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"Independent" Rating Agencies Culpable in Credit Crisis

By Avi Josefson

The collapse of the subprime mortgage markets, and the consequent seizure of the markets for complex securities backed by mortgages and other debt, has brought down many titans of the U.S. economy. Dozens of mortgage lenders lie in bankruptcy, a leading investment bank — Bear Stearns — imploded and two of its investment managers are now under indictment for misleading investors. But the most spectacular fall from grace may be that of the credit rating agencies — Moody's, Standard & Poor's and Fitch. Those firms, considered so independent and unbiased that they are afforded journalistic privileges under the First Amendment, now stand accused of being not merely negligent, but complicit, in the subprime debacle. As ripples of the fiasco continue to spread, analysts, regulators, and investors are increasingly focusing on the role of the rating agencies and their failure to accurately assess the true risk level of the residential mortgages that stood behind billions of dollars worth of securities they rated as investment grade.

The most spectacular fall from grace may be that of the credit rating agencies —Moody's, Standard & Poor's and Fitch. Those firms now stand accused of being, not merely negligent, but complicit in the subprime debacle.

The Changing Role of the Rating Agencies

The rating agencies helped transform the mortgage industry and spur the frenetic and — in retrospect — irresponsible growth that drove the housing bubble. Traditionally, mortgages were issued by banks that retained those loans for their portfolio. Because those lenders faced the risk of default, their limited capital and appetite for risk acted as a natural control on the volume and quality of mortgage originations. A paradigm shift occurred when investment bankers began to bundle pools of mortgages together into complex securities, whose value was ostensibly tied to the quality of those underlying mortgages. By offering these securities to investors, the investment banks created a lucrative new product and severed the historical tie between lenders and their loans.

The rating agencies played a key role in this process because of regulations that require many investors, including banks, mutual funds and many public pension funds, to hold "investment-grade" bonds. The need for investment-grade mortgage-backed instruments created a problematic cycle: the added capital flowing into the mortgage industry spurred a rapid

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RATING AGENCIES

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expansion in mortgage originations, which grew to more than $2.5 trillion in 2006, but the greatest area of growth was in risky subprime mortgages. Subprime loans are issued to borrowers with poor credit. They carry higher interest rates, but bear a much higher risk of default than do prime loans. Astonishingly, according to a Goldman Sachs study, subprime loans grew from just 9% of newly-originated securitized mortgages in 2001, to 40% in 2006. Wall Street banks were faced with a supply of high-risk mortgages and demand for low-risk mortgage-backed securities. It was the rating agencies who stepped in and helped structure highly-complex instruments known as collateralized debt obligations ("CDOs") that, despite being backed by high-risk, subprime loans, had some classes within their structures that were given investment-grade credit ratings.

Structure of a CDO

A recent feature by Roger Lowenstein in *The New York Times* provides a rare glimpse inside Moody's, where Lowenstein had the opportunity to see first-hand how CDOs were rated. The mechanism for converting high-risk mortgages into purportedly low-risk securities involved the use of different "tranches"or classes of debt, each with varying degrees of credit risk. As Lowenstein explains, the subprime mortgages themselves are held by a special purpose vehicle ("SPV") — with no assets apart from those mortgages. "The secret sauce is that the SPV would float 12 classes of bonds, from triple-A to a lowly Ba1. The highest rated bonds would have first priority on the cash received from mortgage holders until they were fully paid, then the next tier of bonds....It was this segregation of payments that protected the bonds at the top of the structure and enabled Moody's to classify them as triple-A. Imagine a seaside condo beset by flooding: just as the penthouse will not get wet until the lower floors are thoroughly soaked, so the triple-A bonds would not lose a dime unless the lower credits were wiped out."

