

- When firms drop coverage of a company without first downgrading it to the equivalent of a sell, they should be required to publish a release indicating why they are dropping coverage. This was a part of the settlement agreement between the New York State Attorney General and Merrill Lynch; many firms – including Merrill – will drop coverage of a company rather than issuing a sell rating. This is a common practice; the firms of three of the four analysts who testified at the Committee’s February 27 hearing did this with Enron. The problem with this practice is that unlike a downgrade, which comes along with an explanation, it does not provide a sufficient indication to investors of the problems with the company that brought about the analyst’s change of heart. In the case of Enron, most investors were aware of the troubles with the company at the time the firms’ dropped coverage: the earliest was J.P. Morgan Chase’s drop on November 29, 2001, the day after the Dynegy merger fell through, when rampant news reports were predicting the company’s imminent bankruptcy. But where investors have purchased stock in companies that are not in the center of the media spotlight based on analyst recommendations to buy, they should be alerted by those very same analysts that there are problems sufficient to lead their firms to abandon coverage.

II. ENRON AND THE CREDIT RATING AGENCIES

Like the analysts, another outside watchdog failed the public with respect to Enron: the credit rating agencies. These companies do what their name implies: rate the creditworthiness of entities, such as public companies, and the debt they issue, so that those wishing to extend credit – by buying bonds, for example – can better understand the risk that they may not see a return on that investment. Ratings have taken on great significance in the market, with investors trusting that a good credit rating reflects the results of a careful, unbiased and accurate assessment by the credit rating agencies of the rated company. But as with so many other market players, Enron caused this legendary reliability to be called into question. It was not until just four days before Enron declared bankruptcy that the three major credit rating agencies lowered their ratings of the company to below the mark of a safe investment, the investment grade rating. And as with other market participants, like securities analysts, auditors, and corporate directors, the example of Enron shows that rating agency reform is needed if the actual performance of these organizations is to live up to public expectations.

This section of the report will provide a brief description of credit ratings, their use and history, and will describe how the credit rating agencies made their assessments of Enron, and where they failed. Finally, it will outline the current regulatory environment in which credit rating agencies operate, and make recommendations for how improvements can be achieved to restore market confidence in the operation of these firms.

A. History and Uses of Credit Ratings

John Moody, the founder of what is now Moody's Investors Service ("Moody's"), is generally credited with devising credit ratings for public debt issues at the beginning of the twentieth century. At that time, the United States had the largest corporate bond market in the world, comprised mostly of railroad bond issues. Investors, however, had few sources beyond bankers and the financial press for information about the quality of those bonds. Moody's credit ratings, first published in 1909, met that need. It was followed by Poor's in 1916, Standard in 1922, and Fitch in 1924. (Standard and Poor's merged in 1941 to become Standard & Poor's ("S&P").)³⁵³ Moody's – now the largest of the three – offers ratings on over \$30 trillion of debt and 4300 corporations.³⁵⁴

Credit ratings, which are expressed in a letter grade, provide an assessment of creditworthiness, or the likelihood that debt will be repaid.³⁵⁵ Generally, companies will receive a long-term "issuer" rating, which is intended to measure the entity's ability to meet its "senior" financial obligations: obligations that have not been "subordinated" to other obligations by law or by agreement.³⁵⁶ Each of the letter grades may be modified with a plus or a minus, indicating relative standing within the categories. S&P and Fitch use the same ratings system.³⁵⁷ Their first four categories, AAA, AA, A, and BBB, are considered "investment grade," or of good or better credit quality, AAA+ representing the highest credit quality, BBB- representing the lowest

³⁵³ See Richard Cantor & Frank Packer, "The Credit Rating Industry," *Federal Reserve Bank of New York Quarterly Review*, Summer/Fall 1994 at 2. Although other credit rating agencies have existed and still exist in the United States, many, such as Duff & Phelps and Thomson BankWatch, have each merged into one of the main three: Moody's, S&P, and Fitch. See Lawrence J. White, "Bond Raters Troika," *U.S. Banker*, May 2002.

³⁵⁴ See "Introduction to Moody's," <http://www.moodys.com>.

³⁵⁵ See Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 82 ("Standard & Poor's Understanding Credit Ratings," January 2002, attached to the Statement of Ronald Barone); "Fitch Ratings Definitions: Issuer Financial Strength Ratings," <http://www.fitchratings.com>.

³⁵⁶ The issuer ratings described here are just one type of rating offered by the credit rating agencies; they also offer short-term ratings (which are most often used to determine issuers' creditworthiness relating to commercial paper), ratings for individual debt offerings, or even ratings of countries' creditworthiness. This report focuses on Enron's long-term issuer ratings, so for simplicity, the other ratings systems are not described here.

³⁵⁷ See generally "Standard & Poor's Understanding Credit Ratings," and "Fitch Ratings Definitions," note 355 above.

investment grade credit quality. BBB generally indicates that economic conditions may weaken the capacity of the issuer to meet its obligations, but overall, the issuer has adequate ability to meet its commitments in a timely manner. Lower ratings – BB, B, CCC, CC, C, and D – indicate that a company is of “speculative grade.” The BB and B ratings indicate that company is able currently to meet its financial commitments, but has significant vulnerability to adverse conditions; lower ratings indicate a current vulnerability and significant likelihood of some default. Bonds given a “speculative” rating are sometimes referred to as “junk” bonds.

Moody’s uses a slight variation on the S&P/Fitch approach: investment grade is reflected by Aaa, Aa, A, or Baa, with Aaa being the most creditworthy, and Baa being the lowest investment grade rating.³⁵⁸ Moody’s “speculative” or “junk” ratings are Ba, B, Caa, Ca, and C. Moody’s does not use pluses or minuses as modifiers; instead it uses numbers: 1 being equivalent to a plus, 2 as consistent with no modifier, and 3 being the same as a minus. In addition to issuing letter-grade ratings, if the agency is about to lower or raise a rating, S&P may put out a “CreditWatch” with a negative (likely to downgrade) or positive (likely to increase) outlook.³⁵⁹ Fitch has a similar “ratings watch,” and Moody’s puts companies “on review” for a upgrade or downgrade.³⁶⁰

When John Moody first initiated the credit rating system, credit ratings simply provided guidance for investors.³⁶¹ According to the credit rating agencies, this remains the primary driver of ratings: as S&P explains on its website, its “recognition as a rating agency ultimately depends on investors’ willingness to accept its judgment.” If history is a guide, credit rating agencies generally get it right: bonds rated AAA have a less than one percent default rate over ten years or more,³⁶² and S&P has found that there is almost an 88 percent likelihood that companies with ratings of A or above will still have that rating one year later.³⁶³ On the other hand, bonds rated

³⁵⁸ See “Ratings Definitions: Issuer Ratings,” <http://www.moody.com>.

³⁵⁹ “Standard & Poor’s Understanding Credit Ratings,” note 355 above, at 2-3.

³⁶⁰ “Fitch Ratings Definitions: Issuer Financial Strength Ratings,” note 355 above.

³⁶¹ See David C. Gates, “Rating Agencies and the SEC Asleep at the Switch? Complying With the Basel Capital Accord,” *Risk Management Association Journal*, October 1, 2001, at 3.

³⁶² Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 63-64; “Moody’s Rating System in Brief,” provided under cover of letter from John J. Goggins, Esq., Senior Vice President and General Counsel, Moody’s Corporation, to Cynthia Lesser, Counsel, Senate Governmental Affairs Committee, dated March 6, 2002.

³⁶³ Leo Brand and Reza Bahar, “Corporate Defaults: Will Things Get Worse Before They
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BB (below investment grade) have an approximately 20 percent default rate over fifteen years, while bonds with a B rating have a 35 percent rate of default and bonds with a CCC rating have a 55 percent default rate over that same period.³⁶⁴

Nevertheless, since the days of John Moody, the uses of credit ratings have evolved. Ratings are currently used more as benchmarks for market participants than as a source of information for investors. Approximately 95 percent of corporate bonds are held by institutional investors,³⁶⁵ which have their own in-house analysts to assess the value of the bonds in which they invest.³⁶⁶ To the extent that sophisticated private parties use credit ratings for their own purposes, they tend to use them in agreements, such as merger or loan agreements, as conditions or triggers for certain rights or obligations.³⁶⁷ A contract might, for example, specify that if a company's rating from S&P or Fitch falls below a specified grade, payments may be accelerated or additional obligations (such as increased interest rates or escrows) may be imposed on the company.³⁶⁸

³⁶³(...continued)

Get Better," *S&P CreditWeek*, January 31, 2001, at 15, 27.

