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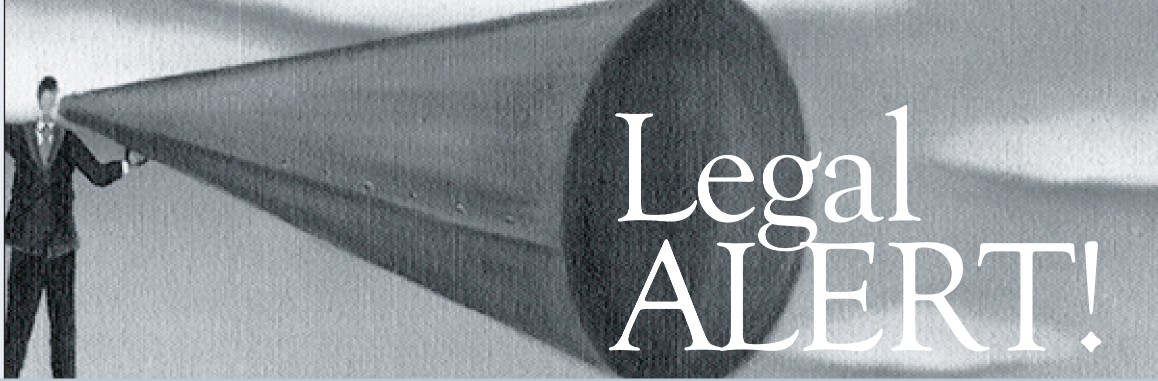

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Rating the Raters

Credit rating agencies have come under criticism lately for their role in the collapse of the financial markets in 2008. Since the summer of 2007, hundreds of billions of dollars of subprime mortgages have gone into default. Hundreds of billions of dollars in principal amount of subprime mortgages had been collected into pools and sold to investors. In many cases the investments had been highly rated for safety by one or more of Wall Street's premier credit rating agencies. However, recently proposed rule changes by the Securities and Exchange Commission ("SEC"), combined with a recent decision by the United States District Court for the Southern District of New York, could improve the usefulness of credit ratings.

On September 17, 2009, *The Wall Street Journal* reported an interesting statistic: of the residential mortgage-backed securities that Standard & Poor's had given their highest rating of "AAA" in the years from 2005 to 2007, only 33.1% still had their "AAA" ratings.[1] The ratings for all of the rest had declined, with 41.7% now rated "C" or "D."

While Congress considers various measures to address the financial failures that resulted in the present harsh economic climate, the SEC is attempting to improve financial markets to the extent its authority under the Federal securities laws permits. On September 17, 2009, the SEC proposed rules that national credit rating agencies or so-called "Nationally Recognized Statistical Rating Organizations" ("NRSROs") must follow (the "Proposed Rules"). At present there are 10 NRSROs, including Moody's Investors Service Ltd. and Standard and Poor's Ratings Services.

Significant requirements of the Proposed Rules include:

- For securities issued under an SEC registration statement, the issuer must disclose whether it received a preliminary rating from another rating agency. Thus, an investor will be able to consider whether the company might have shopped for a better rating. (This requirement will not apply to municipal bonds because they are not issued under SEC registration statements.)

- The rating agency must make available, to paying subscribers, a searchable online history of all of its ratings actions since June 26, 2007.

- If a rating agency is paid by an underwriter to rate a structured finance security, then the rating agency must disclose to other rating agencies that it is in the process of rating the security.

[1]The Wall Street Journal, September 17, 2009, page C1, col. 6.

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- The underwriter who gives information to the rating agency must agree to make the same information available to other rating agencies. As a result, any competing rating agency that desires to rate the structured finance security can obtain the same information that the underwriter gives to the first rating agency. The SEC's goal is to encourage competition among rating agencies with regard to structured finance products.

In addition, the SEC is seeking public comment on a proposal that would make each rating agency potentially liable for misstatements in an SEC registration statement.

As of this writing, the SEC has described the main points of the Proposed Rules, but has not yet published the actual text.

The business of issuing credit ratings could also be affected by the decision of the U.S. District Court for the Southern District of New York in the case of *Abu Dhabi Commercial Bank v. Morgan Stanley*, No. 08-CV-7508, 2009 U.S. Dist. LEXIS 79607, decided September 2, 2009. The judge in that case described two legal principles shielding rating agencies from liability to investors. First, if the agency made its rating publicly available, then the rating is protected by the First Amendment of the U.S. Constitution as a matter of public concern unless the rating was made with "actual malice." Second, whether or not the agency makes its rating publicly available, the rating is merely the agency's opinion rather than a guarantee of the financial condition of the issuer being rated.

In the *Abu Dhabi Commercial Bank* case, the District Court held that a credit rating agency's rating opinion could be the basis of liability, if (1) the agency did not genuinely and reasonably believe its rating, or (2) the rating was without basis in fact. The plaintiff alleged facts showing that the rating agencies knew that their own credit ratings were false and also alleged facts showing that the agencies would profit significantly from issuing unjustifiably high ratings.

The *Abu Dhabi Commercial Bank* decision only ruled on the sufficiency of the plaintiffs' complaint, and the facts have not been tried in court. The case also involved a credit rating used in a private placement of securities and not published. Therefore, the credit rating was not entitled to the broad protection the First Amendment gives to matters of public concern. It remains to be seen whether one of the SEC's Proposed Rules, which would require rating agencies to make all of their rating actions since July 26, 2007 available to paying subscribers, will cause their ratings to become matters of public concern protected by the First Amendment.

If you require further information on the proposed SEC rules, please contact any member of the Practice Area listed on the front of this Alert.