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The Rating Agencies: Where We Have Been and Where Do We Go From Here?

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THE RATING AGENCIES: WHERE WE HAVE BEEN AND WHERE DO WE GO FROM HERE?

JOSHUA D. KREBS*

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I. INTRODUCTION

The credit rating agencies are supposed to be gatekeepers to the public securities markets.¹ As “gatekeepers,” they are reputational intermediaries in the investment process.² Other gatekeepers include: independent auditors, credit rating agencies, securities analysts, investment bankers, and attorneys.³ The function of these reputational intermediaries is to act as neutral third party advisors to the investment process.⁴ While these intermediaries are paid for their opinions by one or more parties to a transaction, in theory the opinions will be neutral. This is due to the thought that any resulting reputational damage from non-neutral opinions would severely damage long-term profitability, in exchange for mere short-term profits.⁵

The rating agencies are very different from other gatekeepers, as they exist in a position of profitable limbo somewhere between market journalist and state authority.⁶ They claim they are merely reputational intermediaries sought by numerous market participants for neutral opinions on the safety of securities products.⁷ At the same time, they uniquely occupy a niche where government regulation mandates that market participants utilize their ratings; they are, in fact, selling compliance with official regulation.⁸ This puts them in a position of incredible power⁹ and provides them with little accountability.¹⁰ With the recent explosion of unregulated securities¹¹ and the ensuing near collapse of the financial

¹ John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1405 (2002).

² *Id.*

³ *Id.*

⁴ *Id.*

⁵ *See id.* at 1406.

⁶ Christopher M. Bruner, *States, Markets, and Gatekeepers: Public-Private Regulatory Regimes in an Era of Economic Globalization*, 30 MICH. J. INT’L L. 125, 168 (2008).

⁷ *See Coffee, supra* note 1, at 1405.

⁸ Bruner, *supra* note 6, at 168 (“[U]nlike auditors, analysts, investment bankers, corporate attorneys, stock exchanges, and others—[the agencies] literally regulate admission to bond markets, and possess the power to articulate public policy in so doing, with no straightforward form of accountability to constrain them.”).

⁹ As *New York Times* Columnist Thomas Friedman put it: “[t]here are two superpowers in the world today in my opinion. There’s the United States and there’s Moody’s Bond Rating Service. The United States can destroy you by dropping bombs, and Moody’s can destroy you by downgrading your bonds. And believe me, it’s not clear sometimes who’s more powerful.” Interview by David Gergen with Thomas Friedman, Columnist, N.Y. TIMES (Feb. 13, 1996), available at <http://www.pbs.org/newshour/gergen/friedman.html>.

¹⁰ Bruner, *supra* note 6. Conversely, auditors, for example, have historically had substantial accountability through the courts. *Id.*

¹¹ Namely, derivatives were made statutorily and were largely unregulated by the Commodity Futures Modernization Act of 2000. Gwen Moran, *Do Derivatives Need More Oversight?*, ON WALL ST., Jan. 1, 2009, http://www.onwallstreet.com/ows_issues/2009_1/do-derivatives-need-more-oversight2637051-1.html. Incidentally, the Commodity Futures Modernization Act of 2000 was a largely bi-partisan act which was introduced by both Republicans and Democrats and was passed by the then Republican controlled House and Senate and was signed into law by President Clinton on December 21, 2000. Karen Buck Burgess et al., *The SEC Speaks in 2001: Recent Legislative Developments Affecting the Work of the Securities and Exchange Commission - DECEMBER 29, 2000*, 1234 PRACTISING L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES, 797, 801, 844, 846 (2001).

markets,¹² it seems these agencies are perhaps not gatekeepers, but rather mechanics, greasing the wheels of a giant runaway train of dangerous financial products.¹³

This article will explore the rating agencies' role in this recent crisis and will discuss the need for increased regulation or liability¹⁴ for the agencies to function effectively. This comment will ask what is the most realistic way to accomplish this. Part II is an introduction to who the rating agencies are and what they do.¹⁵ Part III looks at how we got where we are and explores two common criticisms against the agencies that even their former employees attest to.¹⁶ Part IV navigates recent responses, both by the agencies to criticism and by the government through the SEC.¹⁷ Part V looks at past liability exposure to the agencies and common defenses they have raised.¹⁸ There will also be some discussion of whether legislation passed has changed anything, as well as a look at a common barrier to litigation against the agencies.¹⁹ Finally, Part VI offers the author's own opinions on where we go from here.²⁰

II. INTRODUCING THE PLAYERS

A. *Who The Rating Agencies Are*

While there are possibly 150 credit rating agencies worldwide,²¹ only ten agencies are currently registered with the SEC as a Nationally Recognized Statistical Rating Organization ("NRSRO").²² Of the ten registered NRSROs, only three really matter.²³ These three "major" credit rating agencies include Moody's Investors Service, Inc. ("Moody's"),²⁴ Standard & Poor's ("S.&P."),²⁵

¹² *Soros Sees No Bottom for World Financial "Collapse,"* REUTERS UK, Feb. 21, 2009, <http://uk.reuters.com/article/businessNews/idUKTRE51K0AV20090221>.

¹³ *End of Wall Street: What Happened* (The Wall Street Journal Video Jan. 5, 2009), <http://online.wsj.com/video-center/the-end-of-wall-street.html>. As Frank Raiter, former Managing Director and Head of Residential Mortgage Backed Securities Ratings at Standard & Poor's so aptly put it, the rating agencies were greasing the wheels of this train which was powered by low interest rates, driven by the investment banks, conducted by lenders and investment bankers, and ridden "standing room only" by investors. *Id.*

¹⁴ Alternatively, there could be increased regulation and liability.

¹⁵ See *infra* Part II.

¹⁶ See *infra* Part III.

¹⁷ See *infra* Part IV.

¹⁸ See *infra* Part V.

¹⁹ See *infra* Part V.

²⁰ See *infra* Part VI.

²¹ Alec Klein, *Smoothing the Way for Debt Markets: Firms' Influence Has Grown Along with World's Reliance on Bonds*, WASH. POST, Nov. 23, 2004, at A18.

²² Elliott R. Curzon et al., *SEC Proposes Rules for Registration of Credit Rating Agencies*, 124 BANKING L.J. 438, 441-42 (2007).

²³ Klein, *supra* note 21.

²⁴ Moody's is owned by Moody's Corporation, which is a publicly traded corporation. NYSE Listing Directory: Moody's Corporation, <http://www.nyse.com/about/listed/mco.html> (last visited Feb. 21, 2009).

²⁵ Standard and Poor's is a division of The McGraw-Hill Companies, Inc., which is a publicly

and Fitch Ratings (“Fitch”).²⁶ Moody’s and S.&P. are the largest, with each respectively owning about forty percent of the credit rating markets.²⁷ Fitch is the smallest of the three and is often considered a “tie-breaker” by investors when the other two agencies have assigned similar, but not equal, ratings.²⁸

B. What the Agencies Do

An NRSRO can register in one or more categories with the SEC. These categories include financial institutions; insurance companies; corporate issuers; issuers of government, municipal, and foreign government securities; and asset-backed securities.²⁹ Within these categories, the NRSROs provide self-described “opinions” in the form of ratings on creditworthiness.³⁰ The agencies create these opinions by gathering and analyzing public and private information and reporting the results in a letter, which generally distinguishes at a basic level between investment grade and non-investment grade.³¹ These opinions are highly valued by investors when making investment decisions.³² The ratings are valued because they supposedly convey an evaluation of risk of non-payment and default likelihood,³³ which directly affects how much an investor is willing to pay according to his or her risk appetite.³⁴ A prime example of the importance investors put on these ratings occurred on January 19, 1990, when Moody’s lowered its debt rating on RJR-Nabisco, citing worries about the company’s cash

traded corporation. Standard & Poor’s, www.standardandpoors.com (last visited Feb. 21, 2009).

²⁶ Fitch is a private company. It is owned by Fitch Inc., which is often referred to as the Fitch Group. Fitch Ratings Visual Timeline, http://www.fitchratings.com/web_content/marcom/group_timeline.cfm (last visited Feb. 21, 2009). Fitch Inc. is a majority-owned subsidiary of Fimalac, S.A., an international business support services group headquartered in Paris, France. About Fitch, <http://www.fitchratings.com/jsp/creditdesk/AboutFitch.faces?context=1&detail=1> (last visited Feb. 21, 2009).

²⁷ Klein, *supra* note 21.

²⁸ Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U.L.Q. 43, 60 (2004); Jeff Jewell & Miles Livingston, *A Comparison of Bond Ratings from Moody’s S&P and Fitch IBCA*, 8 FIN. MKTS., INSTS. & INSTRUMENTS 4, Jan. 2002, at 1, available at <http://www3.interscience.wiley.com/cgi-bin/fulltext/119084174/PDFSTART>.

²⁹ Elliott R. Curzon et al., *supra* note 22.

³⁰ See Hill, *supra* note 28, at 48.

³¹ SEC, Credit Rating Agencies—NRSROs, <http://www.sec.gov/answers/nrsro.htm> (last visited Feb. 21, 2009). Ratings are further broken down into tiers and sub-tiers assigned as the agencies determine rating worthiness. BondsOnline: Long Term Bond Ratings, <http://www.bondsonline.com/asp/research/bondratings.asp> (last visited Feb. 21, 2009). All use letter-based grading systems. *Id.* S.&P.’s ratings, for example, range from AAA for the most financially stable companies to D for a company in default. Amy Borrus et al., *The Credit-Raters: How They Work and How They Might Work Better*, BUS. WEEK ONLINE, Apr. 8, 2002, http://www.businessweek.com/magazine/content/02_14/b3777054.htm.

³² Borrus et al., *supra* note 31.

³³ Gregory Husisian, *What Standard of Care Should Govern the World’s Shortest Editorials?: An Analysis of Bond Rating Agency Liability?*, 75 CORNELL L. REV. 411, 413 (1990). However, some commentators argue that the rating agencies assign actually affect the cost of the capital themselves, instead of merely revealing underlying risk. *Id.* at 411 n.1. Either way, investors take these ratings seriously. When applied to a company, investors regard these ratings as a key measurement of the company’s financial health. See Borrus et al., *supra* note 31. Some loans must be restructured or repaid if an issuer’s credit rating falls below investment grade. *Id.*

³⁴ See Borrus et al., *supra* note 31.

flow while S.&P. affirmed an existing higher rating.³⁵ RJR-Nabisco's bonds lost twenty percent of their value within two days, cumulatively equaling several hundred million dollars.³⁶

These opinions are not merely recognized by investors for private market purposes. A large amount of government regulation mandates ratings assigned by these agencies to be considered to meet official regulatory requirements.³⁷ These requirements are extensive and include rating thresholds for banks, trust companies, pension funds, insurance companies, and money market funds.³⁸ This has led to a bit of a paradox: investors required by regulation to consider mere "opinions."³⁹

III. MOUNTING CRITICISM OF THE AGENCIES' ACTIONS

A. *How We Got Here*

Among the many financial instruments rating agencies cover is securitized loan pools.⁴⁰ One early failure attributed to the rating agencies was their assigning faulty risk assessments to securitized loan pools composed of mortgages, known as "mortgage-backed securities" ("MBS").⁴¹ Additionally, in the ensuing economic downturn, the agencies failed to promptly downgrade troubled securities' ratings⁴² and companies' ratings,⁴³ even when it was clear the securities and companies were troubled.

