that the rating symbols or the disclosures that are applied to ratings of structured finance products be distinguished from the symbols for non-structured products; and (2) reforms that would reduce the reliance on NRSRO ratings in the SEC's rules.

In February 2009, SEC Commissioner Kathleen Casey urged her fellow SEC commissioners to remove the regulatory reliance on the NRSRO references. She observed that "... it has become evident over time that there are considerable unintended consequences to the regulatory use of ratings. The purpose was not to establish and preserve a valuable franchise for the large rating agencies, while simultaneously inoculating them from market competition. Nor was it intended to serve as a substitute for adequate due diligence on the part of investors, managers, directors, and others, which could have served as a critical check on the rating agencies. Unfortunately, as recent events have demonstrated, it appears to have led to just such results in too many cases.... [I]n my view, ... [removing the reliance] ... is absolutely essential to the commission's efforts to faithfully implement the clear congressional intent of enhancing transparency, accountability, and competition in this industry."[44]

The SEC's newly adopted reforms also do not address what many observers believe to be the fundamental factor behind the CRAs' failings—their issuer-pays business model.

On September 17, 2009, the SEC continued its efforts toward NRSRO reforms by:[45]

- adopting rules to provide greater information concerning ratings histories;
- adopting rules to enable competing CRAs to offer unsolicited ratings for structured finance products, by granting them access to the necessary underlying data for structured products;
- adopting amendments to the SEC's rules and forms to remove certain references to credit ratings by nationally recognized statistical rating organizations;
- reopening public comment to allow additional comment on SEC proposals to eliminate references to NRSRO credit ratings from certain other rules and forms; and
- proposing amendments aimed at strengthening NRSRO compliance by requiring annual compliance reports and enhance disclosure of potential sources of revenue-related conflicts.[46]

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[43] This was originally limited to issuer-pays NRSROs, but in a December 2009 adopting release, it was amended to apply to all NRSROs.

[44] "Credit Rating Agencies: SEC's Casey Urges Commission To Loosen Reliance on NRSROs," *BNA's Securities Regulation & Law Report*, February 16, 2009.

[45] Available at http://www.sec.gov/news/press/2009/2009-200.htm.

The European Union's Reforms

During the recent global housing boom, numerous European banks were encouraged to buy structured debt because they carried superior ratings from the top CRAs. Many suffered financial losses from such investments, leading to costly financial governmental bailouts by European Union (EU) members.

Reflecting such concerns, EU parliamentary officials have said that the rating agencies "clearly underestimated the risk" that issuers of complex investments would not be able to repay debt and had failed to respond to worsening market conditions by lowering ratings.[47]

In April 2009, attempting to address such concerns, the EU parliament adopted a series of CRA reforms:

- The Committee of European Securities Regulators (CESR), a body composed of national regulators, was placed in temporary charge of registering CRAs, with registration required of all CRAs wanting to do business in the EU. The new rules require the CESR to manage a database of historical performance information about rating agencies operating in the EU. This is meant to allow users of rating services to quickly verify the accuracy of economic predictions and compare them with rival CRAs. Starting in 2010, this responsibility will shift to a new pan-European authority.
- CRAs will be liable for their rating opinions and could face EU sanctions if they are found guilty of professional misconduct, potentially resulting in the loss of their licenses to rate debt in EU nations.
- CRAs will have to have an internal function to review the quality of their own ratings and have at least two independent directors on their boards who do not receive bonuses that are connected to the CRA's performance. One of the directors will be required to be an expert in securitization and structured finance.
- CRAs will have to issue an annual transparency report.
- CRAs will have to disclose the models, methodologies and key assumptions on which they base their ratings.
- CRAs will have to publish an annual transparency report.
- CRAs will have to disclose the names of rated companies that contribute more than 5% of an agency's revenue. They will also be proscribed from rating companies for which their analysts own shares or financial products. The CRA's consulting and advisory roles would be denied to firms that are themselves subject to ratings. CRA analysts will be forced to rotate in order to avoid becoming too close to the industry sector they rate.
- CRAs will be required to distinguish the ratings of complex securities through the use of distinctive symbols.

(...continued)

[46] Ibid.

[47] "EU Approves New Rules for Rating Agencies," *Associated Press*, April 23, 2009.

