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## Toward an Understanding: *NRSRO* *Failings in Structured Ratings* *and Discreet Recommendations* *to Address Agency Conflicts*

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# Toward an Understanding: *NRSRO Failings in Structured Ratings and Discreet Recommendations to Address Agency Conflicts*

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Last summer the Securities and Exchange Commission proposed a number of changes to the practices of the Nationally Recognized Statistical Rating Organizations (NRSROs). The proposals were intended to address concerns about: the integrity of the ratings processes employed by the rating agencies; confusion about the meaning of rating symbols in the structured products relative to the meanings of the symbols in the single issuer debt markets; and measures intended to reduce the reliance on ratings by those chartered investors (insurance companies, pension managers, and banks) that are required to direct their investments toward “investment grade” securities. Unfortunately, last month the SEC scaled back their already inadequate proposals and passed a more limited number of rules that will prove largely symbolic and will result in little fundamental change in the quality of ratings provided by the SEC’s sanctioned and outsourced gatekeepers.

Problems in global credit markets continue to weigh heavily on real economic activity, resulting in greater and greater legislative and regulatory interventions. Stimulus packages, temporary lending facilities, direct aid to failing institutions, and regulatory forbearance continue to be the preferred path to addressing the problems. None of these approaches addresses the underlying root of the credit market problems and, in turn, the

real economy’s contraction of credit. Without an understanding of the roots of the problems, attempts by regulators and policymakers will have little lasting impact. Their centrality to the proper functioning of credit markets, in lieu of better disclosures from issuers, highlights the rating agency sector as among the areas of greatest need for repair.

This article will explain the key differences in the roles of rating agencies in structured finance compared to that of single issuer debt. It will then highlight weaknesses in the current recommendations and oversight of the agencies. It concludes with recommendation of a series of discreet changes that would effectively address the most significant weaknesses within the current oversight regime of rating agencies in structured finance. Over time, these changes would likely significantly diminish market need for and reliance on official ratings.

## WE GOT LOST ALONG THE ROAD TO STRUCTURED FINANCE

Historically, the role of ratings was to provide a consistent framework that allowed investors to reasonably compare risk “within and across sectors and geographies.”<sup>1</sup> As market demand grew for new debt securities offering higher yields, Wall Street responded by issuing new types of securities backed by newer collateral classes. In turn,

the comparability of risk within rating classes (i.e., AAA, AA) across sectors and between structures declined. This was largely driven by a lack of historic data with which the rating agencies could model either the structural performance of the securities or the underlying collateral backing them. Instead they began to enter new markets with new products that were modeled on statistical assumptions for which they had no meaningful cyclical data. As a result they began to rely on a learning-by-doing approach,<sup>2</sup> which resulted in divergence among risk and return profiles of similarly rated securities. As shown in Exhibits 1 and 2, by the summer of 2007 it was clear the relationship between the rating and the risk it suggested was no longer meaningfully comparable across products. In fact, recent CDO market problems suggest that the meaning of ratings within a class of securities became less clear as BBB, A, and AA rated securities actually fared worse than B or C rated securities.<sup>3</sup>

As the French securities regulator asked, “Can specific structured finance products with a AAA credit rating produce a return of up to 200 bp for investors, while a AAA corporate or a AAA MBS tranche produces only a 10/20 bp return? What does that mean?”<sup>4</sup>

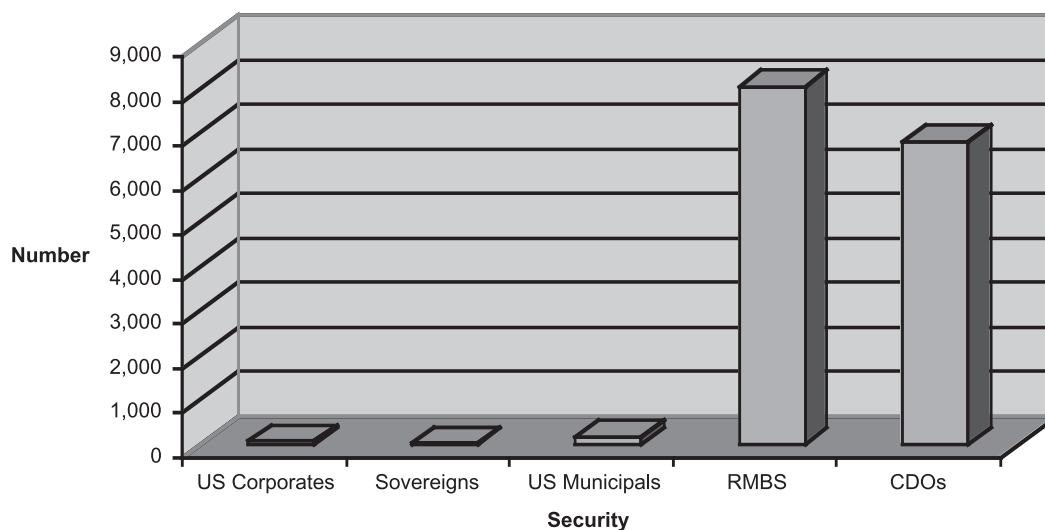
The necessary complexity of ratings models employed to rate these structured securities, coupled

with the lack of empirical data on many of the newer collateral types and predominant liquidity risk features, have further harmed the timeliness and accuracy of ratings and the transparency of ratings definitions.

These changes in ratings posed large and specific risks for those classes of investors (generally bank, insurance, and pension managers) required only to buy investment-grade-rated debt securities. As a result of the misapplication of the same ratings to securities with greatly differing risks, many charter-constrained investors were able to buy thinly traded structured securities offering yields many times higher than equally rated corporate or municipal debt issues. Ironically, the charter constraints placed on these investors were required primarily to support safe and sound adherence to their fiduciary obligations to investors.

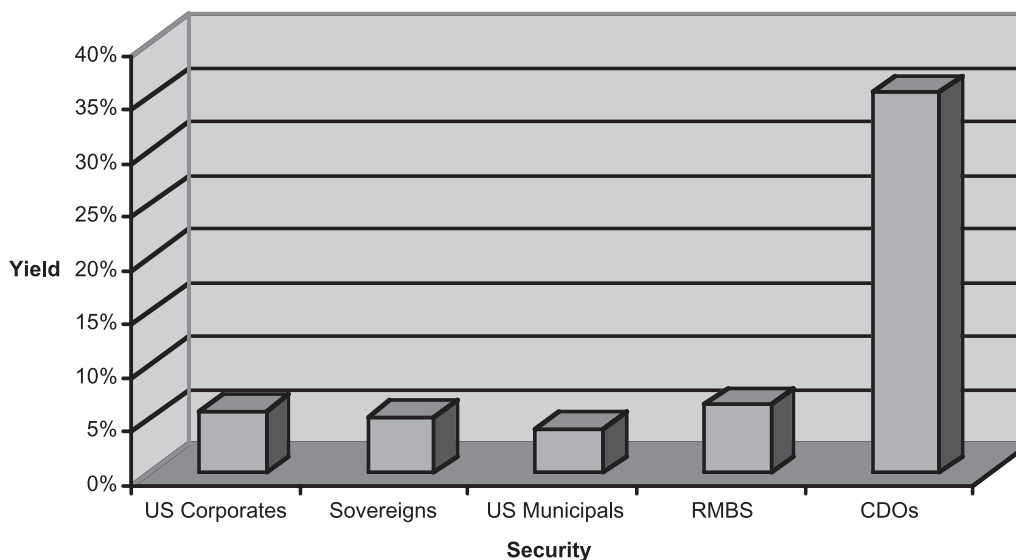
Given the novelty of many structures, inadequate empirical data, and reality that losses caused by illiquidity pose a primary and therefore more prominent risk, in structured securities, than credit risk, it is this author’s view that rating agencies are currently not sufficiently well equipped to provide effective or predictive ratings of most structured securities. In a world of fair-value accounting, in which price has become as important as value to regulators, we should focus on increasing market disciplines

**EXHIBIT 1**  
**Number of AAA-Rated Securities, by Type (As of June 2007)**



## EXHIBIT 2

### Yield of AAA-Rated Securities, by Type (As of June 2007)



regarding both price discovery and value discovery. Pricing without appropriate valuation tools is near impossible, and Congress has yet to recognize the important differences between single-issuer and structured debt.

