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The Changing Landscape For Credit Rating Agencies

Law360, New York (February 03, 2010) -- Credit rating agencies have long played an influential role in the capital and credit markets. Both issuers and investors find credit ratings extremely useful. For issuers, favorable ratings make it easier to sell debt instruments; many institutional investors are limited to investing in only those instruments carrying high ratings.

For investors, agency ratings have become a widely accepted, common yardstick for valuing potential investments. Many investors rely heavily on agency ratings when making investment decisions.

Rating agencies have become so deeply embedded in the capital markets that even U.S. Securities and Exchange Commission regulations reference ratings. Additionally, the absence of a credible, alternative valuation system created an environment in which rating agencies enjoyed great influence and power without commensurate levels of competition or constraint.

Despite the influential role rating agencies played in the capital markets, the industry was only loosely regulated by government and rarely touched by private investor-driven lawsuits.

When the markets collapsed in late 2008, the rating agencies quickly found themselves at the center of attention, facing criticism from all sides. Rating agencies were accused of assigning the highest possible ratings to risky, and ultimately worthless, instruments.

The traditional agency fee structure whereby issuers pay rating agencies to rate their securities also came under scrutiny as a source of potential conflicts of interest.

Credit rating agencies now find themselves in the crosshairs of heightened legislative and judicial attention. A recent federal court decision from the Southern District of New York may indicate the start of crucial changes in the legal protections afforded to credit rating agencies.

Traditionally, it has been difficult to hold rating agencies accountable for granting improper ratings because the agencies have sought protection under the First Amendment, arguing that ratings constitute their opinions and are therefore a protected form of free speech. The agencies have also attacked investor’s standing to bring contract claims where the investors were neither a party to the contract nor a designated third-party beneficiary.

However, Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc. may signify an erosion of the rating agencies’ broad First Amendment protection, thus paving the way for future investor lawsuits. See Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., No. 08 Civ. 7508 (SAS), 651 F.Supp.2d 155 (S.D.N.Y. Sept. 2, 2009).

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In Abu Dhabi Commercial Bank, investors asserted a variety of common law claims, including fraud, negligent misrepresentation and breach of contract, based on their purchase of instruments issued by Cheyne Finance PLC, a structured investment vehicle (SIV), that included some residential mortgage-backed securities.

“[T]he Cheyne SIV’s Senior Notes were ‘top rated’ notes ... Moody’s rated the Senior Notes ‘Prime-1’ and ‘AAA,’ and S & P rated the Senior Notes ‘A-1+’ and ‘AAA’ ... The Cheyne SIV’s Capital Notes received similarly high ratings of ‘investment grade’ and ‘A3/A’ by Moody’s and S & P, respectively ... These ratings were then included in the Cheyne SIV’s Information Memoranda and other Selling Documents that Morgan Stanley distributed to potential investors for the purpose of issuing up to $20 billion dollars in ‘top rated’ Senior Notes and $3 billion dollars in ‘investment grade’ Capital Notes.” Id. at 165-66.

Plaintiffs claimed that granting these high ratings to risky, and ultimately worthless, instruments was misleading.

Furthermore, plaintiffs claimed that such ratings were based on unsound reasoning and driven by conflicts of interest — the agencies having worked with Morgan Stanley to structure the notes so that they could qualify for the highest ratings and the agencies’ compensation being contingent upon, among other things, “the receipt of desired ratings for the [notes].” Id. at 166-67.

Citing traditional First Amendment and contract defenses, the defendants moved to dismiss all of the claims. However, the court held that the plaintiffs had sufficiently alleged common law fraud under New York law.

In a groundbreaking decision, the court held that while agency ratings are typically afforded protection, absent malicious intent, by the First Amendment, “where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection.” Id. at 175-76.

While Abu Dhabi Commercial Bank undermines the rating agencies’ First Amendment defense to some extent, it does not guarantee success to investor suits against rating agencies, and significant obstacles remain. See Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., No. 08 Civ. 7508 (SAS), 2009 WL 3346674 (S.D.N.Y. Oct. 15, 2009).

In a later decision in the Abu Dhabi Commercial Bank case, the court dismissed all contract-based claims for failure to show the existence of a contract between investors and rating agencies. Absent evidence of a contract to which the investors were a party, the court held that investors lacked standing to assert contract claims against the rating agencies. Id. at *2.

Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc. is not the only suit against rating agencies currently making its way through the court system.

In July 2009, the nation’s largest public pension fund, the California Public Employees’ Retirement System, (CalPERS), commenced a suit against Moody’s, Standard & Poor’s and Fitch for improperly assigning their highest ratings to certain risky structured investment vehicles.

In addition, several state Attorneys General have filed suits against rating agencies for allegedly violating state securities laws.

On Nov. 20, 2009, Ohio Attorney General Richard Cordray filed suit against Moody’s, Standard & Poor’s and Fitch, claiming the rating agencies violated Ohio securities law and negligently misrepresented the value of asset-backed securities by assigning unjustifiably high ratings to the instruments.

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Connecticut Attorney General Richard Blumenthal also announced plans in November 2009 to join Ohio and file suit against the three major rating agencies for their "negligent, reckless and incompetent work" in rating investments.

In September 2009, California Attorney General Edmund F. Brown Jr. began investigating the major credit rating agencies' role in the financial crisis and issued subpoenas to the three major rating agencies in an effort to determine whether they violated California laws.

Even earlier, in June 2008 and in response to the subprime mortgage crisis, New York Attorney General Andrew M. Cuomo announced that agreements had been reached with the three major rating agencies that would, among other things, "dramatically increase the independence of the ratings agencies, ensure that crucial loan data is provided to the agencies before they rate loan pools, and increase transparency in the [Residential Mortgage-Backed Securities] market."

Beyond the courtroom, proposed federal legislative and regulatory reforms aimed at rating agency oversight are ongoing. Recently, the SEC approved new rules to increase oversight of the credit rating industry.

The rules require rating agencies to provide more information about their rating history and would allow competing agencies to offer unsolicited ratings for structured finance products. Amendments to the rules also call for the removal of references to ratings in certain SEC rules and forms — an attempt to decrease reliance upon these ratings.

In addition, on Oct. 28, 2009, the U.S. House Financial Services Committee passed the Accountability and Transparency in Rating Agencies Act, a bill intended to bring greater transparency to the credit rating industry and reduce inappropriate actions by rating agencies.

The bill's sponsor, Congressman Paul E. Kanjorski, D-Pa., provided that "this legislation builds on the Administration's proposal and takes strong steps to reduce conflicts of interest, stem market reliance on credit rating agencies, and impose a liability standard on the agencies."

While it is too early to tell what the outcome may be from this new era of litigation and regulation, it is evident that we are witnessing a major shift in the treatment of credit rating agencies, which, in turn, may have wide-ranging implications for the many issuers and investors who use and rely on the agencies' ratings.

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