However, those credit ratings were ultimately based on assumptions as to how many of the underlying mortgages would default. The rating agencies relied on statistical models using historical default patterns, without accounting for material developments in the mortgage industry. For example, the use of adjustable-rate mortgages or "ARMs"— which feature a low initial payment that then adjusts, often dramatically — increased significantly. Such loans enticed many borrowers who clearly would not able to afford the higher "reset"rate. Further, subprime lenders were widely issuing exotic new types of mortgages, including interest-only mortgages and "pay option" ARMs, which allowed borrowers to make payments below the minimum principal payment — loan structures that

Inside Look

Max Berger

This quarter, the *Advocate* continues to focus on the unfolding credit crisis. Wall Street investment firms spent the past quarter assuring investors that an end to subprime-related losses was in sight, only to announce billions of dollars of additional write-downs. With the Federal government opening its coffers to support Wall Street, shareholders suffering massive losses, and taxpayers largely footing the bill, some further explanation of the causation of all the market turmoil seems fitting.

In "'Independent' Rating Agencies Culpable in Credit Crisis" (our cover story), firm associate Avi Josefson provides a detailed look at the role of ratings agencies and their dramatic failure in assessing mortgage related risk.

Firm associate David Webber, in a follow up to our last issue, outlines the problems with the SEC's passive handling of the subprime meltdown and the inaction of SEC Chairman Christopher Cox in the face of the recent financial crisis on page 6.

Another victim of the expanding credit crisis, auction rate securities, failed disastrously in February. As the underwriters of these securities abandoned ship, these "safe"vehicles collapsed.

On page 7, firm associate Paul Kemnitzer demonstrates how investors in these securities soon discovered that these "cash equivalents" were anything but.

I also direct your attention to the regular "Eye on the Issues" column. Firm associate Takeo Kellar provides a perceptive compilation of the most significant recent developments in securities litigation, regulation and corporate governance.

We trust that you will find this issue of the *Advocate* both informative and insightful. As always, we welcome your comments, questions and input.

Max W. Berger

Quarterly Quote...

"Let's hope we are all wealthy and retired by the time this house of cards falters."

E-mail sent by a CDO group analytical manager at Standard & Poor's Ratings Services, cited in the SEC's July 2008 "Summary Report on Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies."

had no historical payment data at all. At the same time, growing competition coupled with the transfer of risk from lenders to investors motivated many mortgage lenders to relax or abandon their loan underwriting standards and issue mortgages to borrowers who could not even document such basic elements of their creditworthiness as income or employment.

Those changes rendered the default models relied on by the rating agencies obsolete. To extend Lowenstein's analogy, the rating agencies were assuming that the penthouse would not get wet simply because it had not gotten wet in the past, despite manifest signs that flood waters were rising quickly. It is clear that the rating agencies never adapted their analyses to reflect the current state of the mortgage industry. Indeed, when Moody's ultimately announced revisions to the model used to evaluate subprime mortgages, it noted that that model "was first introduced in 2002. Since then, the mortgage market has evolved considerably." As J.P. Morgan CEO Jamie Dimon observed, "There was a large failure of common sense. Very complex securities shouldn't have been rated as if they were easy to value bonds."

Lowenstein details Moody's process of rating a $430 million mortgage securitization. The data provided to Moody's showed that 75% of the mortgage pool consisted of ARM loans, and that over 40% of the loans were "stated income" — meaning that the borrowers' income was not verified. In addition, a significant percentage of the loans were concentrated in a single geographic region. Nonetheless, Moody's analysts forecast losses of just 4.9% of the underlying mortgages. In fact, 13% of the loans in that pool became delinquent by the spring of 2007, despite having been issued just one year earlier. The ramifications of credit ratings that ignored those red flags quickly became apparent. As mortgage defaults soared in 2007, the rating agencies reacted by downgrading billions of dollars worth of CDOs and similar instruments. Those downgrades prompted banks to write-down the value of their own mortgage-backed assets, leading to billions in losses at Wall Street and foreign banks, including Citigroup, Merrill Lynch, Bear Stearns, UBS and, most recently, Lehman Brothers.