³⁶⁴ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 64.

³⁶⁵ See The Status of "Corporate Trades I," Hearing Before the Subcommittee on Securities, Senate Banking, Housing and Urban Affairs Committee, 106th Cong., S. Hrg. 106-537 (May 26, 1999) at 22 (Statement of Nelson D. Civello, Chairman, Bond Market Association).

³⁶⁶ Even though the state statutes and regulations limiting the investments allowed to be held by state pension funds to bonds with a certain level of investment grade rating are intended as sufficient protection from too many defaulting bonds, state pension funds are looking for additional "credit-rating tools" beyond the ratings of the three credit agencies to assess the risk associated with potential investments in the wake of WorldCom and Enron. See, e.g., "State Pension Funds Hit But Not Crippled By Enron, WorldCom," *Associated Press*, June 29, 2002.

³⁶⁷ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 142 (Statement of Jonathan Macey, Professor, Cornell University Law School).

³⁶⁸ For example, Enron in one instance used S&P ratings in a debt covenant, otherwise known as a ratings trigger. The trigger was included in an agreement intended to provide additional credit backing to an affiliated limited partnership. When Enron's S&P rating fell to a BBB- on November 9 (the triggering event in the covenant), the partnership was entitled to accelerate payment of a \$690 million note from Enron to November 27, 2001. Enron Corp. Form 10-Q for Quarter Ended September 30, 2001 (filed November 19, 2001) at 70. Enron also had
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Government agencies have found additional uses for credit ratings. In the 1930's, the Federal Reserve began using credit ratings on bonds to assess the safety of the portfolio investments of member banks.³⁶⁹ In 1931, the Comptroller of the Currency adopted credit ratings as measures of quality for the national banks' bond accounts, first allowing non-investment grade bonds as long as banks discounted their value, taking into account their riskiness, then later prohibiting national banks from investing in non-investment grade bonds altogether.³⁷⁰ State laws and regulations soon adopted similar standards for state banks, pension funds, and insurance companies, and additional federal regulation followed.³⁷¹

In 1975, the SEC, by rule, significantly enhanced the importance of credit ratings. In 1970, Penn Central Railroad defaulted on its bonds, leading to unexpected and significant losses for investment firms. The bonds, like many others in the market at the time, had not been rated by any of the credit rating agencies. Due to a general concern about corporate creditworthiness at the time, the SEC adopted new net capital requirements, or asset requirements, for broker-dealers, firms that trade securities in the market, either for themselves (dealers) or on behalf of others (brokers).³⁷² These requirements assure investors that their broker-dealers have sufficient assets to back up the funds that investors entrust them with. Informally called the "haircut" rule, Rule 15c3-1 requires broker-dealers to take a larger discount on below-investment grade bonds – a "haircut" – when calculating their assets for the purposes of the net capital requirements than for investment grade corporate bonds. This rule specified that the ratings come from a "nationally recognized statistical ratings organization," or NRSRO.³⁷³ The term was not defined, but it caught on.

³⁶⁸(...continued)

ratings triggers in agreements backing two related trusts, the Marlin and the Osprey trusts. Those covenants required Enron to repay \$2.4 billion for Osprey and \$915 million for Marlin if Enron's stock price fell below a certain level and its credit rating by any of the three rating agencies fell below investment grade (below BBB- or Baa3). Enron Corp. Form 10-Q for Quarter Ended September 30, 2001 (filed November 19, 2001) at 69.

³⁶⁹ Frank Partnoy, "The Siskel and Ebert of Financial Markets: Two Thumbs Down For the Credit Rating Agencies," 77 *Wash. U. L. Q.* 619 (1999), at 687.

³⁷⁰ *Id.* at 688.

³⁷¹ *Id.* at 688-89.

³⁷² See Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirements for Certain Brokers and Dealers, Release No. 11497 (June 26, 1975) 40 Fed. Reg. 29795 (July 16, 1975). See also Gates, note 361 above, at 4-5 (describing Penn Central collapse and aftermath); Andrew Fight, *The Ratings Game*, Wiley & Sons Ltd (2001), at 6 (same).

³⁷³ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 132 (Statement of the Honorable Isaac Hunt, SEC Commissioner).

The Federal Reserve and the SEC are not alone in giving legal significance to the ratings of NRSROs. Currently, at least eight federal statutes and 47 federal regulations, along with over 100 state laws and regulations, reference NRSRO ratings as a benchmark. On the federal level, they are related primarily to banks and commodities or securities regulation, but a few relate to education (qualifications for schools to participate in a financial assistance program under Title IV of the Higher Education Act),³⁷⁴ to transportation (highway projects must be rated investment grade by an NRSRO to obtain funding under program),³⁷⁵ and telecommunications (requirements for approval of loan guarantees from the federal government).³⁷⁶ On the state level, most of the state statutes and regulations referring to NRSRO ratings – which number over one hundred – relate to permissible investments by insurance companies and state funds, banking and state securities laws and regulations. Because so many regulations affecting institutional investors incorporate NRSRO ratings, issuers must seek out ratings from one of the NRSROs – Moody’s, S&P or Fitch – in order to ensure that they have full access to the capital markets with respect to their debt instruments.

B. Efforts to Regulate Credit Rating Agencies

Although the NRSRO designation has never been formally defined in statute or regulation, the SEC, as the agency that coined the term, has taken on the task of granting requests from rating firms for NRSRO status.³⁷⁷ Upon request, the staff of the Division of Market Regulation provide a “no-action” letter to the firm granting the status.³⁷⁸ Since the inception of the designation, the SEC has granted NRSRO status to seven companies, including the three that remain today; the other four merged with Fitch.³⁷⁹

³⁷⁴ 20 U.S.C. § 1087-2.

³⁷⁵ 23 U.S.C. §§ 181, 182 .

³⁷⁶ 47 U.S.C. § 1103.

³⁷⁷ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 133 (Statement of the Honorable Isaac Hunt, SEC Commissioner).

³⁷⁸ See Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 39457, 62 Fed. Reg. 68018 (December 17, 1994) at 68019 (describing the current process for determining whether an entity is an NRSRO).

³⁷⁹ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 133-34 (Statement of the Honorable Isaac Hunt, SEC Commissioner). Then SEC Commissioner Isaac Hunt recently indicated that the SEC may be planning to grant the designation to additional credit
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Though it has not received that much attention, the informal designation process and the small oligopoly it has created have been somewhat controversial. Throughout the 1990's, Congressman John Dingell wrote a number of letters to the SEC calling for increased competition in the industry and a setting of national standards for NRSROs.³⁸⁰ The Justice Department initiated and subsequently closed an investigation of the credit rating agencies in 1996 to determine if they were engaging in anti-competitive practices.³⁸¹ In addition, in the mid-1990's, a school district in Colorado sued Moody's after it issued unsolicited, and according to the school district, inappropriately low ratings of a bond issue after the school district had chosen to retain a different credit rating company. Following Moody's rating, the school district alleged that it had to reprice the bonds at a cost of over \$750,000.³⁸² The school district lost the suit.

Recognizing that concerns existed and that the public was increasingly relying on NRSROs, the SEC in 1994 asked for public comment on the SEC's role in the use of the NRSRO designation.³⁸³ The Commission received 25 comment letters in response, encouraging it to adopt a formalized process for giving the designation. As a result, the SEC proposed a rule in 1997, seeking to define the term "NRSRO" and provide for a process both for granting the status and removing it, including an appellate process before an Administrative Law Judge.³⁸⁴ The proposed rule set forth the criteria the staff had been relying on: namely, whether the applicant's ratings were nationally recognized, and whether the applicant was independent, sufficiently staffed, had systematic procedures designed to produce credible and accurate ratings,

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rating agencies; he was quoted as saying that "we may have more than three by the end of the year." Alyne Van Duhn, "Big Three Learn Lessons From Enron: Ratings Agencies," *Financial Times (London)*, May 27, 2002. There are a few agencies that have been trying to achieve the designation for some time. John Labate and Jenny Wiggins, "Ratings Agencies Live in Hope of Gaining That Elusive Rise in Status," *Financial Times (London)*, May 21, 2002.

³⁸⁰ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 135 (Statement of the Honorable Isaac Hunt, SEC Commissioner).

³⁸¹ The antitrust investigation was closed in 1999. Kenneth Gilpin, "Justice Dept. Inquiry on Moody's Is Over, With No Charges Filed," *The New York Times*, March 13, 1999.

³⁸² *Jefferson County Sch. Dist. v. Moody's Investors Service*, 988 F. Supp. 1341 (D. Colo. 1997), *aff'd*, 175 F.3d 848 (10th Cir. 1999).

