Via Email

February 26, 2010

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act (File Number: S7-25-09)

Dear Ms. Murphy:

I am writing as a Senior Policy Analyst at Demos, which is a nonprofit, nonpartisan research and advocacy organization dedicated to four overarching goals: a more equitable economy with widely shared prosperity and opportunity; a vibrant and inclusive democracy with high levels of voting and civic engagement; responsible U.S. engagement in an interdependent world; and public sector that commands the resources and the respect to work for the common good of all Americans. Demos is also a steering-committee member of Americans for Financial Reform, a coalition of more than 200 national, state and local consumer, labor, investor, civil rights, and community organizations that are working for a financial economy that serves the real economy.

I am writing in support of the Securities and Exchange Commission's efforts to strengthen oversight of the Nationally Recognized Statistical Rating Organizations, or NRSROs. In particular, I would like to argue in favor of proposed steps, including rescission of Rule 436(g), to put the NRSROs on more of an equal footing, for liability purposes, with other participants in the securities issuance process.

In a paper commissioned by Moody's Investor Service, Laurence H. Tribe, a professor at Harvard Law School, and Thomas C. Goldstein, a partner in the law firm of Akin, Gump, Strauss, Hauer & Feld, describe credit ratings as "speech of public concern." On that basis, they argue that the so-called NRSRO's or Nationally Recognized Statistical Rating Organizations should be shielded against legal liability except in cases of outright fraud or falsehoods issued with malice or "reckless disregard for the truth."[i]

The Tribe/Goldstein paper rests on a serious mischaracterization both of the NRSROs, and of the intent of financial reformers. Through the phrase "speech of public concern," the authors liken credit ratings to political speaking and writing, which have traditionally been accorded an unusually high degree of First Amendment protection. But credit ratings are strikingly different from political speech. Federal and state regulators and

legislators have bestowed a gatekeeper or license-giving role on the NRSROs. Credit ratings determine whether, and to what extent, securities may be sold and held by depository institutions, pension funds, insurance companies, and other institutions that hold money in trust. The NRSRO's have enthusiastically accepted this role; indeed, they have turned it into a source of huge profit.

In the area of structured finance especially, the rating agencies have often played what a federal court recently called an "integral role" in the "structuring and issuing" of securities. (That involvement was cited by Judge Shira Scheindlin as an argument against the grant of virtual immunity sought by lawyers for the ratings agencies in one still-pending case.)[ii] Through early submissions, preliminary ratings, and the granting of access to analytical models, the NRSROs "participated in creating monstrous structured finance transactions with absurdly high ratings based on models and assumptions they knew or should have known were unreasonable," one expert on the NRSRO's has written.[iii] In some cases, rating agencies have helped issuers determine just what combination of assets will enable a particular structured investment vehicle to achieve a desired rating.[iv] A rating agency is also expected to continue monitoring a transaction after the fact. In these respects, the role of the NRSROs is more like that of auditors, accountants, and attorneys who render close and continuing advice to their corporate clients.

Tribe and Goldstein seek to minimize the significance of these business ties by likening NRSRO ratings to the film ratings bestowed by the Motion Picture Association of America and the National Association of Theater Owners. This is another inapt analogy. The film ratings are put together by a board of parents operating under the aegis of two industry trade associations. Film ratings are not a for-profit business unto themselves.

The Tribe/Goldstein memo depicts the credit rating agencies as "publishers" and compares their ratings to the product evaluations made by Consumer Reports. But there are no laws or regulations that rely on Consumer Reports ratings; nor does the magazine take money from manufacturers of the products it reviews. By contrast, the rating agencies are paid and picked by securities issuers. Moreover, a rating agency gets paid only if a particular deal achieves a certain rating; otherwise, typically there is no deal, no rating, and no payment.

The three major rating agencies started out as publishers, selling printed ratings manuals to investors. Since the 1970s, however, they have sold their services to securities issuers. The publishing business has long been known for razor-thin profit margins. By contrast, the credit rating agencies have been hugely profitable in recent years, with operating margins as high as *50 percent*! The profits of the three major rating agencies rose from a combined $3 billion in 2002 to more than $6 billion in 2007. During that time, their CEOs earned a collective $80 million. Moody's profits quadrupled between 2000 and 2007. During five of those years, Moody's had the highest profit margins of any company in the S&P 500.[v]

To summarize, the NRSROs seek to retain and exploit their gatekeeper status – one that assumes a high level of care and analytical rigor. Then, solely for purposes of legal liability, they seek to cast themselves as publishers of "pure opinion," to quote again from the Tribe/Goldstein paper. Some reformers have called for steps to wean the investment world off its current reliance on credit ratings. But it is far from clear how much can be done, or how quickly, to achieve this goal. In the real world of the present and the foreseeable future, NRSRO ratings will continue to play a tremendously important role in the debt-securities markets.

The Tribe/Goldstein paper is additionally misleading about what financial reformers are seeking in the area of NRSRO liability. For First Amendment reasons, Tribe and Goldstein assert, potential liability should be restricted to cases of "knowing or reckless conduct" rather than "mere negligence." Proposed reforms, they warn, could subject the rating agencies to "open-ended liability to all investors for honest mistakes and misjudgments."

They are battling a straw man here. Reformers are not trying to deny First Amendment protection to the rating agencies; rather, they are trying to undo a set of special liability privileges conferred on the NRSROs by the Securities Act of 1933 and the Credit Rating Agency Reform Act of 2006, among other statutes and regulations. None of the regulatory or legislative proposals on the table suggest a simple negligence standard. The House financial reform bill creates a right of private action only in cases of "gross negligence," which is hardly comparable to a situation of "honest mistakes" or "misjudgments."

In any case, the concept of negligence (often understood as a loose, stand-alone criterion, inviting extensive judicial interpretation) is not crucial to the reform objective where the rating agencies are concerned. In recognition of their quasi-official status, Congress has already subjected these entities to a measure of regulation. Based on recent experience, reformers contemplate additional rules involving, among other safeguards, adherence to consistent ratings methodology, compliance machinery, director independence, and avoidance of conflict of interest. It is entirely appropriate for Congress to grant a private right of action to parties who may be damaged by the failure of the NRSROs to live up to a set of obligations imposed on them by law. The ultimate legislation could easily be worded that way, without use of the word "negligence."

Respectfully,

James Lardner
Senior Policy Analyst
Demos

[i] Laurence H. Tribe and Thomas C. Goldstein, "The First Amendment Implications of Expanding the Liability of Credit Rating Agencies for Rating Opinions." Prepared for Moody's Investor Service. December 2009.
[ii] Southern District of New York, *Abu Dhabi Commercial Bank etc. v. Morgan Stanley etc.*, ruling against motion to dismiss, Sep. 2, 2009
[iii] Frank Partnoy, "Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective," Council of Institutional Investors, July 2009.
[iv] Southern District of New York, *Abu Dhabi Commercial Bank etc. v. Morgan Stanley etc.*, ruling against motion to dismiss, Sep. 2, 2009
[v] Henry Waxman, opening statement, hearing of the House Committee on Oversight and Government Reform, Oct. 22, 2008