TESTIMONY OF DEVEN SHARMA

BEFORE

THE UNITED STATES HOUSE OF REPRESENTATIVES

FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

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Chairman Kanjorski, Ranking Member Garrett, Members of the Committee, good afternoon. My name is Deven Sharma. I am the president of Standard & Poor's ("S&P") and I am pleased to appear before you today. I want to commend you, Mr. Chairman and the Subcommittee, for having this hearing to air these important issues and continue this careful effort to construct the foundation for a sounder financial system. S&P is a 150-year-old company. By providing independent credit benchmarks, S&P helps create transparency — one important contributor to the development of the capital markets. S&P's ratings reflect the creativity, independence, rigor and hard work ethic that have built our great economy.

The job of a ratings analyst is a challenging one. It requires intellectual acumen, high integrity and analytic tools that give us the best opportunity to offer some relative predictability of what the future may bring. Over the course of S&P's history, investors have turned to S&P for its credit risk assessment of companies and securities. By and large, private sector investors and other market participants use our ratings, not because they are required to do so, but because our ratings add value to their important deliberations in making investment decisions.

Providing the public with quality ratings, which is our goal, is both an art and a science. We work hard, very hard to do what we do well and continually to improve the quality and timeliness of our work. But like every human endeavor, S&P continues to learn from its past. Among our disappointments has been the ratings of mortgage-backed securities issued between 2005- 2007. Over the course of 150 years, however, our track record is something in which our people can take pride.

We appreciate the Committee's goal to reinvigorate the economy and job growth through stability and innovation. Accordingly, we fully recognize and support the goals behind the recent discussion draft entitled *Accountability and Transparency in Rating Agencies Act*. We will be studying your discussion draft in greater detail in the coming days and will continue to engage with you over the next few weeks. I can say now that we support many — indeed most — of the proposals. We also share the general view that through greater disclosure, oversight and accountability, confidence in ratings can be restored to overcome the recent disappointment in some ratings of residential mortgage-backed securities and related products.

As I will explain, however, some of the recent proposals to increase oversight of NRSROs are problematic and, in our view, would bring unintended harm to the markets. These proposals include amendments to the federal securities laws that would treat NRSROs far more harshly than any other defendant in securities fraud lawsuits, and other measures that would interfere with NRSROs' analytical independence. As I will explain, these proposals would inevitably curtail the scope and availability of credit ratings on a broad spectrum of businesses and the debt they issue. This would add greater hazards, systemic risks and inefficiencies to the market, and would cause confusion among market participants. Importantly, by encouraging homogenized, one-dimensional rating opinions, these proposals would also necessarily restrict the flow of capital across global markets, causing harm not only to established financial enterprises, but — even more so — to the small and medium-sized emerging businesses that are particularly dependent on access to capital and are so important to reinvigorating our economy.

Before discussing these proposals any further, I would like very briefly to address S&P's credit rating history, including the recent performance of our ratings on mortgage-backed securities, as well as important changes we have made to improve our processes and to enhance and broaden our communication with the market.

S&P's Ratings on 2005-2007 Residential Mortgage-Backed Securities

Accordingly, let me begin by acknowledging — as S&P has been saying for quite some time — that S&P is profoundly disappointed with the performance of many of its ratings on the aforementioned mortgage-backed instruments. Although we always expect that some portion of the debt we rate, even highly-rated debt, will ultimately default, our ratings of mortgage-backed securities issued in this time period have been unusually unstable and their performance has not matched our historical track record. Why did these ratings on mortgage-backed securities perform poorly? Put simply, our assumptions about the housing and mortgage markets in the second half of this decade did not account for the extraordinarily steep declines we have now seen. Although we did assume, based on historical data stretching back to the Great Depression, that these markets would decline to some degree, we and virtually every other market participant and observer did not expect the unprecedented events that occurred. It should go without saying that had we anticipated fully the speed and scope of the declines in these markets at the time we issued our original ratings, many of those ratings would have been different.

It is important for me to note, however, that overall S&P's ratings, including in the area of structured finance securities, have historically performed very well. We have been rating structured securities for over thirty years and have developed industry-leading processes and models for evaluating the creditworthiness of a wide array of structured transactions. Since 1978, only 1.15% of structured finance securities rated by us 'AAA' have ever defaulted. For RMBS securities, the percentage of 'AAA' ratings to default over this time period is 0.77%. Our ratings of non-mortgage asset-backed securities ("ABS") have performed notably well, even during the recent credit crisis. As of July 2009, of the more than 6,000 'AAA' ratings we issued on non-mortgage ABS, approximately 90% have remained 'AAA' and only 1% have been downgraded below investment grade. Only four 'AAA' transactions in this group — or approximately 0.07 percent — have *ever* transitioned to default. Our ratings on corporate and municipal debt have also performed extremely well, reflecting a high correlation between rating levels and defaults.

Thus, employing the same general processes and ratings framework across all types of debt securities and issuers, we have historically had a very good overall track record, and our employees remain devoted to providing their highest quality credit analysis to the markets. Of course, we understand that this Committee's current focus, and the focus of investors and other market participants, is — as it should be — not just on our historical ratings history, but on our more recent ratings of mortgage-backed securities. We know we have more work to do in this regard and, both on our own initiative and with regulatory oversight by the Securities and Exchange Commission ("SEC"), we are well into making meaningful improvements.

Mr. Chairman and members of the Subcommittee let me assure you of two things. First, our ratings in the mortgage-backed securities area were not venal. These were honest views expressed based on the best information available, dealing with complex instruments. Second, and more importantly, we have learned from this experience and we have made major changes ourselves to restore confidence in our ratings.

Recent S&P Initiatives

In 2008, we announced a series of initiatives aimed at improving checks and balances in our organization and promoting four broad objectives: (i) ensuring the integrity of the ratings process; (ii) enhancing analytical quality; (iii) providing greater transparency to the market by disseminating relevant information about ratings, as well as information to help the market form its own view of the soundness of rating analysis; and (iv) more effectively educating the marketplace about ratings. To date, we have made significant implementation progress.