- CRAs based outside of the EU will have two years to comply with the new rules, which will require them to show that they have quality information to rate debt and to show regulators the models, methods and key assumptions behind their ratings.
- Non-EU based CRAs like S&P and Moody's will have to have their branches in the EU endorse rating done by their parent firms.[48]

European Commission President José Manuel Barroso lauded the reforms, reportedly saying that they "will help give investors the information, integrity and impartiality they need from credit rating agencies if they are to make prudent investment decisions that create growth and jobs, instead of bubbles of excessive risk."[49] The president of S&P also lavished praise on the reform: he predicted that the newly adopted EU oversight along with ongoing market-based scrutiny of credit ratings will provide for more transparency and accountability from the raters and enhanced public confidence in their ratings.[50]

However, as in the case of the SEC rules, the EU's reforms do not address the concerns of those who say that the issuer-pays structure is a fundamental problem and should be eliminated.

Although the EU's CRA regulations technically went into effect on December 7, 2009, existing CRAs must adopt all the measures necessary to comply with the regulation by September 7, 2010.

The SEC's April 2009 Credit Rating Agency Roundtable

On April 15, 2009, the SEC convened a roundtable on public policy concerns surrounding the CRAs. Convening the roundtable, consisting of panelists representing CRAs, issuers, investors, and academia, SEC Chairman Mary Schapiro reportedly observed:

> The status quo isn't good enough. Rating agency performance in the area of mortgage-backed securities backed by residential subprime loans, and the collateralized debt obligations linked to such securities has shaken investor confidence to its core. Our purpose today is to ask some very basic questions: Should the Commission consider additional rules to better align the raters' interests with those who rely on the ratings—that is, principally, investors? Stated another way, does one form of rating agency business model represent a better way of managing conflicts of interest than another? Is there a way to realign incentives so that rating agencies view investors as the ultimate customer? Do users of ratings—whether they are issuers or investors—have all of the information they need to make the most informed decisions? For example, is there more information about performance, expertise with regard to certain types of securities products, or fees that would be meaningful in restoring investor confidence or would provide investors with the tools to discern the value of the rating? Should we borrow a page from the research analyst conflicts of interest settlement of several years ago and require a mechanism that provides for the issuance of multiple ratings for every security, including one generated independently? Are there additional behaviors—for example, concerning the way that agencies bid for work—that should be examined and

[48] "Approval of New Regulation will Raise Standards for the issuance of Credit Ratings Used in the Community," press release, April 23, 2009, available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/629&format=HTML&aged=0&language=EN&guiLanguage=en.

[49] "Parliament Backs Tighter Rules for Rating Agencies," *Euractiv.com*, April 24, 2009.

[50] "EU Backs New Rules on Rating Agencies," *Associated Press*, April 23, 2009.

> modified? Would increased competition in the rating agency space benefit investors and how would we achieve that? [51]

The panelists also proposed several ideas for regulatory improvements in the treatment of NRSROs, and there reportedly was broad agreement that more accountability and transparency and a stronger investor voice were necessary to improve the reliability of ratings. Among the observations made during the roundtable were the following:

- Former SEC commissioner Joseph Grundfest observed that if systemic risk means that a change in one company can have ripple macroeconomic effects on others, then what the CRAs do clearly has systemic consequences. In agreement, Richard Baker, formerly chairman of the House Financial Services Capital Markets Subcommittee, said that the ratings industry presents a systemic risk because of a concentration of information, not assets, but that "the contagion is the same."
- All the rating agencies present reportedly concurred that due to their complexity, a number of products, including collateralized debt obligations, should never have been rated.
- Robert Dobilas, the CEO of Realpoint LLC, the newest NRSRO, said that issuers should be required to provide information to all rating agencies, not just to a favored few. He asserted that the largest problem was that issuers often went "ratings shopping," in which they looked for the agency that would provide the most favorable ratings.
- Moody's Chairman Raymond McDaniel said that underlying information about structured securities should be provided to institutional investors, which would result in a reduction in the reliance on ratings, advances in the quality of the information available to the market, and result in a wider array different opinions and analyses.
- Frank Partnoy, a law professor at the University of San Diego, who has written extensively on the CRAs, observed that the regulatory references to ratings acted as unfair "regulatory licenses" and proposed a separately funded and independent oversight board largely responsible for weaning investors away from such ratings.
- Similarly, Lawrence White, an economics professor at New York University, who has also written extensively on the agencies, advised that the references to credit ratings and NRSROs be completely eliminated, leaving issuers with the burden to validate the safety of their financial products.
- Ethan Berman, CEO of RiskMetrics Group, observed that in establishing the NRSRO designation, the SEC erected regulatory barriers that make it "virtually impossible" for new CRAs to enter the market or gain a competitive foothold.
- In a similar vein, Alex Pollock, a resident fellow at the American Enterprise Institute, recommended that the NRSRO designation be entirely eliminated, noting that it had effectively created a "government cartel" and that "the U.S. government should not enshrine certain agencies as better."