Failure by the credit rating agencies to assign accurate MBS and collateralized debt obligation ("CDO") ratings was a key contributor to the current

³⁵ Husisian, *supra* note 33, at 411.

³⁶ *Id.*

³⁷ Hill, *supra* note 28, at 53.

³⁸ *Id.* Typically, regulation requires an investment grade "threshold" to be met through encouragement of a requirement of investment grade debt to be held instead of debt that is less highly rated or unrated. These preferences matter; for instance, the designation of "money market" fund for all regulatory purposes generally requires a limit on short-term securities held to only the highest two ratings categories by NRSROs. See Bruner, *supra* note 6, at 140. California's Insurance Code limits "excess funds investments" to only investment in the highest three ratings categories by an NRSRO. *Id.* Additionally, large public pensions, such as CalPers, require ratings thresholds to be met. To understand the extent the use of these "opinions" has reached, consider that the "Basel II" international banking requirements have credit rating consideration requirements incorporated into their regulations. *Id.* at 141.

³⁹ See *infra* Part IV.A (discussing the agencies' continuing contention that they are offering mere opinions). According to their contention, one would think that nobody is actually required to look at ratings.

⁴⁰ Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2046 (2007).

⁴¹ Gretchen Morgenson, *Credit Rating Agency Heads Grilled by Lawmakers*, N.Y. TIMES, Oct. 23, 2008, at B1, available at <http://www.nytimes.com/2008/10/23/business/economy/23rating.html>.

⁴² *Credit Crisis Hurts Rating Agencies*, FORBES, Aug. 14, 2007, http://www.forbes.com/2007/08/13/credit-rating-crisis-oxford_0814oxfordanalytica.html ("Despite widespread awareness of problems in the subprime sector, Moody's and Standard & Poor's did not downgrade mortgage bonds and related structured debt products until July 10, 2007.").

⁴³ Charlie Gasparino, *Rating Agencies Hold Off Downgrading MBIA, Ambac*, CNBC, Jan. 31, 2008, <http://www.cnbc.com/id/22932650>.

economic crisis.⁴⁴ From the late 1990s through 2007, investment banks and other issuers packaged residential loans directly and indirectly into MBSs,⁴⁵ and CDOs.⁴⁶ In an effort to maximize profitability, these issuers created these securities by dividing underlying risk of default into tranches, or levels of security, each of which would be assigned a separate rating grade.⁴⁷ Often, the grade would be based on a sliding scale of coupon rates, which in turn were based on the level of credit protection afforded to the security.⁴⁸ Credit protection was designed to shield the tranches from loss of interest and principal arising from defaults on the loans backing these securities. The degree of credit protection assigned to a tranche was known as its “credit enhancement.”⁴⁹ Three forms of credit enhancement include subordination,⁵⁰ over-collateralization,⁵¹ excess spread,⁵²

⁴⁴ See Marie Leone, *Subprime Slam: SEC Exposes Rating Agency Faults*, CFO, July 8, 2008, <http://www.cfo.com/article.cfm/11699984?f=related>; Drew Voros, *Uncovering the Subprime Debacle*, CONTRA COSTA TIMES, Sept. 24, 2008, http://findarticles.com/p/articles/mi_qn4176/is_20081230/ai_n31157668/.

⁴⁵ According to the SEC, mortgage-backed securities are defined as follows:

[D]ebt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.

SEC, Mortgage-Backed Securities, [http://www.sec.gov/answers/mortgage securities.htm](http://www.sec.gov/answers/mortgage%20securities.htm) (last visited Feb. 21, 2009). MBSs come in many different structures. According to the SEC, the most basic types are “pass-through participation certificates, which entitle the holder to a pro-rata share of all principal and interest payments made on the pool of loan assets.” *Id.* More complicated MBSs are known as collateralized mortgage obligations or mortgage derivatives. These more complicated versions may be designed to protect investors from or expose investors to various types of risk. An important risk with regard to residential mortgages involves prepayments, typically because homeowners refinance when interest rates fall. Absent protection, such prepayments would return principal to investors precisely when their options for reinvesting those funds may be relatively unattractive. *Id.*

⁴⁶ Creation of a CDO is similar to that of a MBS. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 9 (2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>. A sponsor creates a trust to hold the CDO’s assets and issue securities. *Id.* Usually a CDO is comprised of 200 or so debt securities in a pool. *Id.* This pool may include MBSs along with many other types of debt securities. *Id.* Similar to a MBS, the trust then collects interest and principal payments from the underlying debt securities pool and makes interest and principal payments to investors in the CDO securities issued. *Id.* One significant difference between a CDO and a MBS is that the trust may actively manage the CDO’s underlying assets, whereas the mortgage loan pool underlying a MBS generally remains static. *Id.*

⁴⁷ Richard Tomlinson & David Evans, *CDO Boom Masks Subprime Losses, Abetted by S&P, Moody’s, Fitch*, BLOOMBERG, May 31, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajs7BqG4_X8I.

⁴⁸ Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-57967, 93 SEC Docket 1266 (June 16, 2008), available at <http://www.sec.gov/rules/proposed/2008/34-57967.pdf>.

⁴⁹ *Id.*

⁵⁰ Subordination, which is the most common, is the creation of a hierarchy of loss absorption among a pool of tranche securities. *Id.* For example, if securities are issued in ten different tranches, the first (or senior) tranche has nine subordinate tranches; the next highest tranche has eight subordinate tranches and so on. *See id.* Any loss of interest and principal experienced by the pool of tranche securities due to delinquencies and defaults in its underlying loans are allocated first to the lowest tranche until it loses all of its principal amount (or a pre-arranged percentage thereof) and then to the next lowest tranche and so on up the tranche levels. *Id.* Therefore, the senior tranche would be

and bond insurance for CDOs.⁵³ The process of creating these “credit enhanced” securities had almost no official oversight⁵⁴ and grew exponentially in popularity.⁵⁵

MBS and CDO issuers further profited and complicated the process by substituting credit default swaps (“CDS”) into CDOs instead of actual MBSs or MBSs holding CDOs.⁵⁶ Many CDOs were owned by banks or insurance companies. The regulators for those banks and insurance companies were overwhelmed and relied on the NRSOs to police CDOs.⁵⁷ Kevin Fry, chairman of the Invested Asset Working Group of the U.S. National Association of Insurance Commissioners stated: “[a]s regulators, we just have to trust that rating agencies are going to monitor CDOs and find the subprime We can’t get there. We don’t have the resources to get our arms around it.”⁵⁸

With little regulation, the rating companies profited by advising issuers on how to squeeze the most profit out of these securities by maximizing the ratings on tranches.⁵⁹ Additionally, after these securities had been created, investment banks relied on the credit agencies to rate these securities favorably so various investment groups, such as hedge funds, pension funds, and even other investment banks, would invest in these “safe” securities.⁶⁰ These institutions often relied on ratings so heavily that due diligence was overlooked or thought unnecessary.⁶¹ This large scheme of close relationships began to fall apart when mortgage delinquencies and defaults skyrocketed⁶² and the value of these securities plummeted.⁶³ It became

considered very “safe” as it would not incur any losses until all the lower tranches have first absorbed losses from the underlying loans. *Id.*

⁵¹ Over-collateralization refers to an amount of principal balance in a mortgage pool, which exceeds the principal balance of the tranche securities issued by the trust. *Id.* This excess principal creates an additional “equity” tranche, or “cushion” of equity, below the lowest tranche security to absorb losses. *Id.*

⁵² Excess spread refers to the amount by which the total interest received on underlying loans exceeds the total interest payments due to investors in the tranche securities (plus administrative expenses, which include loan servicing fees, premiums due on derivatives contracts, and bond insurance). *Id.* “This excess spread can be used to build up loss reserves or pay off delinquent interest payments due to a tranche security.” *Id.*

⁵³ In addition to subordination, over-collateralization, and excess spread, CDOs often use bond insurance as a method of credit enhancement. *See id.*

⁵⁴ Tomlinson & Evans, *supra* note 47.

⁵⁵ Morgenson, *supra* note 41. One NRSRO claimed the average percentage of subprime MBSs in the collateral pools of CDOs it rated grew from 43.3% in 2003 to 71.3% in 2006. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 11.

⁵⁶ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 11. This way, the issuer did not have to actually purchase subprime MBSs or other CDOs and instead would enter into credit default swaps referencing subprime MBSs or CDOs or indexes on MBSs. *See id.* at 12. Some of these CDOs were composed entirely of credit default swaps (“synthetic CDOs”); others were composed of a combination of credit default swaps and actual MBSs (“hybrid CDOs”). *See id.*

⁵⁷ Tomlinson & Evans, *supra* note 47.

⁵⁸ *See id.*

⁵⁹ *Id.* This created a conflict of interest. *See infra* Part III.B.2.

⁶⁰ *See* Voros, *supra* note 44. This also created a conflict of interest. *See infra* Part III.B.1

⁶¹ *See Testimony of John C. Dugan, Comptroller of the Currency, Before the Comm. on Banking, Housing, and Urban Affairs, United States Senate, (2008), available at <http://www.occ.treas.gov/ftp/release/2008-63b.pdf>.*

⁶² *See* Tomlinson & Evans, *supra* note 47.

clear to everyone that these “safe” securities had been severely overrated by the rating agencies.⁶⁴ Moody’s, S.&P., and Fitch then proceeded to quickly downgrade ratings on thousands of securities, wiping out billions of dollars of investors value.⁶⁵

B. Conflicts of Interest

1. Conflict of Interest: Issuer Pays Model

Ratings were originally conducted on a subscription based method.⁶⁶ However, in the 1970s, the rise of the copy machine led to the issuer pays model.⁶⁷ Former officials of Moody’s and S.&P. testified before Congress that the credit rating agencies’ disastrous performance in the last decade can be attributed to conflicts of interest, which primarily includes their current issuer pays business model.⁶⁸ They allege this model, where securities issuers pay credit rating agencies to rate the issuers’ products,⁶⁹ is inherently flawed. Frank L. Raiter, who was previously the head of mortgage ratings at S.&P. for ten years, summarized the company’s failures by simply saying: “[p]rofits were running the show.”⁷⁰ Jerome S. Fons, who was the managing director for credit policy at Moody’s until 2007, testified that under the issuer pays model, the rating agencies’ interests can eclipse those of investors.⁷¹

Not only is there the general problem with this model in that issuers have great amounts of leverage over the rating agencies, but a further weakness is that it undercuts incentives to monitor and downgrade securities in the post-issuance

⁶³ Stephen Gandel, *For Geithner’s “Bad Bank”: A Toxic Financial Mutant*, TIME.COM, Feb. 9, 2009, <http://www.time.com/time/business/article/0,8599,1878295,00.html>. Not only did the value of these and other similar securities drop, but they became almost worthless as parties tried unsuccessfully to determine a value for them. *See id.*

⁶⁴ Morgenson, *supra* note 41. Over the course of 2007 alone, Moody’s issued 1,655 discrete downgrade actions (including multiple rating actions on the same tranche) on CDOs. Proposed Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 48, at 24. This constituted roughly ten times the number of downgrade actions in 2006 and twice as many as in 2002 (previously the most volatile year for CDOs). *Id.* The magnitude of these CDO downgrades (number of notches) was noticeably sizeable at roughly seven notches. *Id.* Prior to 2007, average downgrades moved three to four notches. *Id.* In the words of a March 2008 report by Moody’s, “The scope and degree of CDO downgrades in 2007 was unprecedented.” *Id.* As of April 1, 2008, S.&P. had downgraded 3,068 tranches from 705 CDO transactions. *Id.* This totaled \$321.9 billion in issuance. *Id.* S.&P. had also placed 443 ratings from 119 transactions on CreditWatch negative. *Id.* By mid-December 2007, Fitch had issued downgrades to 158 of the 431 CDOs it had rated with exposure to RMBS. *Id.* Among the thirty CDOs with exposure to the subprime RMBS which “suffered the greatest extent and magnitude of negative rating migration,” all but \$82.7 million of the \$20.7 billion in balance was downgraded. *Id.*

⁶⁵ Morgenson, *supra* note 41.