For example, we have:

- Established distinct groups and invested significantly in processes around our Criteria, Quality, Compliance and Internal Audit functions each of which has a distinct and important role in the review of the ratings process and related controls;

- Established an Office of the Ombudsman. The Ombudsman addresses concerns related to potential conflicts of interest and analytical and governance processes that are raised by issuers, investors, employees and other market participants across S&P’s businesses. The Ombudsman has oversight over the handling of all issues, with authority to escalate all unresolved matters, as necessary, to the CEO of The McGraw-Hill Companies and the Audit Committee of the Board of Directors;

- Instituted a rotation system for analysts;

- Established an enterprise-wide independent Risk Assessment Oversight Committee. The Committee assesses all risks that could impact the integrity and quality of the ratings process. This Committee also assesses the feasibility of rating new types of securities;

- Enhanced our analyst training programs and have introduced a new Analyst Certification Program in which all S&P rating analysts are required to participate;

- Enhanced and expanded our quality assurance and controls related to the development and implementation of criteria; and

- Created a separate Model Validation Group to independently analyze and validate all models, developed by S&P or provided by issuers, used in the ratings process.

In addition, we have taken steps to raise the disclosure levels on our analyses, strengthen the analytics and educate the market. For example, we have:

- Implemented procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities;
- Published a series of articles addressing certain “what if” scenarios; and
- Published a “Guide to Credit Ratings Essentials” that provides important information about ratings and their role in the markets.

A number of these changes are intended to enhance our controls and protections against potential conflicts of interest, an area which has received considerable attention of late. At the SEC Roundtable in April 2009, discussion among many panelists recognized that there are potential conflicts inherent in any NRSRO business model, including the issuer-pays model that we employ or other models such as the investor-pays model or, for that matter, a government-run model. An important conclusion was that, with any business model, potential conflicts must be managed through internal governance procedures and regulatory oversight. S&P has long maintained, adhered to, and recently strengthened policies that manage or prevent these conflicts. These policies include, among other things, the use of internal firewalls to maintain the independence and integrity of the analytic process, the use of rating committees, and the delineation of separate roles and responsibilities of personnel having an analytic versus a commercial role. These policies, along with the new initiatives discussed above, provide strong protections against potential conflicts and serve to promote the integrity of our ratings process.

Let me assure you that the various improvements I have discussed are substantive. We have gone to great lengths to make serious and meaningful changes in the way we go about doing our credit ratings and we believe the market is taking notice. Virtually everyone I speak to agrees that our ratings have served historically as an extremely valuable tool for evaluating the creditworthiness of issuers and debt securities. We believe firmly that our ratings will continue to be an important part of the information available to investors and other market participants as we move forward and the financial markets continue to improve.

Proposals For Further Regulation

Another way to restore investor confidence in ratings — in addition to the sweeping changes I just described — is to pursue effective regulation of credit rating agencies. Currently, NRSROs are subject to the Credit Rating Agency Reform Act of 2006 (the "2006 Act"), which gave the SEC broad oversight authority and was intended to increase transparency about the ratings process and investor choice and competition among NRSROs. We believe those goals have been significantly advanced in the short time since the 2006 Act became effective. Indeed, the number of NRSROs has grown to ten, double what it was at the time the law was passed. As long as barriers to entry remain low, we expect the number of NRSROs to continue to grow, providing still more options for investors.

Also, as a result of the 2006 Act and implementing regulations, NRSROs are now required to disclose detailed performance data about their ratings. This facilitates comparisons of NRSROs and promotes more informed decisions about their strengths and weaknesses. NRSROs are also now subject to increasingly rigorous and regular oversight, including wide-ranging inspections, the first of which was conducted by SEC staff in 2007 and 2008. This inspection resulted in a lengthy report and a series of recommendations by the SEC for improvements — some of which overlap with the changes described above — which we have worked tirelessly to implement.

On top of this, the Commission issued another layer of rules governing NRSROs in February of this year. Those actions by the SEC require enhanced disclosures of performance measurement statistics and procedures and methodologies; new record-keeping standards; public disclosure of ratings histories; and a comprehensive annual report from each NRSRO. Just this past month, the Commission approved another set of rules which require more complete disclosures of credit rating histories, provide all NRSROs with access to information made available by issuers to NRSROs they pay to rate a transaction, and expand Regulation FD to allow access by NRSROs to sensitive issuer information even if the NRSROs do not make their ratings publicly available for free. The Commission also voted to propose new rules that, among other things, would require a new report from NRSROs that describes compliance reviews and steps taken to enforce compliance policies; and mandate additional disclosures about potential conflicts of interests, including the percentage of revenues attributable to the largest users of credit ratings.

Although the 2006 Act has resulted in a broad and robust regulatory scheme, S&P shares the view that further regulation, appropriately crafted, can serve the goal of restoring and maintaining investor confidence. In our view, such regulation should follow four broad principles: (i) it should be part of "beginning-to-end" regulatory solution; (ii) it should not interfere with analytical independence; (iii) it should foster greater competition in the ratings industry and not impose burdensome barriers to entry; and (iv) it should recognize the critical importance of international consistency. I will say a few words about each of these principles and then I will discuss in more detail some of the specific proposals that have been made.

Beginning-to-End Solutions: From our perspective, any regulatory approach regarding ratings should include "beginning-to-end" solutions. In other words, as noted in the Treasury Department's June report, *Financial Regulatory Reform: A New Foundation*, regulation should cover all aspects of the capital markets that, taken together, contribute in a systemic way to their effective and efficient functioning. In structured finance, this would include not just ratings, but appropriate regulation related to the origination and pooling of assets, the structuring and underwriting of securities, the management of collateral held by a structured vehicle, and the marketing of securities. A "beginning-to-end" focus is important in avoiding the unintended consequences that too often result from piecemeal solutions. With respect to ratings, an appropriate regulatory framework should cover not just rating firms, but also those entities that can play a role in promoting the quality of ratings and their appropriate use. For example, an important factor in ratings quality is the reliability and accuracy of information available to be analyzed by rating analysts. That information is not generated by rating firms, but by others — *e.g*, corporations, mortgage originators, and underwriters. Still others, such as professional audit firms in the corporate world and third-party due diligence firms in connection with certain structured finance securities, are responsible for reviewing that information and verifying it. In our view, these entities and the roles they perform should be an integral part of any regulatory approach for all market participants.