³⁸³ Nationally Recognized Statistical Ratings Organizations, Release No. 34616, 59 Fed. Reg. 46314 (September 7, 1994).

³⁸⁴ See Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 39457, 62 Fed. Reg. 68018 (December 30, 1997).

and had internal procedures to protect against the misuse of inside information. The rule would have required NRSROs to register as investment advisers under the Investment Advisers Act of 1940,³⁸⁵ and would have required NRSROs to inform the SEC of any significant organizational changes. The rule would have officially given the SEC power to withdraw the NRSRO designation if a credit rating agency failed to maintain the required criteria. The 16 commenters on the proposed rule criticized it. Although the rule would have done no more than to codify the status quo – for example, the NRSROs have all voluntarily registered as investment advisers, although they maintain they are not required to – the credit rating agencies nonetheless opposed the rule because they oppose any formal regulation of their business.³⁸⁶ The Justice Department criticized the rule for perpetuating the current anti-competitive environment of credit rating agencies.³⁸⁷ The proposed rule was never finalized.

Even though NRSROs are not subject to any formal process for designation, monitoring or removal, they do receive special treatment in securities regulation. First, they are given special access to companies. SEC Regulation F-D prohibits issuers from making selective disclosure of material information in order to ensure that all investors have access to significant corporate news at the same time.³⁸⁸ The rule was prompted by concern that some favored analysts and market participants received information first, while the rest of the market had to wait to find out. Credit rating agencies, however, are expressly exempted from Regulation F-D.³⁸⁹ The analysts from Moody's, S&P or Fitch can have private conversations with company management that no other analyst can have, and the credit rating analysts can see financial information that no other analyst could see without the company disclosing it publicly. Moreover, NRSROs are officially

³⁸⁵ The Investment Advisers Act prohibits fraud, imposes fiduciary duties on advisers with respect to their advice, requires advisers to maintain certain books and records, and allows the SEC to examine advisers to determine compliance with the Act. *See generally* 15 U.S.C. 80b-1 *et seq.*

³⁸⁶ *See, e.g.,* Comments of Moody's Investors Service in the Matter of File No. S7-33-97, Release No. 39457, Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, dated March 2, 1998.

³⁸⁷ Comments of the United States Department of Justice in the Matter of File No. S7-33-97, Proposed Amendments to Rule 15c3-1 Under the Securities Exchange Act of 1934, dated March 6, 1998.

³⁸⁸ 17 C.F.R. § 243.100.

³⁸⁹ 17 C.F.R. § 243.100(b)(2)(iii). Moody's and S&P supported this exemption. *See* Comments of Standard & Poor's in the Matter of File No. S7-31-99, Release Nos. 33-7787, 34-42259, IC-24209, Regarding Selective Disclosure and Insider Trading, April 17, 2000; Comments of Moody's Investors Service in the Matter of File No. S7-31-99, Release Nos. 33-7787, 34-42259, IC-24209, Regarding Proposed Rule: Selective Disclosure and Insider Trading, April 27, 2000.

shielded from liability for all but fraud under the securities laws. SEC Rule 436, promulgated under the Securities Act, expressly shields NRSROs from liability under Section 11 of the Securities Act in connection with an offering of securities.³⁹⁰ This means that NRSROs are not held even to a negligence standard of care for their work.³⁹¹

The NRSRO designation has had a significant beneficial effect on the profitability of credit rating agencies. Until the late 1960's, the rating agencies made their money by publishing their ratings and selling them to investors.³⁹² This ceased to be profitable due to the increasing use of improved information sharing technology – basically the photocopying machine – by users of the ratings.³⁹³ Starting around 1970, the rating agencies began to charge issuers of debt instruments for ratings.³⁹⁴ That is the system that exists today. With a credit rating effectively required by law for so many purposes, issuers in most instances seek the ratings out of necessity. Credit rating agencies generally charge companies per transaction – for a simple transaction, typically 2 or 3 basis points (.02 or .03 percent of the total amount of the deal), or somewhat more for a complex one.³⁹⁵ If an issuer is extremely active in the markets, agencies also accept an annual fee.³⁹⁶ Some critics suggest that this arrangement causes a conflict of interest,³⁹⁷

³⁹⁰ 17 C.F.R. § 230.436(g)(2). Interestingly, the SEC makes clear in the adopting release for this rule that this rule only applies to NRSROs; to the extent that companies wish to disclose the ratings of non-NRSROs in their filings, those credit rating agencies are required to file consents as attachments to the registration statements (rendering them subject to liability under section 11 of the Securities Act of 1933). *See* 47 Fed. Reg. 11380, 11392 n.55 (March 16, 1982).

³⁹¹ NRSROs argue that they would not be subject to liability under a negligence standard in any event because their ratings constitute opinions protected by the First Amendment. This has been accepted by at least one court. *See, e.g., County of Orange v. McGraw Hill*, 245 B.R. 151 (C.D. Cal. 1999) (where county alleged S&P had negligently issued defective ratings of municipal bonds, court held that in order to prove S&P liable for botched ratings, county had to show actual malice, the standard for protected speech).

³⁹² Bethany McLean, “The Geeks Who Rule the World,” *Fortune*, December 24, 2001.

³⁹³ Lawrence J. White, “The Credit Rating Industry: An Organizational Analysis,” February 2001 (Working Draft) at 13, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=267083.

³⁹⁴ Bethany McLean, “The Geeks Who Rule the World,” *Fortune*, December 24, 2001.

³⁹⁵ Partnoy, note 369 above, at 653.

³⁹⁶ Committee staff interviews With Moody's (March 8, 2002), S&P (March 6, 2002), and Fitch (March 5, 2002), described at note 404 below.

³⁹⁷ The SEC solicited comments on this practice in its 1997 proposed rule. *See also* Fight, (continued...)

although it is unclear how great an impact any such conflict has, given that issuers have no choice but to obtain a rating from one of the limited number of firms offering the service. In other words, the credit rating agencies probably do not feel pressure to please issuers to get their business.³⁹⁸

This enviable market position appears to provide strong profitability: rating agencies can benefit from active capital markets without having to risk any of their own capital. Though S&P is a division of McGraw-Hill (and therefore its individual profitability is not publicly available), and Fitch is a subsidiary of a private corporation, Moody's was recently spun off as its own publicly-held company by Dun & Bradstreet and publicly reports its earnings. Moody's – which is an S&P 500 company and has a market capitalization of approximately \$7.7 billion³⁹⁹ – had record results in 2001. Its revenue was \$797 million, an increase of a full 32% from 2000. Its operating income was \$399 million, 38% higher than 2000. Its profits were \$212 million in 2001, 34% more than 2000.⁴⁰⁰ Ratings generate approximately 85% of Moody's revenues.⁴⁰¹

Although they do not consult with one another on ratings, the rating agencies generally appear to approach the business of rating issuers in a very similar way.⁴⁰² They will assign each

³⁹⁷(...continued)

note 372 above, at 227 (noting “the obvious potential conflict of interest just from the fact that the rating company is taking ratings fees from the companies it rates”); Dave Lindorff, “Judging the Judges: Are the Top Rating Agencies Too Slow to Downgrade?” *Investment Dealers Digest*, August 13, 2001 (taking fees from issuers is “‘a built-in conflict,’ says credit rating agency Egan-Jones’ managing director Bruce Jones, previously a senior analyst at Moody’s. ‘[Moody’s] charges issuers for their ratings, and yet their public posture is to turn double cartwheels to insist that their constituency is the investor.’”)

³⁹⁸ The credit rating agencies, in rare cases, also provide ratings even when they do not get paid. Although Moody's informed Committee staff in an interview that it only does this now for high-yield junk bonds in the United States, S&P and Fitch told Committee staff in interviews that they provide unsolicited ratings as they see fit.

³⁹⁹ Calculated based on closing price of \$49.69 on September 10, 2002.

⁴⁰⁰ “Moody's Corporation Reports Record Results for Fourth Quarter and Full Year 2001,” Moody's Corporation Press Release, February 4, 2002; *see also* Moody's Corporation Annual Report on Form 10-K for year ended December 31, 2001 (filed March 22, 2002), at Item 7, pp.15-16.

⁴⁰¹ Moody's Corporation Annual Report on Form 10-K for year ended December 31, 2001, at Item 7, p. 16.

