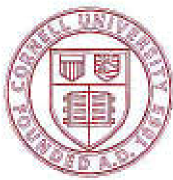

Cornell University
Cornell Law School

William A. Jacobson, Esq.
Associate Clinical Professor
Director, Securities Law Clinic
G57 Myron Taylor Hall
Ithaca, New York 14853
t. 607.254.8270
f. 607.255.3269
waj24@cornell.edu

December 14, 2009

Via Electronic Filing

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

RE: Release Nos. 33-9070; 34-60797; IC-28942; File No. S7-24-09 (Credit Ratings Disclosure)

Dear Ms. Murphy:

The Cornell Securities Law Clinic (the "Clinic") welcomes the opportunity to comment on the proposed rule amendments to Regulation S-K and forms under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 (the "Proposed Rule Amendments"). The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see http://securities.lawschool.cornell.edu.

To enhance credit rating disclosure so that investors will better understand credit ratings and their limitations, the Securities and Exchange Commission (the "Commission") seeks to require disclosure regarding credit ratings in registrants' registration statements under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") if registrants use credit ratings in connection with registered offerings. In addition, the Commission seeks to amend the Exchange Act reports to require registrants to disclose changes to credit ratings.

The Clinic supports the Proposed Rule Amendments because the Clinic believes that the disclosure requirements will further the goal of improving investor protection by providing information about credit ratings that will place the ratings in an appropriate context. In this comment letter, we provide a general background of the problems caused by credit rating agencies, describe how investors use credit ratings, and point out how credit ratings can be misleading to investors. With respect to the specific amendments, the Clinic supports the mandatory disclosure of credit ratings as well as the disclosure of changes to credit ratings. The Clinic believes that neither of these disclosures give too much weight to the credit rating, nor

Cornell University is an equal opportunity, affirmative action educator and employer

will the disclosure of preliminary and final ratings confuse or mislead investors. As we discuss below, however, the Clinic does not believe that a registrant should be required to disclose when a credit rating agency places the registrant on "credit watch" or assigns the registrant's rating to a different "outlook." The Clinic believes that the disclosure of these types of actions may be misleading to investors.

A. Problems Caused by Rating Agencies

Credit rating agencies played a large role in the recent financial crisis. Among other things, these agencies were responsible for setting the credit ratings of securities that were backed by pools of residential mortgages. Investors purchased these securities with the credit ratings attached, but without knowledge of the underlying loans and thus the real risks of such an investment.[1] One such risk associated with these securities was that the pooled mortgages were largely made to borrowers with poor credit histories. On top of that, these borrowers were permitted to borrow more than had previously been the case, seventy-five percent of the value of their homes, for example.[2]

A special purpose vehicle would purchase the mortgages and sell classes of securities with various credit ratings attached; the highest rated securities were those that would be paid first from the homeowners' mortgage payments from all of the classes, and the lowest rated securities would be paid last, although at a higher interest rate.[3] In addition, credit rating agencies set ratings for collateralized debt obligations, which represented the securities that were backed by the mortgages. In setting these ratings, the agencies used historical information on default. However, this was problematic because the agencies assumed that this historical data could predict the risk of a completely different mortgage market.[4]

Once homeowners began defaulting on their mortgages and lenders foreclosed on these homes, mortgage-backed securities declined significantly in value. This resulted in institutional investors that held those securities restricting their own lending and seeking additional capital to meet their capital and liquidity requirements. This in turn led to the recent credit crunch and

---

[1] Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES MAG., Apr. 27, 2008, at 36, *cited in* Credit Ratings Disclosure, Securities Act Release No. 9070, Exchange Act Release No. 60797, Investment Company Act Release No. 28942, 74 Fed. Reg. 53,086, at 53,097 n.82 (Oct. 15, 2009) [hereinafter Proposing Release].

[2] Lowenstein, *supra* note 1.

[3] *Id.*

[4] *Id.*

general economic crisis.[5] Remarkably, until fairly recently certain rating agencies maintained triple-A ratings on thousands of securities backed by these subprime loans.[6]

Although some may argue that the failure of the credit rating agencies in the recent financial crisis is an isolated problem and thus should not warrant the Proposed Rule Amendments, there are other examples demonstrating the problems surrounding credit rating agencies. For example, many believe that rating agencies failed to properly evaluate the creditworthiness of Enron prior to that company's collapse. A similar lack of due diligence by the credit rating agencies existed prior to the collapse of WorldCom.[7] In both cases, the rating agencies rated these companies as "investment grade" months or even days prior to the bankruptcy filings of the companies.[8]

B. How Investors Use and Rely on Credit Ratings

In making investment decisions, there are several reasons why investors use and rely on ratings given by credit rating agencies. First, for most investors, it is expensive and time consuming to obtain information about a particular investment. This holds true even for institutional investors. Moreover, it is difficult for many investors to even understand certain investment information given the complexity of securities such as mortgage-backed securities, for example. In addition, investors rely on credit rating agencies where the investors do not have access to nonpublic information or have a relationship with the issuer of the securities. By contrast, issuers provide rating agencies with such nonpublic information so that the agency will be able to perform an informed risk analysis.[9] As a result, credit ratings reflect information that most investors would not otherwise be able to obtain in making investment decisions. There are thus several good reasons why investors use and rely on credit ratings.