Analytical Independence: We believe analytical independence is a fundamental principle. At its core, a rating is an analytical determination. It results from a group of experienced professionals analyzing a set of facts and forming a judgment as to what might happen in the future. For the markets to have confidence in those ratings, they must continue to be made independently. That means, of course, that they must be free of undue commercial considerations — and S&P is fully committed to that principle — but it also means that they must truly reflect the substantive views of the analysts making them, not the dictates of regulators or other external authorities. Indeed, the key value of ratings is their independence from undue influence. Analytical independence is critical in furthering analytical innovation based on experience. Government mandates to set standard rating definitions or methods will also lead to over-reliance of investors on ratings – the chief reason given for removing government mandates that require use of ratings for certain investment purposes. Accordingly, we would be extremely concerned about regulatory measures that could force analysts to make judgments not based upon their own considered analysis and independent views and experience, but rather out of a desire to avoid subsequent second-guessing by regulators or others. Such proposals, in our view, would lead to uniformity of opinion and, ultimately, systemic risk as the market would be deprived of differing viewpoints on the creditworthiness of issuers and securities.

Fostering Competition in the Ratings Industry: A key aspect of the 2006 Act is a set of provisions designed to ease the burden of becoming an NRSRO. S&P strongly supports that legislative goal. Regulatory requirements, by their nature, are often seen by potential new entrants as burdensome; yet carefully crafted, balanced rules are necessary to establish a fair and level playing field. We believe that new statutory laws will be beneficial to investors and the markets generally, as long as they aim to increase competition in the ratings industry and among NRSROs in order to provide investors with more robust ratings and increased sources of information about evaluations of debt.

International Consistency: We also believe international consistency is critical to an appropriate regulatory framework. Ratings are issued and used globally. This reflects one of their many benefits — their ability to provide a common global language for analyzing credit risk and contribute to the global flow of capital. However, it also underscores the importance of a consistent approach to the regulation of ratings around the world. A rating produced under one set of regulations may not mean the same thing or address the same risks as one produced under another if those regulations are not compatible. Inconsistent ratings regulation could actually promote uncertainty in the global capital markets, at a time when it can be least afforded. To that end, we believe the G20's recent comments about the need for international consistency, and the model code of conduct published by the International Organization of Securities Commissions ("IOSCO") as a possible blueprint in that regard, are constructive.

Specific Proposals That Would Improve Ratings and Benefit The Markets

Let me speak now about specifics. There have been several recent proposals for additional legislative and regulatory action which, on top of the new and far-reaching rules issued by the SEC, would provide for extensive new regulation designed to increase NRSROs' accountability. As noted, S&P agrees with, and is prepared to support, many of the recent proposals to strengthen regulation of NRSROs by: (i) increasing SEC oversight; (ii) protecting against conflicts of interest, which inevitably exist in connection with any credit rating business model; (iii) promoting the use of high quality data by NRSROs; and (iv) improving transparency in the ratings process.

These recent proposals that we broadly support include, specifically:

Oversight and Accountability

- Creating a dedicated office within the SEC to oversee NRSROs and empowering the SEC to conduct frequent reviews of NRSROs to ensure that NRSROs follow their internal controls and policies for determining ratings and managing conflicts of interest;

- Providing the SEC with explicit authority to impose sanctions, including steep fines for NRSROs that fail to comply with the SEC's rules or their own policies and procedures, and to conduct regular, annual reviews of NRSROs;

- Designating a responsible officer (or officers) within each NRSRO with authority to review compliance with procedures and methodologies, administer rating policies, and oversee compliance with the securities laws and regulations;

- Requiring NRSROs to adopt payment practices that are based in part on ratings performance and ongoing surveillance, which will help promote comprehensive and thorough analysis; and

- Mandating comprehensive analyst training programs;

Conflicts of Interest

- Requiring disclosure of a uniform body of underlying information by issuers, according to requirements appropriate to every class of securities to all NRSROs, which would lead to increased transparency and promote the issuance of unsolicited ratings, thus improving competition in the rating industry;

- Requiring analyst rotations so that analysts do not consistently analyze the same issuer or security, further reducing the potential for conflicts of interest;

- Requiring "look-back" reviews whenever former NRSRO employees leave to work for an issuer, thus providing a further check on the integrity of the rating process;

- Requiring that fees for structured transactions are paid at defined milestones in the process, rather than when the transaction closes, which would help avoid potential conflicts of interest and protect against so-called "ratings shopping"; and

- Requiring issuers to make disclosures when they seek preliminary ratings from NRSROs, which will further protect against ratings shopping.

Data Quality

- Requiring disclosures about the use of any third party due diligence services; and

- Requiring NRSROs to receive due diligence certifications from independent, third party firms in connection with credit ratings on structured finance securities backed by residential mortgages.

Transparency

- Requiring frequent dissemination of robust and comparable data about the historical performance of ratings, including default and transition studies, which will permit investors and other market participants to compare NRSROs and improve competition in the industry;

- Requiring broad dissemination of ratings methodologies, analytical assumptions, and practices related to data quality;

- Requiring disclosures about the use of "servicer reports" in connection with structured finance transactions; and

- Improving documentation and broadening public disclosure of internal controls, including conflicts of interest policies and codes of conduct.

On this last category, I will add that while we believe strongly in promoting transparency and a well-informed market, the key is to promote *relevant* transparency; we should seek to avoid the risk of overloading the market with too much information that has no genuine use.

There have been other proposals which S&P generally supports. For example, with the expansion of the number of NRSROs that has occurred as a result of the 2006 Act, there appear to be good grounds for reevaluating the use of NRSRO ratings in federal laws and regulations. On this subject, we have always said that S&P did not seek to include the NRSRO designation in laws and regulations. We agree with the objective of such proposals — namely, to reduce the potential for undue reliance on rating opinions and a misperception among market participants that Congress and the SEC are "endorsing" NRSROs' processes or methodologies by influencing the meaning or substance of NRSROs' ratings. Let me add that if regulators and policymakers ultimately choose to retain ratings in their rules as benchmarks, the use of additional benchmarks, addressing elements other than credit risk, may also be warranted.