⁴⁰² The following description of the credit raters' methodology was derived from telephonic Committee staff interviews with officials from Moody's (March 8, 2002), S&P
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company to one primary analyst (that analyst will cover a number of companies, perhaps between 10 and 30), who typically works with a junior analyst. Analysts work in groups divided by industry sector; the analysts covering the companies within that sector are overseen by a Managing Director in charge of that sector. When a company has been rated before and is being monitored by the rating agencies, analysts will review the company's periodic SEC filings and other public information relevant to the company, including press reports or industry information. The analysts will periodically meet and speak to the company's management and visit the company's facilities. The focus of the rating agencies' analysis is the company's ability to generate cash in comparison to the company's liabilities; the extent to which the former easily covers the latter will be a significant determinant of the rating. In analyzing a company's prospects for paying its obligations, in addition to reviewing the company's own historical performance and industry trends, the credit raters will generally request additional, non-public information. Although the credit raters stress that they rely primarily on public information, they will also ask to review the company's projections of future cash flows and will generally seek a breakdown of cash flows by company segment, to see how each of its businesses have done and how the company believes they will do in the future. According to Moody's, that "segmentation information" is fundamental to assessing a company's creditworthiness. The credit raters will also generally ask for full disclosure of all significant liabilities of the company, including those "off-balance sheet."⁴⁰³

To determine a rating, analysts will convene a credit committee. The committee will consist of anywhere from 4 to 12 people, including the analysts working on the company, their Managing Director, and other analysts, management, or staff with useful expertise. The analyst will make a recommendation, and the committee will vote. The deliberations of a credit committee, and the identities of the participants, are kept confidential. The rating is usually made public through a press release. Companies are generally notified of their ratings in advance of the publication if there is a change or if it is a new rating to allow the issuer to respond if it believes that the rating does not accurately reflect its creditworthiness – S&P refers to this process as an "appeal." Such an "appeal," if the company requests it, is conducted within a day or two of the ratings announcement. S&P has indicated that it is rare that it will change a rating. With a company that has been rated and is being monitored, a committee will be convened periodically, perhaps once a year or once every eighteen months, to reaffirm or change the rating. Prior to a ratings change, a company may be put on a "watch" or "review." An analyst may initiate a "watch" or "review" without a meeting of the credit committee.

⁴⁰²(...continued)

(March 6, 11, 13, 2002), and Fitch (March 5, 2002), described at note 404 below.

⁴⁰³ Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 below.

C. Chronology of Enron's Ratings

Given the significant and market-wide impact of credit ratings, one would expect the rating agencies to perform a careful and searching inquiry into companies they rate. They have access enjoyed by no other corporate watchers – companies can and do share non-public material information with them without disclosing it to the public at large – and with their ability to downgrade a company's credit ratings, the rating agencies can essentially restrict a company's access to the capital markets. Indeed, one must question whether so many state and federal laws, as well as private contracts, would vest such authority in the ratings of these agencies if anyone suspected that the credit raters were not using their power and access to obtain the best information possible.

Unfortunately, at least in Enron's case, the credit rating agencies did not perform as expected. Based on a number of interviews conducted by Committee staff with officials from Moody's, S&P, and Fitch,⁴⁰⁴ Committee staff has concluded the agencies did not perform a thorough analysis of Enron's public filings; did not pay appropriate attention to allegations of financial fraud; and repeatedly took company officials at their word, without asking probing, specific questions – despite indications that the company had misled the rating agencies in the past.

As of late March 2000, the three agencies gave Enron the same rating: Moody's⁴⁰⁵ gave it

⁴⁰⁴ Staff interviewed officials from each of the agencies in preparation for the March 20 Committee hearing. On March 5, 2002, Committee staff interviewed Fitch General Counsel Charles Brown, Glenn Grabelski, Fitch Managing Director, and Ralph Pellecchia, the senior analyst on the Enron credit for Fitch. On March 6, Committee staff interviewed S&P officials, including Leo O'Neill, President of S&P, Executive Vice President Vickie Tillman, and Counsel for Regulatory Affairs Rita Bolger. On March 8, Committee staff interviewed Moody's officials, including Moody's President Ray McDaniel, Pamela Stumpp, Chief Credit Officer, and John Diaz and Stephen Moore. Moore was the primary analyst on the Enron credit for Moody's, but his work was closely overseen by Diaz, Managing Director for the Power and Energy Group. Diaz had been the Moody's analyst following Enron prior to Moore, and thus he maintained watch on the company after he was promoted to Managing Director. On March 11, Committee staff conducted a second interview with S&P officials, including Ronald Barone, Managing Director for the Utilities, Energy & Project Finance Group. On March 13, Committee staff conducted a third interview with S&P officials, including Todd Shipman, an S&P analyst. Shipman was the primary analyst on Enron for S&P, but his work was also closely overseen by Barone, as Barone had also followed Enron when he was an analyst.

⁴⁰⁵ Paul Chivers, "Empowering Enron," *Euromoney Institutional Investor*, June 1, 2000.

a Baa1, and S&P⁴⁰⁶ and Fitch⁴⁰⁷ both rated Enron as BBB+, indicating an upper level within the category of good credit quality.⁴⁰⁸ Retaining this investment grade rating, and even improving it, was vital to Enron because its ability to operate and grow its trading business as well as to access the capital markets for its liquidity needs were absolutely dependent upon the stability that the rating provided. In fact, the company consistently lobbied for a higher rating.⁴⁰⁹ Nevertheless, given the volatility inherent in an industry that was in the process of deregulation, and given that Enron was a company that took a number of risks, the rating agencies did not consider a higher rating appropriate.⁴¹⁰

In early October 2001, Enron's assistant treasurer, Tim DeSpain, called Moody's and S&P to tell them that Enron would soon announce: (1) a \$1 billion writedown on after-tax income due to bad investments, and (2) a \$1.2 billion reduction in shareholder's equity, which DeSpain described only as an accounting adjustment. Moody's analysts were surprised because they had been assured by Enron just weeks before, after CEO Skilling's resignation on August 14, 2001, that a writedown was not imminent. Both Moody's and S&P were concerned about the effect of the large writedown on Enron's financial strength, but neither appeared significantly concerned about the equity reduction.⁴¹¹ Based on information provided to Committee staff, it

⁴⁰⁶ "Standard & Poor's Affirms Enron Ratings Re Cogen Technologies Acquisition," *PR Newswire*, November 3, 1998.

⁴⁰⁷ "Fitch IBCA Affirms Enron Corp. at BBB+," *Business Wire*, November 8, 1999.

⁴⁰⁸ See "Standard & Poor's Understanding Credit Ratings," note 355 above; "Fitch Ratings Definitions," note 355 above; "Ratings Definitions: Issuer Ratings," <http://www.moody.com>, note 358 above.

⁴⁰⁹ See, e.g., *Rating the Raters: Enron and the Credit Rating Agencies*, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 65-66, 122.

⁴¹⁰ As S&P's Barone pointed out in his written testimony, the rating agencies, in consideration of these factors, added back "debt-like burdens" into the numbers it used to calculate Enron's rating. Barone stated that "over the years Standard & Poor's 'put back' onto Enron's balance sheet off-balance sheet amounts of between \$2 billion and \$4 billion in debt-like obligations for purposes of our ratings analysis." *Rating the Raters: Enron and the Credit Rating Agencies*, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 66-67.

⁴¹¹ Committee staff interviews with Moody's (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above. In his testimony at the March 20 hearing, Moody's Diaz said that Moody's was "questioning and scratching our heads about the type of
(continued...)

does not appear that they made any effort to obtain a cogent explanation for why the reduction was taking place or how such a significant accounting error could have occurred.

On or about October 12, Ken Lay, who had resumed his position as Enron CEO following Jeffrey Skilling's resignation in August, called both S&P and Moody's after hearing that the credit raters were considering a downgrade. Lay tried to reassure the agencies that Enron would shore up its balance sheet, selling off assets as necessary to create additional reserves to cover obligations.⁴¹² Neither Moody's nor S&P questioned Lay about the enormous equity adjustment.

On October 16, Enron made the earnings announcement about which it had advised Moody's and S&P nearly two weeks earlier. On October 17, the *Wall Street Journal* broke the story about partnerships run by Enron CFO Andrew Fastow being used to hide Enron losses and debt.⁴¹³ On October 22, Enron revealed that the SEC was investigating the allegations in the report. Two days later, on October 24, Fastow resigned. Although all the analysts said that they asked Enron officials about the allegations in the *Journal* story, they never received – or appear really to have pressed for – a clear explanation from Enron officials, who, according the analysts, simply denied knowledge of the details.⁴¹⁴ In fact, the credit analysts were not focused on Enron's questionable transactions or accounting, despite the possible serious wrongdoing these practices indicated. Despite their stated goal of assessing long-term corporate strength, the raters focused almost exclusively on the cash position of the company, a short-term consideration. It was only when Enron informed the credit rating firms that it was going to draw down on and exhaust its lines of credit – indicating it was in a cash crisis and that it was having difficulty

⁴¹¹(...continued)

accounting that they were using for that charge and how did that \$1.2 billion of equity actually come about.” However, he said that Moody's was “not satisfied with [Enron's] explanations” for the actions. Nevertheless, he testified that Moody's “discussions [with Enron] during that time were concentrated on understanding the liquidity position of the company and how that was impacting the trading business.” Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 13.

