Statement at Open Meeting

Commissioner Luis A. Aguilar

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Today, the Commission considers adopting long-awaited reforms to the rules governing nationally recognized statistical rating organizations, or, as they are more commonly known, rating agencies.[1] I support these rules and amendments, and commend the staff for their hard work in developing and refining them. Additionally, I would like to call attention to the efforts of the Division of Trading and Markets, the Division of Economic and Risk Analysis, the Office of Credit Ratings, and the Office of General Counsel. I appreciate your hard work and diligence.

The Role of Credit Rating Agencies in the Financial Crisis

The rules and amendments the Commission considers today embody the Commission's latest response to the most acute financial crisis our country has faced in almost a century. By one estimate, global losses from the financial crisis may reach $15 trillion.[2] No response to the crisis would be effective without addressing the role played by the rating agencies. Many believe the rating agencies were not just facilitators of the crisis—they were its linchpin.[3] And while there were clearly other players and factors involved, the crisis was fueled, in part, by the rating agencies' willingness to legitimize the massive influx of mortgage-backed securities and CDOs that flooded the market during the housing bubble.[4] The explosive growth of the market for these highly complex structured products was possible only because the rating agencies assured investors that these products were virtually risk free.[5] The rating agencies' willingness to provide these assurances, in turn, emboldened issuers to create ever more toxic structured products.[6] This gave rise to a vicious circle that helped propel the housing bubble far beyond its natural breaking point.[7] Crucially, when the housing market finally began its collapse, and the issuers' financial alchemy could no longer stave off the inevitable, the rating agencies hesitated to correct the flawed ratings they had previously issued.[8] This delay intensified the resulting crisis.

Rating Agencies Debased Their Ratings Process to Shield Profits

We know now that the rating agencies' paramount concern in the years leading up to the crisis was to maximize their revenues and market share.[9] This led the rating agencies to appease certain clients by lowering ratings criteria,[10] failing to require reasonable due diligence reviews,[11] and delaying the implementation of improved ratings models.[12] As a result, the ratings issued on structured products became less and less defensible. In fact, employees of one rating agency likened their ratings to a "scam"[13] and a "house of card[s]" that was destined to falter.[14] The desire to maximize revenues also led some rating agencies to nullify or co-opt their internal controls programs. In a vivid illustration of this, one rating agency demoted its chief compliance officer and replaced much of his staff with the very analysts whose work the compliance department was supposed to oversee.[15] And, a former senior analyst of another rating agency contends that the compliance department followed management's directive to inappropriately pressure analysts whom clients viewed as being uncooperative.[16]

These accounts lay bare a bleak reality: that instead of acting as gatekeepers and protecting investors, as they were supposed to do, the rating agencies allowed issuers of structured products to prey on investors.[17] That the rating agencies were able to debase their ratings in this way

represents a failure on many levels. Internal control structures that were inadequate and easily overridden were certainly one aspect of the problem. A lack of transparency into the ratings process was another.

Today's Rules and Amendments

Today's final rules and amendments recognize the need to protect the rating process from undue influence, and make it more transparent to investors. The changes the Commission considers adopting today directly address a number of the flaws in the credit rating process that emerged during the financial crisis. The centerpiece of these changes is a pair of complementary prohibitions that will better insulate the ratings process from sales and marketing considerations. This is vital, for conflicts of interest represent the most serious threat to the accuracy and reliability of credit ratings.[18] Additionally, the changes will crystallize the Commission's guidance regarding internal controls regimes. This, too, is quite important, as the Commission's examinations of the rating agencies continue to identify situations where agencies fail to follow their procedures and methodologies for producing ratings.[19] The changes also impose new disclosure requirements on the rating agencies, which will give investors better insight into the manner in which ratings are produced.

I believe the final rules and amendments considered today represent a marked improvement upon the Commission's proposal, and that these final rules and amendments will do much to buttress the reliability of credit ratings. I will highlight a few of the more salient provisions.

First, the final rule regarding internal controls prescribes a set of factors that rating agencies must consider when developing, maintaining, and assessing their internal controls structures.[20] By requiring rating agencies to consider these factors, the Commission has established a solid foundation upon which rating agencies can build truly robust internal control systems. This approach has the added virtue of giving each agency the flexibility to tailor its internal control structure to meet its specific risks.