That the rating agencies failed to accurately assess the risks is clear. The question now being debated (and litigated) is whether that failure was driven by a conflict of interest that removed the rating agencies from their traditional role as impartial observers, and turned them into players with vested interests in their own ratings. Rating agencies have traditionally marketed themselves as journalists whose ratings, which are published for a fee to subscribers, reflect their unbiased assessments of risk. Historically, the overwhelming majority of rating agencies' revenues was generated by subscription fees from subscribers who received research and ratings on the creditworthiness of debt issuers. In the structured finance arena, however, rating agencies played an active role in structuring the very instruments that they rate, and received lucrative fees for their services. As the International Herald Tribune reported, "when it comes to CDOs, rating companies actually do much more than evaluate them and give them letter grades. The raters play an integral role in putting the CDOs together in the first place" and "tell CDO assemblers how to squeeze the most profit out of the CDO by maximizing the size of the tranches with the highest ratings." Other market observers have noted "the [rating] agency is involved at an early stage, and the rating is not an outcome but a target for the arranger, with the agency indicating the factors that need to be addressed to obtain the desired rating."

Reflecting the increased role that rating agencies play, fees for structured finance-related work came to represent a disproportionate share of the rating agencies' revenues. As the mortgage industry exploded between 2002 and 2006, driven by securitization fees, Moody's profits nearly tripled to $750 million. This outsized compensation has given rise to questions as to whether the agencies, as Lowenstein puts it, were "far less discerning when the client was a Wall Street securitizer." For example, a Drexel University study compared corporate bonds and CDOs with the same credit rating and found that the CDOs defaulted eight times as often.

Regulatory Intervention Ensues

The rating agencies have now become the subject of regulatory attention. In September 2007, the Securities & Exchange Commission gained regulatory authority over Moody's, Fitch's and Standard & Poor's and quickly launched an investigation. That inquiry was expanded in May 2008 when Moody's disclosed that it had identified errors in

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Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Takeo Kellar

FBI's Corporate, Mortgage, and Securities Investigations on the Rise: The number of corporate, mortgage, and securities investigations by the U.S. Federal Bureau of Investigation ("FBI") increased last year, according to a recently released financial crimes report. The FBI reported it had 529 corporate fraud investigations, nearly double the number just five years ago. The FBI reported that its ongoing corporate fraud investigations allegedly account for more than $1 billion in losses to public investors. Through fiscal year 2007, the FBI reported 183 indictments and 173 convictions of corporate criminals through plea bargains or trials. Among the securities and commodities fraud cases, 2007 saw a five year increase from 937 cases in 2003 to 1,217 last year. The number of mortgage fraud investigations pending nearly tripled, up from 436 in 2003 to 1,204 in 2007. Signaling that the surge in mortgage fraud is not letting up, the FBI recently ordered more than two dozen of its field offices to stop probing certain financial crimes so agents can focus on the subprime crisis. *The National Law Journal, May 23, 2008; Bloomberg, June 12, 2008*

Reports Weigh in on Number of Restatements: A study commissioned by the U.S. Department of Treasury released in April reports that the number of financial restatements filed by public companies to correct accounting errors increased from 90 in 1997 to 1,577 in 2006. The Treasury Department study analyzed 6,633 restatements between 1997 and 2006. While the Treasury Department study did not include 2007 filings, according to a separate study by Glass, Lewis & Co., the number of restatements fell sharply in 2007 by 17 percent after the decade-long increase. The Glass Lewis report also pointed out that about 23% of U.S.-listed companies filed at least one restatement during the last five years. The most common error corrections in each of the last five years related to expense recognition, misclassification, and improper accounting for equity items. Among audit firms, Deloitte & Touche had the highest auditor restatement rate and KPMG had the lowest, according to the Glass Lewis study. *http://www.treas.gov/press/releases/reports/FinancialRestatements_1997_2006.pdf; CFO.com, April 9, 2008 and June 3, 2008*