S&P recognizes the potential benefits of further regulation and wishes to work with this Subcommittee and your colleagues to pursue meaningful change to the regulatory landscape which will, ultimately, restore and maintain the confidence of investors and provide them additional choice in what ratings they use. This is an important point in time, as extensive new regulation in this area will undoubtedly shape our capital markets for years to come.

Proposals That Raise Concerns For NRSROs and the Markets Generally

Although S&P broadly supports the proposals I have mentioned, there are several that raise particular concerns. Some of these can be alleviated by simple revisions to the proposed text while preserving the core goals of the proposals. Other provisions, however, raise serious concerns, not only for the significant effect the proposals would have on S&P and other NRSROs, but also for the broader implications they would have for the United States and global financial markets as a whole.

Amendments to Pleading Standards

One proposal that has been discussed in recent months could have the effect — at least as interpreted by aggressive plaintiffs' lawyers not always seeking to advance the broader interests of the market — of lowering the threshold legal requirements for bringing a securities fraud claim against NRSROs and *only* NRSROs. On the subject of litigation, let me first correct one misperception, namely, that the First Amendment insulates rating agencies from all liability. Although I am not a lawyer, I understand that courts have indeed affirmed that credit ratings are opinions that are matters of public concern protected by the First Amendment. However, the First Amendment provides no exemption from liability to any company, including a rating agency, that intentionally misleads or defrauds investors. Indeed, the First Amendment provides no protection in a securities fraud under the Securities Exchange Act — the very statute that this proposal would seek to amend.[1]

If the proposal under consideration were to become law, plaintiffs' lawyers would use it to argue that NRSROs may be sued for securities fraud under the Securities Exchange Act whenever they act "unreasonably." This would differ materially from the legal standard applicable to *every other* defendant — including auditors, equity analysts, issuers, underwriters and others — who must be found to have acted intentionally with bad faith (or in legal terms with "scienter") before they can be found liable. Such a distinction is inappropriate and unfair. We are not suggesting that NRSROs should receive special treatment in such cases, but rather that they should be subject to the same pleading standards as other defendants.

Thus, under such a new legal framework, if a plaintiffs' lawyer were to bring a securities fraud suit jointly against three defendants -- a securities analyst, an auditor and an NRSRO -- the plaintiff would have to allege that the securities analyst and auditor acted intentionally in bad faith but, with respect to the NRSRO, would argue that it need to allege only that the NRSRO acted "unreasonably." In other words, materially different legal standards would apply in the

1 For the information of the Subcommittee, I am attaching a copy of written testimony recently submitted by S&P's outside legal counsel, Floyd Abrams, to the House Committee on Oversight and Government Reform which addresses issues of rating agency liability.

same case. We respectfully submit that any such change is both unfair and unjustified. There is simply no basis for providing any less legal protection to NRSROs than, say, analysts who issue recommendations to buy or sell stock, or arrangers and sellers of securities.

This proposal could lead to a torrent of new litigation against S&P and other NRSROs, which would be in addition to the many lawsuits, seeking tens of billions of dollars, currently pending against us in state and federal courts across the country.

On this point, it is important to understand that the very nature of credit ratings makes NRSROs uniquely susceptible to potential harm from the creation of a new lower liability standard. Credit ratings are not statements of existing fact but rather opinions about the future. They are not some sort of guarantee of performance or investment recommendation but rather, by their nature, are forward-looking opinions that speak primarily to the *likelihood* that a particular security or obligor will default in the future. Market participants have long understood that some portion of rated debt — even highly rated debt — will ultimately be downgraded and, in some cases, default as issuers encounter financial difficulties, the markets they operate in shrink, or economies go into recession. That some percentage of defaults occur is not evidence that the initial ratings were "too high," "too low," or otherwise "inaccurate" and certainly not of wrongdoing that should expose NRSROs to expanded securities fraud claims as contemplated by proposals now before this Committee.

If S&P or other NRSROs could potentially be liable under the securities laws even where it acts in good faith, plaintiffs' lawyers would inevitably file suit against them any time rated securities default, or even when ratings are simply downgraded. There would be limitless opportunities for such second-guessing because, at any moment, S&P has well over 1 million ratings currently outstanding and rates more than $32 trillion of debt. Our lawyers have explained that this dynamic could create the potential for an unprecedented number of lawsuits from an unknown but vast class of potential plaintiffs.

More importantly from a market perspective, the harm I am discussing would not just be limited to vastly increased litigation risks and costs for NRSROs. More to the point, any law that could be read as subjecting NRSROs to the prospect of liability, in hindsight, for opinions issued in good faith, would be affirmatively harmful to the markets as a whole. For example:

- ***NRSROs could adopt a one-dimensional approach:*** Exposing NRSROs to new expansive liability could well lead to a more homogeneous approach to ratings among NRSROs, resulting in less diversity of opinion and strong disincentives for analytical innovation, thereby stifling a prime goal of increased competition in the industry. Faced with potential liability under the proposed standard, NRSROs across the board would have strong incentives to adopt only those processes that courts would deem "reasonable," even if they believe a different approach might be more appropriate analytically and provide more robust ratings for investors. The result could generate serious systemic risk. As NRSROs would adopt narrower, less diverse opinions, the market would be left with one uniform, conventional view of credit risk when making investment decisions and other financial judgments.

- ***The market would have access to fewer ratings:*** The proposal could also result in the scaling-back of ratings coverage, with the most profound impact felt by newer and smaller issuers, including those in emerging sectors critical to the future growth of our markets and economy. Faced with a dramatic increase in liability risk, NRSROs would likely rate only those entities and securities that are least likely to default or be downgraded or which have a long history of providing the highest quality data. As a result, issuers who are relatively new to the debt markets may have a difficult time getting rated and, therefore, greater difficulty accessing capital and contributing to the economic recovery. Since small and medium enterprises, as well as new technology companies -- for example, green energy producers and broadband providers -- represent critical and emerging elements in our national production and employment bases, this result could have long-standing, detrimental results for economic growth.