[51] "Speech by SEC Chairman: Statement at SEC Roundtable on Credit Rating Agencies," April 15, 2009.

- Greatly at odds with the view that the NRSRO protocol should be abandoned were the views of James Gellert, president of Rapid Ratings International. He suggested that in the interest of boosting rating agency competition, the SEC should consider making it easier for CRAs to receive the NRSRO designation.
- Daniel Curry, president of DBRS Ltd., observed that removing the references to NRSROs was a "good" idea, but it should be done incrementally so the market could gradually adjust to it.
- Alan Fohrer, chairman of Southern California Edison, expressed concerns about the prospect of removing the NRSRO references, noting that any changes that create uncertainty would have a huge impact on his company and its customers.
- Sean Egan, president of Egan-Jones Ratings, claimed that increased CRA competition solves little and that the fundamental public policy need was the removal of the conflict of interest ridden investor-paid model.
- Rebutting the aforementioned critique, a number of panelists, including representatives from S&P, Moody's and Fitch, contended that issuers and investors have varying objectives, and that any kind of product in which there is a client who pays will have potential conflicts of interest.
- In response to a question on making ratings publicly available, a number of smaller subscriber-pays CRAs warned that it would be at odds with their basic business model. They also argued that it could increase their legal liability, which would be much less of a concern with the bigger CRAs who they said could insulate themselves against the threat by being indemnified by their issuer clients.[52]

The Obama Administration's Legislative Draft on Rating Agency Reform

On July 21, 2009, the Obama Administration through the Treasury Department issued draft legislation designed to "increase transparency, tighten oversight, and reduce reliance on credit rating agencies."

Among other things, the draft legislation would

- prohibit rating agencies from providing consulting services to companies that contract for ratings;
- prohibit or require the management and disclosure of conflicts arising from the way a rating agency is paid, its business relationships, affiliations or other conflicts;

[52] All of these comments come from: "Securities: Panelists Call for More Competition, Accountability, Transparency in Ratings" *BNA's Daily Report for Executives*, April 16, 2009.

- require each rating agency to disclose the fees paid by issuers for a particular rating and the total amount of fees paid by the issuer to the rating agency in the previous two years;
- require rating agency to conduct a review of ratings for that issuer to determine if any conflicts of interest influenced the rating and adjust the rating as appropriate if agency employees are hired by an issuer and if the employee had worked on ratings for that issuer in the preceding year;
- require each rating agency to designate a compliance officer who directly reports to the board or the senior officer of the firm;
- require an issuer to disclose all of the preliminary ratings it had received from different CRAs so that investors will see how much "ratings shopping" has occurred and whether there were discrepancies with final ratings.
- require different symbols to be used to distinguish the risks of structured products;
- require that each rating includes a clear report containing assessments of data reliability, the probability of default, the estimated severity of loss in the event of default, and the sensitivity of a rating to changes in assumptions;
- require the establishment of a dedicated Securities and Exchange Commission office for the supervision of the rating agencies; and
- require mandatory NRSRO registration through the SEC for all CRAs.

In addition, the legislative draft indicated that Treasury would work with the SEC and the President's Working Group on Financial Markets to determine where references to ratings can be removed from regulations.[53]

During an August 2009 Senate Banking, Housing, and Urban Affairs Committee hearing on the rating agencies, the committee's chairman, Senator Christopher Dodd, reportedly said that he was "stunned" to learn that the agencies routinely did not perform any due diligence to verify the information that is presented to them by issuers. He also indicated that he was disappointed that the Obama Administration's draft legislation did not require them to do so.[54]

In response, Michael Barr, the Treasury assistant secretary for financial institutions, reportedly indicated that requiring the rating agencies to perform such due diligence would problematically involve the government in dictating the kind of methodology that the rating agencies should use.[55]

[53] See "Administration's Regulatory Reform Agenda Moves Forward, Credit Rating Agency Reform Legislation Sent to Capitol Hill." *U..S. Treasury Department Fact Sheet*, July. 21, 2009, available at http://74.125.113.132/search?q=cache:S9DXdOnPgzQJ:www.treas.gov/press/releases/tg223.htm+treasury+and+rating+agencies&cd=6&hl=en&ct=clnk&gl=us.