⁶⁶ Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1679 n.416 (2008).

⁶⁷ *Id.*

⁶⁸ Morgenson, *supra* note 41.

⁶⁹ Proposed Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 48, at 26.

⁷⁰ Morgenson, *supra* note 41.

⁷¹ *Id.*

market.⁷² This is because the continuing “surveillance” of the security is paid for in advance from each issuer.⁷³ Few issuers are eager for their securities to be monitored closely, especially if it could result in downgrades.⁷⁴ So ratings are seldom downgraded until long after public information has signaled an obvious deterioration in an issuer’s probability of default.⁷⁵

2. *Conflict of Interest: Active Role in Creation of Securities*

The process of rating securitized products is very different from the process of rating traditional debt.⁷⁶ In the case of traditional debt, an issuer is unable to adjust creditworthiness before issuance.⁷⁷ Therefore, pre-rating dialogue between the rating agency and the issuer is of limited significance.⁷⁸ However, in the case of securitized products, extensive pre-rating dialogue takes place.⁷⁹ This process begins with an issuer telling the rating agency a desired rating, and the rating agency indicating whether the structure and level of credit support proposed by the issuer will suffice to achieve that rating.⁸⁰ The increased complexity and introduction of MBSs and CDOs led to the precarious position of the agencies not merely creating neutral ratings on other parties’ instruments, but instead becoming creators of the instruments themselves. This created a unique conflict of interest, as the agencies had previously merely assigned ratings to debt and companies in which they had no active role.⁸¹ With these new structured finance vehicles “the agencies [were] effectively involved in structuring these transactions,” according to Karl Bergqwist, a senior manager at Gartmore Investment Management Plc in London.⁸² This is something the agencies vehemently deny.⁸³

IV. RESPONSE TO THE AGENCIES’ ACTIONS

In response to the rating agencies’ actions, there have been numerous proposals for reform of the rating methods by industry groups, policymakers and

⁷² *Do the SEC’s New Rating Agency Rules Have Any Bite?*, KNOWLEDGE@WHARTON, Dec. 10, 2008, available at <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2112>.

⁷³ *Id.* “Surveillance” refers to the process of an agency monitoring its own ratings on an ongoing basis in order to ensure accuracy, and so it may enact rating changes as necessary. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 21. The agencies charge issuers, upfront or annual fees, for surveillance. Proper surveillance is important, especially where issuers do not publicly make available their due diligence information or underlying loan performance information. *Id.*

⁷⁴ *Do the SEC’s New Rating Agency Rules Have Any Bite?*, *supra* note 72.

⁷⁵ *Id.*

⁷⁶ Kettering, *supra* note 66, at 1681.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* at 1681-82.

⁸¹ Tomlinson & Evans, *supra* note 47.

⁸² *Id.*

⁸³ *Id.* It seems as though this active role at least raises a strong possibility for closer than arms-length rating transactions to occur.

even the agencies themselves.⁸⁴ Organizations that have issued propositions and/or requested comments relating to the role of ratings and agencies include the SEC, the President's Working Group on Financial Markets, the International Organization of Securities Commissions (IOSCO), the Financial Stability Forum, and the agencies themselves.⁸⁵

A. *The Agencies' Own Response*

The agencies' response to the idea that they held the role of de facto regulator in a securities market that had no official watchdog was that policing these securities is not their job.⁸⁶ The companies point out that they only offer their educated opinions.⁸⁷ Noel Kirnon, senior managing director at Moody's said "[w]hat we're saying is that many people have the tendency to rely on [our ratings], and we want to make sure that they don't."⁸⁸ Moody's, S.&P., and Fitch all presently assert investors should not base any investment decision on their analyses, as they are merely opinions.⁸⁹

The three current executives of Moody's, S.&P., and Fitch also deny that conflicts of interest impaired their companies' judgment on mortgage securities.⁹⁰ They all claim their methods of rating were not flawed.⁹¹ However, all of the companies are engaged in some form of implementation of initiatives which they claim are designed to address conflicts of interest or strengthen rating methods.⁹²

B. *The Government's Response: SEC Findings*

Since the origination of the "NRSRO" designation in 1975,⁹³ the procedure to become an NRSRO was tightly held by the SEC.⁹⁴ Not only did the SEC choose who they wanted designated as an NRSRO, there were no statutes or regulations establishing substantive or procedural requirements for becoming an

⁸⁴ Proposed Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 48.

⁸⁵ *Id.*

⁸⁶ Tomlinson & Evans, *supra* note 47.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.* The idea that investors shouldn't rely on these ratings seems preposterous. If ratings are only opinions, as the agencies claim, then they should be nearly worthless as they would leave investors "with very little new information." *Id.* However, the reality is these ratings are not only highly coveted by investors, but are often required to be considered by government mandate. *See supra* note 38. It seems ridiculous that the agencies charge hefty fees to digest information and issue ratings that investors *must* look at, all the while saying "we hope these ratings are not relied upon." Surprisingly, this "opinion" designation has successfully formed the basis as one of the agencies' claimed legal defenses. *See infra* note 198; Kettering, *supra* note 66, at 1689.

⁹⁰ Morgenson, *supra* note 41.

⁹¹ *Id.*

⁹² *See id.* Interestingly, S.&P. has taken twenty-seven initiatives to "enhance the integrity of [its] ratings process." *Id.* For example, S.&P. now rotates analysts in their assignments and has established an ombudsman office, "to protect against conflicts." *Id.* Moody's has also changed its practices "to strengthen its standards." *Id.* These actions seem to strongly infer an admission of wrongdoing.

⁹³ Hill, *supra* note 28, at 54.

⁹⁴ *Id.*

NRSRO.⁹⁵ A principal of the Egan-Jones rating agency once said an SEC official told him, “We won’t tell you the criteria [for obtaining NRSRO designation], otherwise you might qualify.”⁹⁶

On September 29, 2006,⁹⁷ the Credit Rating Agency Reform Act (the “Act”) was signed into law.⁹⁸ The Act sought to modify the Securities Exchange Act of 1934 and create greater oversight of the rating agencies by creating a new section, section 15E.⁹⁹ Section 15E provided much needed SEC registration requirements for NRSROs; ¹⁰⁰ it also provided authority for the SEC to implement financial reporting and oversight rules with respect to registered NRSROs.¹⁰¹ Additionally, the Act amended section 17(a) of the 1934 Securities Exchange Act to provide that the SEC require reporting and recordkeeping requirements for registered NRSROs.¹⁰² The Act also established procedures to manage the handling of material non-public information.¹⁰³ It also required disclosure and management of conflicts of interest, and it prohibited a NRSRO from having certain conflicts of interest and engaging in certain unfair, abusive, or coercive practices.¹⁰⁴

The agencies objected to the Act, arguing that the legislation represented an unconstitutional infringement of the company’s free speech.¹⁰⁵

Ultimately though, while the Act did require disclosure to the SEC of a general description of each agency’s procedures and methodologies for determining credit ratings, and granted the SEC broad authority to examine all books and records of the agencies, it did not allow the SEC to regulate “the substance of the credit ratings or the procedures and methodologies” by which any NRSRO determines credit ratings.¹⁰⁶ In fact, the Act expressly prohibited this. This effectively left the act toothless, other than giving the SEC the ability to expose the agencies’ practices to the light of day.

⁹⁵ *Id.*

⁹⁶ *Id.* at 54-55. Although the NRSRO designation may not seem like much, because of government regulation, this designation was and still is very valuable.

⁹⁷ While the Act was introduced on September 29, 2006, the SEC’s related rules were not adopted until June 18, 2007, and they became effective on June 26, 2007. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 4.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.* Until this, “NRSRO” had remained undefined. There was no formal procedure for qualifying as a NRSRO, and the SEC had tightly controlled who was given the designation. *See* Hill, *supra* note 28, at 54 and accompanying text.

¹⁰¹ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 4.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ Marie Leone, *Bush Signs Rating Agency Reform Act*, CFO, Oct. 2, 2006, http://www.cfo.com/article.cfm/7991492/c_7989907?f=TodayInFinance_Inside. This seems like a poor argument in light of the use of ratings being mandated by government to be considered. This goes back to the agencies’ constant assertion that ratings are merely “opinions.” While this argument has held up historically, it would seem time to move forward and admit these ratings are significant tools used in financial analysis, and are sold as such. Additionally, it would seem the government should have some authority to set standards for quality of the ratings since the government is going to mandate reliance on the quality of the ratings.

¹⁰⁶ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 4.

While the changes under the Act were welcome, more was needed. On June 16, 2008, in response to the recent economic catastrophe that the rating agencies had contributed to, the SEC published a new “Proposed Rules for Nationally Recognized Statistical Rating Organizations” (“Proposed Rules”).¹⁰⁷

On December 1, 2008, The Financial Economists Roundtable, a group

¹⁰⁷ *Id.* These Proposed Rules sought to:

- Enhance the disclosure and comparability of credit ratings performance statistics;
- Increase the disclosure of information about structured finance products;
- Require more information about the procedures and methodologies used to determine credit ratings for structured finance products;
- Strengthen internal control processes through reporting requirements; and
- Address conflicts of interest arising from the process of rating structured finance products; and
- Reduce undue reliance in the Commission’s rules on NRSRO ratings, thereby promoting increased investor due diligence.