If our structured products markets and securitization markets are ever to become efficient and effective tools, it is imperative that we consider and correct for a nonfunctional regulatory framework for structured ratings. Doing so would first require an inventory of the differences between single-issuer and structured obligations. Exhibit 3 highlights some of the key differences.

As a result of these differences, the rating agencies' role has transmuted from independent and outside journalist-like observers to necessary participants or architects with a deeply subjective opinion. While the rating agencies frequently assert journalistic privileges and First Amendment protections, it is clear from their own statements and actions they do not hold themselves to journalistic standards.<sup>5</sup>

The NRSROs' direct involvement in defining the corporate structure that an issuer must achieve in order to be rated may be the most significant difference between the rating of structured securities and the rating of single-issuer debt. Traditional corporations, municipalities, and sovereign nations exist prior to being

rated, while the corporations/trusts that issues structured securities are structured with an eye toward ratings. As a result, the rating agencies have a direct hand in defining the structure that a corporation must adhere to in order to have the lowest possible cost of funding. Even so, rating agencies frequently deny that they advise issuers of structured securities about how to structure securities to achieve desired ratings. Their defense appears to be backed more by circular logic and semantics than evidence. They have, by their own words<sup>6</sup> and actions,<sup>7</sup> been found to advise.

Given requirements that certain investors may buy only investment-grade-rated securities, that the ratings are a precondition to the sale of structured securities, that the rating agencies define the corporate structure that must be achieved to rate a deal, and the agencies' apparent role in advising issuers on structuring, there seems to be some basis to consider whether rating agencies should have different legal liability exposures in structured securities than in traditional single issuer debt ratings.<sup>8</sup>

The rating of structured securities has caused the NRSROs to depart from their traditional role and, in so doing, has added support to the notion that reducing reliance on the gatekeeper role of NRSROs is a worthy goal. It cannot be achieved by the SEC alone, and can be

## EXHIBIT 3

### Key Differences Between Single-Issuer and Structured-Product Ratings

The single issuer rating	The structured product rating
Broad base of issuers, law firms, corporate management, allowed investors Less complex legal structures Lengthy legal precedent on structures Issuers are “dynamic” Rating is a passive opinion Structures transparent Structures liquid Issuers generally issued for economic business management purpose Corporation exists prior to rating Assets are generally dynamic and managed Models are based on long history of empirical data Diverse issuer corporate structures create heterogeneity - low correlation Collateral is heterogeneous from issuer to issuer Large body of required public filing disclosures Corporations define their own corporate structures Credit risk is the primary (first) risk to the instruments Little principal risk	Concentration of issuers, law firms, buyers, structure management (Servicer, CAM), allowed investors Complex Legal Structures Relatively little legal precedent on structures Issuers are generally “static” Rating is more active iterative process Structures opaque Structures often illiquid Issuers often issue for speculative returns purpose Corporation exists upon rating Assets are expected to be static (other than during revolving period) Models are based on statistically derived assumptions Similarity of issuer corporate structures creates homogeneity - high correlation Collateral is homogeneous from issuer to issuer Almost no required public filing disclosures Rating agencies define the corporate structures Market and liquidity risk is the primary (first) risk to the instruments Large amount of principal risk

achieved only as a result of coordinated rulemaking or legislation. This would require the creation of specific standards, schedules, and formats of information issuers must make publicly available, as well as the creation of specific methodological and organizational structure requirements for new and existing NRSROs.

There are several questions that policymakers should consider and to which answers should be sought before embarking on any approach to address rating standards.

#### ARE THERE STRUCTURAL REASONS NRSROs HAVE LAGGED THE MARKETS?

Will credit rating agencies always lag markets in instruments for which liquidity risk may be a more real risk than credit risk and, if so, is it prudent for regulators to direct chartered investors to rely on credit ratings as a primary determinant of investment worthiness?

In the fall and winter of 2006–2007, markets spreads on MBS began to widen as a result of a significant increase in early payment defaults (EPDs). While these EPDs were credit events, they were seemingly either too novel a phenomenon or not recognized by rating models as credit events of significant predictive import to ratings models to support rating actions from the NRSROs. In fact, the rating agencies did not begin large-scale reviews and downgrades of RMBS pools until the summer of 2007, and those downgrades have accelerated and continued to increase. Even when they finally began large-scale RMBS downgrades, the rating agencies continued to claim, in the

face of illiquid markets, that active management of the underlying collateral in a CDO’s revolving period would result in low correlation between RMBS performance and CDO performance and would prevent significant downgrades to the referencing CDOs. Because they had not sufficiently considered the impact that liquidity risk posed to CDO pool management, the rating agencies lagged in the downgrades of not only RMBS but of CDOs as well.

As credit market problems spread to other products and asset classes, the agencies have, as witnessed by spreads, generally lagged market expectations. This has largely resulted from the anticipatory nature of market participants. While credit ratings are expected to be predictive of future credit quality, without historically relevant data to inform their models they are unable to properly anticipate either probability of default or expected loss with a level of confidence that would inform rating actions. As a result, ratings have lagged market expectations of credit deterioration in asset-backed commercial paper, structured investment vehicles, collateralized loan obligations, commercial mortgage-backed securities, commercial mortgage-based collateralized debt obligations, and trust-preferred collateralized debt obligations. The rating agencies appear to have even lagged market participants in the pricing of debts of single issuers with large exposures to structured obligations, such as “monoline” insurance companies.

The rating agencies have demonstrated questionable predictive power in structured securities ratings,

a significant part of their supposed value.<sup>9</sup> As a result, regulators, legislators and policymakers should, for the purpose of allowable holdings of charter-constrained investors, distinguish between the use of credit ratings for single-issuer debt and structured securities.

## **IS THE ISSUE COMPETITION OR REGULATORY LICENSE?**

In 2006 Congress passed the Credit Rating Agency Reform Act. A guiding principle of the act was that, in order to foster more accurate ratings and a more effective ratings industry, the SEC should foster increased competition by increasing the number of approved NRSROs.

To date the SEC has granted NSRSRO status to 10 credit rating agencies.<sup>10</sup> In approving the applications of new and existing NRSROs, it appears that the SEC, a lead member of the International Organization of Securities Commissions (IOSCO), has failed to enforce rating agency compliance with basic standards set in the IOSCO Code of Conduct.<sup>11</sup> Without specific legislation or regulation of the conduct and methodologies of NRSROs, it is unclear that the oversight of the rating agencies can be effective. Increasing the number of NRSROs, without first tightening compliance, may actually result in increased competition to inflate ratings.

The IOSCO Code, which was created in 2004 by regulators as a voluntary code of conduct, states: “The CRA should ensure that it has and devotes sufficient resources to carry out high quality credit assessments of all obligations and issuers it rates. When deciding whether to rate or continue rating an obligation or issuer, it should assess whether it is able to devote sufficient personnel with sufficient skills sets to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order to make such an assessment.”<sup>12</sup> This requirement stands in stark contrast to the actual findings of a July 2008 SEC examination report that found significant deficiencies in personnel and staffing at several agencies.<sup>13</sup>

Even before the meltdown of the credit markets, the SEC had reason to know that rating agencies, by defining their methodology in a vague and self-serving manner, were failing to live up to the spirit of the IOSCO Code.