[54] Andrew Ackerman, "Regs For Raters Faulted; Lawmakers Say More Is Needed," *the Bond Buyer*, August 6, 2009.

[55] Ibid.

CRA-Related Legislation

Congress has also shared many of the concerns over the perceived failures of the dominant CRAs in the area of structured finance. Several legislative efforts in this area are described below. The first two efforts described below pertain to H.R. 4173, which was passed in the House as amended on December 11, 2009. In the Senate, Chairman Christopher Dodd of the Senate Banking, Housing, and Urban Affairs Committee issued a single comprehensive committee print on November 16, 2009, the Restoring American Financial Stability Act of 2009. The proposal was revised over the following months and a committee print of the Restoring American Financial Stability Act of 2010 (RAFSA) was issued on March 15, 2010. This original bill was amended in committee on March 22, 2010, and ordered reported to the Senate floor. It has yet to be formally introduced and receive a number.

H.R. 4173 as passed by the House contains several provisions that are similar those in the July 21, 2009 Treasury Department legislative draft on rating agency reform (described above). The key rating agency provisions in the bill are as follows:[56]

- It would replace the term ''nationally recognized statistical rating'' with ''nationally registered statistical rating'' in the Securities Act of 1933 (which requires that various publicly traded securities must be registered) and the Securities Exchange Act of 1934 (which created the SEC and gives it broad authority to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as securities self regulatory organizations). *It has been reported that the provision was inserted to let investors know that NRSRO status does not imply a governmental "seal of approval" of a rating and that the agency has merely registered with the government as being a nationally registered statistical rating organization.*[57] *Chairman Paul Kanjorski, however, raised concerns that the change would "put thousands of contracts in default and upset numerous Federal and State laws, rules, and regulations...."*[58] *While acknowledging that a number of states and private institutions have the "nationally recognized" language embedded in their statutes, Chairman Frank has pledged to meet with various state agencies and pension funds to see if there is some legislative fix short of reverting back to the "nationally recognized" terminology.*[59]
- It would strike references to "not investment grade" or to "ratings" or similar language in a number of federal statutes such as the Federal Deposit Insurance Act (which embodies the basic authority for the operation of the Federal Deposit Insurance Corporation, FDIC); the Investment Company Act of 1940 (which regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public); the National Bank Act (which

[56] The provisions are available from the House committee's website at http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/Financial_Regulatory_Reform.html.

[57] See the comments of Hon. Scott Garrett in "Wall Street Reform and Consumer Protection Act," *Congressional Record*, December 11, 2010, p. H14752.

[58] Ibid.

[59] Ibid.

established a system of national banks headed by the Comptroller of the Currency); and the Securities Exchange Act of 1934 and substitute language requiring the regulator instead to establish standards of creditworthiness. It would also require the federal financial regulatory agencies to identify regulations that require or reference ratings and to substitute such standard of creditworthiness, as each respective agency shall determine for such regulation. *These provisions are consistent with arguments that removing specific regulatory and statutory references to rating or certain kinds of ratings such as "investment grade" have contributed to overreliance on ratings from the dominant rating agencies. Some would, however, argue that the provisions are potentially sweeping, although they appear to have generated little commentary. Various advocates of removing regulatory and statutory references say that there are viable market-based substitutes to CRA rating, including credit spreads of fixed income instruments and the market prices of credit default swaps. Others, however, have concerns that market-based indicators like credit default swaps can display excessive short-term volatility,*[60] *can be influenced by rumors, are often unavailable for more illiquid securities, and in the context of bank capital requirements, they could have more pronounced pro-cyclical effects than conventional credit ratings.*

- It would clarify the ability of individuals to sue rating agencies and lower the pleading standard for legal actions with respect to a complaint that a NRSRO knowingly or recklessly violated securities laws.
- All CRAs would be required to register as NRSROs with the SEC; exemption from registration would be available to non-issuer pays rating agencies, and the SEC would be authorized to provide for other exemptions.
- The SEC would be required to issue rules prohibiting, or requiring the management of, conflicts of interest related to an NRSRO's issuance of credit ratings. This could include conflicts of interest related to how NRSROs are compensated for issuing credit ratings, or providing related services. It would also include the establishment of a compensation system for the provision of credit ratings that would require payments to be structured to ensure that the NRSRO conducts accurate and reliable surveillance of credit ratings over time.
- Each NRSRO or each NRSRO holding company would be required to have a board of directors with at least one-third of the directors being independent directors.
- Each NRSRO would be required to disclose whether and to what extent it employed third parties for due diligence purposes.
- Each NRSRO would be required to maintain on a publicly accessible website, a record of the default history of all types of financial products that they have rated.