Proposed Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 48, at 7. These Proposed Rules included prohibiting an NRSRO from issuing a rating on a structured product unless information on the characteristics of assets underlying the product is available. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 4. This allows other credit rating agencies to use the information to rate the same product and, potentially, expose ratings unduly influenced by the product’s sponsors. *Id.* Additionally, the Proposed Rules sought to:

- Prohibit an NRSRO from issuing a rating where the NRSRO or a person associated with the NRSRO has made recommendations as to structuring the same products that it rates.
- Require NRSROs to make all of their ratings and subsequent rating actions publicly available, to facilitate comparisons of NRSROs by making it easier to analyze the performance of the credit ratings the NRSROs issue in terms of assessing creditworthiness.
- Prohibit anyone who participates in determining a credit rating from negotiating the fee that the issuer pays for it, to prevent business considerations from undermining the NRSRO’s objectivity.
- Prohibit gifts from those who receive ratings to those who rate them, in any amount over \$25.
- Require NRSROs to publish performance statistics for one, three and ten years within each rating category, in a way that facilitates comparison with their competitors in the industry.
- Require disclosure by the NRSROs of whether and how information about verification performed on the assets underlying a structured product is relied on in determining credit ratings.
- Require disclosure of how frequently credit ratings are reviewed; whether different models are used for ratings surveillance than for initial ratings; and whether changes made to models are applied retroactively to existing ratings.
- Require NRSROs to make an annual report of the number of ratings actions they took in each ratings class.
- Require documentation of the rationale for any material difference between the rating implied by a qualitative model that is a “substantial component” in the process of determining a credit rating and the final rating issued.
- Require NRSROs to differentiate the ratings they issue on structured products from other securities, either through issuing a report disclosing how procedures and methodologies and credit risk characteristics for structured finance products differ from other securities, or using different symbols, such as attaching an identifier to the rating.

Id. at 4-5.

composed of senior financial economists,¹⁰⁸ issued a statement of strong support for the SEC's Proposed Rules.¹⁰⁹ Some of the SEC's Proposed Rules were adopted by the SEC on December 3, 2008.¹¹⁰ However, the SEC's adopted version of these rules turned out to be largely toothless compared to the June Proposed Rules.¹¹¹

In addition to the SEC's June 2008 Proposed Rules, in July 2008, the SEC issued its Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies.¹¹² This report was the culmination of an almost yearlong thorough examination conducted by the SEC.¹¹³

Although the firms under examination became subject to regulation as NRSROs when they registered with the Commission as NRSROs in September 2007, and were therefore not subject to legal obligations applicable to NRSROs during most of the review period, "the [SEC] nonetheless sought to make relevant

¹⁰⁸ The Financial Economists Roundtable is a "15-year-old group of top economists from around the world that meets every year to tackle economic issues." *Do the SEC's New Rating Agency Rules Have Any Bite?*, *supra* note 72.

¹⁰⁹ Financial Economists Roundtable, Statement on Reforming the Role of the Statistical Ratings Organizations in the Securitization Process (Dec. 1, 2008), <http://fic.wharton.upenn.edu/fic/Policy%20page/FER12%201%2008rev.pdf>.

¹¹⁰ *SEC adopts new rules for credit-rating agencies*, INT'L HERALD TRIB., Dec. 3, 2008, available at <http://www.ihf.com/articles/ap/2008/12/03/business/NA-US-SEC-Rating-Agencies.php>. While these rules were adopted December 3, 2008, they were published February 2, 2009, and they were made effective April 10, 2009. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342 (Feb. 2, 2009) <http://www.sec.gov/rules/final/2009/34-59342.pdf>.

¹¹¹ *Do the SEC's New Rating Agency Rules Have Any Bite?*, *supra* note 72. These new rules do ban agencies from rating securities they helped create, bar raters from accepting gifts worth more than \$25 from clients, mandate disclosure of statistics on upgrades and downgrades, and require description of information verification steps taken. However, these rules do not adopt the proposed extra requirements on ratings for complex securities. *Id.* Additionally, the rules that proposed reduced use of ratings in SEC regulations were not adopted. *Id.* This ends up being the SEC adopting the equivalent of a "quarter of a loaf" as described by one Wharton finance professor. *Id.* Another Wharton finance professor noted the original June proposal as being "very bold," but the new rules are "very limited." *Id.* This seems to follow a trend of the government doing very little to really interfere in the agencies' actions. Ironically, one of the major rules adopted by the SEC, the new ban on agencies from rating securities they helped create, is commendable in theory, but may be ultimately unenforceable. *Id.* Because there is so much back and forth in the normal rating process it may be "impossible for the courts to distinguish ratings services from advisory services in a definitive way." *Id.* at 3. Additionally, the June proposal for reduced use of ratings in SEC regulations, could have been the most valuable as it would have limited the government mandated use of agencies, forced investors to do more research on their own, and ultimately decreased the massive amounts of power the agencies hold. *Id.* It seems unfortunate that the SEC did not adopt this proposal.

¹¹² OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46.

¹¹³ This examination began on August 31, 2007, and review period generally covered January 2004 through July 2008. *Id.* It was conducted by the Staff in the Commission's Office of Compliance Inspections and Examinations ("OCIE"), Division of Trading and Markets ("Trading & Markets") and Office of Economic Analysis ("OEA Staff"). *Id.* at 3. It included examinations of Fitch, Moody's and S&P with respect to their activities in rating subprime MBSs and CDOs. *Id.* According to the SEC:

The examinations included extensive on-site interviews with the rating agencies' staff, including senior and mid-level managers, initial ratings analysts and surveillance analysts, internal compliance personnel and auditors, personnel responsible for building, maintaining and upgrading the ratings models and methodologies used in the ratings process and other relevant rating agency staff.

Id.

factual findings and observations with respect to the activities of these firms in rating subprime RMBS and CDOs during the period, as well as to identify possible areas for improvement in their practices going forward.”¹¹⁴ This examination led the SEC to conclude that there were failures by the agencies in seven key areas: (1) the rating agencies dealing with market growth; (2) ratings process disclosure; (3) ratings policies and procedure documentation; (4) implementation of new practices; (5) documentation; (6) internal surveillance processes; and (7) management of Conflicts of Interest.¹¹⁵

1. The Rating Agencies Struggled to Keep up with the Increasing Number and complexity of deals

The SEC found that from 2002 to 2006, the volume and complexity of RMBS and CDO deals rated by the rating agencies increased exponentially.¹¹⁶ While the agencies increased staffing percentage-wise to match the increase in MBS deal volume, their staffing appeared to lag with regard to the increase in CDO deal volume.¹¹⁷ Additionally, the agencies appeared to struggle to adapt to the increased complexity of the instruments the agencies were asked to rate.¹¹⁸ However, even with this struggle, the agencies pushed for continued ratings in a business-as-usual manner.¹¹⁹

The SEC recommended each NRSRO evaluate whether it has sufficient staff and resources to manage its volume of business and meet its obligations under section 15E of the Exchange Act and the rules applicable to NRSROs.¹²⁰

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 10-13.

¹¹⁷ *Id.* It could be that the agencies did not want to increase staffing costs. This however, seems to not address the agencies’ desire to handle as much business as possible and be as profitable as possible.

¹¹⁸ This increased complexity arose from expanded use of credit default swaps as well as RMBSs, became more complex and less conservative. *Id.* It also may be that due to the increased complexity of these products it was difficult to find qualified individuals to fill the positions needed. The agencies probably also just had no idea how large, and how fast the market for these complex securities would explode, and couldn’t find people to keep up with the complexity and the workload. It sounds like there was a great deal of burnout. The SEC report does not address this, but the employees of the agencies were not compensated nearly as much as the employees for the issuers and other parties to the securitization process. With their experience, there was probably great incentive to leave the agencies for higher paying positions elsewhere.

¹¹⁹ In one now famous email exchange, an analyst expressed concern that her firm’s model did not capture “half” of the deal’s risk, but that “it could be structured by cows and we would rate it.” *Id.* at 12.

¹²⁰ *Id.* This evaluation was to be conducted both at the time of the recommendation and on a continuing periodic basis. *Id.* at 10-13. While this sounds good, it seems that telling the agencies that they need to evaluate their workforce is no real answer. It would seem logical that they are already aware of their staffing levels, particularly given the internal emails addressing this problem which are referenced in the SEC report.

2. *The Agencies Failed to Disclose Significant Aspects of the Rating Process*

While the rating agencies stated to the SEC that they had always disclosed their MBS and CDO ratings process, certain significant aspects of their ratings processes and methodologies were not always disclosed, or were not fully disclosed.¹²¹

Prior to being registered as NRSROs, the rating agencies did not have a regulatory requirement to disclose their methodologies. In September 2007, three major agencies became subject to these rules. They are required to submit detailed descriptions of the procedures and methodologies they use.¹²² The Exchange Act and rules applicable to NRSROs specifically delineate the importance of disclosure.¹²³

The SEC stated that each NRSRO must conduct a review of its current disclosures relating to processes and methodologies for rating RMBS and CDOs to assess whether it fully discloses its ratings methodologies in compliance with section 15E of the Exchange Act and the rules applicable to NRSROs.¹²⁴ Further, the SEC recommended that each NRSRO be examined to review whether its policies governing the timing of disclosure of a significant change to a process or methodology are reasonably designed to comply with these requirements.¹²⁵ Each examined NRSRO stated that it will implement the staff's recommendations.¹²⁶

The SEC noted that under its Proposed Rules it sought to require enhanced disclosure about the procedures and methodologies that NRSROs use to determine credit ratings.¹²⁷ The Proposed Rules also seek to add additional areas that an

¹²¹ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 13. This lack of disclosure included use of unpublished ratings criteria, failure to disclose materials used in the ratings process, disclosure of a criteria report that was obsolete, use of an obsolete model, lag time between announcement of implementation of ratings procedure, regularly making of "out of model adjustments" without rationale documentation, reducing subprime loss expectations from model projections, and not adjusting collateral or cash flow analysis based upon factors not included in the firms models. *Id.*

¹²² *Id.* at 15. Since the government mandates reliance on these ratings, it seems the government should know how these ratings are being calculated.

¹²³ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 15.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.* at 15. Additional proposals included requiring the NRSROs to provide descriptions of:

[P]olicies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; the quantitative and qualitative models and metrics used to determine credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings; and procedures to withdraw, or suspend the maintenance

applicant and a registered NRSRO would be required to address in its description of its procedures and methodologies in its registration form (“Form NRSRO”).¹²⁸

3. *The Agencies Lacked Written Policies & Procedures for Complex Securities*

The rating agencies have always had in-house policies which emphasized integrity-driven accurate ratings.¹²⁹ When the agencies registered as NRSROs in September 2007, they became required to make and retain specific internal documents.¹³⁰ The SEC noted that while the agencies had improved their policies and procedures during the examination period, none of the rating agencies examined had specific written procedures for all significant aspects of the process of rating RMBSs and CDOs.¹³¹ Additionally, the SEC noted that it did not appear that the agencies had specific policies and procedures to identify or address errors in their models or methodologies.¹³²

The SEC recommended that each NRSRO conduct an internal review and be sure that its written MBS and CDO ratings policies and procedures are fully documented in accordance with the requirements of Rule 17g-2.¹³³

of a credit rating.

Id. at 15 n.18. These proposals were adopted by the SEC. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 110, at 12.

¹²⁸ These NRSRO registration form changes include:

How frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings;

Whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings; and

Whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction play a part in the determination of credit ratings.

