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Chairman Dodd, Ranking Member Shelby, and Fellow Senators:

I am honored to be back before this Committee to discuss the proposed "Investor Protection Act of 2009" and its provisions in Subtitle C ("Improvement to the Regulation of Credit Rating Agencies"). Frankly, I have Yogi Berra's sense of "déjà vu all over again" in reviewing this legislation, because it borrows very heavily from legislation introduced earlier this year by Senator Reed, which he called the "Rating Accountability and Transparency Enhancement Act of 2009." Senator Reed (and his staff) crafted an important and constructive piece of legislation, and the Administration has wisely adopted most of it.

Nonetheless, there are two respects in which the Administration's proposals in my judgment fall short. Unless these two problems are better addressed, I am afraid that the current and unsatisfactory status quo will persist. Credit rating agencies are unlike the other major gatekeepers of the financial markets (e.g., accountants, investment banks and securities analysts) in two critical respects:

(1) Unlike other gatekeepers, the credit rating agencies do not perform due diligence or make its performance a precondition of their ratings. In contrast, accountants are, quite literally, bean counters who do conduct audits. But the credit rating agencies do not make any significant effort to verify the facts on which their models rely (as they freely conceded to this Committee in earlier testimony here). Rather, they simply accept the representations and data provided them by issuers, loan originators and underwriters. The problem this presents is obvious and fundamental: no model, however well designed, can outperform its information inputs – Garbage, In; Garbage Out. Although the Administration's bill does address the need for due diligence, its current form (unlike the Reed bill) may

actually discourage third party due diligence. Ultimately, unless the users of credit ratings believe that ratings are based on the real facts and not just a hypothetical set of facts, the credibility of ratings, particularly in the field of structured finance, will remain tarnished, and private housing finance in the U.S. will remain starved and underfunded because it will be denied access to the broader capital markets.

(2) Credit rating agencies have long and uniquely been immune from liability to their users. Unlike accountants or investment banks, they have never been held liable. At the same time, because the "issuer pays" business model of the ratings agencies seems likely to persist (despite the creative efforts of many who have sought to develop a feasible "user pays" model), we have to face the simple reality that the rating agencies have a built-in bias: they are a watchdog paid by the entities they are expected to watch. Because the ratings agencies receive an estimated 90% of their revenues from issuers who are paying for their ratings,[1] the agencies will predictably continue to have a strong desire to please the client who pays them. Moreover, the market for ratings has become more competitive, and the latest empirical research finds that, with greater competition, there has come an increased tendency to inflate ratings.[2] This is predictable – unless there is some countervailing pressure on the gatekeeper. In the case of accountants and underwriters, there clearly is such countervailing pressure in the form of the threat

[1] See Frank Partnoy, "How and Why Credit Rating Agencies Are Not Like Other Gatekeepers" (http://ssrn.com/abstract=900257) (May 2006).
[2] See Bo Becker & Todd J. Milbourn, <u>Reputation and Competition: Evidence from the Credit Rating Industry</u>, (Harv. Bus. School Fin. Working Paper No. 09-051) (2008) (available at http://ssrn.com/abstract=1278150) (finding that the percentage of investment grade ratings went up and the percentage of non-investment grade ratings went down after competition intensified in the industry, beginning in the late 1990s).

of liability under the federal securities laws. But that threat has never had any discernable impact on the credit rating agencies. Let me make clear that I do <u>not</u> want to subject credit rating agencies to class action litigation every time a rating proves to be inaccurate. Rather, the goal should be more modest: to use a litigation threat to induce the rating agencies not to remain willfully ignorant and to insist that due diligence be conducted and certified to them with regard to structured finance offerings.

I. <u>The Disappearance of Due Diligence</u>

A rapid deterioration in underwriting standards for subprime mortgage loans occurred over a very short period, beginning around 2001. As the chart set forth below shows, low or no-document loans (also known in today's parlance as "liar's loans") rose from 28.5% in 2001 to 50.7% in 2005.

<u>Underwriting Standards in Subprime Home-Purchase Loans, 2001-2006</u>[3]

	Low/No-Doc Share	Debt Payments/ Income	Loan/Value	ARM Share	Interest-Only Share
2001	28.5%	39.7%	84.0%	73.8%	0.0%
2002	38.6%	40.1%	84.4%	80.0%	2.3%
2003	42.8%	40.5%	86.1%	80.1%	8.6%
2004	45.2%	41.2%	84.9%	89.4%	27.3%
2005	50.7%	41.8%	83.2%	93.3%	37.8%
2006	50.8%	42.4%	83.4%	91.3%	22.8%

Source: Freddie Mac, obtained from the International Monetary Fund.