[60] Some advocates of the market-based measures, however, argue that to the extent there are concerns about short-term market volatility, market participants could look to rolling averages of market prices with an appropriate term (e.g., a 90-day rolling average).

- The SEC would be required to establish an office that administers the agency's rules with respect to the NRSRO's practices.
- Each NRSRO would be required to disclose the procedures and methodology used to perform credit ratings on structured securities, including data by sponsors, issuers, and underwriters of the underlying collateral.
- Each NRSRO would be required to have established internal controls over the processes used to determine credit ratings.
- Each NRSRO would have to disclose the potential shortcomings of its credit ratings, and the types of risks not measured in the credit ratings such as liquidity, market, and other risks.
- It would initiate a process ultimately aimed at the removal of references to credit ratings in federal statutes under the jurisdiction of the House Financial Services Committee. As part of this, it would direct applicable federal financial regulators to devise a standard of creditworthiness to serve as a substitute for ratings in rules and regulations.
- It would require NRSROs to disclose the primary assumptions used in constructing the procedures and methodologies for arriving at credit ratings.
- It would require NRSROs to use credit rating symbols that distinguish credit ratings for structured products from credit ratings for other products.
- It would require NRSROs to supervise their employees and would authorize the SEC to sanction supervisors for failing to do so.
- NRSROs would have to designate a compliance officer who would report directly to the board and would review all of the agency's policies to manage conflicts of interest and, in consultation with the board, resolve any conflicts of interest that arise. The compliance officer would also have to asses the risk that compliance or lack of such may compromise the integrity of the rating process.
- When specific NRSRO employees go to work for an issuer, the bill requires the NRSRO to conduct a one-year look-back into the ratings in which the employee was involved to make sure that its procedures were followed and proper ratings were issued. The bill also requires NRSROs to report to the SEC the names of former NRSRO employees who go to work for issuers, and for the agency to make these reports available to the public.
- Each NRSRO would be required to structure payments to ensure that it conducts accurate and reliable surveillance of ratings over time.
- Each NRSRO would be required to disclose along with the publication of a credit rating the type and number of credit ratings it has provided to the person being rated or affiliates of such person, the fees it has billed for the credit rating, and the aggregate amount of net revenue earned by the rating agency in the preceding two fiscal years attributable to the person being rated and its affiliates.

Key CRA-related provisions in the Senate Banking Committee marked up bill, RAFSA, include the following:

- It would require the establishment of an SEC office for the oversight of NRSROs.

- It would require NRSROs to have established internal controls over the processes used to determine credit ratings.
- It would clarify the ability of individuals to sue rating agencies and lower the pleading standard for legal actions with respect to a complaint stating facts that a NRSRO knowingly or recklessly failed to conduct a reasonable investigation of the factual elements of a rated security or failed to secure independent verification of such factual elements.
- It would require NRSROs to clearly define symbols used to denote credit ratings and consistently apply them to all types of rated securities.
- It would require NRSROs to disclose the primary assumptions used in constructing the procedures and methodologies for arriving at credit ratings and to provide information on the potential limits of the ratings.
- It would require NRSROs to disclose whether and to what extent they employed third parties for due diligence purposes.
- It would authorize the SEC to fine and revoke a credit rating agency's NRSRO registration with respect to a particular class of security if it determines that the NRSRO lacks adequate financial and management resources needed to consistently provide ratings with integrity.
- It would require NRSROs to separate ratings from their sales and marketing activities.
- NRSROs would be required to consider credible and potentially significant external information about a rating outside of that supplied by the issuer.
- NRSROs would be given rules to ensure that any person employed by them to perform credit ratings meets certain standards of training, experience, competence, and is tested for knowledge of the credit rating process.
- It would require each NRSRO to disclose information on initial ratings and subsequent changes to them that allows users to compare the performances of ratings across NRSROs.
- It would forbid NRSRO compliance officers from performing credit ratings, taking part in sales or marketing, developing ratings methodologies, or setting compensation levels for NRSRO employees.
- It would direct the General Accountability Office (GAO) to study the scope of federal and state laws and regulations related to financial regulation and other areas that require the use of ratings issued by NRSROs; and directs the agency to evaluate the necessity of such rating requirements and the potential impact on markets and investors of removing them.