Id. at 16.

¹²⁹ *Id.* While these policies were in place, it is not clear to what extent they were actually observed. Clearly, at least to some degree, the SEC investigation shows a propensity for the agencies to engage in less than transparent procedures.

¹³⁰ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 16. Some of these requirements include: records pertaining to accounting, employee identities, customers, subscribers, products offered, procedures and methodologies, securities rated, internal affairs, credit analysis, compliance, internal audits, marketing materials, and communications. Records to be made and retained by NRSROs, 17 C.F.R. § 240.17g-2 (2009).

¹³¹ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 16. The SEC noted that this lack of documentation made it difficult for SEC Staff to confirm that the individual ratings complied with policies and procedures. It also noted that this lack of documentation could also impede the effectiveness of internal and external auditors conducting reviews of rating agency activities. *Id.*

¹³² *Id.* at 16-17.

¹³³ *Id.* at 17. Each examined agency stated that it will conduct this review. *Id.*

4. *The Agencies Lacked Issuer Due Diligence Requirements*

Presently there are no requirements that the rating agencies verify information in MBS loan portfolios.¹³⁴ Additionally, there are no requirements that the agencies request performance of due diligence on any of the information they receive.¹³⁵ Nor are they required to obtain information about the level of due diligence that has or has not been performed by the issuers supplying them with information.¹³⁶ In fact, each rating agency publicly disclosed that it did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying their ratings.¹³⁷ While all of the rating agencies examined have implemented, or announced that they would implement, measures that are designed to improve the integrity and accuracy of the loan data they receive on underlying RMBS pools,¹³⁸ as of the time of this writing, all three agencies' websites continues to contain extensive language disclaiming they do not engage or require any sort of due diligence.¹³⁹

¹³⁴ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 17.

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.* at 17-18. This again proves the agencies' attempts to disclaim any and all responsibility for their ratings. While this probably should not even be acceptable for transactions where they were truly brought in at arms-length, it becomes especially dubious in situations where they were involved in the actual process of creating of securities.

¹³⁸ *Id.* at 18. In January 2008, one agency began conducting more extensive reviews of mortgage originations and their practices, including a review of originator/conduit/issuer due diligence reports and a sample of mortgage origination files for all subprime transactions. *Id.* This same agency had conducted an internal review of forty-five loan files and reported that it had found the appearance of fraud or misrepresentation in almost every file. *Id.* Another agency announced that after May 1, 2008, it was requesting updated loan level performance data from issuers on a monthly basis. *Id.* It also intended to incorporate the quality of an originator's fraud tools and detection policies into its ratings criteria by mid-year 2008. *Id.* Additionally, all three of the major rating agencies agreed to develop and publicly disclose due diligence criteria to be performed by underwriters on all mortgages comprising MBSs, and to review those results prior to issuing ratings. *Id.*

¹³⁹ Moody's code of conduct on its website currently includes:

[Moody's] has no obligation to perform, and does not perform, due diligence with respect to the accuracy of information it receives or obtains in connection with the rating process. [Moody's] does not independently verify any such information. Nor does [Moody's] audit or otherwise undertake to determine that such information is complete. Thus, in assigning a Credit Rating, [Moody's] is in no way providing a guarantee or any kind of assurance with regard to the accuracy, timeliness, or completeness of factual information reflected, or contained, in the Credit Rating or any related [Moody's] publication.

Moody's, *Code of Professional Conduct*, Nov. 6, 2008, http://v2.moody.com/cust/content/Content.ashx?source=StaticContent/Free%20Pages/Regulatory%20Affairs/Documents/professional_conduct.pdf
f. S.&P.'s code of conduct on its website currently includes:

[S.&P.] is not obligated to perform any due diligence or independent verification of any information submitted to, or obtained by, [S.&P.] in connection with its rating and surveillance processes. [S.&P.] does not perform an audit and does not undertake to verify that the information submitted to, or obtained by, [S.&P.] is complete. Ratings are not verifiable statements of fact. The assignment of a rating to an issuer or an issue by [S.&P.] should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. [S.&P.] reserves the right at any time to suspend, modify, lower, raise, or withdraw a rating or place a rating on CreditWatch in accordance with

The SEC's Proposed Rules include two additional due diligence requirements which include:

Whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings; and

Whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction play a part in the determination of credit ratings.¹⁴⁰

5. *The Agencies Failed to Document Major Steps in the Rating Process*

After September 2007, the agencies became required to retain their internal records, including any non-public information and work-product, used to form the basis of their ratings.¹⁴¹ Prior to September 2007, the agencies had established policies and procedures generally requiring documentation of their ratings committee processes and key deliberations.¹⁴² However, the agencies did not always fully document certain significant steps in their subprime MBS and CDO ratings processes.¹⁴³ This made it difficult or impossible for the SEC to assess

its policies, guidelines and procedures.

Standard & Poor's, *Ratings Services Code of Conduct*, Dec. 2008, at 3, http://www2.standardandpoors.com/spf/csv/equity/Code_of_Conduct_December%202008.pdf?vregion=us&vlang=en. Fitch's code of conduct currently includes:

Ratings are based on information obtained directly from issuers, other obligors, underwriters, their experts and other sources Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of such information and has undertaken no obligation to so audit or verify such information or to perform any other kind of investigative diligence into the accuracy or completeness of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate and Fitch assumes no responsibility for this risk. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information.

Fitch Ratings, *Code of Conduct*, Jan. 2009, at 16-17, http://www.fitchratings.com/web_content/credit_policy/code_of_conduct.pdf.

¹⁴⁰ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 46, at 19.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.* Specifically the SEC noted lax documentation for: reasoning for deviating from models, rating committee actions and decisions, and identification of major process participants. *Id.* Rationale for deviations from the model or out of model adjustments was not always documented, this led to the SEC being unable to understand the process leading to a rating and identifying the factors that led to the ultimate rating. *Id.* Lack of documentation on committee actions and decisions included: rating committee vote tallies being rarely documented despite being a required item; numerous deal files failing to include required addenda and/or included no documentation of the ratings surveillance process; failures to make or retain committee memos and/or minutes; and failures to include certain relevant information in committee reports. *Id.* Lack of documentation on internal procedures and analysts and/or ratings committee participants approving ratings included: lack of documentation of

compliance and identify factors considered when developing ratings.¹⁴⁴ This lack of documentation also made it difficult for the rating agencies' internal staff to review activities and assess compliance with the firms' policies.¹⁴⁵

Since September 2007, NRSROs are required to make and retain certain records relating to their businesses and to retain certain other business records made in the normal course of business operations which include identities of any credit analyst(s) participating in determining a rating; the identity of the person(s) approving the rating before issuance; an indication of whether the rating was solicited or unsolicited; and the date of the rating action.¹⁴⁶

The SEC again recommended that each examined NRSRO conduct a review of its documentation policies and practices to ensure compliance with Rule 17g-2.¹⁴⁷ Each NRSRO stated that it would implement the staff's recommendations.¹⁴⁸

In the SEC's Proposed Rules there was an amendment that would require that if a quantitative model was a substantial component of a ratings process, the rating agency would be required to keep a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued.¹⁴⁹

6. *The Agencies Engaged in Low Quality Surveillance*

Rating agencies are not required to perform surveillance,¹⁵⁰ but they often have done so in order to change the ratings when circumstances indicate that a change is required.¹⁵¹ The SEC found that resources devoted to surveillance were limited, making surveillance and any accompanying surveillance documentation limited.¹⁵² This occurred while the agencies claimed they carried out surveillance.

committee attendees even though internal procedures called for it. *Id.* at 20.

¹⁴⁴ *Id.* at 19.

¹⁴⁵ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 19.

¹⁴⁶ *Id.* at 20.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* The SEC adopted this proposed rule. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 110, at 98-99.

¹⁵⁰ *Id.* at 21.

¹⁵¹ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 21.

¹⁵² *Id.* Specifically, the SEC found the surveillance process to be of an even lower quality than that of the initial ratings process. *Id.* A large reason for this seems to be due to a lack of resources. *Id.* Internal emails demonstrate the lack of employees; in one email addressing surveillance, a manager wrote:

I have been thinking about this for much of the night. We do not have the resources to support what we are doing now. I am seeing evidence that I really need to add to the staff to keep up with what is going on with sub prime and mortgage performance in general, NOW.

Id. at 21 n.29 (internal quotation marks omitted). This caused surveillance to be untimely at best. *Id.* at 21. At worst, the lack of follow up was ridiculous. Scott McCleskey, head of compliance at Moody's from April 2006 to September 2008 testified that some ratings were not reviewed, sometimes for decades. Gretchen Morgenson, *When Bond Ratings Get Stale*, N.Y. TIMES, Oct. 11, 2009, at BU1, available at <http://www.nytimes.com/2009/10/11/business/economy/11gret.html>. The agencies often lacked procedures and policies to perform surveillance. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 22. When there were procedures and policies in place, the

Therefore, changes that should have been made to a security's rating often did not happen.

The SEC noted under the Exchange Act that the NRSROs are required to publicly disclose their procedures and methodologies used to determine ratings.¹⁵³ The SEC recommended that the NRSROs review their resources devoted to surveillance of existing MBS and CDO ratings to determine adequacy.¹⁵⁴ Additionally, the SEC recommended the NRSROs ensure that they have comprehensive written surveillance procedures, and that they maintain appropriate surveillance records.¹⁵⁵

Under the SEC's Proposed Rules, the SEC proposed enhanced disclosure of procedures and methodologies that the NRSROs would use to determine credit ratings, which would include disclosing how frequently credit ratings are reviewed, whether surveillance models and criteria equal their initial rating model counterparts, whether changes to initial rating models and criteria are applied retroactively to surveilled ratings, and whether changes made to surveillance models and criteria are incorporated into initial ratings models and criteria.¹⁵⁶

7. *The Agencies Failed to Properly Manage Conflicts of Interest*

a. The "Issuer Pays" Conflict

Similar to the allegations by the agencies' own former executives,¹⁵⁷ the SEC found that the "issuer pays" model involves an inherent conflict of interest.¹⁵⁸ SEC policies require NRSROs to "establish, maintain and enforce policies and procedures reasonably designed to address and manage conflicts of interest."¹⁵⁹ The NRSROs have their own policies emphasizing their ratings' accuracy and integrity.¹⁶⁰ These policies include restricting analysts from participating in fee

agencies often failed to follow them. *Id.* Often surveillance did not occur, or if it did, the company could not process its own surveillance. *Id.* One internal email stated, "[i]f I were the S.E.C. I would ask why can [sic] you go back and run the report for each of the months using the same assumptions? In theory we should be able to do this." *Id.* at 22 n.31 (internal quotation marks omitted). So it does not seem as though the agencies did not know this was going on. It appears that they were overworked, and the last thing they were addressing was re-rating securities they had already initially rated. It would seem that this lack of surveillance would hurt the agencies' reputations, but they did not seem to care, as there was blatant lack of surveillance.