C. How Credit Ratings Are Misleading

Earlier this year, the California Public Employees' Retirement System sued the three leading credit rating agencies for setting "wildly inaccurate" credit ratings on investments that

---

[5] Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 5–6 (Indiana Univ. Maurer School of Law-Bloomington, Legal Studies Research Paper Series, Paper No. 133, 2009), *available at* http://ssrn.com/abstract=1374907.

[6] FRANK PARTNOY, RETHINKING REGULATION OF CREDIT RATING AGENCIES: AN INSTITUTIONAL INVESTOR PERSPECTIVE 3 (2009), *available at* http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf.

[7] Lynch, *supra* note 5, at 35.

[8] Letter from Egan-Jones Ratings Company to Jonathan G. Katz, Secretary of the U.S. Securities and Exchange Commission (Nov. 10, 2002), *available at* http://www.sec.gov/news/extra/credrate/eganjones2.htm.

[9] Lynch, *supra* note 5, at 15–17.

held primarily mortgage-backed securities.[10] As discussed above, although the rating agencies set high ratings for certain mortgage-backed securities, these ratings were misleading. The triple-A ratings represented the fact that these securities would be paid first among the classes of securities held by a special purpose vehicle, rather than representing the underlying risk of mortgage default.

Credit ratings can also be misleading because there is a misalignment of interests with respect to the issuance and use of credit ratings. Investors have an interest in accurate ratings, whereas issuers whose securities are being rated have an interest in favorable ratings. Since issuers usually pay credit rating agencies for the ratings, these agencies have an interest in serving their issuer customers. It has been suggested that the agencies' concern about their reputation for providing accurate ratings provides a check on this misalignment of interests.[11] However, rating agencies face short-term pressure regarding their earnings growth that can outweigh longer-term reputational concerns.[12] Because many investors do not know that issuers pay credit rating agencies for their ratings, these investors are unaware that the ratings could potentially be inflated.

Credit ratings can also be misleading because only certain credit rating agencies are designated as Nationally Recognized Statistical Rating Organizations ("NRSOs"). Companies can only use ratings from these agencies to meet certain regulatory requirements, thus giving these agencies a great deal of power.[13] Although the Credit Rating Agency Reform Act of 2006 opened the NRSO designation to more firms, the increased competition can result in rating shopping and a "race to the bottom" with respect to the quality of ratings.[14] Currently, investors do not know if the ratings they are looking at are the result of an issuer shopping around for the most favorable rating.

D. <u>The Clinic Supports the Proposed Rule Amendments</u>

In light of the problems caused by credit rating agencies, the fact that investors justifiably use and rely on credit ratings, and the potential for investors to be misled by credit ratings, the Clinic supports the Commission's Proposed Rule Amendments.

---

[10] Marc Lifsher & Jerry Hirsch, *CalPERS Sues 3 Rating Firms Over Its Losses*, L.A. TIMES, Jul. 16, 2009, at 2.
[11] Bo Becker & Todd Mibourne, *Reputation and Competition: Evidence from the Credit Rating Agencies* 2 (Harvard Business School Working Paper, Paper No. 09-051, 2009), *available at* http://www.hbs.edu/research/pdf/09-051.pdf.
[12] JEROME S. FONS, WHITE PAPER ON RATINGS COMPETITION AND STRUCTURED FINANCE 2 (2008), *available at* http://www.whanalysis.com/PDF/WPRatingCompJFons.pdf.
[13] PARTNOY, *supra* note 6.
[14] FONS, *supra* note 12, at 4.

1. Mandatory Disclosure of Credit Ratings

If a registrant uses a credit rating in connection with a registered offering, the Commission specifically proposes requiring disclosure of (1) all material scope limitations of the credit rating and any related published designation; (2) the source of payment for the credit rating; (3) non-rating services, if any, provided by the credit rating agency and the fees paid for those services, and (4) preliminary ratings and final ratings if not used by the registrant.