Instead of creating much-needed legislative or regulatory oversight of the rating agencies’ newer products and processes, the SEC, IOSCO, and the European Com-

mission have proposed actions that fail to address market needs or the necessary coordination and harmonizing of their securities regulator’s actions with those of bank, pension, and insurance regulators. The U.S. Congress has failed to consider any changes.

## **WHY IS THE SEC AFRAID TO ESTABLISH METHODOLOGICAL (NOT MODEL) STANDARDS?**

Many of the problems that have infected global credit markets result from poor modeling, untested assumptions, staffing inadequacies, lack of transparency, and lack of consistently applied methods and models.

The SEC claims it is not empowered to oversee or interfere with the models or methods employed by NRSROs. The SEC is correct that Congress prohibited it from regulating “the substance of the credit ratings or the procedures and methodologies”<sup>14</sup> the NRSROs use. The SEC does, however, have authority to require significantly more detail and disclosure of the “the procedures and methodologies that the applicant uses in determining credit ratings.”<sup>15</sup> Given that it would be impossible for any investor or regulator to read the currently published methodologies of an NRSRO and determine either how it rates a security or uses the methodology to recreate the existing rating of a security, it would seem the SEC could test the disclosures of, application of, and effectiveness of rating methods and, in the interest of useful disclosure to investors, require non-specific changes to currently published and applied structured ratings procedures. This would allow investors to replicate the ratings analysis, ensure consistency, and support ratings integrity. After all, the SEC is authorized to revoke the approval or deny the application of an applicant to NRSRO status that “does not have adequate financial and managerial resources to consistently produce credit ratings with integrity and to materially comply with the procedures and methodologies disclosed.”<sup>16</sup>

Without greater legislative direction, or the creation of a more comprehensive oversight regime, the SEC will not correct fundamental problems in the global structured rating sector or be able to effectively protect the most regulated and charter-constrained investors. Without significant changes the prospects for functioning and vibrant credit markets are dire.

## AVAILABILITY OF DATA

The sale of most primary market structured securities is rating-dependent. With this in mind, the SEC had, in its proposed rulemaking, intended to provide non-issuer-paid ratings firms with data so that they may rate securities prior to issuance. The SEC has not directed specific data fields or standardized formats of available data be made available, and it is therefore unclear if the disclosed data would, on a timely basis, prove to be useful. Without significant extensions of the disclosure requirements of “Regulation AB”<sup>17</sup> and broader disclosure of information about stressed performance assumptions, this data may not be fully utilizable.

Given the limited amounts of time investors have to analyze deals before they are sold into the market, there is a real premium on useful information rather than just data. With that in mind, the SEC should codify clear, specific, and uniform data release requirements for both issuers and NRSROs, similar to those required by the Federal Financial Institutions Examination Council (FFIEC) under the Home Mortgage Disclosure Act.

## “ISSUER PAYS” CONCERNS AND SPREAD BASED RATING SOLUTIONS

Conflicts of interests inherent in the predominant “issuer-pays” model are often theorized to have been a primary cause of the failings of the rating agencies in the structured finance markets.<sup>18</sup> It seems appropriate to question the notion that an issuer-pays model is inherently more conflicted than an “investor-pays” model. Both models suffer potentially significant and inherent conflicts of interest. Just as conflicts of interest in the issuer-pays model can cause rating inflation pressures directly or through rating shopping there are similar conflicts that can arise in an investor pays model. Realized conflicts in an issuer-pays model would benefit issuers as a result of rating inflation and the resultant lower costs of funding, while realized conflicts in an investor-pays model would benefit investors as a result of overly critical ratings that enhance the yields on the debt instruments they would purchase. In both models the conflicts have larger potential market implications and must be managed by appropriate regulators’ oversight.

Attempts to require a restructuring of the payment model for the industry would likely result in other unintended consequences without any basis of expectation that the resulting ratings process would be fundamentally improved.

Just as flawed logic leads to recommended solutions that merely replace conflicts of interest posed by an issuer-pays model with new conflicts posed by an investor-pays model, well intended analysis often leads to suggestions that the capital held against a debt security should be determined not by a rating but rather by market based mechanism such as the yield spread differential between the instrument and Treasury bonds or relative to credit default swap spreads.<sup>19</sup>

Such recommendations appear pro-cyclical, unworkable and assume a degree of near and intermediate term market efficiency that recent history has gravely called into doubt. Requiring capital to be tied to the market yield of debt holdings creates risks that, for example, banks would not hold sufficient capital relative to their actual risk exposures at times that markets underestimate risk. Conversely and of greater concern, at times that markets have awoken from a period of underpricing of risk and may have become irrational in their risk aversion, banks would be required to compete to raise capital to compensate for excessive spreads and therefore exacerbate market problems. Of even greater shortcoming would be utilization of credit default swaps (CDS) as an indicator of underlying risk. Even were credit default swaps used only as a tool of risk mitigation or economic hedging and not for speculative purposes, there would remain a risk of mispricing of risk in the market leading to misrating of risk by market-based measures. That CDS have become an instrument used for speculation and not only economic hedging increases the risks that CDS pricing is driven less by fundamental credit risk analysis than by market liquidity.

## RECOMMENDATIONS

As outlined below, this author would prefer that policy-makers focus on discreet and targeted changes that:

- Require that charter-constrained investors, with limited exception, may only buy exchange-traded structured instruments.

- Require the application of updated models in a timely manner.
- Require the automation and utilization of full original assumptions and a life-loss curve coupled with monthly remittance data for regular secondary market re-rating.
- Reduce liability exemptions for certain structured finance rating practices.
- Create minimum industry standards for analyst professional training in structured finance.
- Prohibit revolving-door practices.
- Require an independent office of chief statistician, or keeper of the models, at each NRSRO.

### **Recommendation 1: Charter-Constrained Investors Should Own Only Exchange-Traded Structured Securities**

The current credit market crisis, which has spilled over into the broader economy, has been exacerbated by an inability to correctly value complicated and illiquid structured securities. The difficulty in valuing these instruments has caused regulated holders of these securities to claim that current market bids do not reflect the underlying fundamental value of the cash flows being generated by the securities they hold. Investors, on the other hand, suggest regulated institutions are holding securities at values that reflect unrealistic cash flow performance. These disagreements have been exacerbated by a lack of standards in the pooling, differences in representations and warranties among deals, disparate quality of disclosures, and differences in servicing standards, all of which have magnified the lack of liquidity that exists in what has ostensibly been a private market.

Regulators repeatedly claim the crisis has been caused by a lack of liquidity. But the cause may be neither a lack of adequate capital available to purchase these securities nor a lack of interest by buyers. It is conceivable that the principal problem undermining investors' confidence is the lack of an exchange or orderly market in which prices are competitively determined and supported by standardized listing requirements. Orderly and efficient markets are the only sustainable method of reducing spreads between bids and offers and, in turn, price and value.

It is the author's view that charter-constrained investors, whose mandate requires they purchase or hold only investment-grade securities, should only purchase

structured securities that are traded on an exchange or in an established market. This would:

- Create incentives for market participants to list and standardize securities.
- Ease safety-and-soundness regulatory burdens stemming from inadequate market-based valuation measures.
- Require issuers to meet basic market-defined disclosure requirements.
- Create reputation-based incentives for issuers to build high-quality securitized pools.

In a world where the performance of specific structured securities is not observed, except by holders, there is little ongoing or residual reputational damage to an issuer whose pools are poorly structured. A market with a few structural improvements, such as broad availability of valuation and pricing information that allows easy analysis of all of an issuers' deals, would likely result in reputational costs that would align market discipline with better pooled assets.

