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Senate Approves New Curbs On Rating Agencies, Though One Provision Overlooked

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While the much-maligned credit rating agencies lost some power today after the Senate approved two measures pushing the government into the ratings business, they dodged a bullet in the exclusion of another.

The agencies, which rate the creditworthiness of corporations and the financial obligations they sell to investors, like bonds and commercial paper, have been blamed for playing a major role in exacerbating -- if not causing -- the worst financial crisis since the Great Depression. By slapping flawed AAA ratings (*allegedly sometimes knowingly) on financial products like mortgage-backed bonds and other mortgage-linked securities, the agencies lulled investors and regulators into thinking they were risk-free. Then, after they finally woke up to the inaccurate ratings, they downgraded them in near-unison, compelling many big investors to dump the securities and causing a downward spiral in prices that resulted in losses totaling in the hundreds of billions.

But because of the protections the agencies have been afforded in law, investors and others have been unsuccessful in exacting monetary revenge. Worse, the government's stamp of approval on the ratings the agencies issue -- federal rules compel institutional investors and regulators to use them -- virtually guarantees the major credit raters' oligopoly, and the public's continued reliance on them.

Investors, legislators, academics and policymakers all agree that the agencies -- and the way they do business -- need to be reformed.

But in passing a measure that attempts to end their oligopoly, the Senate purposely did not include a provision in the House bill that forces major credit rating agencies to be accountable to investors by scrapping a Securities and Exchange Commission rule that has shielded them from civil lawsuits for nearly 30 years.

The provision, known as Rule 436(g), insulates the 10 credit rating agencies recognized by the government as "Nationally Recognized Statistical Rating Organizations" from liability if they knowingly make false or misleading statements in connection with securities registration statements to dupe investors. Other experts -- like the rating agencies not part of the group of 10 -- are legally liable for their statements "to assure that disclosure regarding securities is accurate," according to a 2009 SEC document supporting the removal of the exemption.

In short, if a Standard & Poor's or Moody's Investors Service knowingly tries to deceive an investor, under current law that investor can't sue.

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The SEC document references a paper prepared by Frank Partnoy, a professor at the University of San Diego School of Law and an expert on securities law, who "argues that in order to make [major credit rating agencies] more accountable, they must be subject to a credible threat of liability," according to the SEC.

Public employee pension funds, like the California Public Employees' Retirement System, the largest in the country, support the removal of the exemption. So does the Council of Institutional Investors, a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion.

"[T]his would represent a large step forward in deterring harmful conduct by the [credit rating agencies] in the area of structured finance," CalPERS wrote in an April 21 letter to the SEC.

The major credit rating agencies are "financial gatekeepers" whose "actions have a significant impact on the health and well-being of the financial markets, both at home and abroad," the Council wrote in a Wednesday letter to top Senate leaders. "As experts, they have the ability to analyze and verify mountains of information for investors who do not have the capabilities to do so for themselves." The major agencies also have access to "material non-public information" which in part makes them "even more important to the functioning of the market" because "financial products have become more complex and opaque."

"In the eyes of investors, regulators and the market at large, rescinding the exemption would remove [the 10 major credit rating agencies] from the pedestal they have come to occupy," according to the Council's letter.

Those who support a removal of the exemption argue that by subjecting the credit raters to the possibility of lawsuits, it will force them to be more thorough and careful when issuing their ratings. In other words, it will discipline them.

In a January op-ed published in the Wall Street Journal, Deven Sharma, the president of S&P, wrote: "Currently, rating agencies face the same liability standards as accountants and securities analysts."

That's not true, retorted a top SEC official less than two weeks later in a letter to the editor.

"Nearly 30 years ago, the SEC adopted a rule that effectively exempts recognized credit rating agencies from experts' liability under the Securities Act," wrote David Becker, the SEC's general counsel and senior policy director. "No other experts have this protection."

The three biggest rating agencies -- S&P, Moody's and Fitch Ratings -- oppose the removal of this protection.

The House bill, which passed in December, calls for its removal. The Senate bill that hit the floor, though, did not, and after the chamber passed an amendment Thursday offered by Sens. George LeMieux (R-Fla.) and Maria Cantwell (D-Wash.) that copied some of the language in the House bill (except for this particular provision), it probably never will. Sen. Sherrod Brown (D-Ohio) offered an amendment that would get rid of the exemption, but because the Senate is reportedly allowing its members to bring just one amendment up for a vote, and a Brown amendment was already voted on, the Senate likely will not have an opportunity to vote on his amendment.

The LeMieux-Cantwell amendment passed by a 61 to 38 margin (one Senator didn't vote). Of the 38 votes against it, 37 were cast by Democrats; the other dissenter was Joe Lieberman, a Connecticut Independent who caucuses with Democrats.

At least one of the dissenters, Virginia Democrat Jim Webb, cast his vote against the provision "because it wasn't strong enough," Will Jenkins, Webb's deputy communications director, said in an e-mail.

But the Senate bill, like the House bill, does provide investors with an improved ability to sue credit raters for faulty ratings. A spokesman for LeMieux pointed to these provisions when asked why his amendment did not include the House language on the 436(g) rule.

The agencies have enjoyed a near-perfect legal record by claiming that their ratings fall under the protection of the First Amendment -- free speech, they've successfully argued. The House and Senate bills attempt to address this by strengthening investors' hand when it comes to suing the rating agencies, but the First Amendment defense may be hard to overcome, as ultimately the courts decide -- not Congress.

Still, according to experts like Barbara Roper, director of investor protection at the Consumer Federation of America, the bills are a big improvement over the status quo.

Many consumer groups say the provisions approved Thursday strengthened the Senate bill.

Elsewhere in those amendments were measures that remove various references in federal law to credit ratings, which had compelled their use and guaranteed the majors' oligopoly, and a government mechanism that would inject government officials into deciding which agency rates which securities.

Regarding the removal of the references, federal regulators will largely be forced to define creditworthiness, rather than regulations that currently rely on the credit rating agencies for that.

However, there are open questions about the LeMieux-Cantwell provision. The House bill, largely authored by Rep. Paul Kanjorski (D-Pa.), directs the various federal agencies that would need to modify their rules, like the Office of the Comptroller of the Currency, the SEC and the Federal Deposit Insurance Corporation, to harmonize their standards of creditworthiness "to the extent feasible." The Senate provision includes no such language.

Also, the House bill compels federal agencies to look for other such references to credit ratings in their rules and regulations, and modify them so they instead refer to government-defined standards. The Senate amendment doesn't include this, either.

The measures in the LeMieux-Cantwell amendment won't take effect until two years after the bill is enacted into law; the House provisions take effect within six months.

As for the other amendment, offered by Sen. Al Franken, it calls for a panel overseen by the SEC to pick which rating agencies will rate new securities. Should issuers choose to pick their own rating agencies, any differences between the ratings would have to be made public.

The Minnesota Democrat's amendment aims to end the alleged conflict of interest that exists when issuers of securities get to shop around for who rates them.

It passed 64 to 35. One of the dissenters was prominent reformer Sen. Jack Reed, a Rhode Island Democrat who chairs the Senate subcommittee that oversees the securities industry. He's consistently been among the few Senators trying to fundamentally clean up and reform the credit ratings business.

*This story has been updated to reflect that the major credit rating agencies are alleged to have knowingly applied misleading ratings to financial products. An earlier version of this story did not include the word "allegedly."

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