PCAOB Adopts Rules for Annual and Special Reporting: The Public Company Accounting Oversight Board (the "PCAOB") adopted new rules requiring the more than 1,800 registered public accounting firms to file their own annual reports, as well as special reports on events such as disciplinary actions against the firm or key individuals. The PCAOB, created by the Sarbanes-Oxley Act of 2002 to oversee the auditors of public companies, believes the new reporting rules will give investors and the public more transparent information about auditing firms. Under the rules, accounting firms will be required to fulfill the new reporting obligations starting on June 30, 2009, for the 12-month period ending March 31, 2009, if the rules are approved by the SEC. In addition to basic information, the annual report will have to include information about audit reports issued by the firm during the year, certain disciplinary history information about persons who have joined the firm, and information about fees billed to clients. The Board will make each firm's annual and special reports available to the public on the Board's Web site, subject to exceptions for information that satisfies specified criteria for confidential treatment. *http://www.pcaobus.org/News_and_Events/News/2008/06-10.aspx; CFO.com June 10, 2008*

Costs for SOX Compliance Decline: The Financial Executives International survey of 185 companies conducted in March and April found that there was a decline in the cost of complying with the Sarbanes-Oxley Act ("SOX"), even as overall audit expenses rose last year. Congress enacted SOX in 2002 in the wake of financial scandals to focus greater attention on internal financial reporting controls. The law calls for companies to make an annual assessment of such controls, subject to review by the company's outside auditor. The survey found that larger firms spent an average of $3.6 million on total audit fees last year, up nearly 2% from 2006. But overall, there was a decline of 5.4% in the costs of auditors reviewing the effectiveness of corporate management's internal controls over financial reports, as required by SOX. Higher hourly rates for auditors likely explain why total costs are rising even as internal control review costs fell, according to the survey. The amount of hours spent internally on assessing internal controls fell about 8.6% last year, while time spent by outsiders fell nearly 14%. *The Wall Street Journal, May 1, 2008*

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Shareholder Voting Declines as Companies Switch to E-Proxy: The Securities and Exchange Commission ("SEC") adopted Rule 14a-16 last July to allow companies to collect shareholder votes online. According to recent data from Broadridge Financial Solutions, Inc., ("Broadridge") which processes proxy votes, there has been a decline in individual shareholder votes at companies that are now using the electronic model, dubbed "e-proxy." On average, just 4.6% of individual shareholders voted on company matters using e-proxy, down from the 19.2% who voted in the year-earlier period, when the companies sent out traditional paper ballots. According to Broadridge, a variety of reasons could account for the decline in voter participation. It could be a temporary phenomenon as individual shareholders make the adjustment to the web ballots. Similarly, several companies have stated that investors were confused by the mailed notice explaining the electronic procedures. Other companies have stated that elderly people and those living in remote areas are less likely to go online and prefer to receive the documents in the mail. The SEC says it is studying the latest Broadridge data and that "some of the effects may be overstated." A spokesman for the SEC says the Commission "will continue to monitor these issues closely and to consider whether any revisions to the notice and access rules would improve shareholder participation." *The Wall Street Journal, April 23, 2008*

SEC Chairman Seeks Oversight Body for International Accounting Standards: In a recent interview, SEC Chairman Christopher Cox said he wants to propose a "public policy oversight body" that will oversee the trustees of the International Accounting Standards Board ("IASB"). Mr. Cox stated that the oversight body should be made up of national securities regulators and will help make IASB's governance consistent with the requirements of Sarbanes-Oxley corporate-governance rules. This step could smooth the way to allow domestic companies to choose international standards over traditional U.S. accounting standards. The SEC last year passed a rule allowing foreign companies with U.S. listings to report using only International Financial Reporting Standards ("IFRS"); previously, they had to file another set of accounts using U.S. Generally Accepted Accounting Principles, or GAAP. The SEC has been considering allowing U.S. companies to comply with IFRS instead of GAAP, although it has not yet reached a decision on whether it would be an option or required after a certain period of time. *The Wall Street Journal, May 28, 2008*

Banks Looking For Lawyers: Financial institutions hard hit by the subprime mess are seeking to recover losses by suing other banks for alleged misrepresentations in the sale of mortgage-backed securities and related products. The banks, however, are reportedly having a difficult time finding law firms to file a suit for them. Historically, Wall Street law firms that represent financial institutions do not sue other banks. In return for declining the occasional case, law firms were rewarded with transactional, defense, and regulatory work as preferred outside counsel. The number of potential cases that pit bank against bank is currently bumping up against this policy, causing firms to consider loosening their business conflict standards. Still, many firms are reluctant to file suits against other banks for fear of losing financial industry clients. As exemplified in a recently reported case, a global financial institution dropped its long-time outside counsel after the law firm participated in a suit against the bank. *Law.com, July 14, 2008*

By The Numbers...