In support of market innovation and development of market-based valuation tools, this author would propose a limited carve-out. Where issuers chose not to list securities, chartered investors could still purchase structured securities, up to a limited percentage of their total structured exposures, but would be required to demonstrate to examiners that their own internal risk analysis independently supported the holdings. As listed markets became more standardized, the regulatory and investor knowledge would likely increase and reliance on credit ratings would be reduced.

### **Recommendation 2: Require the Application of Updated Models in a Timely Manner**

Unlike single-issuer debt rating models that have existed with little change in methodology for almost 100 years, most of the models used to rate structured securities have been created only recently and have changed frequently.<sup>20</sup> The changes have generally resulted from a learning-by-doing approach in rating novel structures often backed by untested or novel collateral.

Unfortunately, when agencies introduce new models they generally do not, on a timely basis, apply the newer models to re-rate those secondary market securities rated with the older model.<sup>21</sup> Instead they tend

to apply new models to secondary-market securities only after their “surveillance” teams recognize a significant ratings event that causes them to review the ratings of a specific security or group of securities.

As a result, it is not uncommon for NRSROs to have multiple models contemporaneously employed in the secondary market to rate substantially similar securities. This continued use of legacy models suggests that ratings most likely do not fully reflect the most current risk assessment methods that have informed more recent models.

Since structured securities may be collateralized by assets for which there is limited historic data and no through-the-cycle performance data, the risks posed by a failure of modeled assumptions about the structure may be amplified by poor modeling of the performance assumptions of collateral backing the structure.

Even with the rating migration risks and the collateral model risks posed by NRSRO methodologies, the SEC’s proposed rule did not require the agencies to use the most current ratings model, nor did it require them to re-rate existing secondary market securities at the time the new model was introduced to rate primary market securities. Instead they proposed the NRSROs should disclose whether the models used for initial ratings and secondary market rating surveillance are the same and whether changes made to surveillance models in the secondary market are incorporated into primary market rating models. This approach, with a lack of standards and uniformity, risks creating greater confusion about differences in substantially similar securities, carrying the same alpha-numeric ratings but rated with different models.

It is recommended that the NRSROs be required to: detail the methodology for the model used; advise investors if the model used is the most current used to rate similar securities in the primary markets; and, within a specified and reasonable framework, harmonize the ratings model used in the re-rating of all primary and secondary market securities of similar structures.

### **Recommendation 3: Require the Automation and Utilization of Full Original Assumptions and Life Loss Curve Coupled with Monthly Remittance Data for Regular Secondary Market Re-rating**

NRSROs generally receive separate revenue streams for initial ratings (primary) and secondary market “surveillance.” While initial rating fees are typically calculated as a

percent of the total value of the deal and can often reach into the hundreds of thousands of dollars, surveillance fees are typically assessed annually at a fixed price and often range from \$2,000 to an atypically high \$30,000 depending on the size of the deal, complexity, and relationship with the customer. Surprisingly, and almost certainly unknown to most investors, the agencies often structure their ratings agreements in a manner that allows secondary market surveillance fees to be assessed from the cash flows of the deal even before investors receive their cash flows.<sup>22</sup>

Given the disparity of revenues generated by initial rating engagements relative to secondary market surveillance, there are incentives for the rating agencies to under-allocate resources to the latter business line. In fact, the rating agencies surveillance processes appear to have been less robust than their initial ratings processes.<sup>23</sup> As highlighted in Exhibit 3, there are significant differences between single-issuer and structured securities. Key differences suggest that perhaps agencies should employ a different secondary market approach than that utilized in the surveillance approach used for single-issuer securities. A regular process of objective, data-informed secondary market re-rating is clearly appropriate.

Unlike a corporation that is intended and expected to be an ongoing concern whose assets grow and replenish, the corporation/trust that is created to hold a pool of securitized assets is a functionally limited life corporation whose assets will diminish over a predetermined life. Unlike a corporation that actively manages its assets through, for example, the purchase or sale of assets and business units, the reallocation of capital, and the renegotiation of labor, structured pools are, outside of a revolving period, comprised of largely static assets that are actively serviced but not managed. Where a corporation can, through active decisions, positively or negatively affect its ratings, the trusts holding structured securities are intended to be brain-dead. As a result, if the initial rating was accurate, then the key assumptions about expected loss or the probability of default, made at the origination of the issue, should be proven out over time through the realized losses or defaults.

It is our recommendation that the rating agencies, in structured securities markets (adjusting for revolving periods), should be required to automate a process that utilizes actual monthly servicer remittance data and available loan-level performance data for the purpose of re-rating securities relative to the original deal assumptions

at issuance. The rating should reflect actual performance relative to initial assumptions and re-rate using a re-drawn curve of remaining cash flows and losses.

Although this recommended approach could initially cause ratings volatility, it ultimately should foster stability as it would be objective, consistent, replicable, and removed from potential conflicts of interest. It would reduce the incidence of multiple-notch downgrades and create a productive and positive feedback loop to enhance rating agencies' modeling capabilities.

#### **Recommendation 4: Reduce Liability Exemptions for Certain Structured Finance Rating Practices**

In rating single-issuer debt, including corporate, municipal, and sovereign issues, the rating agencies are generally accepted to be outside observers. It is this outside perspective that has been the basis of courts determining, "absent special circumstances," that their work is protected as freedom of speech<sup>24</sup> or by journalistic privilege.<sup>25</sup>

In the world of structured ratings, the role of the rating agency is part and parcel to the issuance. The corporate structure is determined in consideration of its ratings impact, the assets of the corporation/trust are created in consideration of the ratings impact, and the entirety of a deal could not find market acceptance without first being rated. In the words of Moody's former President and COO Brian Clarkson, in the world of structured securities "you start with a rating and build a deal around a rating."<sup>26</sup> This different role in structured finance ratings raises questions about their potential liability as statutory underwriters.<sup>27</sup> These differences have been recognized by at least one appellate court in its ruling that a rating agency did not qualify for journalistic protections.<sup>28</sup>

Because there are fundamental differences in the roles the rating agencies play with single-issuer versus structured securities, the SEC should modify the liability exemptions the agencies are afforded under Section 11 of the Securities Act of 1933<sup>29</sup> and create different liability standards for the role of rating agencies in structured finance.

Instead, without first creating a bright-line standard or definition of "advising," the SEC had proposed a rule that sought to prohibit NRSROs from "advising" on the structuring of a deal. Without promulgation of such a standard or definition it seems unrealistic to expect the SEC's prohibition will be effective when,

in the face of evidence to the contrary,<sup>30</sup> the major NRSROs continue to claim they do not advise.<sup>31</sup> This semantic argument over structuring advice is not new<sup>32</sup> and yet there remains neither a standard definition nor any materially enhanced exposure to liability for violation of the prohibition.

Creating a standard definition of "advising" or "structuring" may be as elusive as creating a definition of pornography.<sup>33</sup> Instead, I propose that, where it can be demonstrated beyond any reasonable doubt that an agency has crossed the line "from an objective credit analyst to subjective consultant," that agency should be unambiguously exposed to the same liabilities as any statutory underwriter. Even in the face of current rule-making, which resulted from massive failures of the rating agencies, S&P acknowledges the "complexity of determining what a prohibited "recommendation" is" and does not seem to believe regulators have the ability to create a clear and bright line defining where "the NRSRO's role would transition from an objective credit analyst to subjective consultant". Instead they again argue this ongoing conflict "would be best managed through an NRSRO's policies and procedures, rather than through an outright, and imprecise, ban."<sup>34</sup> It is this ongoing failure of self-regulation and the lack of a workable definition that leads to a recommendation that a common-man definition should define the NRSROs' ability exposure for advising or structuring.