¹⁵³ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 22. This lack of surveillance may be addressed under the SEC's power to censure, limit the activities, functions, or operations of, suspend, or revoke the registration of an NRSRO that fails to maintain adequate financial and managerial resources to produce credit ratings with integrity. *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 22-23. The SEC adopted this proposed rule. *See also* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 110, at 14.

¹⁵⁷ *See supra* Part III.B.1.

¹⁵⁸ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 23. SEC rules specify that a conflict of interest exists if an NRSRO being paid by issuers or underwriters to rate their securities. *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* Practically every major company has similar policies. This does not seem to mean much, especially in light of the SEC finding numerous questionable actions in its investigation.

discussions with issuers.¹⁶¹ While these policies existed, the SEC found key participants in the ratings process still participated in fee discussions.¹⁶²

The SEC's Proposed Rules included a proposal to amend existing rules to disallow NRSRO employees from being involved in both fee discussions and ratings decisions.¹⁶³ This amendment prohibits an NRSRO from having an individual participate in any fee discussions or arrangements when that individual has participated in developing, determining, or approving procedures or methodologies used for determining credit ratings.¹⁶⁴

"Analysts appeared to be aware, when rating an issuer, of the rating agency's business interest in securing the rating of the deal."¹⁶⁵ The SEC staff noted multiple communications indicating that some analysts were aware of the firm's fee schedules and actual fees.¹⁶⁶ There did not appear to be any shielding analysts from emails and other communications that discussed fees.¹⁶⁷

b. The "Market Share and Business Interests" Conflict

While there was no evidence that ratings methodologies, models, or decisions were based on attracting or losing market share,¹⁶⁸ the SEC did find evidence that employees involved in the ratings process voiced concern about market share to other employees involved in the ratings criteria developing department.¹⁶⁹

Under current regulations,¹⁷⁰ in addition to NRSROs being required to establish, maintain, and enforce policies and procedures reasonably designed to take into consideration the nature of its business and address and manage conflicts of interest, they are further prohibited from having certain conflicts unless they disclose the type of conflict and implement policies and procedures to address and manage it.¹⁷¹

¹⁶¹ *Id.* at 23-24. The idea behind these policies is separation of the individuals who set and negotiate fees from the individuals who actually engage in the rating process. This is in an effort to mitigate the possibility or perception that an agency would link its ratings to its fees. *Id.* This does not appear to in any way mitigate the financial relationship between the companies though, and in no way did this seem to slow the rating agencies' propensity to slap ratings on everything including "cows." See *supra*, note 119.

¹⁶² OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 24. Some of the agencies implemented policy changes in 2007 to address analytical personnel being involved in fee discussions. *Id.*

¹⁶³ Amendments to Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 110, at 43. This amendment was adopted by the SEC in April 2009. *Id.* at 43-44.

¹⁶⁴ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 24.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* at 25. This included emails between analysts and management discussing fees, as well as even analysts discussing fees with billing departments of issuing clients. *Id.*

¹⁶⁸ *Id.* at 25.

¹⁶⁹ *Id.*

¹⁷⁰ See section 15E(h)(1) of the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78o-7(h)(1) (2006)); Rule 17g-5 of the Securities Exchange Act (found at 17 C.F.R. § 240.17g-5(b)(6)).

¹⁷¹ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 26 ("Included among these conflicts is being paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.").

Each NRSRO agreed to implement the SEC's recommendations which included reviewing "practices, policies and procedures" for mitigating and managing this conflict of interest.¹⁷²

The SEC noted its Proposed Rules called for necessitated disclosure on assets underlying a security to issue or maintain a rating.¹⁷³ This allows other parties to rate the security allowing for greater accountability by the NRSROs.¹⁷⁴

c. The Internal Audit Process Conflict

The SEC concluded that the rating agencies varied in their internal audit programs and compliance with these programs.¹⁷⁵ Only one of the three appeared adequate in terms of assessing compliance with internal control procedures.¹⁷⁶

According to Exchange Act Rule 17g-2(b)(5), NRSROs are required to "maintain internal audit plans, reports and related follow-up documents, including internal audit plans and reports, documents relating to audit follow-up measures and documents identified by auditors as necessary to audit an activity relating to the NRSRO's business as a rating agency."¹⁷⁷ Both of the NRSROs which did not conduct acceptable audits agreed to the SEC's request to review their internal audit functions and subsequent management follow-up, particularly in the RMBS and CDO ratings areas.¹⁷⁸

In summary, with respect to these previous seven areas, the SEC found that from 2002 to 2006, the agencies struggled to keep up with the increasing number and complexity of deals, failed to disclose significant aspects of the rating process, lacked written policies & procedures for complex securities, lacked issuer due diligence requirements, failed to document major steps in the ratings process, engaged in low quality surveillance, failed to properly manage the "issuer pays" conflict of interest, mishandled their focus on market share, and failed to maintain quality internal audit processes.¹⁷⁹ Amazingly, with all of these shortcomings, the SEC's response was, basically, "do better."¹⁸⁰ The SEC "recommended" changes, many of which were required under the 2006 Credit Rating Agency Reform Act. However, the SEC still had no real power to regulate "the substance of the credit ratings or the procedures and methodologies."¹⁸¹ This left the SEC as an observer,

¹⁷² *Id.* at 27 ("In particular, the [s]taff recommended that each NRSRO examined consider and implement steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.").

¹⁷³ *Id.* This proposed rule was adopted by the SEC. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, *supra* note 110, at 69.

¹⁷⁴ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 27.

¹⁷⁵ *Id.* at 29. The SEC examined the internal audit portion of their investigation for the time period January 2003 to November 2007. *Id.*

¹⁷⁶ *Id.* This sole agency conducted substantive audits of the securities MBSs & CDOs it rated, as well as reviews of particular concerns. *Id.* at 30. Additionally, management responded adequately to recommendations arising from the audits. *Id.* One of the other two agencies only performed cursory MBS and CDO audits, while the other agency's audits were full of shortcomings. *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Id.* at 3.

¹⁸⁰ OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, *supra* note 46, at 10-20.

¹⁸¹ *Id.* at 4.

who can and did expose harmful practices, but cannot do much more than that. It is clear in the SEC's report it was a weak observer, choosing to constantly recommend strengthening practices and changing methods, but never clearly and succinctly stating something was wrong, even when something clearly was.

V. LIABILITY EXPOSURE

Regulation has historically been kept away from the complex financial product that the ratings agencies rate.¹⁸² It has been only recently that regulators became interested in the rating agencies. Such interest was sparked in 2001, when the agencies failed to adjust ratings down from investment grade on the ordinary debt of Enron Corporation until four days before Enron filed for bankruptcy.¹⁸³ A subsequent tidal wave of legislative and administrative activity pertaining to the agencies ensued.¹⁸⁴ Congress' response included the previously discussed 2006 Credit Rating Agency Reform Act, which ultimately imposed a small measure of regulatory oversight on the NRSROs, which, until then, were essentially unregulated.¹⁸⁵ The previous lack of regulation has historically left the tort system and the market to serve as checks on these agencies.¹⁸⁶

Securitized products in general lacked early litigation challenging their legal underpinnings.¹⁸⁷ The ratings agencies not only lacked early legal challenges like the securitization process in general, but subsequently the agencies have successfully avoided liability when legal challenges have occurred.¹⁸⁸ Much of

¹⁸² Moran, *supra* note 11.

¹⁸³ Kettering, *supra* note 66, at 1674.

¹⁸⁴ *Id.* at 1674-75. This included at least nine separate congressional hearings, a major congressional staff report, and usual reports on the legislation as enacted and predecessor bills. *Id.* In addition, the SEC held its own hearings, issued a congressionally-mandated report, and floated proposals for changing the regulatory treatment of rating agencies before Congress took the subject into its own hands. *Id.* It is interesting that this wave of political action occurred after the Commodity Futures Modernization Act of 2000 was passed. *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified in scattered sections of 7 U.S.C.). Effectively, the government deregulated complex securitized instruments, and then turned around and voted for more regulation of the ratings agencies, when the political fallout from Enron occurred. *See* Kettering, *supra* note 66. It would seem these two courses could contradict, but the Commodity Futures Modernization Act of 2000 actually allowed the SEC to inspect ratings agencies (more oversight); it also attempted to open the door to free market competition in the rating industry by allowing new agencies to achieve NRSRO designation. Leone, *supra* note 105.

¹⁸⁵ *See, e.g.,* Husisian, *supra* note 33.

¹⁸⁶ *Id.*

¹⁸⁷ *See* Kettering, *supra* note 66, at 1672. There are many theories as to why the securitization process did not come under legal attack in its early years. *Id.* This failure to come under early attack has led to securitization becoming "too big to fail." *Id.* at 1672-74. The ratings agencies have been thought to contribute to the "too big to fail" status of securities. *Id.* This is because they created securitized products that will survive challenge in an originator's bankruptcy by the originator appropriately setting the ratio of assets in the pool to the amount of debt issued, so the resulting instrument was rated at a high investment grade, superior to the originator's own credit rating, allowing the originator to obtain financing at the lower interest rates associated with the highly-rated debt it would have been otherwise unable to obtain. *Id.*

¹⁸⁸ *See id.* at 1687, 1691 (noting that NRSROs have been very successful in avoiding liability for allegedly incorrect ratings).

this success has arisen from active protections in security laws.¹⁸⁹

One commenter stated that in the relatively few cases in which anyone has tried to pursue the rating agencies, “the only common element . . . is that the rating agencies win.”¹⁹⁰ This success has often been based on commonplace defenses.¹⁹¹

A. Common Defenses

Investors who wish to claim that dealing with a rating agency has established, by contract, a greater standard of care by the agency,¹⁹² will find the agencies have not only not negotiated such contracts, but have explicitly disclaimed liability.¹⁹³ The agencies hide behind the claim that they rely on information provided to them by others, and therefore, they are not responsible for any errors or omissions or for the results obtained from use of that information.¹⁹⁴

The argument that a bond rating agency is an investor’s fiduciary fails because in the investment field fiduciary duties are implied only where there is a more specialized relationship than that which exists between a rating agency and its subscribers.¹⁹⁵ Additionally, courts would risk a potential chilling effect on credit ratings if they imposed a negligent misrepresentation standard because there is no fiduciary relationship or contractual relationship.¹⁹⁶

The agencies have consistently claimed “they are financial publishers whose ratings are equivalent to newspaper editorials.”¹⁹⁷ They claim that a rating is an “unfalsifiable opinion.”¹⁹⁸ Therefore, it is wholly protected, or in the alternative,

¹⁸⁹ A 2002 congressional staff study noted that NRSROs are “officially shielded from liability for all but fraud under the securities laws” and are “not held even to a negligence standard of care for their work.” *Id.* at 1687.

¹⁹⁰ *Id.* at 1688.

¹⁹¹ *Id.* (such as lack of duty to an aggrieved investor and the unreasonableness of an investor relying on a rating).

¹⁹² Husisian, *supra* note 33, at 456.

¹⁹³ *Id.*

¹⁹⁴ *See id.* For current disclaimers by the agencies, see resources cited in note 138.