[3] See Allen Ferrell, Jennifer Bethel and Gang Hu, Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis (Harvard Law & Economics Discussion Paper No. 612, Harvard Law School Program in Risk Regulation Research Paper No. 08-5) at Table 4.

Concomitantly, interest-only loans (on which no amortization of principal occurred) rose from 0% in 2001 to 37.8% in 2005. These changes should have prompted the ratings agencies to downgrade their ratings on securitizations based on such loans – but they didn't. As the housing bubble inflated, the ratings agencies slept.

Two explanations are possible for their lack of response: (1) the ratings agencies willfully ignored this change, or (2) they managed not to learn about this decline, because issuers did not tell them and they made no independent inquiry. Prior to 2000, the ratings agencies did have a reliable source of information about the quality of the collateral in securitization pools. During this period prior to 2000, investment banks did considerable due diligence on asset-backed securitizations by outsourcing this task to specialized "due diligence" firms. These firms (of which Clayton Holdings, Inc. was probably the best known) would send squads of loan reviewers (sometimes a dozen or more) to sample the loans in a securitized portfolio, checking credit scores and documentation. But the intensity of this due diligence review declined over recent years. The Los Angeles Times quotes the CEO of Clayton Holdings to the effect that:

> "Early in the decade, a securities firm might have asked Clayton to review 25% to 40% of the sub-prime loans in a pool, compared with typically 10% in 2006…"[4]

The President of a leading rival due diligence firm, the Bohan Group, made an even more revealing comparison:

> "By contrast, loan buyers who kept the mortgages as an investment instead of packaging them into securities would have 50% to 100% of the loans examined, Bohan President Mark Hughes said."[5]

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[4] See E. Scott Reckard, "Sub-Prime mortgage watchdogs kept on leash; loan checkers say their warnings of risk were met with indifference," Los Angeles Times, March 17, 2008 at C-1.
[5] Id.

In short, lenders who retained the loans checked the borrowers carefully, but the investment banks decreased their investment in due diligence, making only an increasingly cursory effort as the bubble inflated.

The actual loan reviewers employed by these firms also told the above-quoted Los Angeles Times reporter that supervisors in these firms would often change documentation in order to avoid "red-flagging mortgages." These employees also report regularly encountering inflated documentation and "liar's loans," but, even when they rejected loans, "loan buyers often bought the rejected mortgages anyway."[6] In short, even when the watchdog barked, no one at the investment banks truly paid attention, and no one told the rating agencies.

If mortgage-backed securitizations are again to become credible, ratings agencies must be able to distinguish (and verify) whether an asset pool consists mainly of "liar's loans" or is instead composed of loans made to creditworthy borrowers. This requires the restoration of due diligence – presumably by independent, third party due diligence firms.

Both the Administration bill and the earlier Reed bill make an effort to restore due diligence, but the impact of the Administration's bill is uncertain and possibly even counterproductive. In proposed Section 932(s)(3)(D) ("Transparency of Credit Rating Methodologies and Information Reviewed"), the Administration bill requires disclosure of:

> "whether and to what extent third party due diligence services have been utilized, and a description of the information that such thirty party reviewed in conducting due diligence services."

Then, in Section 932(s)(5) ("Due Diligence Services"), the Administration bill requires that where "third-party due diligence services are employed by a nationally recognized statistical rating organization or an issuer or underwriter, the firm providing the due diligence services shall

[6] Id.

provide to the [NRSRO] written certification of the due diligence, which shall be subject to review by the Commission."

This makes great sense – except for the fact that it is optional. The issuer or underwriter (who will likely be the parties retaining and compensating the due diligence firm) may decide that it is easier not to retain such an outside firm than to have to describe its procedures and the information it reviewed and then provide a certification to the ratings agency. In full compliance with §932(s)(3)(D), it could answer that third party firms were not used. To make this appear more palatable, the underwriter might describe some internal review procedures that were followed by its own staff (which would not trigger any mandatory certification to the rating agency). In short, given the choice, issuers and underwriters might prefer the easier course of doing nothing, and thus the current opacity surrounding structured finance offerings would persist. To be sure, some rating agencies might insist on third party due diligence (at least for a period of time), but they might thereby place themselves at a competitive disadvantage and lose business until they gave in.