Similarly, the rating agencies' obligations as "registered advisors" under the Investment Advisors Act of 1940 should expose them to the same standards as any other registered investment advisors that fail to "base their opinions upon current and adequate information."<sup>35</sup> It also seems supportable, in the spirit of the IOSCO Code of Conduct for Credit Rating Agencies at 1.9,<sup>36</sup> to create a liability exposure standard for any rating agency that agency knowingly issues any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of any issuer or obligation.

Liability protections the NRSROs are afforded in their structured finance ratings business should be tied to the same responsibilities in fact finding, independence and ethics as those expected of journalists.<sup>37</sup> The IOSCO Code at 1.1 appears intended to hold the agencies to a journalistic standard in stating the rating agencies "should adopt, implement and enforce written procedures to ensure that the opinions it disseminates are based on a

thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodology."<sup>38</sup> It should not, therefore, be permissible for an NRSRO to hide behind "we didn't know and have no obligations" hedge clauses as they seem to have done in statements such as, "Fitch shall have no obligation to verify or audit any information provided to it from any source or to conduct any investigation or review, or to take any other action, to obtain any information that the issuer has not otherwise provided to Fitch."<sup>39</sup> Moody's plays similar semantic games to skirt the spirit of the code when it claims "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."<sup>40</sup>

There have been clear and public examples in which rating agency management had knowledge of flaws in the information they relied upon, of failures in their models,<sup>41</sup> failures to use their published ratings methods,<sup>42</sup> or policies regarding their ratings committees.<sup>43</sup> In several instances, the rating agencies neither announced their findings, nor corrected their models, nor adjusted their ratings accordingly until these issues came to light in the broader press, and it appears almost certain there will be more, and perhaps more significant, failures still likely to come to light.

Contrary to persistent claims by rating agencies that the importance of their reputations are a natural incentive to perform high-quality work,<sup>44</sup> it appears that attempts to protect their reputations may actually drive them to hide material information from investors.<sup>45</sup> In fact, an internal Moody's memo seems to highlight the conflict between market share and ratings quality.<sup>46</sup>

Such instances strike at the core of market confidence in ratings and serve only to erode investor confidence in public markets and the value and independence of ratings. Where a ratings analyst or manager knows or has reason to believe that a flaw exists in firm analysis or models, or that fraud exists in a deal, there should be an obligation either to abstain from rating the security or to disclose these findings. Alternatively, where the firm continues with the rating assignment and does not disclose these findings, the firm should be subject to clear liability.

### **Recommendation 5: Create Minimum Industry Standards for Analyst Professional Training in Structured Finance**

The inherent complexity of structured securities, the innovation of new structured products, and the frequent changes to ratings models and methodologies suggest it would be advisable to create some minimum standards for the professional training of structured ratings analysts and to create benchmarks to assess professional competency.

In 2005 the SEC began to consider of the issue of analysts' competency and training and, as a part of a rulemaking process, requested comment on "the appropriate subjective criteria that a credit rating agency should use in assessing the experience and training of an analyst ... How can a credit rating agency in seeking to meet the proposed NRSRO definition demonstrate that it has adequate procedures designed to ensure that its analysts are competent?"<sup>47</sup> S&P's then-president responded that S&P "is confident that its standards and procedures for analyst background and training would meet any minimum requirements imposed by the Commission. Ratings Services does not support the promulgation of NRSRO designation criteria that are conditioned on specific attributes of a rating agency's staff ... rating agencies have strong incentives to monitor the quality of their analysts without government mandate due to constant scrutiny from issuers and investors."<sup>48</sup> The SEC has not yet taken specific action in regard to industry standards of analysts training, staffing levels, or competency.

Just as there are licensing standards for financial analysts, brokers, auditors, appraisers, and other financial professionals, it seems that standards of professional competency in structured finance ratings would enhance the standardization, objectivity, and comparability of ratings by analysts within a specific NRSRO and across the industry. The curriculum could be standardized and licensing requirements could require specific initial and ongoing professional education.

### **Recommendation 6: Prohibit Revolving-door Practices**

In rules proposed last summer, the SEC announced its intent to reduce the risk of analyst conflicts of interest and ensure the objectivity and quality of analyst ratings.

In the proposed rule the commission announced it would “prohibit an NRSRO from allowing a credit analyst who participated in determining or monitoring a credit rating, or a person responsible for approving a credit rating, from receiving gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than the items provided in the context of normal business activities such as meetings, if such gifts have an aggregate value that exceeds \$25. We believe these prohibitions are appropriate because they address potential practices at an NRSRO that could impair its objectivity and quality of its rating.”<sup>49</sup>

This approach ignores a larger and more pernicious risk to analyst objectivity and ratings quality. Given the lower compensation levels of NRSRO analysts relative to their counterparts at investment banks and other issuers, there is a real risk that analysts, seeking to elicit future offers of employment, would compromise their objectivity or ratings quality in an effort to curry favor from those firms whose products they have been called to rate. The numerous examples of NRSRO analysts leaving an NRSRO to work for a firm whose securities the analyst had been engaged to rate begs attention and reflection.

If the SEC is genuinely seeking to reduce the risks of analyst conflicts, it should consider placing revolving door limits on ratings analysts and engagement team members. This approach, which most officials on Capitol Hill are familiar with, was incorporated, with seeming success, in Section 206 of Sarbanes-Oxley.<sup>50</sup> I would recommend that similar language be crafted in the ratings industry. While, for a period of one or two years, rating analysts would be prohibited from acquiring employment with issuers for whom they provided rating services, there would be no prohibition from leaving a rating agency to work for a ‘buy-side’ firm.

### **Recommendation 7: Office of Chief Statistician**

While the SEC has identified the risk of analyst conflicts of interest as an item worth addressing through rule-making, it has failed to consider a related item of perhaps even greater importance. Just as risks that business-line and revenue pressures may create incentives for analysts to compromise their ratings, there are real risks and reasons

to believe that the modeling staff at a rating agency may be subject to business-line or revenue pressures.

This is an area that deserves a significant amount of consideration by policymakers. Even the most competent, ethical, and objective analyst’s work would be compromised if he were tasked to rate securities using poorly developed models.

With NRSROs being “statistical rating organizations,” it maybe surprising that, to our understanding, none of the three major rating agencies has an explicit or functional PhD-level “chief statistician.” In fact, there may not be a single PhD-level statistician in any executive role at any of the NRSROs whose is exclusively responsible for the independent development, testing, implementation, and ongoing surveillance of ratings models. Similarly, there do not appear to be any substantive regulatory requirements that the development of ratings models be protected and fire-walled from revenue generation pressures.

If rating agencies are to effectively serve a public good, and deserve the public trust, then the independence and separation of modeling staff from revenue generating business pressures must be a paramount goal of policymakers and regulators. To that end I would recommend that each NRSRO be required to form an independent “office of statistical staff” tasked to develop, test, implement and review the models.

Just as good corporate governance recognizes that internal audit functions should be removed from regular reporting lines, the most senior executives at NRSROs who are responsible for these modeling functions should report only to a committee of independent board members. This would protect the integrity, innovation, and reputation of the agencies.

## **CONCLUSION**

Thus far, U.S. and international regulatory responses to the role of rating agencies in the current credit crisis have been largely symbolic, uncoordinated, and perfunctory. The SEC promulgates rules with the stated intent of reducing reliance on ratings at the same time as the Federal Reserve and Treasury introduce new emergency liquidity and asset purchase programs that rely only on discredited ratings models, thus exposing taxpayers to potentially hundreds of billions in losses.