Second, the final rule regarding conflicts of interest[21] includes, consistent with the Dodd-Frank Act's mandate and verbatim language,[22] an absolute prohibition against allowing sales and marketing considerations to influence the production of ratings in any way. The final rule also retains the proposed rule's absolute prohibition against allowing sales and marketing personnel to participate in the ratings process. Both prohibitions are essential in order to fully implement the specific Dodd-Frank mandate, because each prohibition reaches conduct that is potentially not covered by the other.[23]

Third, the final rule requires that, if a credit rating agency's look-back review determines that a former employee's conflict of interest influenced a rating, the agency must promptly determine whether the rating must be revised.[24] Further, the rating agency must place that rating on watch or review unless it can publish a revision or affirmation within 15 days.[25] This approach gives rating agencies a strong incentive to begin and complete their reviews quickly.

There Is More Work to Be Done

The task of fully restoring integrity to the credit rating process will require more work. I would like to highlight two priorities that deserve consideration as we move forward. First, while the final rules' conflict of interest provisions are an important step in addressing the corrosive effects of the issuer-pays model, a more focused solution is necessary. The Commission should consider proposing rules that would more directly address the conflicts that arise when rating agencies are paid by the very issuers of the products they rate. This conflict of interest continues to jeopardize the quality of credit ratings today. If we are to restore integrity to the ratings process, the Commission must address this conflict of interest in a meaningful and effective way.

Second, the Commission should consider prescribing the policies and procedures that would govern the look-back reviews required by Dodd-Frank.[26] The rating agencies currently have discretion to develop these procedures themselves, and this may have led to predictable results. As far as my office has been able to determine, in 2013, rating agencies conducted a number of look-back reviews prompted by

employees going to work for issuers.[27] Nonetheless, my office was unable to identify any rating that was revised because of such a conflict. This suggests that many of these reviews are not as robust as they need to be, and I urge the Commission to consider whether any action is necessary.

Conclusion

Given how poorly the credit rating agencies performed, one might expect the financial crisis to have vastly reshaped the industry. But this is not so. The three largest rating agencies remain dominant, controlling 95% of the global ratings market.[28] And, profits at two of these rating agencies are at or near record highs.[29] You can also expect that, as the market for structured products stirs back to life, as it appears to be doing,[30] rating agencies will once again play a significant role in that market. Hopefully, the rules and amendments being adopted today will keep the rating agencies from once again succumbing to the temptation to sacrifice the quality of their ratings just to get hired.

These developments underscore the importance of the rules and amendments we are adopting today. Investors' reliance on credit ratings continues to put them and the broader economy at risk.[31] For that reason, I support these rules and amendments, and I call on the Commission to propose additional safeguards to ensure that credit ratings are as accurate and reliable as possible.

Thank you.

[1] *Nationally Recognized Statistical Rating Organizations*, Securities Exchange Act Release No. XXXXX (August 27, 2014) (File No. S7-18-11).

[2] Mark Adelson, *The Deeper Causes of the Financial Crisis: Mortgages Alone Cannot Explain* It, 39 J. Portfolio Mgmt., 16 (Spring 2013), *available at* http://www.iijournals.com/doi/pdfplus/10.3905/jpm.2013.39.3.016.

[3] Testimony of Alan Greenspan, Former Chair, Federal Reserve, before the House Committee on Oversight and Government Reform (Oct. 23, 2008), *available at* http://oversight-archive.waxman.house.gov/documents/20081023100438.pdf ("The consequent surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem."); *see also* Frank Partnoy, *Overdependence on Credit Ratings was a Primary Cause of the Crisis*, 11, San Diego Legal Studies Paper No. 09-015 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430653&rec=1&srcabs=1374907 .

[4] Neil Fligstein and Adam Goldstein, *The Anatomy of the Mortgage Securitization Crisis*, Institute for Research on Labor and Employment, IRLE Working Paper No. 200-10, 4 (February 2010), *available at* http://www.irle.berkeley.edu/workingpapers/200-10.pdf.