- ***There could be less comprehensive ratings analysis:*** Expanding the potential for litigation against NRSROs would create incentives for NRSROs to narrow the scope of their rating analysis in order, again, to minimize the areas for potential second-guessing by plaintiffs' lawyers. For example, a number of NRSROs consider projections prepared by management when rating corporations, public finance issuers, and others. Performing a "reasonable" investigation of such projections — as would be required under the current discussion draft — would be difficult if not impossible to do, yet an NRSRO would face new potential liability risk for failing to do so. Faced with this choice, an NRSRO might decide to stop taking such information into account. Ratings would thus become more backward-looking and, as a consequence, less geared towards their primary purpose: an assessment of likely credit quality on a going forward basis.

- ***NRSROs may avoid downgrades to limit potential liability:*** Ratings are forward-looking opinions. As such, they sometimes change as the economy does or as updated facts about a rated entity or security become available. Some rated securities inevitably default; others are downgraded as new facts surface. If NRSROs could be sued every time an obligor or security is downgraded or defaults, the ratings process itself could be distorted so as to avoid downgrading ratings even if circumstances warrant, thus lowering NRSROs' potential legal exposure.

I am not suggesting, of course, that S&P should receive special legal treatment in lawsuits for securities fraud under the Exchange Act. Rather, I am raising probable, unintended consequences not just for NRSROs but, more importantly, for issuers who must access the debt markets and for investors who want and need additional information about the debt. I am simply saying that we should be subject to the same legal standards as everyone else in such cases. The discussion draft suggests the possibility of new language explicitly stating that Congress would not be amending existing pleading requirements under the federal securities laws, and that NRSROs would be subject to the same legal standards that apply to issuers and underwriters. While this provision would certainly help to alleviate the significant concerns I have raised, the discussion draft still contains much of the problematic language I have discussed and, therefore, should be made clearer in order to avoid any possibility of these very serious potential harms.

Collective Liability

Another proposal that has given us great cause for concern is one that would subject each NRSRO to "collective liability" for judgments against any NRSRO. Thus, if an analyst at one NRSRO commits securities fraud, S&P could be required under some circumstances to compensate the victim of the fraud even if S&P had nothing whatsoever to do with the other NRSRO's fraudulent activity. Respectfully, we believe there is no basis for this unique and unjust legislative scheme. Put simply: No NRSRO should be required to act as an insurer and compensate plaintiffs for harm caused by employees of its competitors.

This proposal is particularly alarming because it contrasts so sharply with the primary goal of the 2006 Act — to increase competition in the credit rating industry and lower barriers to becoming an NRSRO. Indeed, it is difficult to imagine a greater deterrent to entering this industry than the knowledge that one may be required to act as an insurer and held financially responsible for the fraudulent actions of and harm caused by its competitors and its competitors' employees.

In this regard, we must also recognize that the 2006 Act succeeded in increasing competition by reducing the authority of the SEC to evaluate the track records of entities seeking NRSRO status. S&P has always embraced more competition in the rating industry and we supported this purpose of the 2006 Act. We did not expect, however, that we would ultimately be made in effect a legal guarantor and insurer of the work performed these new entrants. Such a result is not fair, and there is no legal or policy basis for it.

Sharing and Verification of Information

The discussion draft includes another troubling provision, which would mandate that NRSROs disclose to one another all information they receive from issuers. On its face, the proposal would also require NRSROs to disclose — to competitors no less — all of their own internal work papers, meeting notes and any other analytical support for their rating opinions. This would constitute an unprecedented intrusion into competitive businesses and fundamentally subvert intellectual property rights in a manner that would undoubtedly chill robust analysis by NRSROs and otherwise restrict development and innovation in the ratings industry.

In addition to such sweeping disclosures, the proposal would also require NRSROs to review and "verify" any information similarly disclosed to them by their competitors. This would constitute a seemingly insurmountable burden, considering that S&P alone has well over 1 million ratings outstanding right now and currently rates more than $32 trillion of debt. The proposal raises a number of serious questions: How would an NRSRO go about "verifying" all of this information, which presumably would include financial statements, management projections, and the like? Would NRSROs be required to verify such information even if they did not rate the relevant issuer or security? Would NRSROs be expected to establish entire departments dedicated to verifying the reams of information flowing in from their competitors? Rather than NRSROs, these roles are properly held by those involved in the securitization process who are responsible for the review and verification of such information.

Whatever the answers to these and other questions raised by this provision, it is clear that this concept is unprecedented and would inevitably create extraordinary barriers to entry, particularly for start-up firms who would not conceivably be equipped to take on the massive burden of verifying information on virtually all of the major securities issuances in the U.S., as well other issuances abroad.

Potential Interference With Analytical Independence

A core provision in the 2006 Act prohibits the SEC from regulating "the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings." This important limit on SEC authority was designed to protect NRSROs' analytical independence and to ensure that they are able to issue rating opinions free from government-mandated analytics, which would stifle innovation, lead to less robust ratings, and have the appearance to investors that the government is somehow "sanctioning" or "endorsing" a particular rating or NRSRO. Some recent proposals, however, cross that threshold and suggest a substantive role for regulators in determining how an NRSRO forms its rating opinions. One example is a provision in the discussion draft that would strictly define the meaning of a credit rating, limiting it to an assessment of risk that investors "may not receive payment in accordance with the terms of issuance" — in other words, the likelihood of default.

As I have discussed today, S&P's credit ratings express forward-looking opinions about the creditworthiness of issuers and obligations. More specifically, our ratings express a relative ranking of creditworthiness -- issuers and obligations with higher ratings are judged by us to be more creditworthy than issuers and obligations with lower credit ratings. Legislative proposals attempting to define and limit the definition of a credit rating do not account for the reality that creditworthiness is a multi-faceted phenomenon. Although there is no "formula" for combining the various facets, our credit ratings attempt to condense their combined effects into rating symbols along a simple, one-dimensional scale, and the relative importance of the various factors may change in different situations.