Without a focused and targeted effort to restore confidence in the rating agency sector and to provide investors with sufficient information to make educated investment decisions, there is little hope of credit markets becoming self-sustaining or functional.

The discreet but material recommended changes to NRSRO regulation proposed would foster an environment where market reliance on NRSROs should diminish over time. Importantly, these changes would, in the near term, increase investor confidence in the quality and objectivity of ratings models.

## ENDNOTES

<sup>1</sup>Nomura, *Bond Rating Confusion*, June 29, 2006, at 2, available at [http://www.adelsonandjacob.com/pubs/Bond\\_Rating\\_Confusion.pdf](http://www.adelsonandjacob.com/pubs/Bond_Rating_Confusion.pdf)

<sup>2</sup>Xudong Yongheng Deng and Anthony B. Sanders, *Subordination Levels in Structured Financing*, Oct. 30, 2006, at 2, available at [http://fisher.osu.edu/~sanders\\_12/Sub.pdf](http://fisher.osu.edu/~sanders_12/Sub.pdf)

<sup>3</sup>Griffin, John M. and Dragon Yongjun Tang, "What Drove the Mismatch between Initial CDO Credit Ratings and Subsequent Performance?" Working paper presented by Mr. Griffin at INSEAD Finance Research Seminar on September 26, 2008. The following excerpt from the paper is of interest: "CDOs have experienced an unprecedented loss of capital and downgrading. Multiple notch downgrading is commonplace, and some AAA CDO tranches are downgraded to junk grade. We show that these AAAs were not the same as traditional AAAs. While poorly rated asset underpinning CDOs are often blamed for the poor performance, we find that most of the collateral value evaporation actually occurred in CDOs with BBB, A, or AA ratings, while B or C rated collateral experienced little collateral depreciation. Thus the ratings on the underlying collateral were misleading, particularly for the ABS, CDO, and Synthetic CDOs. A second problem is that the credit models used by rating agencies were sensitive to the credit rating assumption, and this assumption appeared to be relatively low. Third, we find some support for conflicts of interest in that larger deals with larger fees received a larger proportion of AAA, worse subsequent performance, and correlation assumptions that were too low."

<sup>4</sup>However, in light of the constant flow of new innovative structured products, questions should be raised at the European level concerning the potential limitations of agencies' models—can everything really be rated?—and the meaning of ratings. This should be done in close cooperation with the prudential authorities in charge of the implementation of Basle II and of the OEEC regime<sup>10</sup>, with the principal objective of encouraging understanding among the

participants and strengthening the market's credibility. It is also necessary to determine if a structured finance rating is equivalent to a corporate rating and, within securitization ratings, whether or not the rating of a cash CDO is equivalent to the rating of a synthetic CDO. In this respect, is there a need for either differentiating structured finance and corporate ratings or for requiring additional information regarding the volatility or sensitivity attached to each structured finance rating, which, for certain products like CDOs, seems indispensable?

<sup>5</sup>See as example: (Committee of European Securities Regulator's Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code - Ref: CESR/06-545 at 13, available at [http://www.cesr-eu.org/data/document/06\\_545.pdf](http://www.cesr-eu.org/data/document/06_545.pdf): "[Fitch has] no obligation to verify or audit any information provided to it from any source or to conduct any investigation or review, or to take any other action, to obtain any information that the issuer has not otherwise provided") and (Moody's Investor Service, Code of Professional Conduct 6 (June 2005), available at <http://www.moody.com/cust/research/MDCdocs/01/2003400000425277.pdf>: "[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").

<sup>6</sup>Hearing of the U.S. Senate Committee on Banking, Housing and Urban Affairs, "The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets," September 26, 2007, available at: <http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=973eab2d-f498-412b-86f3-ae6a4b147f03> (see: (2:14:43) "Senator Menendez "... I listened to your answers to these questions and Ms. Tillman you say 'we don't tell them what to do, we have a dialog' and Mr. Kanef you said 'we have a feedback'. Well, clearly someone comes to you and in this 'dialog', in this 'feedback', I assume there are conversations going on that say 'well, if you did this' or if the person or entity comes to you and says 'well what if we did this?' then you would say 'then we would to x in terms of the rating'. Is that a fair assumption?" Mr. Kanef: "Yes Sir, I believe it is". Senator Menendez: "So then the 'dialog', the 'feedback' goes into a process in which the entity is molding how they are going to present to you in order to achieve a certain rating, a higher rating, hopefully, for their purposes. Is that a fair statement?" Mr. Kanef (2:14:43): "I believe Senator that is a fair statement."")

<sup>7</sup>In *Re Fitch, Inc.*, Appellant-cross-appellee, American Savings Bank, Fsb, Plaintiff-appellee-cross-appellant, v. Ubs Painewebber, Inc., Defendant United States Court of Appeals, Second Circuit.—330 F.3d 104, Argued: April 4, 2003, Decided: May 21, 2003, available at <http://cases.justia.com/us-court-of-appeals/F3/330/104/565141/> (see: “We conclude that the sealed material makes it clear that ASB’s claim that Fitch plays an active role in structuring the transaction is extremely credible. ASB submitted under seal electronic mail correspondence that indicates fairly strongly that Fitch played an active role in helping PaineWebber decide how to structure the transaction. The sealed portion of the record consists of the Declaration of Paul Alston (ASB’s lawyer in the Hawaii action) and attachments. The attachments reflect a series of electronic mail and fax communications between a Fitch employee and two of PaineWebber’s employees. This correspondence indicates a fairly active role on the part of the Fitch employee in commenting on proposed transactions and offering suggestions about how to model the transactions to reach the desired ratings”).

<sup>8</sup>Mason, Joseph R. and Rosner, Josh, “Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions” (May 3, 2007). Available at SSRN: <http://ssrn.com/abstract=1027475>, p. 14.

<sup>9</sup>Letter from Brian Clarkson of Moody’s to Jonathan Katz of the SEC, July 12, 2004 available at <http://www.sec.gov/rules/proposed/s72104/clarkson071204.pdf> (see: “Rating agencies help improve market transparency and efficiency when they provide objective forward looking opinions that are predictive tools in assessing credit risk. Therefore, for rating agencies to effectively fulfill this role, they should compete on the basis of the quality (predictive content) of their ratings rather than their price”).

<sup>10</sup><http://www.sec.gov/answers/nrsro.htm> (A.M. Best Company, Inc., DBRS Ltd., Egan-Jones Rating Company, Fitch, Inc., Japan Credit Rating Agency, Ltd., LACE Financial Corp., Moody’s, Standard & Poor’s Ratings Services).

<sup>11</sup>Committee of European Securities Regulator’s Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code – Ref: CESR/06-545, available at [http://www.cesr-eu.org/data/document/06\\_545.pdf](http://www.cesr-eu.org/data/document/06_545.pdf) (hereafter CESR Report).

<sup>12</sup>CESR Report, p. 16 (IOSCO Code at 1.7).

<sup>13</sup>“Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies,” p. 10–12, available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> (see: “There was a Substantial Increase in the Number and in the Complexity of RMBS and CDO Deals Since 2002, and Some Rating Agencies Appeared to Struggle with the Growth” and “There are indications that ratings were issued notwithstanding that one

or more issues raised during the analysis of the deal remained unresolved. For example, in one exchange of internal communications between two analysts at one rating agency, the analysts were concerned about whether they should be rating a particular deal. One 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.” Resource issues appear to have existed in other structured finance groups outside of the RMBS and CDO areas. For instance, at one rating agency, an analytical manager in the firm’s real estate group stated in one email that “[o]ur staffing issues, of course, make it difficult to deliver the value that justifies our fees” and in another email that “[t]ensions are high. Just too much work, not enough people, pressure from company, quite a bit of turnover and no coordination of the non-deal ‘stuff’ they want us and our staff to do.” Similarly, an email from an employee in the same firm’s asset backed securities group stated that “[w]e ran our staffing model assuming the analysts are working 60 hours a week and we are short on resources. ... The analysts on average are working longer than this and we are burning them out. We have had a couple of resignations and expect more”).