100,000
Jobs cut by the world's biggest banks and securities firms in the past year

$ 40 Billion
Amount of auction rate securities which Citigroup, UBS and Merrill have been forced to buy back from clients in a settlement with the SEC and the NY Attorney General

$ 500 Billion
Credit losses and writedowns by the world's largest banks and securities firms linked to the subprime meltdown

Source: *Bloomberg* – Aug 12, 2008; July 31, 2008; *Wall Street Journal* – Aug 8, 2008

Appeals Court Upholds Sarbanes-Oxley Audit Panel: In ruling on an appeal of a case dismissed by a lower court last year, the U.S. Court of Appeals for the District of Columbia upheld the legality of the Public Company Accounting Oversight Board ("PCAOB") which was created by the Sarbanes-Oxley Act ("SOX") in 2002 to oversee auditors. This case was an appeal from the district court's grant of summary judgment rejecting a Las Vegas accounting firm's claims that, by stripping the President of all power to appoint, remove or otherwise supervise the members of the PCAOB, SOX violates the Constitution's separation of powers and Appointments Clause. Writing for a 2-1 majority of the Court of Appeals, Judge Judith Rogers ruled that PCAOB members are "not required to be appointed by the president." There had been predictions that the court may rule the other way, which would have potentially unraveled SOX. This is because the Act apparently lacks a "severability" clause; that is, if one of its provisions was found to be unconstitutional, the whole law would fail. SEC Chairman Christopher Cox said the decision was "welcome news for the commission, investors and U.S. capital markets." The case is *Free Enterprise Fund v. Public Company Accounting Oversight Board, No. 07-5127. Bloomberg.com, August 22, 2008; WashingtonPost.com, July 20, 2008*

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Let Him Eat Cake

SEC Chairman Cox attends birthday party while Wall Street implodes

By David Webber

As we enter a bear market created by the credit crisis, subprime mortgages, and the collapse of Bear Stearns, the two most visible government officials coping with the financial emergency have been Ben Bernanke, Chairman of the Federal Reserve, and Henry Paulson, Secretary of the Treasury. Conspicuously absent from the headlines — noticeable, if anything, for his prominent place on the sidelines — has been the Chairman of the Securities and Exchange Commission, Christopher Cox. For a crisis created by Wall Street and unfolding on Wall Street, the sidelines are a very strange place for the country's chief securities regulator to be.

Like James Cayne, the former CEO of Bear Stearns, who was playing in a bridge tournament while the investment bank disintegrated, Cox was enjoying a friend's birthday party the Saturday night that Bernanke, Paulson, and others worked around the clock to ensure the success of J.P. Morgan's buyout of Bear Stearns. In fact, Bernanke had been invited to the same party, but declined to attend, believing that staving off the collapse of the financial markets was more important. When asked by the *Wall Street Journal* why he had played such a marginal role in addressing the Bear Stearns debacle, Cox resorted to technical arguments about the SEC's jurisdiction: once the J.P. Morgan/Bear Stearns deal closed, he said, it became a "commercial transaction" which meant the SEC's only role was to assure that customer accounts were protected.

Few people would categorize the evaporation of $18 billion of shareholder value in one weekend followed by the fire sale of one of the country's oldest and most prominent investment banks as a mere "commercial transaction." If Bernanke and Paulson had understood their jurisdictions as narrowly, nothing at all might have been done about the maelstrom that threatened to consume the credit markets (and still does). Likewise, precipitating factors in Bear Stearns's demise, including the collapse of two of its hedge funds last July for bad bets made on subprime mortgages, and the dangerously low levels of capital maintained by the bank through the worst credit crisis in decades, cannot be safely branded as "commercial transactions" and sloughed off as some other regulator's responsibility.