⁴¹² Committee staff interviews with Moody's (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above.

⁴¹³ John Emshwiller and Rebecca Smith, “Enron Jolt: Investments, Assets Generate Big Loss; Part of Charge Tied to 2 Partnerships Interests Wall Street,” *Wall Street Journal*, October 17, 2001.

⁴¹⁴ Committee staff interviews with Moody's (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above.

placing its commercial paper – that the raters acted.⁴¹⁵

On October 25, S&P changed Enron's ratings outlook to negative (though it kept Enron at BBB+).⁴¹⁶ Fitch, having digested the news from the earnings announcement and concerned about the drawdown on credit, also placed Enron on watch for a downgrade.⁴¹⁷ On October 29, Moody's downgraded Enron one notch to Baa2 (still investment grade) and kept it on review for another downgrade.⁴¹⁸ According to its press release, Moody's main concern was Enron's shrinking access to liquidity and the reduction in equity: neither the SEC investigation nor the underlying allegations about possible financial fraud were mentioned.⁴¹⁹ That same day, S&P's primary Enron analyst, Todd Shipman, appeared on CNN Financial News Network. Even though S&P had placed Enron on CreditWatch negative, Shipman said, "Enron's ability to retain something like the rating they're at today" – meaning an investment grade rating – "is excellent in the long term."⁴²⁰ When asked about the off-balance sheet partnerships, Shipman remarked that S&P was "confident that there's not any long term implications to that situation and that's something that's really in the past."⁴²¹ As he appears to have gotten no information from Enron about the allegations of questionable transactions and accounting, it is unclear what basis Shipman had for those remarks.⁴²²

⁴¹⁵ Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above.

⁴¹⁶ "Ratings on Enron Corp. Affirmed; Outlook to Negative," S&P Press Release, October 25, 2001.

⁴¹⁷ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 11 (Testimony of Ralph Pellecchia).

⁴¹⁸ "Moody's Downgrades Enron Corp. Long-Term Debt Ratings (Senior Unsecured to Baa2) and Keeps Them Under Review For Downgrade," Moody's Press Release, October 29, 2001.

⁴¹⁹ *Id.*

⁴²⁰ Interview of Todd Shipman, S&P, by Deborah Marchini (CNNFN Street Sweep, October 29, 2001), available on Lexis/Nexis, Transcript #102915cb.l06.

⁴²¹ *Id.*

⁴²² Barone testified at the March 20 hearing that Enron officials had told him that "they would be surprised if they found anything further," but conceded that he had told Committee staff that Enron officials had said that "they didn't know what else was out there." Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 11 (continued...)

Despite Shipman's public comments of confidence in Enron, on November 1, S&P downgraded Enron to BBB (two notches above junk), and placed it on negative CreditWatch, although in its press release, S&P indicated its belief that Enron was sufficiently liquid to get through "the current period of uncertainty."⁴²³ On November 2, the very next day, in a public conference call set up by S&P to answer questions about Enron,⁴²⁴ Shipman, this time along with Ronald Barone, his supervisor and S&P Managing Director, again commented on S&P's "confidence" that there would be no more revelations about off-balance sheet partnerships at Enron. Barone said, "We have a great deal of confidence there are no more surprises to come." Shipman added, "We're confident we capture or are privy to the obligations that Enron has." Barone finished, "I think it's gonna take a little bit more time before everybody can get fully comfortable that there's not something else lurking out there. But at this point, we feel very confident that that's unlikely."⁴²⁵

On November 5, Fitch issued a two-notch downgrade on Enron to BBB- (just one level above junk).⁴²⁶ In its release regarding the downgrade, Fitch mentioned the SEC investigation as "an additional uncertainty," and cited as a concern "an erosion in investor confidence" but expressed the belief that "Enron should be able to manage through this challenging environment, ultimately recognizing the values of the company's core businesses," which Fitch said have "generated strong, predictable performance." Fitch expressed this confidence in Enron's "strong performance" despite the reports about its questionable transactions, which may have been used to make the company's performance seem better than it was.

In the meantime, on or around November 5, Moody's and S&P were informed by Enron about the upcoming announcement of a merger with Dynegy.⁴²⁷ Fitch was also notified of the

⁴²²(...continued)
Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 14.

⁴²³ "Enron Corp.'s Rating Lowered, Placed on CreditWatch Negative," S&P Press Release, November 1, 2001.

⁴²⁴ This conference call was open to the public; anyone who wanted to listen in or ask questions could call into a number provided by S&P.

⁴²⁵ Transcript of S&P Teleconference re: Enron, dated November 2, 2001, provided to the Committee under cover of letter from Floyd Abrams, Esq. to Cynthia Gooen Lesser, Counsel, Senate Governmental Affairs Committee, dated March 19, 2002.

⁴²⁶ "Fitch Downgrades Enron to 'BBB-'; Maintains Rtg Watch Negative," *Business Wire*, November 5, 2001.

⁴²⁷ It was in connection with the discussions about the merger that Moody's received
(continued...)

merger plans in advance. All the credit raters said that they retained Enron's credit rating at above investment grade through November 28 *solely because* of the proposed merger.⁴²⁸ On November 9, Fitch essentially improved Enron's credit outlook by putting it on an "evolving" ratings watch, rather than a negative one, due to the good prospects from the merger. In its November 9 release, Moody's downgraded Enron to Baa3 (one notch above junk) due to shrinking investor confidence, but indicated that it would view "a substantial near term injection of equity capital as a stabilizing event," an implicit reference to the merger.⁴²⁹ S&P also downgraded Enron to BBB- (one notch above junk), with a negative watch on November 9, with

⁴²⁷(...continued)

telephone calls about Enron's credit rating, mostly from Enron's bankers. According to a description of these calls provided to Committee staff by Moody's attorneys on March 19, 2002, after receiving a copy of the merger term sheet on November 8, Moody's was concerned that the merger terms too easily allowed Citigroup and J.P. Morgan Chase, the banks financing the merger, and Dynegy, Enron's prospective acquirer, to drop the deal. Moody's told Enron that it was seriously considering downgrading Enron below investment grade as a result of this uncertainty. After that, the CEO of Moody's, John Rutherford, received a number of telephone calls. Former Treasury Secretary Robert Rubin, Chairman of Citigroup's Executive Committee, and Michael Carpenter, CEO of Citigroup Salomon Smith Barney, conference called Rutherford, who was in his car on his cellphone at the time. Before the call got started, Rubin apparently was dropped from the call; he and Rutherford did not speak again on the matter. Carpenter told Rutherford that he was concerned about the possible Enron downgrade; Rutherford replied that he did not get involved with ratings matters, and told Carpenter he would have Debra Perry, a senior managing director and executive officer of Moody's, call him. Rutherford called Perry, who called Carpenter, and set up a meeting with her and James Lee, another Citigroup official, and William Harrison, CEO of J.P. Morgan Chase. (Harrison left a message for Rutherford also, but they never spoke.) In Perry's meeting with Harrison and Lee, Lee mentioned that William McDonough of the Federal Reserve might call, but neither he, nor any other government official ever did. (Richard Grasso, CEO of the New York Stock Exchange, left a message for Rutherford that day, but by the time Rutherford called him back, the issue had been resolved and they never discussed Enron.) Ultimately, Lee and Harrison agreed to change the terms of the merger to accommodate Moody's concerns; Dynegy agreed to similar changes. Neither S&P nor Fitch received such calls, according to their testimony at the Committee's March 20 hearing. Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 28.

⁴²⁸ Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above.