While likelihood of default is the single most important factor in our analysis of creditworthiness, investors have repeatedly cited other factors as useful to them in their investment decisions. Our analysis therefore addresses secondary factors, including the payment priority of an obligation following default. For example, when a corporation issues both senior and subordinated debt, we typically assign a lower rating to the subordinate debt. We also consider the projected recovery that an investor would expect to receive if an obligation defaults. Another factor is credit stability, which accounts for the expectation that some types of issuers and obligations are prone to displaying a period of gradual decay before they default, while others may be more vulnerable to sudden deterioration or default. Accordingly, in 2008, we introduced an explicit "stability" measure into our ratings criteria, which addresses whether, in our view, an issuer or security has a high likelihood of experiencing unusually large adverse changes in credit quality under conditions of moderate stress.

Any government mandate that arguably would prohibit an NRSRO from considering any secondary credit factors that are relevant to our opinion of creditworthiness would lead not only to homogenized ratings, thus depriving investors of the full breadth and diversity of NRSROs' opinions, but could also result in undue investor reliance on rating opinions and a misperception that Congress or the SEC has endorsed NRSROs' methodologies and their ultimate rating opinions -- again, precisely the opposite of Congress' goal in pursuing proposals to remove the NRSRO designation from existing laws and rules. Such mandates could also lead to narrower, more homogeneous ratings, giving rise to many of the harmful market effects I have mentioned.

S&P supports a transparent system in which the market has the benefit of an NRSRO's complete and independent opinion of a bond or security, along with a clear understanding about the different aspects of creditworthiness that ratings can address. This is far more beneficial to the market than a system in which the government mandates what a rating must mean or what it must address.

Removing Protections for Forward-Looking Statements

We also have serious concerns about proposals providing that rating opinions shall not be deemed "forward-looking statements" under the federal securities laws. These proposals ignore that the very essence of a rating is that it is forward looking — it speaks to the likelihood that a particular obligor will pay back principal and interest in the future. Unlike statements that speak to an entity's current financial condition, ratings expressly relate to what may likely happen on a going-forward basis. If ratings were not forward-looking, but instead simply reported on existing facts about an issuer or security, they would serve very little, if any, purpose to the markets. Indeed, at S&P we have heard consistently from market participants over the years that ratings *must* be forward-looking in order to have value.

While we understand that one of the purposes of this proposal is to subject NRSROs to a high level of accountability and promote quality rating opinions, we believe legislation can achieve these goals in a manner that is consistent with the genuine nature of ratings.

Corporate Governance Restrictions

Another proposal would regulate and restrict the corporate governance practices at NRSROs or their parent companies. Among other things, the proposal would dictate the composition of boards of directors, restrict the activities of board members and control their compensation structure and length of term. In addition, board members would be required to oversee analytical processes, including the development of ratings criteria and methodologies — subjects that would ordinarily fall far outside the knowledge and experience of corporate board members, who are not trained analytical staff or management of NRSROs.

Such interference with NRSROs' corporate governance structure would treat NRSROs differently and much more harshly than all other market participants, including, for example, auditors and equity analysts. Members of Congress and critics of NRSROs have frequently observed that NRSROs should be treated "the same as" auditors and equity analysts; yet, the effect of this proposal represents the opposite approach.

Prohibitions on the Activities of NRSRO Affiliates

Finally another provision of the discussion draft would impose restrictions on the affiliates of NRSROs, prohibiting them from engaging in an array of services unrelated to any credit rating service. S&P has further strengthened its policies in this area since 2007 and strongly supports the goal of protecting against potential conflicts of interest. These new proposals, however, would sweep too broadly and would increase barriers to entry. By way of example, S&P is owned by The McGraw-Hill Companies, Inc., which itself operates a number of entities and business units that have nothing to do with — and are segregated both structurally and substantively from — S&P's credit rating activities. McGraw-Hill's education and information and media segments, for example, have nothing to do with S&P's ratings yet would be covered by this sweeping prohibition. Imposing restrictions on the ability of units like these to do business with issuers on matters totally unrelated to ratings would be unfair and could well prevent new businesses that currently offer similar services from considering entrance into the ratings business as an NRSRO.

This problem could be solved rather easily by creating a safe-harbor provision for those NRSROs, such as S&P, that maintain policies and procedures that establish firewalls to insulate ratings-related activities from other business activities under the same corporate umbrella. This approach would be consistent with rules announced by the SEC earlier this year and now in effect, which include restrictions that are focused on situations in which affiliates of NRSROs provide consulting advice in connection with credit rating activity. We would be pleased to offer specific language to the Committee on this matter.

In summary, we are concerned not only with potential effects on S&P, but also the effects these changes would have on the market. While we agree completely with the goal of improving the quality and transparency of credit rating analysis, we urge caution in the crafting of proposals that would ultimately result in less comprehensive ratings, covering a narrower scope of world markets to the detriment of investors and business enterprises large and small. Any regulatory scheme that effectively scales back the availability of robust, independent rating opinions will result, inevitably, in a reduction to the flow of capital in global markets, stalling innovation and growth in emerging sectors and beyond.

Conclusion

I thank you for the opportunity to participate in this hearing. Since our founding over a century ago, S&P's consistent approach has been to learn from experience and to improve and strengthen our analytics, criteria, and review processes when appropriate. You can expect that same approach going forward. Let me also assure you again of our commitment to analytical excellence and our desire to continue to work with Congress and governments, legislatures and policy-makers worldwide as they strive to develop productive solutions that restore stability in the global capital markets. I would be happy to answer any questions you may have.

TESTIMONY OF FLOYD ABRAMS

BEFORE

THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

UNITED STATES HOUSE OF REPRESENTATIVES

September 24, 2009

Mr. Chairman, Mr. Ranking Member, Members of the Committee, good morning. My name is Floyd Abrams. I am a senior partner in the law firm of Cahill Gordon & Reindel LLP and I appear today, at your invitation, to discuss issues relating to the imposition of liability on credit rating agencies. It is an honor for me to be here.