Conspicuously absent from the headlines—noticeable, if anything, for his prominent place on the sidelines—has been the Chairman of the Securities and Exchange Commission, Christopher Cox. For a crisis created by Wall Street and unfolding on Wall Street, the sidelines are a very strange place for the country's chief securities regulator to be.

In times of crisis, leaders take action. They do not seek excuses for inaction. In 1990, when Drexel Burnham Lambert Inc. collapsed, then-SEC Chairman Richard Breeden participated directly in the decision not to bail out the ailing bank. In response to the Asian financial crisis of the late nineties, then SEC Chairman Arthur Levitt cut short an overseas trip to join Treasury Secretary Robert Rubin on the working group assembled by President Clinton. On September 11th, 2001, then SEC Chairman Harvey Pitt stayed behind at the evacuated SEC headquarters to coordinate the temporary cancellation of market trading with representatives from the White House, Treasury, the Federal Reserve and the heads of the NYSE and Nasdaq.

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"Safe" Auction Rate Securities Collapse

By Paul Kemnitzer

In mid-February 2008, the holders of an investment that had been marketed as a safe and liquid alternative to money market accounts — Auction Rate Securities ("ARS") — discovered that this image was a mirage. Financial instruments once marketed as a more lucrative but equally safe alternative to money market accounts became cash traps for thousands of investors.

During that month as many as 80% of ARS put up for sale at scheduled periodic auctions across the country failed to attract bidders. Typically, the large investment banks such as Citigroup, UBS, Morgan Stanley, and Merrill Lynch — who underwrite the majority of securities — step in to buy any unsold ARS and support the market. This time they declined to act as bidders of last resort as they had in the past.

ARS, which have been around since 1984, have just in recent years become a popular and widely-used form of long-term financing for municipalities, banks, financial institutions, and bond and equity funds with annual sales volume approaching $45 billion and outstanding ARS at numbers nearing $330 billion in 2008. Wall Street meanwhile earned as much as $2 billion per year from handling the auctions and underwriting the ARS.

An ARS is an investment with a fixed long-term maturity, either a debt instrument such as a municipal bond, with an associated interest rate, or a preferred equity instrument with an associated dividend rate, that resets at scheduled periodic auctions. At these scheduled auctions, investors and holders come together and enter a competitive bidding process which establishes a new rate, called the "reset" rate. Because the minimum investment in an ARS is $25,000, they have been primarily marketed to high net worth individuals, corporate cash managers and institutional investors, such as state and municipal pension funds.

At a typical ARS auction, a buyer offers to pay an existing holder $25,000 par value for each share at a preferred dividend rate. The buyer also bids the rate he wants such shares to earn. If the rate the buyer bids equals the lowest rate bid by any potential buyer at the auction, the seller receives $25,000 from the buyer. The seller also receives from the issuer the interest earned at the rate that had been set at the prior auction, or reset date. The buyer, upon purchasing the ARS, earns interest at the rate set at the current auction. This process is repeated at each periodic auction.

Financial instruments once marketed as a more lucrative but equally safe alternative to money market accounts became cash traps for thousands of investors.

As a result of the February 2008 collapse of the ARS market, investors who were led to believe in the safety and liquidity of ARS, and planned their cash needs around that belief, were faced with the prospect of selling at deep discounts and losses, with some exceeding 25%, to gain access to their cash. Soon, even deep-discount buyers disappeared and these holders were left with completely illiquid ARS.

Brokers, banks, and investment firms that structured ARS and sponsored the auctions marketed them to investors as safe, liquid investments that were comparable to money market investments and, in some cases, cash equivalents. As we now know, however, these marketing tactics were just ploys. The only reason ARS appeared to be highly liquid investments was because the sponsoring brokers, banks, and investment firms would buy any unsold ARS. By stepping in to buy any unsold ARS at an auction, they created the illusion of demand. Once they refused to step in and buy the unsold ARS, the true nature of these securities was revealed — as synthetic, investment house created, higher risk, longer-term, lower liquidity investment vehicles with a limited market, which could only be sold at deeply discounted prices, if at all.