⁴²⁹ "Moody's Downgrades Enron Corp. Long-Term Debt Ratings And Keeps Them Under Review For Downgrade," Moody's Press Release, November 9, 2001.

its investment grade rating at this point due entirely to the merger.⁴³⁰ Despite the fact that Enron had just one day before, on November 8, announced a restatement for the past four-and-a-half years, with a charge to earnings of approximately \$500 million – about 20 percent of earnings during that period – none of the credit rating agencies showed concern about the possibility of financial fraud and the damage that such illegalities could cause Enron and its merger partner.⁴³¹

On November 19, Enron filed its Form 10-Q, which reported its third quarter results. For the first time, to the surprise of all the credit rating agencies, Enron disclosed that the November 9 S&P downgrade to BBB- had triggered a demand obligation for \$690 million.⁴³² Although the credit rating agencies were aware of other such agreements backing other special purpose entities associated with Enron, they did not know about this one. According to what the credit analysts told Committee staff in interviews, the analysts had never specifically asked Enron if other triggers dependent on credit ratings existed.⁴³³ Enron officials told S&P that current Enron management had not even known about the \$690 million obligation; it was a surprise to *them* when the trustee for the affected entity had exercised the trigger.⁴³⁴ S&P not only failed to ask if there were other “surprises” regarding credit triggers or other obligations, but the S&P analysts

⁴³⁰ “Dynergy Ratings Placed on Watch Negative; Enron Rating Lowered to BBB-,” S&P Press Release, November 9, 2001.

⁴³¹ To the extent that the credit rating agencies expressed concerns in this regard, they were limited to concerns about counterparty and investor confidence as a result of the allegations – a short-term concern – not about the inherent, long-term damage that serious fraud could inflict on a corporation. *See, e.g.*, Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 11, 13.

⁴³² Enron Corp. Form 10-Q for Quarter Ended September 30, 2001, filed November 19, 2001, at 10, 33. News reports have indicated that the \$690 million obligation was associated with an entity called Whitewing. *See, e.g.*, Peter Behr, “Enron Raised Funds in Private Offering; Shareholders in Dark, Documents Show,” *Washington Post*, January 22, 2002. Whitewing was an Enron-affiliated entity that the credit rating agencies were well aware of; they had rated debt offerings that were associated with Whitewing. Indeed, the other obligations Enron had with ratings triggers that the rating agencies knew about were related to Whitewing. The credit rating agencies told Committee staff that their understanding was that the \$690 million obligation was associated with a partnership called Rawhide that the credit raters were unaware of prior to the 10-Q filing.

⁴³³ Committee staff interviews with Fitch (March 5, 2002), Moody’s (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above.

⁴³⁴ Committee staff interviews with S&P (March 11, 2002, March 13, 2002), described at note 404 above.

appear to have also been unconcerned about the fact that Enron management itself appeared to lack knowledge about a major company commitment.⁴³⁵ On November 20, the day after this disclosure, S&P reaffirmed its investment grade rating with a negative watch. S&P said that it believed Enron could deal with the \$690 million obligation (without mentioning the fact that Enron had failed to disclose a significant financial obligation and that S&P believed the obligation was a surprise even to management at Enron).⁴³⁶

Over the next few days, however, the credit rating agencies heard about a renegotiated deal for the proposed merger, and the likelihood of the merger seemed more and more remote. Finally, on November 28, after hearing that the terms had been revised to give Dynegy additional ways to terminate the transaction, and without additional cash from the banks involved, the rating agencies decided to give up on Enron.⁴³⁷ On November 28, all three agencies downgraded Enron to below investment grade: Moody's downgraded Enron to B2 (5 notches below the previous rating),⁴³⁸ S&P downgraded Enron to B- (6 notches below previous rating),⁴³⁹ and Fitch lowered Enron to CC (more than 8 notches below previous rating).⁴⁴⁰ Currently, Fitch and S&P rate Enron as a D and Moody's rates Enron as a Ca.

D. Problems With the Agencies' Analyses and Actions

While the credit rating agencies did not completely ignore problems at Enron when those problems became very apparent, their monitoring and review of the company's finances fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance. Instead, based on what the credit rating analysts told Committee staff in interviews and the analysts' testimony at the Committee's hearing on March 20, 2002, entitled "Rating the Raters: Enron and the Credit Rating Agencies," it appears that the credit raters took

⁴³⁵ *Id.*

⁴³⁶ "Enron Corp.'s Ratings Still Watch Negative," S&P Press Release, November 20, 2001.

⁴³⁷ Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above.

⁴³⁸ "Moody's Downgrades Enron Corp.'s Long-Term Debt Ratings (Senior Unsecured to B2); Commercial Paper Confirmed at Not Prime; Ratings Remain Under Review For A Downgrade," Moody's Press Release, November 28, 2001.

⁴³⁹ "Enron Rating Cut to 'B-'; Doubt Cast on Dynegy Merger," S&P Press Release, November 28, 2001.

⁴⁴⁰ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 12.

Enron at their word and failed to probe more deeply. Moreover, in general, the ratings analysts appear to have taken too narrow a focus in determining what Enron's problems were: they focused on short-term problems, like cash flow or counterparty confidence, rather than deep-rooted problems, such as questionable transactions or suspect accounting. In short, based on the credit rating agency analysts' testimony at the March 20 hearing, and what they told Committee staff in interviews, the Committee staff has concluded that the credit rating agencies' approach to Enron fell short of what the public had a right to expect, having placed its trust in these firms to assess corporate creditworthiness for the purposes of federal and state standards. It is difficult not to wonder whether lack of accountability – the agencies' practical immunity to lawsuits and non-existent regulatory oversight – is a major problem.

Insufficient Review of Company Materials. When asked if he thought the credit rating agencies had done a good job, former SEC Chief Accountant Lynn Turner testified that his own initial review of Enron's financial statements "raised more questions than they answered," and that anyone doing a similar review should have been given pause by their opacity.⁴⁴¹ One of the more glaring concerns Committee staff developed based on their interviews of the credit rating agencies was that the analysts who worked on Enron appear to have been less than thorough in their review of Enron's filings, even though they said that they rely primarily on public filings for information in determining credit ratings. Enron's disclosure in its 2000 Form 10-K filing about related-party transactions – footnote 16 – where information about the company's questionable deals with partnerships and special purpose entities run by Enron insiders should have been disclosed, was very difficult to understand. When Committee staff asked the analysts if they understood the disclosures in footnote 16, Moody's and Fitch told staff they did not understand precisely what those disclosures referred to, but were only concerned about the impact these transactions had on cash flow, which they believed had been disclosed elsewhere. The analysts from Moody's and Fitch told Committee staff that they were not concerned about the details of the transactions themselves, despite the fact that those details might have indicated a problem – that Enron was gaining significant income from deals with partnerships run by its own CFO – and led them to wonder whether fraud was afoot. The S&P analysts told Committee staff that they simply assumed that the opaque disclosures regarding related-party transactions in the 2000 Form 10-K referred to the off-balance sheet entities of which they were aware (because S&P rated some of these in connection with debt offerings). According to their remarks to Committee staff, the S&P analysts did nothing to confirm their understanding.

In fact, the S&P analysts could have checked their understanding of this disclosure, to some extent, by reviewing Enron's proxy statement, which is required to contain additional information about related-party transactions. (Proxy statements also have other relevant information not found in other filings, such as disclosures about certain insider sales.) The

⁴⁴¹ The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-__ (July 23, 2002) at __ (Printed Hearing Record Pending) (Testimony of Lynn Turner, former Chief Accountant of the SEC).

analysts from S&P said that they did not read Enron's proxy statements.⁴⁴² In fact, they told Committee staff that they did not even know how the information they could find in a proxy statement in this regard might differ from that found in the 10-K. If the S&P analysts had read Enron's 2001 proxy statement, they may have learned that their assumption about Enron's 2001 Form 10-K disclosure was incorrect. The proxy contains a more explicit description of the related-party transactions than is contained in the 10-K; for instance, the proxy statement specifically states that the company had engaged in numerous transactions with an entity called LJM2 (not the Whitewing, Osprey and Marlin entities with which the S&P analysts said that they were familiar) and indicates that Enron Chief Financial Officer Andrew Fastow was the general partner of that entity.⁴⁴³

Short Term v. Long Term Focus. The agencies told Committee staff that their ratings reflect an analysis of long-term creditworthiness. In the case of Enron, however, the credit raters, according to their remarks to Committee staff in interviews, failed to do simple things one would expect from someone conducting a long-term evaluation of a company's financial health. For example, based on the information gathered by Committee staff, it appears that the credit analysts did not look for fundamental problems at the company by scrutinizing the financial statements or assessing the aggressiveness of Enron's accounting methods. When asked by Committee staff whether they considered as a qualitative factor in their analysis whether the company was engaging in aggressive accounting, the agencies indicated that they rely on the auditors' work. This was consistent with their testimony at the hearing.⁴⁴⁴ In the Committee staff interviews, the credit rating analysts resisted staff's suggestion that a company's accounting methods should be part of their analysis, because even when financial statements comply with Generally Accepted Accounting Principles (GAAP), they nevertheless may not present all the information an investor would want to know, or all the information a credit rater would want to know. This is troubling, because the fact that a company may be using the flexibility of GAAP to hide problems should be a consideration, particularly if the credit raters take a long-term view.