I appear on my own behalf today and not on behalf of any client. My law firm has served as outside counsel to The McGraw-Hill Companies, Inc. ("McGraw-Hill"), and its subsidiary, Standard & Poor's Ratings Services, LLC ("S&P") on a variety of matters for over 20 years. Lately, I have spent much of my time defending both companies in a wide array of lawsuits in state and federal court, many arising out of S&P's recent credit ratings on certain structured finance securities backed by residential mortgages. There are almost three dozen of these lawsuits currently pending. In these cases, plaintiffs are seeking — literally — tens of billions of dollars in damages.

In my testimony today, I will discuss some of these pending cases, along with recent proposals to amend the pleading standards in new cases brought against S&P and other Nationally Recognized Statistical Rating Organizations ("NRSROs"). I will also address certain protections that apply to S&P and other rating agencies under the First Amendment to the United States Constitution.

Pending Litigation Against NRSROs

S&P is currently facing a number of litigations related to its ratings, including its ratings on certain mortgage-backed securities. These cases have been brought in state and federal courts around the country and have included a wide array of claims based on a wide range of theories. Cases rooted in federal law have been brought under statutes as distinct as the federal securities laws and ERISA. Cases commenced under state or common law seek recovery on grounds ranging from negligent misrepresentation to breach of contract to fraud. And lots of other theories as well. I may disagree with plaintiffs' lawyers on a lot of subjects but no one can deny their creativity in conjuring up theories upon which to base lawsuits.

Although most of these cases are still in their early stages, courts have begun issuing rulings in some of them. In one case in which a judicial opinion was issued three weeks ago, a federal court in the Southern District of New York dismissed most claims by the Abu Dhabi Commercial Bank and another plaintiff but concluded that enough facts had been asserted (although not, of course, proved) to allow a claim for common law fraud against S&P and another NRSRO to go forward.[1] The *Abu Dhabi* suit relates to rating opinions on a structured investment vehicle that held, among other things, residential mortgage-backed securities. When the securities issued by the vehicle defaulted, the plaintiffs sought to recover their claimed losses from rating agencies and others, asserting, among other things, that they would not have purchased the securities – valued in billions of dollars – were it not for the supposedly inflated credit ratings.

The plaintiffs are seeking significant damages in the *Abu Dhabi* case. More immediately, S&P will now have to incur the extensive costs associated with sweeping and burdensome discovery above and beyond the costs it has already incurred in that case in turning over thousands of documents before the court's decision.

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[1] *Abu Dhabi Commercial Bank* v. *Morgan Stanley & Co*., 2009 WL 2828018 (S.D.N.Y., Sept. 2, 2009).

In another case, also in the Southern District of New York, the court let a federal securities fraud case continue against Moody's under SEC Rule 10b-5. In that case, the court held that the plaintiffs had sufficiently alleged various actionable misstatements. Another NRSRO, Fitch Ratings, has also been sued, along with S&P and Moody's, in a number of actions over its rating opinions, including its ratings on mortgage-backed securities.

Although S&P intends to contest all claims against it vigorously and believes it will ultimately prevail, there can be no doubt that ongoing multi-billion dollar claims certainly reflect the availability of legal redress if it is warranted.

Proposals to Amend The Pleading Standard in Cases Against NRSROs

In the midst of these litigations, Congress is considering various proposals to increase further oversight of NRSROs by the SEC (most of which S&P takes no issue with) as well as at least one legislative proposal that could be read to lower the pleading standard in securities fraud cases against NRSROs and which would make NRSROs uniquely vulnerable to a flood of additional and still more costly litigations.

Before discussing this potential change in the law, I think it is important to address briefly the current state of the law on securities fraud and how it treats NRSROs and other defendants. Under the Private Securities Litigation Reform Act, passed in 1995, a plaintiff seeking to recover against *any* defendant for securities fraud under Rule 10b-5 must allege particular facts providing a strong inference that the defendant acted with "scienter," which is another way of saying that the defendant acted in bad faith. This standard was imposed by Congress in a uniform manner in order to prevent strike suits, in which plaintiffs' lawyers file weak, sometimes frivolous, claims that are designed to extract settlements from defendants that would rather avoid the high cost and inherent risks of large litigations, even if they are entirely without merit. Congressional support for the PSLRA's heightened pleading standard was strong and came from both sides of the aisle.

One proposal currently pending in Congress could undo this standard for claims against NRSROs — and *only* NRSROs. Specifically, this bill, as drafted, could be read to permit securities fraud claims against NRSROs based not on allegations that they acted in bad faith, but instead that they failed to conduct a "reasonable investigation" of a rated security, or failed to obtain "reasonable verification" of the facts underlying their rating. Plaintiffs' lawyers will surely argue that this bill represents a complete departure from the PSLRA, and provides for claims against NRSROs — and again, *only* NRSROs — even where they issued their ratings in complete good faith.

Under such a framework, if a plaintiffs' lawyer were to bring a securities fraud suit against three defendants, a securities analyst, an auditor and an NRSRO, the plaintiff would have to allege that the securities analyst and auditor acted in bad faith but, with respect to the NRSRO, would argue that it need to allege only that the NRSRO acted "unreasonably." Different standards would apply in the same case. I respectfully submit that any such change is both unfair and unjustified. There is simply no basis for providing ratings of debt instruments with *less* legal protection than that afforded to recommendations to buy or sell stocks.

Potential Harms Resulting From An Amended Pleading Standard

Any law that subjected NRSROs to the prospect of liability by way of hindsight for opinions issued in good faith would be affirmatively harmful to the markets. In this respect, it is important to focus on what a credit rating really is and what it is not. A rating is not a statement of existing fact. It cannot be since it is an opinion about the future. Nor is it some sort of guarantee of performance. It is, by its nature, a forward-looking opinion that speaks primarily to the *likelihood* that a particular security or obligor will default in the future. Market participants have long understood that some portion of rated debt — even highly rated debt — will ultimately be downgraded and, in some cases, default as issuers encounter financial difficulties, the markets they operate in shrink or economies go into recession. This has been borne out over the years in default and transition studies which show that rated entities across the spectrum, including some AAA-rated securities, have historically defaulted, albeit with increasing frequency at lower rating levels. This is the case even where the NRSRO's work is beyond criticism. That some percentage of defaults occur is not evidence that the initial ratings were "too high," "too low" (we have one case alleging that too) or otherwise "inaccurate."