How then can the use of third party due diligence be more effectively encouraged? One very feasible approach might be to focus on the users of credit ratings, for example by instructing mutual funds and other institutional investors that they could not rely on a rating issued by an NRSRO for purposes of their own need to comply with their own "prudent man" fiduciary obligations unless the ratings was explicitly based on third party due diligence. This would avoid any conceivable Constitutional issue, because Congress would not be mandating procedures for the NRSRO, but instead would be telling institutional investors what they needed to rely upon. To illustrate this approach, let me give two examples: Under current Rule 3a-7 under the Investment Company Act exempts fixed-income securities issued by a special purpose vehicle from the Investment Company Act if, at the time of sale, the securities are rated in one of four highest categories of investment quality by an NRSRO.[7] Congress could simply instruct the SEC that such an exemption should also require that the requisite investment grade rating be based on third party due diligence that was certified to the rating agency pursuant to Section 932(s)(5). Similarly, Rule 2a-7 ("Money Market Funds") under the same Act defines an "Eligible Security" as one that has a specified rating given by an NRSRO.[8] If this rule required that the rating be based in addition on a due diligence certification, money market funds would be effectively required to demand that NRSROs receive such certifications. The attraction of this approach is that it does not mandate what the NRSRO must do, but instead tells the users of ratings what they must have. Effectively, issuers, underwriters and NRSROs would know that they had to use a due diligence firm to verify the critical information assumed by the rating agency's model in they intended to sell the offering to these institutions.

A second approach to this same end could be achieved through the reformulation of liability rules, as next described.

II. Using Liability to Compel Due Diligence

The most serious failing in the proposed legislation is that it ducks the issue of enforcement and relies solely on SEC monitoring and disclosure. Even if we assume that the SEC will always be vigilant (which may be a heroic assumption after the Madoff debacle), the SEC is not given any clear authority to mandate due diligence. Moreover, over the last decade, we have seen the rating agencies behave in a manner that approached willful ignorance about changes in the credit environment that were clear to almost everyone else.

[7] See 17 C.F.R. §270.3a-7.
[8] See 17 C.F.R. §270.2a-7.

Here, a balance must be struck. Ratings agencies appear never to have been held liable under the federal securities laws.[9] Even in the Enron litigation, a proceeding in which underwriters paid over $7 billion in settlements, the credit rating agencies escaped liability.[10] Although it is not possible to be aware of every possible settlement in federal or state court, recent surveys by legal scholars continue to reach this same conclusion. See, e.g., Frank Partnoy, Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective (Council of Institutional Investors White Paper April 2009) at 14-15; Kenneth Kettering, Securitization And Its Discontents: The Dynamics of Financial Product Development, 29 Cardozo L. Rev. 1553, 1687-93 (2008); Arthur R. Pinto, Control and Responsibility of Credit Rating Agencies in the U.S., 54 Am. J. Comp. L. 341, 351-356 (2006). As a Congressional staff study found in 2002, the rating agencies that qualify as NRSROs are legislatively shielded from liability under the federal securities laws.[11] The First Amendment defense is only one of many defenses relied upon by the industry, and probably not the most important. Yet, although many tort law theories have been attempted by plaintiffs, "the only common element . . . is that the rating agencies win."[12] Since the 2006 legislation, the ratings industry now takes the position that that legislation preempted state tort law and thus precludes even fraud actions based on the

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[9] Recently, a number of securities class actions have included rating agencies as defendants. In a few cases, federal courts have refused to grant motions to dismiss sought by the ratings agency. See, e.g., In re Moody's Corp. Sec. Litig., 599 F. Supp. 2d 493 (S.D.N.Y. 2009); In re National Century Financial Enterprises Inc. Invest. Litig., 580 F. Supp. 2d 630 (S.D. Ohio 2008). But this simply means that the plaintiff has survived the first round in a long fight. My discussions with plaintiffs attorneys suggest that they see the underwriters as the "deep pocket" defendant in these cases and are not expecting significant contributions from the rating agencies, given the many legal obstacles to suing them.

[10] See Newby v. Enron Corporation, 511 F. Supp. 2d 741, 815-817 (S.D. Tex. 2005).

[11] See Staff of the S. Comm. on Governmental Affairs, 107 Cong., Report: Financial Oversight of Enron: The SEC and Private-Sector Watchdogs (Comm. Print Oct. 8, 2002) at 104-05. In particular, Rule 436(g) under the Securities Act of 1933 specifically exempts the ratings agencies from liability as an expert under Section 11 of that Act.

[12] See Frank Partnoy, "The Paradox of Credit Ratings" in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM (Richard Levich et al. eds 2002) at 79; see also First Equity Corp. v. Standard & Poor's Corp., 869 F.3d 175 (2d Cir. 1999) (rejecting common law theories under New York and Florida law).

common law.[13] In short, while a settlement may have been paid somewhere in the recent flurry of litigation, the risk of liability for ratings agencies remains remote.

This does not mean, however, that we should seek to maximize liability. Clearly, the rating agencies cannot be insurers of credit quality and could conceivably be drowned under a sea of liability if the liability rules were greatly liberalized. Precisely for that reason, Senator Reed's bill struck a very sensible compromise in my judgment. It created a standard of liability for the rating agencies, but one with which they easily could comply (if they tried). Specifically, his bill contained a Section 4 ("State of Mind in Private Actions") that permitted an action against a credit rating agency where:

> "the complaint shall state with particularity facts giving rise to a strong inference that the [rating agency] knowingly or recklessly failed either to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk, or to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that it considered to be competent and that were independent of the issuer and underwriter."