In the wake of the market collapse, the New York Attorney General launched an investigation into 18 banks involved in the collapse of the ARS market — including Citgroup, Merrill Lynch, UBS and JP Morgan Chase — in order to determine whether these banks committed fraud by telling investors that ARS were as safe as cash, while failing to disclose that funds invested in ARS could be tied up indefinitely. The SEC and state securities regulators also made requests for information concerning the underwriting, sale and subsequent auctions of ARS from some of these banks.

As a result of both the New York Attorney General and SEC investigations, on August 8, 2008, Citigroup and Merrill Lynch agreed to buy back $17 billion in ARS, ostensibly in order to avoid further inquiry into their sales practices. Specifically, Citigroup agreed to repurchase approximately $7.3 billion in ARS and agreed to use its "best efforts" to help institutional investors sell roughly $12 billion in ARS. Merrill agreed to buy back $10 billion in ARS starting in 2009, and UBS recently reached an agreement to buy back $19.4 billion in ARS.

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AUCTION RATE SECURITIES

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Institutional investors have also taken action. The Commonwealth of Massachusetts, among others, has filed suit against banks involved in the ARS market alleging that the banks continued to aggressively market ARS as safe investment alternatives to money market accounts, even after these banks realized that the ARS market was in danger of collapse.

Clearly, the regulatory investigations alarmed the banks enough to spur action. Hopefully, private actions by institutions will be able to prompt similar recompense. It seems only appropriate that ARS holders should be able to liquidate some of these "cash equivalents" six months after the fact.

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RATING AGENCIES

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its ratings of certain European debt instruments known as constant-proportion debt obligations ("CPDOs"). In a rare act of contrition, Moody's announced, in July 2008, disciplinary action against employees involved in rating those CPDOs. Shortly thereafter, the SEC released a summary version of its own findings, which tempered explosive revelations about the agencies' failings by concealing the identities of the specific firms. For example, the SEC found that all three rating agencies failed to monitor the performance of CDOs they had rated previously, and cited internal e-mails such as one that stated bluntly "we do not have the resources to support what we are doing now." Other e-mails quoted in the SEC report reflect remarkable prescience about the fragility of the CDO market built largely on the strength of the rating agencies' opinions, including one that described that market as a "monster" and concluded "let's hope we are all wealthy and retired by the time this house of cards falters." Notwithstanding, the SEC — lacking any enforcement power over the rating agencies for the time period at issue — was constrained to merely recommend remedial action and propose new regulations that might prevent recurrences of the same conduct.

In June 2008, New York Attorney General Andrew Cuomo announced a reform pact with the three rating agencies, which his office had been investigating for several months. That pact is designed to limit conflicts of interest by, among other things, changing the agencies' fee arranged for structured finance transactions. The Connecticut Attorney General, Richard Blumenthal, is also conducting an investigation of the rating agencies focused on possible anti-trust violations. Most recently, Fitch's, Moody's and McGraw Hill (the corporate parent of Standard & Poor's) were named as defendants in an action by a group of mortgage investors for failing to accurately rate those instruments. The success of this action may determine whether the rating agencies face additional claims from investors who relied upon their ratings.

Can Credibility be Regained?

While the rating agencies continue to provide a necessary service, and one required by many institutions still bound to hold investment-grade instruments, there is no question that their failures in the mortgage arena have damaged their credibility. Indeed, recent research by one Citigroup analyst suggests that changes to credit ratings are more reactive than predictive. For example, companies downgraded by Moody's, Standard & Poor's and Fitch's generally saw their stock price decline 25% in the 12 months prior to the downgrade, but that prices of such companies rose 50% after such downgrades. Internal analyses by Moody's that used the prices of credit default swaps showed that market price changes identified credit risk at companies such as Ambac and MBIA long before Moody's own credit ratings were lowered to reflect that risk. Reforms at the credit rating agencies, driven by regulation, litigation, and the barrage of criticism they have faced in the past year are inevitable. The question is: will those reforms will be sufficient to enable the rating agencies to reclaim the position of trust they once held?

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