[5] Siegfried Utzig, *The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective*, ADBI Institute, ADBI Working Paper Series No. 188, 1 (Jan. 2010), *available at* http://www.adbi.org/files/2010.01.26.wp188.credit.rating.agencies.european.banking.pdf ("Markets for structured products could not have developed without the quality assurance provided by [credit rating agencies] to unsophisticated investors about inherently complex financial products.").

[6] *See, e.g.*, Email from Chris Meyer, of Standard & Poor's, to Belinda Ghetti, of Standard & Poor's, *et al.* (Dec. 15, 2006, 8:31 PM), Senate Permanent Subcommittee on Investigations Hearing, Exhibits, PSI-SP-000045-46 (Apr. 23, 2010), *available at* http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/042310Exhibits.pdf?attempt=2 ("Rating agencies continue to create and [sic] even bigger monster — the CDO market.").

[7] John Crawford, *Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry*, 42 Conn. L. Rev., 14-15 (Fall 2009).

[8] Sam Jones, *How Moody's Faltered*, Financial Times Magazine (Oct.17, 2008), *available at* http://www.ft.com/intl/cms/s/0/65892340-9b1a-11dd-a653-000077b07658.html#axzz3B4qTLI2f.

[9] *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies*, Hearing Before the Senate Permanent Subcommittee on Investigations, 111th Cong. 14-16 (Apr. 23, 2010), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/hearings/wall-street-and-the-financial-crisis-the-role-of-credit-rating-agencies (Testimony of Eric Kolchinsky, Former Team Managing Director, Structured Derivatives Products Group, Moody's Investor Service); *see id.* (Testimony of Scott McKlesky, Former Head of Compliance, Moody's Investor Service); *see also* Comment Letter of William J. Harrington, Senior Vice President, Moody's Investor Services (Aug. 8, 2011)*, available at* http://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

[10] *See, e.g.*, Email from Gale Scott, of Standard & Poor's, to Richard Gugliada, of Standard & Poor's, *et al.* (Aug. 17, 2004, 6:14 PM), Senate Committee on Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations Hearing, Exhibits, PSI-SP-000346 (Apr. 23, 2010), *available at* http://www.hsgac.senate.gov/imo/media/doc/Financial_Crisis/042310Exhibits.pdf?attempt=2 ("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"); Email from Richard Michalek, of Moody's to Yvonne Fu, Moody's, *et al.* (Oct. 24, 2006, 12:21:54 GMT), Senate Committee on Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations Hearing, Exhibits, PSI-MOODYS-000092 (Apr. 23, 2010), *available at* http://www.hsgac.senate.gov/imo/media/doc/Financial_Crisis/042310Exhibits.pdf?attempt=2 ("I mention this to reinforce the expectation that concessions we make in the interest of getting the deal(s) rated will [ultimately] be used against us").

[11] *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Report, Permanent Subcommittee on Investigations 111th Cong. 277-78 (Apr. 13, 2011), *available at* http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf.

[12] *Id.*

[13] Email from Elwyn Wong, of Standard & Poor's, to Andrea Bryan, of Standard & Poor's (Nov. 23, 2005, 10:21:32), Senate Committee on Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations Hearing, Exhibits, PSI-SP-000192 (Apr. 23, 2010), *available at* http://www.hsgac.senate.gov/imo/media/doc/Financial_Crisis/042310Exhibits.pdf?attempt=2 ("Lord help our . . . scam . . . this has to be the stupidest place I have worked at.").

[14] Email from Chris Meyer, of Standard & Poor's, to Belinda Ghetti, of Standard & Poor's, *et al.* (Dec. 15, 2006, 8:31 PM), *available at* Senate Committee on Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations Hearing, Exhibits, PSI-SP-000045-46 (Apr. 23, 2010), *available at* http://www.hsgac.senate.gov/imo/media/doc/Financial_Crisis/042310Exhibits.pdf?attempt=2 ("Let's hope we are all wealthy and retired by the time this house of cards falters.").

[15] Testimony of Scott McCleskey, *supra* note 8.