Moreover, despite their stated effort to take a long-term approach to ratings, the credit rating agencies appear to have focused primarily on short-term issues with Enron, like access to cash in the near term, counterparty confidence, or whether the Dynegy merger would succeed, even as there continued to be revelations about Enron's questionable use of off-balance sheet entities run by its CFO. For example, when Enron's \$690 million obligation was disclosed for

⁴⁴² Committee staff interviews with S&P (March 11, 2002, March 13, 2002), described at note 404 above. It is worth noting that proxy statements are incorporated by reference in Forms 10-K; a thorough review of any 10-K would have to include a review of the proxy statement as well.

⁴⁴³ Enron Corp. Definitive Proxy Statement (Schedule 14A) (filed March 27, 2001) at 26.

⁴⁴⁴ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 29.

the first time – to the surprise of everyone, including, S&P believed, company management – S&P analysts told Committee staff that they did not ask if there were other potential triggers (nor did any of the other credit rating agencies), nor did they appear to register much concern about Enron management’s expressed lack of knowledge. Indeed, although the credit analysts told Committee staff that they asked Enron officials about the *Wall Street Journal* allegations, they acknowledged that they did not press for a detailed answer when none was forthcoming, even after an SEC investigation was announced. Both Moody’s and S&P stressed to Committee staff that the revelations in the *Wall Street Journal* were just allegations, and the analysts were not inclined to render judgment until all the facts were in.⁴⁴⁵ In interviews with Committee staff, the credit analysts seemed unwilling to distinguish between rendering judgment and asking probing questions – and demanding answers.

Lack of Inquisitiveness. Leo O’Neill, S&P’s President, said in a staff interview that fixed income analysts ask “green-eyeshade questions,” referring to the green eyeshades auditors were noted for wearing in earlier times, and the tough, probing queries for which they were then known.⁴⁴⁶ Credit rating analysts should take a similar approach – they, like fixed income analysts, assess the ability of the company to repay debt (fixed income analysts focus on bonds, as opposed to equity analysts, who focus on stocks). Based on their testimony at the March 20 hearing and their remarks to Committee staff in interviews, however, Committee staff concluded that the credit rating agency analysts did not take this skeptical approach. Not only did they apparently fail to scrutinize Enron’s public filings (indeed, they failed even to read all the major filings), the credit analysts in general appear to have taken the company officials at their word, simply assuming that they were telling the truth. As Ronald Barone of S&P testified at the March 20 hearing, “we do rely on what senior management tells us. It is in their best interest to tell us and be forthright and not convey a different message, because if we convey a message to the market that is different that what the market perceives over the long term, then the credibility of Standard & Poor’s and then ultimately the credibility of the company is at risk. . . . And so it is in their best interest to tell us the truth, and we rely on that.”⁴⁴⁷ Senator Thompson called this reasoning “a chicken-and-egg deal,” pointing out that corporate executives might instead view it in their best interests “to minimize bad news and stretch the truth.”⁴⁴⁸

In addition, from what the credit analysts told Committee staff, they did not pursue what even they admitted was fundamental information, despite the fact that the credit raters publicly

⁴⁴⁵ Committee staff interviews with Moody’s (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above.

⁴⁴⁶ Committee staff interview with S&P (March 6, 2002), described at note 404 above.

⁴⁴⁷ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 15.

⁴⁴⁸ *Id.*

acknowledged that Enron was a complex company. In a March 2001 article about Enron's opaque financial statements, in response to the question of how Enron makes its money, S&P's Todd Shipman, the analyst working under Ronald Barone, was quoted as saying, "If you figure it out, let me know," and Fitch's Ralph Pellecchia joked, "Do you have a year?"⁴⁴⁹ The point of this article was that Enron was generally understood by Wall Street to be a "black box," difficult to understand and loath to answer too many questions about ambiguities. While Pellecchia explained at the Committee's March 20 hearing that his response was merely a "glib answer," he acknowledged that the "spirit of the answer was Enron's a big company, a complex company"⁴⁵⁰ In other words, these analysts well understood that getting a clear picture of Enron's financial situation was not a simple matter. Yet, they apparently failed to use the necessary rigor – the "green-eyeshade" approach – to ensure that their analysis of such a company was sound.

As early as May 2001, the independent research firm Off Wall Street Consulting Group called Enron a bad bet. Off Wall Street's analysis showed that Enron's trading operation – its most profitable venture – was starting to turn weaker profits as the market it helped open up became more liquid and prices less volatile.⁴⁵¹ Enron did not, in its public filings, indicate how much money its trading business made as distinct from the rest of its "Wholesale Division," which contained other investments and businesses. Accordingly, there was no way to tell how its trading business was really doing. When the credit rating agencies asked for this information – information which Moody's Chief Credit Officer Pamela Stumpp told Committee staff was "fundamental" to a credit analysis⁴⁵² – Enron, according to the credit analysts, told them that it did not have that kind of detail. Enron's response appears to be either not credible or a sign of a company in trouble. A company must know how each of its businesses is performing in order to monitor it. Nevertheless, even though the credit rating agencies were allowed to ask for and receive this information under their exemption from SEC Regulation F-D (their special access to material information not shared with the rest of the market), and even though they knew that Enron was very concerned about its credit rating, the credit rating agencies acknowledge that they did not push for the information. According to what the credit analysts told Committee staff, they simply accepted Enron's refusal.

⁴⁴⁹ Bethany McLean, "Is Enron Overpriced?," *Fortune*, March 5, 2001.

⁴⁵⁰ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 23.

⁴⁵¹ Off Wall Street Consulting Group, Research Report Regarding Enron Corp., May 6, 2001 at 3.

⁴⁵² Committee staff interview with Moody's (March 8, 2002), described at note 404 above.

In interviews with Committee staff, all the agencies acknowledged that they could withdraw a rating for failure to provide sufficient information. In the March 20 hearing, for example, S&P's Barone said that "if we knew . . . then what we know now, we would have withdrawn Enron's rating for failure to disclose proper information."⁴⁵³ Nevertheless, the agencies told Committee staff in interviews that in response to Enron's refusal to provide important information – like information about the trading operation – they did not even raise the possibility of withdrawing the rating, a suggestion which, if made, might have convinced Enron to send the agencies the information requested.⁴⁵⁴

Similarly, and as noted above, based on what they told Committee staff, when S&P analysts read the related-party transactions disclosure in Enron's 2000 Form 10-K, they assumed, without asking, that the entire footnote referred to the Osprey and Marlin transactions. It is unclear whether the disclosure's text is entirely consistent with this assumption, but the analysts appear to have done nothing to verify their beliefs. Moreover, according to what the S&P analysts said to Committee staff in interviews, the *Wall Street Journal* article did not lead them to question their assumptions. To the extent that any of the analysts asked about the allegations in the *Journal*, they accepted the answer from the company that a special committee would investigate, without questioning whether the problems were so deep that they might permanently scar Enron's future. In short, as Glenn Reynolds, Chief Executive Officer of independent credit research firm CreditSights, Inc., stated in his testimony before the Committee at the March 20 hearing, "As we look back at the performance of the rating agencies in the case of Enron, we are hard pressed to recall a situation where the rating agencies held so much sway over a company and had such commanding leverage to extract information, and yet were so ineffective at doing so."⁴⁵⁵

At the Committee's March 20 hearing, the credit rating analysts – in particular Ronald Barone of S&P – stressed over and over again that they were simply duped by Enron management, and there was nothing they could do. When Chairman Lieberman asked the analysts whether in retrospect, they felt they should have asked more questions of Enron, Barone responded, "Senator, we rely on the audited financial statements We are not forensic accountants, if that is the question, and we don't have subpoena power. . . ."⁴⁵⁶ Barone attached to his written testimony what he referred to as the "kitchen sink" documents, which were

⁴⁵³ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 29.

⁴⁵⁴ Committee staff interviews with Fitch (March 5, 2002), Moody's (March 8, 2002) and S&P (March 11, 2002, March 13, 2002), described at note 404 above.

⁴⁵⁵ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 157 (Statement of Glenn Reynolds, Chief Executive Officer, CreditSights, Inc.).