This language does not truly expose rating agencies to any serious risk of liability – at least if they either conduct a reasonable investigation themselves or obtain verification from others (such as a due diligence firm) that they reasonably believed to be competent and independent.

Given the express certification requirement in the proposed legislation, this language could be picked up and incorporated into an updated revision of the above language in the Reed bill, so that a rating agency would be fully protected when it received such a certification from an independent due diligence firm that covered the basic factual elements in its model. Arguably, this entire liability provision could be limited to structured finance offerings, which is where the real problems lie.

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[13] See Section 15E(c)(2) of the Securities Exchange Act of 1934 (discussed infra), 15 U.S.C. §78o-7(c)(2).

The case for this limited litigation threat is that it is unsafe and unsound to let rating agencies remain willfully ignorant. Over the last decade, they have essentially been issuing hypothetical ratings in structured finance transactions based on hypothetical assumed facts provided them by issuers and underwriters. Such conduct is inherently reckless; the damage that it caused is self-evident, and the proposed language would end this state of affairs (without creating anything approaching liability for negligence).

III. Drafting Suggestions

There are some ambiguities and inconsistencies in the draft bill that should be corrected:

1. First, there is a clear inconsistency between the amendment to Section 15E(c)(2), which would continue to state that:

> "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 [NRSRO] determines credit ratings."

and proposed Section 932(r), which provides that:

> "The Commission shall prescribe rules . . . with respect to the procedures and methodologies, including qualitative and quantitative models, used by [NRSROs] that require each [NRSRO] to _"

This conflict is dangerous, and it might be cured in part by stating in §15E(c)(2) that: "except as otherwise specifically provided in this title, neither the Commission nor any State . . . may regulate . . . ." Even more importantly, Congress should realize that, whatever it may have intended, the ratings industry is arguing in court that this language in Section 15E(c) also preempts common law claims for fraud and negligence. If Congress did not intend to preempt the common law, it should correct this looming misinterpretation and limits its preemption provision so that it does not reach the common law. If fraud can be proven under state law or Blue Sky statutes, such an action should not be preempted.

2. Under existing Section 15E(d), the SEC may censure, suspend (and now fine) an NRSRO for limited reasons only. The last and residual clause (Section 15E(d)(5)) says that such discipline or suspension may be invoked if the NRSRO "fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity." This is too high a standard and also too narrow a standard. With the revisions to be made by this legislation, an NRSRO will also be expected to maintain conflict of interest policies and to comply with the SEC's new procedural and disclosure rules under Sections 932 and 933. Hence, this Section should be broadened to read:

> "(5) failed to (i) operate in substantial compliance with the rules promulgated by the Commission, (ii) maintain adequate financial and managerial resources to consistently produce credit ratings with integrity, or (iii) demonstrate sufficient competence or accuracy to justify continued reliance by investors upon its ratings."

The last clause would also entitle the Commission to discipline, suspend or revoke the registration of a ratings agency that was systematically inaccurate or inferior over a sustained period. An incompetent ratings agency does not merit tenure.

3. Proposed §934 requires the SEC to adopt rules requiring issuers to disclose "preliminary credit ratings received" from NRSROs. Because the term "preliminary credit rating" is not defined, this rule could be easily sidestepped if the NRSRO gave the issuer instead a general (or even a specific) description of how it would evaluate the issuer's credit, but not an actual or tentative rating. Hence, it would be advisable to broaden this section so that it required disclosure of "preliminary credit ratings or any other assessment or information that informed the issuer of the likely range within which it would be rated or the likely outcome of the rating process."

4. If we want the ratings agency to rely on more than the facts provided by the issuer or underwriter, consideration should be given to expanding the required disclosures under §932(s)(3)(E). For example, the new form specified by that Section should require disclosure of:

> "(E) a description of all relevant data, from whatever source learned or received, about any obligor, issuer, security, or money market instrument that was used and relied upon, or considered but not relied upon, for the purpose of determining the credit rating, indicating the source of such information;"

This is an admittedly broad provision, but aimed at making it more difficult for the rating agency to ignore information from third parties.

5. Consideration should be given to requiring the new compliance officer (which each NRSRO will be required to employ under this legislation) to provide any credible information that it learns indicating fraudulent or unlawful behavior to an appropriate law enforcement agency and/or the SEC. This is in effect a mandatory whistle-blowing provision, and exceptions could be created to cover circumstances when the compliance officer concluded that the information was false or unreliable.