<sup>14</sup>“Credit Rating Agency Reform Act of 2006,” available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109\\_cong\\_bills&docid=f:s3850enr.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_bills&docid=f:s3850enr.txt.pdf)

<sup>15</sup>IBID.

<sup>16</sup>IBID.

<sup>17</sup>Available at <http://www.sec.gov/rules/final/33-8518.pdf>

<sup>18</sup>“Senators accuse rating agencies of conflicts of interest in market turmoil.” *International Herald Tribune*, September 26, 2007, available at <http://www.iht.com/articles/2007/09/26/business/credit.php>

<sup>19</sup>See, example: *WSJ Opinion*, January 2, 2009. “Let’s Write the Rating Agencies Out of Our Law. Bond ratings should be like a recommendation.” From Consumer Reports available at: <http://online.wsj.com/article/SB123086073738348053.html>

“The amount of capital required to hold a fixed-income security should be determined not by a rating but by its yield, expressed as a spread over Treasuries. The higher the spread, the riskier the market has determined the asset to be, and more capital should be required to hold it. Similarly, financial institutions should be required to set aside a percentage of their interest income every year as reserves for credit losses; the higher the spread, the higher the reserve percentage. Should spreads widen, the share of the return set aside for reserves should increase, thus gradually increasing reserves commensurate with the market’s perception of increased risk.” ALSO SEE: Partnoy, Frank, How and Why Credit Rating Agencies are Not Like Other Gatekeepers. *Financial Gatekeepers: Can They Protect Investors?*, Yasuyuki Fuchita, Robert E. Litan, eds., Brookings Institution Press and the Nomura Institute

of Capital Markets Research, 2006; San Diego Legal Studies Paper No. 07-46. Available at SSRN: <http://ssrn.com/abstract=900257> or at [http://www.tcf.or.jp/data/20050928\\_Frank\\_Partnoy.pdf](http://www.tcf.or.jp/data/20050928_Frank_Partnoy.pdf) p.39 “If regulators decided simply to open the market to competition, they might improve that approach by including among new NRSROs one or more credit rating agencies that rated debt issues using a market-based measure. For example, a credit rating agency might simply follow credit spreads or CDS prices and issue alphabetical ratings based on market prices. The algorithm for converting credit spreads or CDS prices could be straightforward and transparent, perhaps even automated, based on a rolling average of credit spreads, the market prices of credit default swaps (which are becoming increasingly standardized), or even one of the equity-based methodologies currently used by the rating agencies themselves. The next section assesses these alternatives.”

<sup>20</sup>Rosner/Mason Paper, May 3, 2007, Hudson Institute, p. 20 (*The Problems With Ratings In Structured Finance—Evolving Models*).

<sup>21</sup>Authorite des Marches Financiers, Ratings in the Securitization Industry 16 (Jan. 2006) (see: “The agencies rate a transaction when it is carried out. Published changes in methodology apply to future transactions. However, the agencies do not take the same approach when updating ratings for past transactions. Some of the agencies do not revisit the old ratings but use the new method in their surveillance. Thus, the surveillance process is based on both the old and new methodologies.”)

<sup>22</sup>Letter from Brian Clarkson of Moody’s to Jonathan Katz of the SEC, July 12, 2004, available at <http://www.sec.gov/rules/proposed/s72104/clarkson071204.pdf> (see: “A surveillance fee; which is paid on an on-going basis during the life of the transaction and may be paid from the proceeds of the assets securitized prior to payments to be made to investors”).

<sup>23</sup>Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies,” available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>

<sup>24</sup>County of Orange v. McGraw Hill Cos., Inc., 245 B.R. 151, 156 n. 4 (C.D. Cal. 1999) (“Standard & Poor’s ratings are speech and, absent special circumstances, are protected by the First Amendment. In reaching this ruling, the Court assumed any First Amendment protected speech, as a matter of public concern, would receive the heightened protection of the actual malice standard”).

<sup>25</sup>In re Pan Am Corp., 161 B.R. 577, 581–583 (S.D.N.Y. 1993) (quashing subpoena to S&P for records of communications with Delta Air Lines based on qualified journalist’s privilege because “S&P functions as a journalist when gathering information in connection with its ratings process”).

<sup>26</sup>*Portfolio Magazine*, “Overrated,” Jesse Eisinger, September 2007, available at <http://www.portfolio.com/news-markets/national-news/portfolio/2007/08/13/Moody-Ratings-Fiasco> p. 2 (““You start with a rating and build a deal around a rating,” explains Brian Clarkson, Moody’s co-C.O.O”).

<sup>27</sup>Mason, Joseph R., and Rosner, Josh, “Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions” (May 3, 2007). Available at SSRN: <http://ssrn.com/abstract=1027475>, p. 14 (see: Because even the investment grade tranches of RMBS-based CDOs are generally comprised of non-investment grade equity tranches of RMBS, it seems that the role of rating agencies is a necessary function of their sale and distribution. While that is not to say that no investors would purchase the senior assets without ratings, “rating agency ‘approval’ still appears to determine the marketability of a given structure to a wider market” ... Are agencies possibly in a “control” position with the “practical ability to direct the actions of the people who issue or sell the securities”? ... According to the 1933 Securities act the term “underwriter” includes “any person who ... has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking ...”).

<sup>28</sup>In Re Fitch, Inc., Appellant-cross-appellee, American Savings Bank, Fsb, Plaintiff-appellee-cross-appellant, v. Ubs Painewebber, Inc., Defendant United States Court of Appeals, Second Circuit.—330 F.3d 104. Argued: April 4, 2003, Decided: May 21, 2003, available at <http://cases.justia.com/us-court-of-appeals/F3/330/104/565141/>

<sup>29</sup>17 C.F.R. § 230.436.

<sup>30</sup>See endnotes vi and vii.

<sup>31</sup>Westbrook, Jesse, and Tyson, James, “SEC Probes Whether Issuers Pressured S&P, Moody’s (Update6),” Bloomberg.com (see: ““Moody’s does not structure, create, design or market securitization products,” Kanef said. “We do not have the expertise to recommend one proposed structure over another, and we do not do so.” And also, “S&P doesn’t structure debt transactions, and the company’s criteria for ratings are “absolutely transparent,” Tillman said. There isn’t any collaboration between S&P and debt issuers on constructing mortgage-backed securities, she said. “We have an open dialogue with investment bankers,” Tillman added. “We don’t tell them how to make it better. That’s up to them.” In his prepared testimony, Kanef of Moody’s said the company has “successfully managed related conflicts of interest and provided the market with objective, independent and unbiased credit opinions””).

