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Credit Rating Agency Oversight Reform: Addressing the Weak Link in the Chain

By Ian Berg

"Credit rating agencies are the weak link in the chain," said Congressman Keith Ellison (Minnesota), echoing the March 2008 assessment of the President's Working Group on Financial Markets and prevailing investor sentiment that the credit rating agencies were a "principal underlying cause" of the recent financial market melt-down. Congressman Ellison issued his remarks on July 8, 2009, when he introduced legislation to strengthen the regulation of credit rating agencies. Under Congressman Ellison's proposed legislation, the Federal Reserve would have oversight authority when the rating agencies analyze and rate structured financial products. This would extend to all asset-backed securities ("ABS") the oversight power that the Federal Reserve has already assumed over ABS issued in accordance with the government's \$200 billion Term Asset-Backed Securities Loan Facility (TALF) bail-out program. The credit rating agencies currently fall under the purview of the U.S. Securities & Exchange Commission (the "SEC"), pursuant to the Credit Rating Agency Reform Act of 2006, but Ellison believes that the "oversight to which they are subject is wholly inadequate." Newly-appointed SEC Chairman Mary Schapiro would likely agree, but she maintains that the SEC needs more authority to better regulate credit rating agency conduct as opposed to extending new authority to the Federal Reserve.

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mortgage-backed securities ("MBS") and other ABS over the past several years. Specifically, analysts charged with rating the securities were often aware that a high rating would improve the financial success of the firm, and altered their conduct accordingly. The SEC report additionally concluded that the rating agencies failed to maintain adequate resources to properly assess and track the issues they rated. Since then, Chairman Schapiro has been trying to answer the loud calls for meaningful reform from various investors, regulators and legislators.

In March 2009, Schapiro testified during her first Congressional hearing as Chairman that the SEC needs broader authority from Congress to oversee the credit rating agencies. Since then, Chairman Schapiro has been active in her reform efforts, examining how rating

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agencies are compensated, how they manage conflicts of interest and what role they should play in the markets. On April 15, 2009, Chairman Schapiro held a roundtable discussion on the SEC's oversight of the rating agencies that included industry leaders and leading academic experts. The roundtable discussed topics including: the rating agencies' perspective on what went wrong to cause the current credit crisis and the remedial steps being taken by the agencies; competition issues that present barriers to entry for competing ratings agencies; ratings users' perspectives on the rating industry; and, approaches to improving rating agency oversight. As suggested by the roundtable agenda, Chairman Schapiro's ultimate goal is for the SEC to explore ways to diminish the market's dependence on the inherently unreliable ratings by the large rating agencies.

Despite Chairman Schapiro's efforts to work within the current regulatory framework, it has become clear that the best chances to enact meaningful reform would require new legislation and enhanced regulatory oversight power. To that end, on July 21, 2009, the U.S. Treasury Department proposed an 18-page draft bill to Congress that would prevent credit rating agencies from consulting for the companies they are responsible for evaluating. Under the Treasury Department's proposal, the SEC would have increased powers to regulate the credit rating agencies, including requiring debt issuers to disclose all preliminary ratings that they receive from rating agencies prior to selecting a firm to conduct the final issued rating. The idea is to stop issuers from shopping around for the best rating and leveraging rating agencies against each other.

Whether or not these latest proposals are enacted, the mere existence of the Treasury Department bill is a positive

indication that the Obama administration will be active in seeking reform. Of course, questions remain over who should be charged with administering and enforcing any additional regulations. There is an ongoing debate over whether the SEC should retain exclusive authority over the credit rating agencies, or if oversight should be shared by other agencies, such as the Federal Reserve, as Congressman Ellison proposes. In addition, there is considerable debate over what role, if any, investors should have in holding the credit rating agencies accountable.

In his recent report commissioned by the Council for Institutional Investors, titled, "Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective," Frank Partnoy, Professor of Law and Director of the Center of Corporate Securities Law at the University of San Diego Law School, examined what types of legislative reform would be needed to ensure the integrity of the ratings industry, particularly from the perspective of institutional investors. Professor Partnoy joined many other voices calling for enhanced government oversight of the rating agencies, either by the creation of a new "Credit Rating Oversight Board" or by increasing the authority of the SEC. However, Professor Partnoy also called for a better judicial enforcement mechanism, which would include removing rating agencies' exemption from liability under the Securities Act and otherwise making rating agencies subject to private rights of action under the anti-fraud provisions of securities laws.

Fittingly, Professor Partnoy's report was released two weeks after Senator Jack Reed (Rhode Island) circulated the proposed Credit Rating Agency Reform Act of 2009 (the "2009 Reform Act") to the United States Senate seeking to, *inter alia*, amend Section 21D(b)(2) of the Exchange Act, 15 U.S.C. 78u-4(b)(2), to allow for a private right of action against credit rating agencies for failing to conduct a reasonable investigation of a rated security. The 2009 Reform Act would

also eradicate the First Amendment protections from litigation that judges have liberally afforded to rating agencies in the past. These reforms would enable investors to play a critical role in policing the rating agencies and to help hold rating agencies accountable for their misconduct. On July 14, 2009, Chairman Schapiro indicated support for this private right of action, telling a Congressional panel that it could result in higher-quality work by the rating agencies.

In addition to creating a private right of action, the 2009 Reform Act (in its current form) would require rating agencies to implement written controls policies, greater disclosures and record keeping, and new compliance measures to deal with conflicts of interest and ratings model issues. The 2009 Reform Act would also grant the SEC more authority to oversee the rating agencies, which is a compliment to legislation introduced to the United States House of Representatives by Representative Gary Ackerman (New York) that would prohibit rating agencies from issuing SEC-recognized ratings on debt securities without a "documented history" showing how the particular pool of assets would likely perform.

Ultimately, credit rating reform mandates, whether governmental or private, have become an integral part of the financial markets and of critical importance to securities market participants and creditors. Despite some reckless and harmful past conduct, ratings — and credit rating agencies — are a necessary link in the financial market's proverbial chain. Absent meaningful legislative reform, including an enforceable private right of action for civil liability, the rating agencies will continue to operate unfettered at the expense of investors, and the securities market could become increasingly vulnerable to another financial crisis in the future.

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