¹⁹⁵ Husisian, *supra* note 33, at 457. In his article, Husisian notes:

As the parties’ relationship changes from one of private counseling to one of public offerings of information, the client’s fiduciary interest declines, and the publisher’s first amendment protections increase. Once the publication reaches the level of general publishing, where the clients are known to the publisher only as names on a mailing list, the publishers’ fiduciary duty diminishes to zero. Thus, Standard & Poor’s has ample support for its contention that “[ratings] do not create a fiduciary relationship between Standard & Poor’s and users of the ratings since there is no legal basis for the existence of such a relationship.”

Id. at 458 (citing S & P DEBT RATINGS CRITERIA 3 (Roy Weinberger ed. 1986).

¹⁹⁶ *Id.* at 455.

¹⁹⁷ Kettering, *supra* note 66, at 1689. Several courts have accepted this argument. *See infra* Part V.A.

¹⁹⁸ Kettering, *supra* note 66, at 1689. According to Husisian, the agencies contend that:

Ratings are editorial opinions, published in letter form. The purpose of any editorial, whether or not it is in the financial arena, is to communicate information to the reader. The form of the speech is irrelevant, as the Court has recognized by granting first amendment protections to certain symbolic acts, such as flag-burning. The first amendment is only concerned with whether ideas are

they claim that it is about a matter of public interest and is protected by the “actual malice” standard laid down in *New York Times Co. v. Sullivan*.¹⁹⁹ Some courts have accepted this argument.²⁰⁰ Even Congress took the First Amendment argument seriously when it deliberated about the Credit Rating Agency Reform Act.²⁰¹

This First Amendment defense will have to be litigated further. While “the First Amendment has been held by the Supreme Court to protect the editorial content of [financial] newspapers and newsletters,”²⁰² ratings may be distinguished from these. It will remain to be seen whether those distinctions will be constitutionally significant.²⁰³

B. Has the Credit Rating Agency Reform Act Changed Anything?

Instead of the 2006 Credit Rating Agency Reform Act opening the door to liability against the ratings agencies, it may have pushed the door even further closed.²⁰⁴ The Act forecloses the argument that a rating agency’s election to register as an NRSRO can be viewed as a waiver of any First Amendment protection that might otherwise apply.²⁰⁵ Additionally, instead of creating any new private rights of action, depending on future interpretation, this legislation might be read to actually immunize the rating agencies from tort liability stemming from allegedly inaccurate ratings.²⁰⁶ One sentence in this legislation states

being communicated from one person to another, and not the form of the communication.

It is apparent, therefore, that bond ratings are indeed the world’s shortest editorials. As editorials, courts should grant them the same deference they grant any other protected first amendment publication. Ratings merely provide a simple means for consumers to compare rough levels of risk among varying companies and industries.

Husisian, *supra* note 33, at 454-55.

¹⁹⁹ *N.Y. Times Co. v. Sullivan*, 376 U.S. 254 (1964); *Kettering*, *supra* note 66, at 1689.

²⁰⁰ *Kettering*, *supra* note 66, at 1689 n.450 (citing *Compuware Corp. v. Moody’s Investors Servs., Inc.*, 499 F.3d 520 (6th Cir. 2007); *Jefferson County Sch. Dist. No. R-1 v. Moody’s Investor’s Servs., Inc.*, 175 F.3d 848 (10th Cir. 1999); *In re Enron Corp. Sec., Derivative & “ERISA” Litig.*, 511 F. Supp. 2d 742 (S.D. Tex. 2005); *County of Orange v. McGraw Hill Cos., Inc.*, 245 B.R. 151 (C.D. Cal. 1999); *Commercial Fin. Servs., Inc. v. Arthur Andersen LLP*, 94 P.3d 106 (Okla. Civ. App. 2004); *LaSalle Nat’l Bank v. Duff & Phelps Credit Rating Co.*, 951 F. Supp. 1071 (S.D.N.Y. 1996)).

²⁰¹ During these deliberations the agencies raised First Amendment objections which led to the revision of an early version of the legislation. *Kettering*, *supra* note 66, at 1689-90. Even after the law passed, the agencies still stuck to these objections.

²⁰² *Id.* at 1690, n.453 (citing *Lowe v. SEC*, 472 U.S. 181 (1985)).

²⁰³ Some courts have noted that the “issuer pays” model is unlike ordinary journalists being paid by a (hopefully) neutral party, while other courts have not. *Kettering*, *supra* note 66, at 1690, n.454 (citing *Commercial Fin. Servs.*, 94 P.3d at 110; *LaSalle Nat’l Bank v. Duff & Phelps Credit Rating Co.*, 951 F. Supp. 1071, 1095-97 (S.D.N.Y. 1996)). Another proposition is that rating agencies are associated with the structuring of a transaction, therefore they are too dissimilar from common journalistic activity to merit journalist legal protection. *Id.* at 1690-91 n.455 (citing *In re Fitch, Inc.*, 330 F.3d 104, 110-11 (2d Cir. 2003)).

²⁰⁴ *Id.* at 1688.

²⁰⁵ *Id.* at 1691.

²⁰⁶ The 2006 Credit Rating Agency Reform Act forecloses the argument that a rating agency’s election to register as an NRSRO can be viewed as a waiver of any First Amendment protection that

“[n]otwithstanding any other provision of law,” no state or political subdivision “may regulate the substance of credit ratings.”²⁰⁷ This sentence raises the question of whether state law is preempted from extending application of ordinary tort law to an allegedly inaccurate rating; whether it does will turn on the interpretation of “regulat[ing] the substance” of a rating.²⁰⁸

C. Barrier to Litigation: Complexity of the Ratings Process

In the past, the idea of holding ratings agencies to a negligence standard has been proposed but issues have been raised.²⁰⁹ One issue with attempting to litigate with a negligence standard against the rating agencies is that securitization and the ratings process is very complex and specialized.²¹⁰ Most jurors are unfamiliar with the field, and would “have great difficulty distinguishing significant factors from insignificant ones.”²¹¹ Therefore any negligence standard may be difficult for an agency to be held to because of the lack of clarity about what is reasonable, and what is negligent.²¹² Additionally, past commentators have stated the agencies have a high degree of accuracy.²¹³ This accuracy, coupled with the inherent complexity has resulted in a situation where only major instances of clear negligence could be pursued.²¹⁴ Possible clear enough negligence has not existed, until now.

might otherwise apply. *Id.* at 1691.

²⁰⁷ Securities Exchange Act of 1934 §15E(c)(2) as added by the 2006 legislation. The statute reads in full as follows:

Limitation--The rules and regulations that the Commission may prescribe pursuant to this title, as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations. Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings.

²⁰⁷ Securities Exchange Act of 1934 §15E(c)(2) as added by the 2006 legislation. The statute reads in full as follows:

Securities Exchange Act of 1934 §15E(c)(2) (2008). After the legislation had been reported out of committee, this sentence was slipped in through a last-minute amendment, made on the Senate floor. Kettering, *supra* note 66, at 1688-89.

²⁰⁸ Kettering, *supra* note 66, at 1689. Language elsewhere by the same floor amendment preserves the power of state securities commissions to bring enforcement actions against rating agencies with respect to “fraud or deceit.” *Id.* This would seem to discourage a broad reading of “regulate the substance.” *Id.* Additionally, congressional intent reflects a desire to impose some modest controls on the rating agencies. *Id.* Nowhere does congressional intent approach the notion of awarding the rating agencies immunity from any risk of tort liability on account of their ratings. *Id.* However, “plain language” interpretation may promote this interpretation. *Id.*

²⁰⁹ Husisian, *supra* note 33, at 443.

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.*

D. Future Litigation

The SEC's findings may set the stage for potential disclosure-related claims by purchasers of subprime RMBS and CDOs against the rating agencies.²¹⁵ Failure by the agencies to disclose modeling risks or other practices may amount to materially false or misleading statements.²¹⁶ Additionally, the numerous conflicts of interest issues raised by the SEC could clearly weigh against the agencies.²¹⁷

Rating agencies will defend themselves by claiming they used proven modeling, material process disclosure, and appropriate on-going surveillance.²¹⁸ They will also claim their models were valid and accurate when made,²¹⁹ and the ensuing downgrades were due to market failure, coupled with appropriate surveillance.²²⁰ However, the notion of existence of appropriate surveillance seems preposterous when it is considered that at least ten of the large companies that failed or were bailed out in 2008 had investment grade ratings when they went under.²²¹ It would seem ridiculous that an "appropriate surveillance" defense could be used on far more complex securities if the agencies could not even remotely accurately conduct surveillance on large companies with relatively transparent books.

The defense that then-made assertions were valid and "no one could have foreseen this" will probably be raised by many companies and individuals. However, many people held positions where they were responsible for understanding what they were analyzing. Their jobs as analysts were to literally understand the risk. It would not seem incredulous that with even a small amount of foresight all one of these individuals would have to do would be to realize that lending to consumers was out of control and unsustainable, which would, in turn, cause a decrease in the payouts of underlying securities and therefore a decline in these securities' respective values.

Investors may bring actions based on "information failures" under antifraud provisions of the federal securities laws.²²² These claims may or may not involve fraud, depending on whether false or misleading representations are made with

²¹⁵ Robert N. Rapp & Scott C. Matasar, Commentary, *Risk Modeling Implications for Potential Rating Agency Liability to Purchasers of Subprime Mortgage-Backed Securities*, Sept. 30, 2008, 2008 Emerging Issues 2966 (LEXIS).

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ *Id.* This will likely be a cry heard from many institutions. They may claim in collective unison that "no one could have foreseen this." However, many people held positions where they were responsible for understanding what they were analyzing. Their jobs as analysts were to literally understand risk. It would not seem incredulous that with even a small amount of foresight, only one of these individuals would have to realize that lending to consumers was out of control and unsustainable, which would, in turn, cause a decrease in the payouts of underlying securities and therefore a decline in these securities respective value.

²²⁰ *Id.*

²²¹ David Segal, *Buffett Is Unusually Silent on Rating Agencies*, N.Y. TIMES, Mar. 18, 2009, at B1, available at <http://www.nytimes.com/2009/03/18/business/18buffett.html>.

²²² *Id.* For these purposes the definition of information failure would be "an untrue statement of a material fact or the omission to state a material fact such that a statement actually made is not misleading." *Id.*

scienter.²²³ Alternatively, when claiming information failures claimed under sections 11 and 12 of the 1933 Securities Act, scienter may not need to be shown to recover.²²⁴ These claims would include the ratings agencies with respect to their positions as advisors in the public offering process.²²⁵

Additionally, 15 U.S.C. § 77(l)(2) provides a “private right of action for a purchaser of a security to recover from any person who sells the security by means of a prospectus or oral statement in which there is an information failure.”²²⁶ However, while there is also not a requirement for fraud or deception, there is a reasonable care defense and a causal connection must be established between the information failure and the purchaser’s loss.²²⁷ The large problem here is that, while the agencies may have been involved in the formation of the securities as they took a hands-on approach to the structuring process, they were not involved in the actual distribution or sale of the securities.²²⁸

Investors could also seek to recover under section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 adopted under it.²²⁹ However, under

²²³ *Id.* “Scienter” is a mental state embracing intent to deceive, manipulate, or defraud. *Id.*

²²⁴ *Id.*

²²⁵ *Id.* The Securities Act of 1933 grants a right to action for purchasers and states:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue [A]ny person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.

