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SECURITIES LAW

SEC: Rating Agencies Suffer From Conflicts of Interest

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Special to the Legal

Market participants no longer view the three main credit rating agencies — Fitch Ratings, Moody's Investor Services and Standard & Poor's Rating Services — as the "de facto watchdog over the mortgage industry" that enabled them to transform "what had become the sleepiest corners of finance" into a virtual gold-rush of mortgage-backed asset generation that served as the Achilles' heel of the economy through the end of 2006. As Roger Lowenstein reported in an April 2008 issue of *The New York Times Magazine*, the rating agencies put "what amounted to gold seals on mortgage securities." He quoted former Securities and Exchange Commission Chairman Arthur Levitt, charging that "the credit-rating agencies suffer from a conflict of interest … that may have distorted their judgment." Even the chief executive of JPMorgan Chase, Jamie Dimon, which acquired the failing Bear Stearns in the aftermath of the credit market implosion, reportedly admitted a "large failure of common sense" among credit rating agencies and investment banks, saying that residential mortgage-backed securities, or RMBS, and collateralized debt obligations, or CDOs, are all "very complex securities" that "shouldn't have been rated as if they were easy-to-value bonds."

With recent growth in structured finance, corresponding wealth created for banks and revenues generated for the rating agencies, longtime rating agency veterans saw their companies go "from being obscure and unimportant players to central ones," according to Lowenstein. Lewis Ranieri, a key mortgage-bonds Salomon Brothers banker, reportedly stated that the "whole creation of mortgage securities was involved with a rating." The rating agencies held the key to the capital markets and the banks involved in structured finance wanted to get through the door, leading commentators, regulators and lawmakers to suggest that the rating agencies behaved less like gatekeepers than gate-openers.

After the credit markets fell through the floor, the staff of the SEC and the Office of Economic Analysis, or OEA, commenced examinations concerning the role of the rating agencies in causing economic losses from transactions involving subprime RMBS and CDOs. This column describes the conflicts of interest and inadequate procedures revealed by the SEC and OEA examinations, as set forth in a July 2008 Summary Report of Issues in the Commission Staff's Examinations of Select Credit Rating Agencies and details the evidence demonstrating those failures, and further suggests certain theories of liability under which the rating agencies may be held responsible for the economic losses that they caused.

EXAMINATIONS UNCOVER CONFLICTS OF INTEREST

The SEC and OEA examinations of Fitch, Moody's and S&P commenced in August 2007, focusing on their activities in rating

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subprime RMBS and CDOs. New York Sen. Charles Schumer stated that there was "ample evidence that the credit rating agencies have embraced a set of practices that stoke conflict-of-interest issues. The agencies have refused to play by the rules, even those of their own making." Indeed, in April 2007, Moody's announced that it was scrapping the model it had been using for years to evaluate subprime mortgages and related securities, noting that it "was first introduced in 2002. Since then the mortgage market has evolved considerably." Lowenstein noted that the agencies were working from a "world that no longer existed."

The SEC and OEA staff examinations concurred, and their summary report details the results with specific documentary and email evidence. The examinations revealed:

- There was a substantial increase in the number and complexity of RMBS and CDO deals since 2002, and the rating agencies struggled with the growth.
- Significant aspects of the ratings process were not disclosed.
- Policies and procedures for rating RMBS and CDOs were not adequately documented.
- The rating agencies did not adequately document significant steps in the ratings process — including the rationale for deviations from their models and for rating committee actions and decisions — and they did not adequately document significant participants in the ratings process.
- The agencies did not adequately manage their conflicts of interest.

The OEA staff sought "to better evaluate the extent to which conflicts of interest may have entered into and affected the ratings process," concluding that certain conflicts of interest are "inherent, and in some cases, unique to" RMBS and CDO products. As discussed more below, while the conflicts of interest that have long been known to exist due to the "issuer pays" model with respect to all asset classes that receive ratings, the conflicts created from the "issuer pays" model in rating structured finance products, particularly RMBS and related CDOs, were exacerbated. The summary report sets forth detailed and persuasive documents and e-mail.

EVIDENCE IS COMPELLING

The summary report sets forth significant and compelling evidence that the rating agencies operated with the knowledge, and in reckless disregard, of debilitating conflicts of interest and operating deficiencies at the core of their lucrative residential mortgage-backed securities and CDO rating operations.

Rating agency internal documents reflect struggles to adapt to the increase in the volume and complexity of the RMBS and CDO deals. Documents in one deal-file identify an unresolved issue that was disregarded: "[w]e didn't ha[ve] time to discuss [an issue] in detail at the committee, so they dropped the issue for this deal due to timing. We will need to revisit in the future." Another document describes an outstanding weighted average recovery rate issue as "poorly addressed — needs to be checked in the next deal."