<sup>32</sup>Mason, Joseph R., and Rosner, Josh, “Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation

Market Disruptions” (May 3, 2007). Available at SSRN: <http://ssrn.com/abstract=1027475>,<sup>13</sup> “The need for rating agencies to objectively assess and verify information rises in structured finance transactions since, unlike the traditional ratings process in which an enterprise can do little to change its risk characteristics in anticipation of an issuance, in structured finance, the rating agency is an active part of the structuring of the deal.<sup>29</sup> In practice, arrangers will routinely use the rating agencies’ publicly available models to pre-structure deals and subsequently engage in a process that is “iterative and interactive,”<sup>30</sup> informing the issuer of the requirements to attain desired ratings in different tranches and largely defining the requirements of the structures to achieve target ratings.<sup>31,32,33</sup>”

<sup>33</sup>Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (see: “I shall not today attempt further to define the kinds of material I understand to be embraced ... [b]ut I know it when I see it ... ”)

<sup>34</sup>Letter from S&P’s Vickie Tillman to the SEC, “Re: Proposed Rules for Nationally Recognized Statistical Rating Organizations, Securities Exchange Act of 1934 Release No. 57967 (June 16, 2008) File No. S7-13-08,” July 24, 2008 available at [http://www2.standardandpoors.com/spf/pdf/media/SEC\\_Proposed\\_Rules\\_0724008.pdf](http://www2.standardandpoors.com/spf/pdf/media/SEC_Proposed_Rules_0724008.pdf)

<sup>35</sup>See, e.g. Memorandum from Annette L. Nazareth, Director, Division of Market Regulation, United States Securities and Exchange Commission, to William H. Donaldson, Chairman, Securities and Exchange Commission 4 (June 4, 2003), available at <http://www.sec.gov/spotlight/ratingagency/baker060403.pdf>. (“The Commission has emphasized that, NRSROs, as registered investment advisers under the Investment Advisers Act of 1940 (the “Advisers Act”), have a special duty to base their opinions upon current and adequate information”).

<sup>36</sup>see CESR Report at 1.9 (see: “The CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of any issuer or obligation”).

<sup>37</sup>See, as example: Society of Professional Journalists, Code of Ethics at <http://www.spj.org/ethicscode.asp> (“Test the accuracy of information from all sources and exercise care to avoid inadvertent error. Deliberate distortion is never permissible ... Identify sources whenever feasible. The public is entitled to as much information as possible on sources’ reliability ... Make certain that headlines, news teases and promotional material, photos, video, audio, graphics, sound bites and quotations do not misrepresent. They should not oversimplify or highlight incidents out of context ... Distinguish between advocacy and news reporting. Analysis and commentary should be labeled and not misrepresent fact or context ... Distinguish news from advertising and shun

hybrids that blur the lines between the two ... Recognize a special obligation to ensure that the public’s business is conducted in the open and that government records are open to inspection ... Avoid conflicts of interest, real or perceived ... Remain free of associations and activities that may compromise integrity or damage credibility ... Refuse gifts, favors, fees, free travel and special treatment, and shun secondary employment, political involvement, public office and service in community organizations if they compromise journalistic integrity ... Disclose unavoidable conflicts ... Admit mistakes and correct them promptly ... Expose unethical practices of journalists and the news media”).

<sup>38</sup>CESR Report p. 13.

<sup>39</sup>Ibid.

<sup>40</sup>Moody’s Investor Service, Code of Professional Conduct 6 (June 2005), available at <http://www.moody.com/cust/research/MDCdocs/01/2003400000425277.pdf>.

<sup>41</sup>Jones, Sam, Tett, Gillian, Davies, Paul J., “CPDOs expose ratings flaw at Moody’s,” *Financial Times*, May 20, 2008 available at [http://us.ft.com/ftgateway/superpage.ft?news\\_id=fto052020081848170758&page=2](http://us.ft.com/ftgateway/superpage.ft?news_id=fto052020081848170758&page=2) (see: “It was during this time that the bug in Moody’s model for rating CPDOs was uncovered. By February 2007, documents seen by the FT show that staff were discussing the issue and the impact on ratings of fixing the error. It was nothing more than a mathematical typo—a small glitch in a line of computer code. The impact of the “bug” Moody’s analysts discovered was, nevertheless, significant. When the model was re-run it became clear that the CPDOs could no longer achieve triple A ratings, according to documents seen by the FT. The results showed that early CPDOs might lose between 1.5 and 3.5 notches in the Moody’s Metric, an internal measure, which equals up to four ratings notches.”) and Smith, Elliott Bair, “Race to Bottom’ at Moody’s, S&P Secured Subprime’s Boom, Bust,” *Bloomerg.com*, available at: [http://www.bloomerg.com/apps/news?pid=20601109&sid=ax3vfya\\_Vtdo&refer=home](http://www.bloomerg.com/apps/news?pid=20601109&sid=ax3vfya_Vtdo&refer=home) (see: “Errors sometimes worked their way into the analysis. Kai Gilkes, 40, a former S&P quantitative analyst in London, says he discovered a flaw in the company’s main CDO model, the CDO Evaluator, which he updated in late 2005. In some cases, the S&P system overstated the quality of synthetic CDO Squared securities, Gilkes says. These complex investment pools are based on credit default swaps, a type of insurance against corporate default. “On collateral rated AA or higher, the S&P model did not properly stress the default behavior of the underlying CDOs, resulting in assets with a lower default probability than their ratings suggested,” Gilkes says”).

<sup>42</sup>Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies,” available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>, (see;\, as example, p. 13–16).

<sup>43</sup>Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies," available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> see p. 19.

<sup>44</sup>Kopecki, Dawn, "The Credit Ratings Blame Game," *Businessweek*, September 28, 2007 available at [http://www.businessweek.com/investor/content/sep2007/pi20070927\\_267775.htm](http://www.businessweek.com/investor/content/sep2007/pi20070927_267775.htm) (see, as example: "Our reputation is our business; when it comes into question, we listen, learn, and improve. ...").

<sup>45</sup>Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies" available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> p.25 (see: "Another rating agency reported to the Staff that one of its foreign ratings surveillance committees had knowledge that the rating agency had issued ratings on almost a dozen securities using a model that contained an error.<sup>47</sup> The rating agency reported to the Staff that, as a result, the committee was aware that the ratings were higher than they should have been. Nonetheless, the committee agreed to continue to maintain the ratings for several months, until the securities were downgraded for other reasons. Members of the committee, all analysts or analytical managers, considered the rating agency's reputational interest in not making its error public, according to the rating agency").

<sup>46</sup>Raymond McDaniel, Internal Memo, "Credit Policy issues at Moody," Sunday, October 21, 2007 11:08 PM available at <http://oversight.house.gov/documents/20081022111050.pdf> (see: "Ideally, competition would be primarily on the basis of ratings quality, with a second component of price and a third component of service. Unfortunately, of the three competitive factors, rating quality is proving the least powerful given the long tail in measuring performance. Were that the extent of the problem—that it is hard to measure quality and hence price and service are disproportionately weighted—it would pinch profitability, forcing rating agencies to spend more on service and take less in fees. But that is no different than for most other businesses and we can cope. The real problem is not that the market does underweight ratings quality but rather that, in some sectors, it actually

penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating. Unchecked, competition on this basis can place the entire financial system at risk. It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution. Moody's for years has struggled with this dilemma. On the one hand, we need to win the business and maintain market share, or we cease to be relevant. On the other hand, our reputation depends on maintaining ratings quality (or at least avoiding big visible mistakes)").

<sup>47</sup>17 CFR Part 240, "Definition of Nationally Recognized Statistical Rating Organization"; Proposed Rule Federal Register: April 25, 2005 (Volume 70, Number 78)] [Proposed Rules] [Page 21305–21323] available at <http://edocket.access.gpo.gov/2005/05-8158.htm>

<sup>48</sup>Letter from Kathleen Corbett of S&P to Jonathan Katz of SEC, June 9, 2005, p. 4, available at <http://www2.standardandpoors.com/spf/pdf/media/RatingsServices.pdf>

<sup>49</sup>Speech, Erik R. Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, June 11, 2008, available at <http://www.sec.gov/news/speech/2008/spch061108ers.htm>

<sup>50</sup>SARBANES-OXLEY ACT OF 2002, Section 206, available at <http://www.cfr.org/publication/16033/> (see: "(l) CONFLICTS OF INTEREST—It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit").

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