15 U.S.C. 77k(a)(4) (2008) (emphasis added). This allows for a purchaser to recover without having to show fraud or deception, but it does provide a due diligence defense. Rapp & Matasar, *supra* note 215.

²²⁶ Rapp & Matasar, *supra* note 215 (citing 15 U.S.C. 77(l)(2) (2009)).

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ *Id.* Section 10b states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C.A. § 78j(b) (2008). Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in

these antifraud provisions, there must be scienter to recover.²³⁰ Scienter could also be inferred. There are two interesting theories on inferring the proper scienter. First, it could be argued that scienter could be inferred “at least in part from the fact that rating agencies were paid by issuers in a competitive market to achieve desired rating outcomes.”²³¹ Second, the agencies’ failure to disclose modeling risk, especially in light of their use of out-of-model and undocumented adjustments, could be used to infer scienter.²³² The SEC’s report supports these lines of reasoning by its clear showing of a lack of transparency at the agencies.²³³

Intent to deceive would be harder to prove especially as the agencies would argue that their reputational values would have been on the line, and they of course would not have wanted to risk that for something so fleeting as short-term profits.

VI. CONCLUSION: WHERE DO WE GO FROM HERE?

Whether or not suits are brought, the system is clearly broken and the role of the agencies is not clear. Currently, the agencies have the best of both worlds: they issue ratings which must be observed according to regulation, and they also maintain the defense that they merely issue non-binding “opinions” that investors may or may not observe. With the government now taking a closer look at increasing regulation across the board, there is increased possibility that the NRSROs will perhaps be even more defined than the loose parameters set by the Credit Rating Agency Reform Act. It is true the SEC has inquired into the agencies’ actions. However, the SEC’s report on the agencies seems to handle numerous and serious errors and omissions with kid gloves. It would seem, in light of the financial crisis we face, that it is time to call a spade a spade and for the government to intervene and allow organizations that created this mess to be punished. This may not mean actual government sponsored prosecution against all participants, but rather allowance of free market principles to work and weed out the institutions that should fail. With regard to the rating agencies, the government should take a more activist approach and allow the SEC real authority to take action against the agencies. However, in the present case, this seems almost impossible in light of the fact that NRSROs have had no regulation, so in effect they have committed no sins.

To what standard can we hold organizations that are not subject to any standards? It is here we face a choice to regulate or deregulate. Preferably, the

any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2009).

²³⁰ Rapp & Matasar, *supra* note 215. Scienter could be shown by “knowledge of false or misleading information and intent to deceive, or by proof of reckless disregard for the truth of information on which investors relied.” *Id.* It would seem that the SEC’s report would point at least to this knowledge. Intent to deceive would be harder to prove, especially as the agencies would argue that their reputational values would have been on the line, and they, of course, would not have wanted to risk that for something so fleeting as short-term profits.

²³¹ *Id.*

²³² *Id.*

²³³ *Id.*

government would decrease its use of mandated reliance on the rating agencies' ratings, which could open the door to competition and decreased reliance on the big three agencies. However, if governments continue mandating the use of ratings in globalized regulations, it would seem that increased regulation is a must. Transparency is a start. If investors are to use ratings to attain and achieve government recognized positions, then those investors must be able to clearly understand what those ratings mean. Allowing investors access to the fundamentals of the ratings analysis and clarifying exactly what constitutes the ratings themselves is imperative. This, however, is highly unlikely as the big three agencies have a stranglehold on the rating market for which they will be loathe to give up as there is sure to be increased competition with increased transparency. Ironically, this seems negligible by the reputational element that the agencies constantly remind us is their sole concern. For if reputation is what matters in this game, why would investors want to use late entrants, even if these late entrants are using similar ratings analysis? Another interesting twist is while governments may choose to increase requirements for these agencies, what is the risk to those governments? The agencies are so powerful that they can take even the mightiest governments to their knees.²³⁴ Will this prove to be a disincentive for governments to impose any real regulation on the agencies? Only time will tell.

While the agencies have remained until now "litigation-proof," it will remain to be seen if this can continue. One interesting result of this current crisis is increased awareness by the public-at-large of the way our economy works and its key players to the economy. It would seem that lay people, who had no previous interest, now have motivation to understand what happened to their retirement accounts. Now appears to present a perfect storm of laypeople's interest piqued in complex financial instruments and finance market participant interactions. This could lead to the ability, at least at some level, for lay persons to grasp the intricacies necessary to hold rating agencies accountable. Even if the complexities of the securitization processes are beyond jurors, now more than ever, jurors would be more likely to side with injured plaintiffs against large recognizable entities who contributed to the current international economic downfall. The rating agencies seem perfect candidates as such entities. This may provide the incentive for plaintiffs to test legal theories, such as "information failure," on the agencies and other key economic players. Where scienter is necessary, juries may be more likely to infer it now.

After the disappointing SEC rule adoption on December 3, 2008, President Barack Obama has called for increased government oversight of the rating agencies.²³⁵ Legislators seem to be paying attention and are introducing

²³⁴ See Bruner, *supra* note 6, at 141 (discussing the ill effects befalling Malaysia when it adopted capital controls counter to the ratings agencies' preference for none).

²³⁵ *Do the SEC's New Rating Agency Rules Have Any Bite?*, *supra* note 72. President Obama's original transition team asked the Financial Economists Roundtable for its views on ratings reform. *Id.* Later, in July 2009, President Obama released a rating agency reform plan. Ronald D. Orol, *Obama Releases Credit Rating Agencies Reform Plan*, MARKETWATCH.COM, July 21, 2009, <http://www.marketwatch.com/story/obama-releases-credit-rating-agencies-reform-plan>. The proposal included efforts to limit conflicts of interest by "barring rating firms from consulting with companies they rate and requiring corporations to disclose 'pre-ratings' obtained from credit rating agencies before a rating firm

legislation aimed at reigning in the rating agencies.²³⁶ States are exploring pursuit of the agencies through criminal liability.²³⁷ The SEC has shown increased interest in the role of the rating agencies.²³⁸ Private money is finally taking strong swings at the agencies.²³⁹ Additionally, the creation of new competitive alternatives to the big three is being explored.²⁴⁰ Of course, the agencies are still protesting increased oversight and defending their actions.²⁴¹ However, calls for action by the public and private sectors will likely only increase as it is being estimated that the failure of credit rating agencies in the recent financial crisis “will cost the world economy as much as \$3 trillion by the end of 2010.”²⁴² Whether any of the recent momentum against the agencies will result in real changes remains to be seen.²⁴³ Perhaps soon, with increased scrutiny, these gatekeepers’

is selected to conduct a rating.” *Id.* This would give investors access to all the pre-ratings a corporation received, thus eliminating (hopefully) “ratings shopping” by corporations and issuers. *Id.* The Proposal also included the formation of a special office at the SEC to watch over rating agencies. *Id.*

²³⁶ Marcy Gordon, *Lawmaker Wants to Hold Ratings Firms Liable For Inaccuracies*, ASSOCIATED PRESS, Oct. 1, 2009, http://www.boston.com/business/personal_finance/articles/2009/10/01/lawmaker_wants_to_hold_ratings_firms_liable_for_inaccuracies/. Specifically, a draft bill was introduced that included a plan meant to make ratings agencies collectively liable for inaccuracies. *Id.* This draft also included President Obama’s proposals. *Id.*

²³⁷ Pia Sarkar, *California Subpoenas 3 Firms in MBS Ratings Probe*, PENSIONS & INVESTMENTS, Sept. 17, 2009, <http://www.pionline.com/apps/pbcs.dll/article?AID=/20090917/DAILYREG/909179984&crit=Pia%20Sarkar,%20California%20Subpoenas%203%20Firms%20in%20MBS%20Ratings%20Probe>. California Attorney General Edmund “Jerry” Brown Jr. initiated an investigation to determine whether the three rating agencies “violated state law by assigning high ratings to risky assets.” *Id.* New York and Connecticut initiated similar investigations before California. Lyanne Melendez, *Brown to Probe Credit Rating Agencies*, ABC7NEWS.COM, Sept. 17, 2009, http://abclocal.go.com/kgo/story?section=news/local/east_bay&id=7019369.

²³⁸ See Press Release, SEC, SEC Roundtable to Examine Oversight of Credit Rating Agencies (Apr. 6, 2009) (on file with author), available at <http://www.sec.gov/news/press/2009/2009-46.htm>.

²³⁹ In July 2008, the \$198.9 billion Sacramento-based California Public Employees’ Retirement System, the nation’s biggest public pension fund, initiated a \$1 billion lawsuit against all three agencies for “wildly inaccurate” credit ratings. See Sarkar, *supra* note 237. In New York, a class-action lawsuit was filed by investors claiming “the raters hid the risks of securities linked to subprime mortgages.” Joel Rosenblatt, *California Will Investigate Ratings Firms, Brown Says (Update2)*, BLOOMBERG.COM, Sept. 17, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aAjpJ7wqnuw0>. With regard to fraud charges filed in this suit, a federal judge forced the companies to respond. *Id.* The Judge rejected arguments by Moody’s and S.&P. that investors cannot sue over deceptive ratings of private-placement notes because those opinions are protected by free-speech rights. *Id.* It remains to be seen what will come of this action. Until now, no rating agency has ever been successfully sued for misleading investors. Steven Pearlstein, *Missing the Mark On Ratings-Agency Reform*, WASH. POST, Sept. 18, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/09/17/AR2009091704608.html>.

²⁴⁰ Several investment companies, including BlackRock, PIMCO, Promontory, and Risk Metrics, are in discussions to create alternatives to Fitch, Moody’s and S.&P. Yael Bizouati, *NY State Wants to Fire Moody’s and S&P*, THE BUS. INSIDER, Sept. 18, 2009, <http://www.businessinsider.com/ny-state-insurance-department-asks-top-firms-to-replace-rating-agencies-2009-9>.

²⁴¹ See Kim Dixon, *UPDATE 1-Rating Agencies Protest Broader Oversight*, REUTERS, Sept. 30, 2009. Moody’s CEO, Raymond McDaniel, said imposing “collective liability” on the agencies is unnecessary and could lead to more lawsuits. *Id.*

²⁴² Timothy Inklebarger, *CalPERS Exec Urges Credit-Rating Reform*, PENSIONS & INVESTMENTS, Sept. 30, 2009, <http://www.pionline.com/article/20090930/DAILYREG/909309983>.

²⁴³ See Colin Barr, *Business As Usual for Moody’s and S&P*, CNNMONEY.COM, Oct. 9, 2009, <http://money.cnn.com/2009/10/09/news/economy/ratings.reform.fortune/index.htm?postversion=2009100915>. The agencies have performed poorly in the past and, although cries for change occurred then, not much came of it. *Id.*

role for the future will become clearer.