Neither H.R. 4173 nor RAFSA, however, would address possible conflicts of interest associated with the issuer-pays business model. Joseph A. Grundfest, a former SEC commissioner and currently a professor of securities law at Stanford University Law School, is therefore dismissive of the ultimate benefits from the rating agency reforms in the Dodd Committee Print and H.R.

4173: "What you see in these bills are Botox shots. For a little while, everyone is going to be frozen into a grin, and then the shots are going to wear off."[61]

Responding to such concerns after the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises marked up H.R. 3890 (which is incorporated into H.R. 4173), the bill's sponsor, Congressman Paul E. Kanjorski, reportedly said: "People do tend to favor those people who pay them. I wanted to remove that conflict of interest. But quite frankly, having talked to some of the most informed people, the agencies probably could not have funded themselves. [And without cash from those they cover] we'd be creating an even larger void."[62]

Earlier on, with respect to the rating agency elements of RAFSA's legislative antecedents, which RAFSA has essentially kept intact, Senator Jack Reed, (also see S. 1073 below), who has been active in crafting its provisions on rating agency reform, has reportedly observed: "We all understand the outrage, but our priority is to prevent this from happening again, rather than looking backwards and punishing."[63] Senator Reed has reportedly also been concerned about the large numbers of professional investors—such as those who work for small towns—who lack the wherewithal to do bond research every time that the town is slated to acquire them.[64]

Both H.R. 4173 and RAFSA direct the GAO to conduct a study of alternative means for compensating CRAs and what statutory changes would be required to facilitate such alternatives.

Other CRA reform legislation has also been introduced:

S. 927 (Pryor) would direct the SEC to annually audit each NRSRO to ensure that the NRSRO is sufficiently disclosing its rating procedures and methodologies, they are sound, and the NRSRO is adhering to them.

S. 1073 (Reed) would

- require the SEC to review credit ratings and methodologies employed by each NRSRO to ensure that the NRSRO complies with its internal controls for determining credit ratings;
- require each NRSRO to establish and enforce governance procedures to manage conflicts of interest in accordance with SEC rules;
- require each NRSRO to designate a compliance officer;
- require the SEC to establish an office to administer SEC rules with respect to the practices of NRSROs;

[61] "Debt Raters Avoid Overhaul After Crisis," *New York Times*, December 8, 2009, available at http://dealbook.blogs.nytimes.com/2009/12/08/debt-raters-avoid-overhaul-after-crisis/.

[62] Joseph N. DiStefano, "Assessing the House's Financial-Legislation Agenda*," Philly Business Today*, October 27, 2009, available at http://www.philly.com/philly/business/homepage/20091027_PhillyDeals__Assessing_the_House_s_financial-legislation_agenda.html.

[63] David Segal, "Debt Raters Avoid Overhaul After Crisis," *New York Times*, December 7, 2009, available at http://www.nytimes.com/2009/12/08/business/08ratings.html.

[64] Ibid.

- require the SEC to promulgate rules on credit rating procedures and methodologies;
- require each NRSRO to disclose publicly information on initial ratings and subsequent changes to provide a gauge of the accuracy of ratings and allow users of credit ratings to compare performance of ratings by different NRSROs;
- require the SEC to explore alternative means of NRSRO compensation;
- require certification if due diligence services are used to ensure that appropriate and comprehensive information was received by the NRSRO for an accurate rating;
- create a look-back provision requiring that if an NRSRO employee later becomes employed by an issuer, the NRSRO must review any ratings that the employee participated in over the previous year to identify and remedy any conflicts of interest; and it provides for SEC reviews of NRSRO look-back policies and their implementation; and
- allow investors to take legal action against rating firms that “knowingly or recklessly” fail to review key information in developing ratings.

H.R. 1181 (Ackerman) would direct the SEC to establish both a process by which asset-backed instruments can be deemed eligible for NRSRO ratings and an initial list of such eligible asset-backed instruments.

H.R. 1445 (McHenry) would require NRSROs to provide additional disclosures with respect to the rating of structured securities, including (1) ensuring that issuers and originators are providing NRSROs with adequate information on the assets underlying a structured security; (2) instituting a process of obtaining data from issuers and originators concerning the procedures employed to attest to the data’s veracity and the fraud detection capabilities surrounding the process; and (3) disclosing in a central database the historical default rates of all classes of financial products they have rated.

H.R. 2253 (Delahunt) would establish a commission that would, among other things, investigate the role in the financial and economic crisis, if any, of NRSROs.

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