[16] Comment Letter from William J. Harrington, *supra* note 8, at 36, 61 ("The Compliance Department of Moody's has eagerly embraced its mandated role to . . . intimidate analysts and reverse committee outcomes"; "The Compliance Department tried to reverse a committee opinion on a [security] with which AIG was planning a transaction by searching for infractions that could be attributed to the contributor.").

[17] Frank Partnoy, *How And Why Credit Rating Agencies Are Not Like Other Gatekeepers*, 2, San Diego Legal Studies Paper No. 07-46 (May 2006) ("With respect to these new instruments, the agencies have become more like 'gate openers' than gatekeepers; in particular, their rating methodologies for collateralized debt obligations (CDOs) have created and sustained that multi-trillion dollar market."), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257.

[18] Günter Strobl and Han Xia, *The Issuer-Pays Rating Model and Ratings Inflation: Evidence from Corporate Credit Ratings* (May 2012) (providing "evidence that the conflict of interest caused by the issuer-pays rating model leads to inflated corporate credit ratings"), *available at* http://www.frankfurt-school.de/clicnetclm/fileDownload.do?goid=000000401336AB4.

[19] Securities and Exchange Commission, *2013 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization*, 10, 16 (Dec. 2013), *available at* http://www.sec.gov/news/studies/2013/nrsro-summary-report-2013.pdf.

[20] 17 CFR 240.17g-8(d).

[21] 17 CFR 240.17g-5(c)(8).

[22] 15 U.S.C. § 78o-7(h)(3)(A).

[23] For instance, the prohibition against allowing sales and marketing considerations to influence ratings (the "influence" prong) would preclude employees who are not involved in sales from influencing a rating. This conduct would clearly not be covered by the prohibition dealing with sales personnel (the "sales personnel" prong). At the same time, the sales personnel prong does not require that a rating actually be influenced, and thus it reaches conduct not captured by the influence prong. *See* 17 CFR 240.17g-5(c)(8).

[24] 17 CFR 240.17g-8(c).

[25] A number of academic studies indicate that both stock and bond prices of an issuer react adversely when credit ratings are placed on negative credit watch. *See* Kee H. Chung, Carol Ann Frost, and Myungsun Kim, *Characteristics and Information Value of Credit Watches*, Financial Management 119-158 (2012); Sugato Chakravarty, Chiraphol N. Chiyachantana, and Yen Teik Lee, *On the Informativeness of Credit Watch Placements* (Apr. 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1252542; Christina E. Bannier and Christian W. Hirsch, *The Economic Function of Credit Rating Agencies—What Does the Watchlist Tell Us?*, J. of Banking and Finance 3037-3049 (2010); John R.M. Hand, Robert W. Holthausen, Richard W. Leftwich, *The Effect of Bond Rating Agency Announcements on Bond and Stock Prices*, J. of Finance 733-752 (1992); Robert W. Holthausen and Richard W. Leftwich, *The Effect of Bond Rating Changes on Common Stock Prices*, J. of Fin. Economics 57-89 (1986).

[26] 15 U.S.C. § 78o-7(h)(4).

[27] *See supra* note 19 at 22.

[28] *Credit where credit's due*, The Economist (Apr. 19, 2014), *available at* http://www.economist.com/news/finance-and-economics/21601020-ratings-industry-has-bounced-back-financial-crisis-credit-where.

[29] *Id.*

[30] *Id.*; *see also* Kevin McPartland, *Return to Profits*, Calypso (May 28, 2004), *available at* http://www2.calypso.com/return-to-profits/ (noting that "structured derivatives (including both structured products and structured finance) are making a rebound, recovering from the reputational issues they faced following the financial crisis. Greenwich Associates research shows that buy-side trading of structured derivatives continued its growth trend in 2013, including all flavors of ABS, MBS and CMOs.").

[31] Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis*, 1 (2010), *available at* http://www.law.yale.edu/documents/pdf/cbl/Partnoy_Overdependence_Credit.pdf ("A primary cause of the recent credit market turmoil was overdependence on credit ratings and credit rating agencies. Without such overdependence, the complex financial instruments, particularly collateralized debt obligations (CDOs) and structured investment vehicles (SIVs), which were at the center of the crisis could not, and would not, have been created or sold.").

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