If S&P could be liable under the securities laws even where it acts in good faith, plaintiffs' lawyers would have an irresistible incentive to file suit against it any time rated securities default, or even when they are simply downgraded. The opportunities for such second-guessing would be legion since at any moment S&P rates trillions of dollars of debt. This dynamic could create the potential for an unprecedented number of suits from an unknown but vast class of potential plaintiffs. Although there would be an opportunity in these cases for S&P to contest clams that it had acted "unreasonably" in investigating and verifying the information used to formulate its ratings, the reality is that the cost of putting up this defense every time disappointed investors bring suit could be prohibitively high, giving rise to the very problem that the PSLRA was intended to address.

The harms I refer to would not just be limited to increased litigation costs. They would extend across the market as a whole. Among other things:

- ***There could be less comprehensive ratings analysis*** — Expanding the potential for litigation against NRSROs would create incentives for NRSROs to narrow the scope of their rating analysis in order, again, to minimize the areas for potential second-guessing by plaintiffs' lawyers. For example, a number of NRSROs consider projections prepared by management when rating corporations, public finance issuers, and others. Performing a "reasonable verification" of such projections would be difficult if not impossible to do, yet the liability risk for failing to do so would be enormous. Faced with this choice, an NRSRO might decide to stop taking such information into account. Ratings would thus become more backward-looking and, as a consequence, less geared towards their primary purpose: an assessment of likely credit quality on a going forward basis.

- ***NRSROs could adopt a homogeneous approach*** — Exposing NRSROs to new expansive liability could well lead to a more homogeneous approach to ratings, resulting in less diversity of opinion and strong disincentives for analytical innovation. Faced with potential liability under the proposed standard, NRSROs across the board would have strong incentives to adopt only those processes that courts deem "reasonable," even if they believe a different approach might be more appropriate analytically.

- ***The market would have access to fewer ratings*** — The proposal could also result in the scaling-back of ratings coverage, with the most profound impact felt by newer and smaller issuers. Faced with a dramatic increase in liability risk, NRSROs would likely rate only those entities and securities that are least likely to default or be downgraded or which have a long history of providing the highest quality data. As a result, issuers which are relatively new to the debt markets may have a difficult time getting rated and, therefore, greater difficulty accessing capital.

- ***NRSROs may avoid downgrades to limit liability*** — Ratings are, as I have said, forward-looking opinions. As such, they sometimes change as the economy does or updated facts about a rated entity or security become available. Some rated securities inevitably default; others are downgraded as new facts surface. If NRSROs could be sued every time an obligor or security is downgraded or defaults, the ratings process itself could be distorted so as to avoid downgrading ratings even if circumstances warrant, thus lowering their potential exposure.

Let me be clear. I am not urging that S&P should receive any special treatment in a securities fraud suit brought under Rule 10b-5. I am simply saying that there is no basis for — and there would be harmful consequences resulting from — any effort to subject NRSROs to a different, more relaxed, pleading standard than the one that applies to all other defendants.

I also want to be clear that S&P has supported efforts by some in Congress and within the SEC seeking greater accountability by NRSROs. S&P has supported proposals to provide the SEC with stronger powers to ensure that NRSROs comply with their policies and procedures designed to promote independence and objectivity. S&P has also supported strengthened oversight of NRSROs by the Commission in the form of increased fines and other sanctions where NRSROs fail to comply with those policies and procedures.

Put simply, increased regulatory oversight of NRSROs would provide a more direct, efficient and fair means of improving NRSROs' accountability as compared to a special pleading standard that is not only unnecessary given the current law, but would also facilitate the filing of new, frivolous lawsuits and would very likely reduce the quality and transparency of credit rating analysis available to the market.

Rating Agencies and the First Amendment

I have also been asked to address certain protections that have been afforded to rating agencies under the First Amendment. In this regard, let me first say that while the First Amendment does protect rating agencies in certain circumstances, it does not provide immunity from all potential claims. Indeed, S&P and its parent company McGraw-Hill have filed many motions seeking the dismissal of the cases filed against them, the vast majority of which do not rely in any respect on the First Amendment.

The First Amendment provides no defense against sufficiently pled allegations that a rating agency intentionally misled or defrauded investors. Thus, the First Amendment would not and does not protect a rating agency in a Rule 10b-5 case — the very type of lawsuit that is addressed by the proposal I have been discussing today. Nor does it protect a rating agency if it issues a rating that does not reflect its actual opinion. In these cases, under the law as it currently stands, rating agencies are subject to the same standard as auditors, equity analysts and other defendants, and have no special defenses available to them. If there is any doubt about that, legislation could make it clearer still.

In certain non-fraud cases, courts have recognized, for a variety of reasons, that credit ratings issued by S&P and other rating agencies are entitled to a level of First Amendment protection. These rulings focus less on the nature of ratings as opinions and more on the need to avoid chilling the speech of those who offer ratings lest they refrain from doing so to avoid the dangers of prolonged and potentially crippling litigation. Indeed, in the recent *Abu Dhabi* discussion that I discussed earlier, the court recognized that it is generally "well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an 'actual malice' exception, from liability arising out of their issuance of ratings and reports[.]"[2] But in that very case, as I stated earlier, the court concluded, based on the plaintiff's allegations, that the First Amendment did not preclude the case from going forward.

As the *Abu Dhabi* case thus illustrates, the First Amendment does not provide immunity in all cases. That includes cases brought today under the very statute, Section 10(b) of the Securities Exchange Act of 1934, that would be affected by the proposed amendment in Congress. It also includes claims that meet the well-established standards for pleading common

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[2] 2009 WL 2828018, at *9.

law fraud. The First Amendment is not and has never served as some sort of absolute shield against all such claims.

Conclusion

I thank you for the opportunity to participate in this hearing, and I would be happy to answer any questions you may have.