In another communication between two analysts at one rating agency, the analysts were concerned about whether they should even be rating a particular deal. One analyst expressed concern that her firm's model did not capture "half" of the deal's risk, and that "it could be structured by cows and we would rate it." In another e-mail, an analytical manager in the same rating agency's CDO group wrote to a senior analytical manager, saying: "[The rating agencies continue to create an] even bigger monster — the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters. ;o)."

The 'issuer pays' model is one by which the arranger or issuer of the security that is seeking the rating pays the rating agency for that rating.

The summary report demonstrates that relevant ratings criteria were not disclosed and that the agencies regularly used unpublished ratings criteria. A criteria officer in the structured finance surveillance group of one rating agency noted: "[O]ur published criteria as it currently stands is a bit too unwieldy and all over the map in terms of being current or comprehensive. It might be too much of a stretch to say that we're complying with it because our [structured finance] rating approach is inherently flexible and subjective, while much of our written criteria is detailed and prescriptive. Doing a complete inventory of our criteria and documenting all of the areas where it is out of date or inaccurate would appear to be a huge job."

The summary report also notes evidence that rating agencies made "out of model adjustments" but did not document or disclose the rationale for them, nor did the agencies have specific policies and procedures to identify or address errors in their models or methodologies. The evidence of debilitating conflicts of interest and operating deficiencies riddling RMBS and CDO rating operations is significant and compelling.

'ISSUER PAYS' MODEL EXACERBATES CONFLICTS

The "issuer pays" model is one by which the arranger or issuer of the security that is seeking the rating pays the rating agency for that rating. The conflict of interest inherent in this model is that rating agencies have a financial interest in generating business from the firms that seek the rating. A low rating might affect future business. While each rating agency has policies and procedures restricting analysts from participating in fee discussions with issuers, the summary report notes that "these policies still allowed key participants in the ratings process to participate in fee discussions," including senior analytical managers and supervisors.

The summary report identifies numerous communications demonstrating that analysts were aware of fee schedules and actual, negotiated fees. In one instance, a senior analytical manager distributed a negotiated fee schedule to her analytical staff. In another, analytical staff were copied on an e-mail communication to an issuer containing a letter confirming the fees for a transaction. An e-mail communication from a senior analytical manager to at least one analyst requested that the recipient(s): "Please confirm status codes as soon as possible on the below mentioned deals. [A]ny fees that are blank should be filled in. All issuer/bankers should be called for confirmation." In the same e-mail chain, this request was reinforced by a senior analytical manager who stated that it was "imperative that deals are labeled as to Flow or Pending … These codes along with the fee and closing date, drive our weekly revenue projections."

Finally, the summary report identifies a document in which a senior analytical manager in the structured finance group wrote: "I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision [on assigning separate ratings to principal and interest] and if so, how much?" The document further stated: "Essentially, [analytical staff] ended up agreeing with your recommendations but the CDO team didn't agree with you because they believed it would negatively impact business." In another example, after noting a change in a competitor's ratings methodology, an employee stated: "We are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals." The evidence set forth in the summary report demonstrates that ratings were indeed influenced by the business goals of the particular rating agency to maximize its fees and new business.

QUESTION OF RATING AGENCY LIABILITY

In an article in the *New York Law Journal*, a sister publication of *The Legal*, last fall, Jonathan Sack and Stephen Juris outlined the past unsuccessful attempts to hold rating agencies responsible for losses caused by their conduct. Sack and Juris noted that the agencies no longer play the roles of "aloof reporters" that traditionally secured for their ratings the protections of the First Amendment. Rather, in structured finance, "the rating agency is an active part of structuring the deal." They note that historically courts have been reluctant to hold rating agencies liable for their rating on the theory

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that the rating is analogous to the opinion of a journalist. Today, however, courts are more apt to conclude that ratings are linked to "client's needs" and that the agency plays an "active role" in the transaction. That is exactly what the 2nd U.S. Circuit Court of Appeals determined in a decision enforcing a subpoena against Fitch. No longer viewed as the disinterested opinion maker, the rating agency was viewed as an actor with real obligations inuring to the benefit of those who rely on the ratings it issues.

In one federal securities suit pending in the Southern District of New York, Moody's investors are asserting a fraud claim against the rating agency for making false and misleading statements about its structured finance rating business and the manner in which it had generated financial growth in recent years. The case is at a preliminary stage and anticipated motions to dismiss have not yet been filed.

But other theories of liability exist by which injured persons may seek redress from the rating agencies. A company that has had its securities rated may assert a breach of contract claim or a professional malpractice claim directly, or a shareholder may assert such a claim derivatively on behalf of such a company. According to Sack and Juris, "rating agencies are likely to come under increased pressure as courts and commentators reexamine their business model." Time will tell how far the pendulum will swing toward greater transparency and accountability in our capital markets by holding the credit rating agencies responsible for their roles in causing economic losses related to the unraveling of the RMBS and CDO markets. •