The Clinic supports requiring disclosure of all material scope limitations of the credit rating and any related published designation. According to a Senate staff report, credit ratings "have taken on great significance in the market with investors trusting" the credit rating reports because investors assume that the ratings are "careful, unbiased and accurate."[15] To combat this assumption, registrants should provide an appropriate context for their credit ratings. The Commission asks whether the proposed disclosure adds too much weight to the credit rating. The Clinic believes the proposed disclosure provides the appropriate context for credit ratings, which play an important and justifiable role in investment decisions. As discussed above, there are several legitimate reasons why investors use and rely on credit ratings in making an investment decision. Even if the proposed disclosure increases investor reliance on credit ratings, the proposed disclosure simultaneously increases the information available to investors in understanding these ratings.

The Clinic also supports requiring disclosure of the source of payment for the credit rating and any non-rating services provided by the credit rating agency and the fees paid for those services. Contrary to arguments made by commenters against the Commission's 1994 proposal to require disclosure of credit ratings,[16] rating agencies actually have diminished incentives to provide quality ratings. As discussed above, credit rating agencies have a conflict of interest because they are paid by issuers and thus have an interest in serving their issuer customers. Given that the issuer-pays revenue model is not likely to be abandoned[17] and thus conflicts of interest will persist, the Clinic supports these disclosures. If investors learn of the existence of possible conflicts of interest, investors can discount their reliance on potentially inflated credit ratings.

The Clinic supports requiring mandatory disclosure of preliminary ratings and final ratings if not used by the registrant. Because the ratings provided by the leading rating agencies are interchangeable to many investors, issuers enjoy a great deal of leverage over the rating agencies and are thus able to engage in rating shopping.[18] If registrants are required to disclose preliminary and final ratings, registrants will be less inclined to shop around for the best rating to disclose to investors. If registrants lose their incentive to shop for favorable ratings, credit rating agencies may even be less likely to inflate ratings to compete with other agencies. The

---

15 *Objectivity of a Rating Questioned*, N.Y. TIMES, Dec. 12, 2006, at C1.
16 Proposing Release, *supra* note 1, at 53,088.
17 Lynch, *supra* note 5, at 65.
18 FONS, *supra* note 12, at 8.

Commission asks whether disclosure of preliminary ratings would be confusing or misleading. The Clinic does not believe that disclosure of preliminary ratings would give investors a mistaken impression about the quality of the security so long as registrants also disclose the limitations of preliminary ratings, i.e., that such ratings are not based on final and full information. However, the Clinic suggests that the Commission consider ways to prevent registrants from "reclassifying" securities so as to avoid disclosing preliminary or final ratings for a class of securities being offered.

2. Mandatory Disclosure of Changes to Credit Ratings

If a registrant uses a credit rating in connection with a registered offering, the Commission proposes requiring disclosure on Form 8-K if a credit rating that was previously disclosed pursuant to the Proposed Rule Amendments has been changed or withdrawn. The Commission asks whether investors would benefit from having companies disclose this information in a uniform place. Commenters who were against the Commission's 2002 proposal to require a registrant to file a Form 8-K to disclose certain rating changes argued that the requirement was unnecessary because this information was publically available.[19] However, the Clinic believes that investors may not monitor press releases issued by credit rating agencies relating to rating changes. Moreover, such press releases would not be accompanied by a discussion of the impact of the rating change, which an issuer may include on a Form 8-K.

The Commission also asks whether it should require disclosure of other actions, such as a credit rating agency placing a registrant on "credit watch" or assigning a different outlook to the registrant's rating. Credit rating agencies use credit watches to indicate that there is a significant likelihood that a registrant's rating will change in light of a certain event. Credit rating agencies use rating outlooks to indicate that a rating is likely to change within one or two years based on certain trends.[20] The Clinic believes that credit watch and outlook actions may lead to an overreliance on credit ratings by investors. Specifically, the Clinic wonders whether investors might believe credit watches or outlooks are direct performance indicators of the issuer's securities. Instead, the Clinic believes that where there are registrant-related events or trends, investors should rely on the registrant's disclosure of material corporate events on Form 8-K rather than relying on a credit watch or outlook.

---

[19] Proposing Release, *supra* note 1, at 53,088.

[20] *See e.g.*, Fitch Rating Definitions, http://www.fitchratings.com/creditdesk/public/ratings_defintions/index.cfm (last visited Nov. 29, 2009).

Conclusion

The Clinic greatly appreciates the opportunity to comment on the Proposed Rule Amendments. Because investors have legitimate reasons for using and relying on credit ratings, the Clinic supports the Proposed Rule Amendments because it believes the amendments will improve investor protection by providing information about credit ratings that will place ratings in an appropriate context.

Respectfully submitted,

William A. Jacobson, Esq.
Associate Clinical Professor of Law
Director, Cornell Securities Law Clinic

Josephine Djekovic
Cornell Law School, Class of 2010