⁴⁵⁶ *Id.* at 29.

presentations made by Enron to the credit raters, in October 1999 and in January 2000, to convince the agencies to improve Enron's credit rating.⁴⁵⁷ Barone pointed out in his testimony that, in fact, Enron did not reveal all of its obligations in this presentation; one example he gave was that Enron did not disclose that it had billions of dollars in derivative transactions that were, in substance though not in form, loans.⁴⁵⁸ Committee staff asked Barone and Shipman in interviews prior to the hearing whether they had ever asked about Enron's portfolio of derivatives, or whether, knowing that Enron was engaging in some rather complex transactions, they had ever consulted with a derivatives expert at S&P to get a more specific sense of the obligations Enron could be facing in connection with its derivative transactions. While they could not remember if they ever consulted with such an expert, both Barone and Shipman acknowledged that they had never specifically asked Enron to detail derivative transactions that could have loan-like characteristics.⁴⁵⁹ Similarly, Barone stated in his testimony that S&P was misled by Enron's failure to provide information about the LJM partnerships.⁴⁶⁰ However, if he or Shipman had reviewed Enron's proxy statement, they would have discovered these entities, and could have inquired about them. Barone summed up his attitude about S&P's responsibility with respect to Enron when he made the following statement in response to a question by Senator Bunning at the March 20 hearing: "Senator, this was not a ratings problem. This was a fraud problem."⁴⁶¹

Moody's took a more measured approach at the March 20 hearing. Diaz of Moody's had the following exchange in response to a question by Senator Thompson about the related-party transaction disclosures in Enron's 2000 10-K (which appeared in footnote 16 to the financial statements in that filing):

⁴⁵⁷ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 87-115.

⁴⁵⁸ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 70. On July 23, 2002, PSI held a hearing on these transactions, with witnesses from the credit rating agencies as well as from Citigroup and J.P. Morgan, the banks that had facilitated the deals. The Role of Financial Institutions in Enron's Collapse, Hearing Before the Permanent Subcommittee on Investigations, Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-___ (July 23, 2002) (Printed Hearing Record Pending).

⁴⁵⁹ Committee staff interviews with S&P (March 11, 2002, March 13, 2002), described at note 404 above.

⁴⁶⁰ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 72.

⁴⁶¹ *Id.* at 25.

DIAZ: “I think in looking at footnote 16, clearly what needs to be done in those situations is try to get behind it and try to understand a lot more of what’s there. You know, looking in hindsight at how that impacted the ultimate confidence in the company, it’s pretty clear that there were – and from my point of view, we certainly look at a situation where we could have dug more into and tried to get behind that.”

SENATOR THOMPSON: “It would be fair to say that if you ran across this same situation again, you would delve into it deeper?”

DIAZ: “Yes sir.”⁴⁶²

In addition, in his written testimony, Diaz stated that “[g]oing forward, we are enhancing the ratings process by putting increased focus in several areas,” including “corporate governance and how aggressive or conservative are accounting practices” at the companies Moody’s is rating.⁴⁶³

Lack of Accountability. The credit rating agencies are aware of how much their decisions can affect the fortunes of the companies they rate (and therefore the fortunes of the companies’ investors). Nevertheless, based on the testimony of the credit analysts at the March 20 hearing and the remarks of the analysts in interviews with Committee staff, Committee staff concluded that the credit analysts do not view themselves as accountable for their actions. For example, the remarks of S&P analysts Ronald Barone and Todd Shipman in late October and early November about their “confidence” that there would be no more surprises from Enron do not appear to be based on anything more than assumption. In his testimony at the Committee’s March 20 hearing, Barone said that he gained the confidence from a conversation with Enron management, but conceded after specific questioning that management had told him that they did not know whether other entities or special purpose entities existed, and a special committee had just begun an investigation.⁴⁶⁴ The credit rating agencies acknowledged in interviews with Committee staff that others in the market believe the agencies have access to more information about companies than any other outsiders due to their market power (their ability to downgrade) and their exemption from SEC Regulation F-D. Despite this public expectation about their superior level of knowledge, S&P, for example, could not cite to Committee staff any policies to ensure that its analysts conducted themselves responsibly in media appearances, or in making public statements similar to those Shipman and Barone made on CNN and in the S&P conference call (which was reported in the press⁴⁶⁵).

⁴⁶² *Id.* at 16.

⁴⁶³ *Id.* at 128.

⁴⁶⁴ *Id.* at 14.

⁴⁶⁵ Tom Fowler, “S&P: ‘No More Surprises For Enron,’” *Houston Chronicle*, November (continued...)

When asked by Committee staff about accountability concerns, the rating agencies had two responses. First, they said that their concern for their reputation keeps them on their toes: as S&P's Barone stated in his testimony: "Standard & Poor's recognition as a rating agency ultimately depends on the credibility of its opinions with investors, importantly, but also with bankers, financial intermediaries, and securities traders."⁴⁶⁶ The second response, which the raters stated a number of times in interviews with Committee staff, was that their ratings were just opinions, protected by the First Amendment.⁴⁶⁷ Fitch's general counsel referred to the letter grades given by the credit rating agency as "the world's shortest editorial."⁴⁶⁸ The credit rating agencies seem to be trying to walk a fine line between maintaining enormous market power through both official and unofficial uses of their ratings, and insisting that their ratings are purely their "opinion," and therefore pure speech under a First Amendment analysis. First Amendment-protected opinions about matters of public concern can give rise to liability only when, to the extent they convey facts, they convey them with actual knowledge of or reckless disregard for their accuracy.⁴⁶⁹ This standard poses such a high barrier that it virtually insulates the speaker from liability.

Indeed, courts have extended First Amendment protections to credit ratings, shielding the agencies from liability.⁴⁷⁰ Courts have even refused to require that credit rating agencies produce

⁴⁶⁵(...continued)
3, 2001.

⁴⁶⁶ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 60.

⁴⁶⁷ S&P arranged a meeting for Committee staff with Floyd Abrams, its First Amendment counsel, who also prepared a memorandum for staff laying out the basis for S&P's First Amendment argument.

⁴⁶⁸ Committee staff interview with Fitch (March 5, 2002), described at note 404 above.

⁴⁶⁹ *Milkovich v. Lorain Journal Co.*, 497 U.S. 1, 20-21 (1990) ("where a statement of 'opinion' on a matter of public concern reasonably implies false and defamatory facts regarding public figures or officials, [plaintiff] must show that such statements were made with knowledge of their false implications or with reckless disregard of their truth").

⁴⁷⁰ See, e.g., *County of Orange v. McGraw Hill Cos., Inc.*, 245 B.R. 151, 156 n.4 (C.D. Cal. 1999) ("Standard & Poor's ratings are speech and, absent special circumstances, are protected by the First Amendment. In reaching this ruling, the Court assumed any First Amendment protected speech, as a matter of public concern, would receive the heightened protection of the actual malice standard"); *Jefferson County Sch. Dist. v. Moody's Investors Service*, 175 F.3d 848 (10th Cir. 1999) (applying the *Milkovich* standard to a claim that the
(continued...)

records in connection with their work, citing the “journalist’s” privilege.⁴⁷¹ However, the fact that the market seems to value the agencies’ ratings mostly as a certification (investment grade vs. non-investment grade) or as a benchmark (the ratings triggers in agreements) and not as information,⁴⁷² and the fact that the law, in hundreds of statutes and regulations, also uses their work that way, seems to indicate that their ratings are not the equivalent of editorials in *The New York Times*. The fact that the rating agencies have received First Amendment protection for their work should not preclude greater accountability.

The rating agencies, however, have escaped regulation thus far. In his testimony at the March 20 hearing, then SEC Commissioner Isaac Hunt stated that all three of the current NRSROs were registered with the SEC under the Investment Advisers Act of 1940,⁴⁷³ which prohibits fraud, imposes fiduciary duties on advisers with respect to their advice, requires that advisers maintain certain books and records, and allows the SEC to examine all registered advisers to assure compliance with the Act. According to Commissioner Hunt’s testimony, the Act would therefore require that NRSROs have an adequate basis for their ratings.⁴⁷⁴ Commissioner Hunt testified in addition that the SEC does examine NRSROs, as with other investment advisers, approximately every five years. In the course of those examinations, the SEC reviews the books, records, and the operation of the agencies. The legal application of the Investment Advisers Act to the credit rating agencies, however, is in doubt. As part of the designation, the agencies agreed to voluntarily register, but they insist that they are not covered by the Act and that any information they provide the SEC is given strictly on a voluntary basis, not pursuant to the requirements of the Act. The Act, in defining investment advisers, contains

⁴⁷⁰(...continued)

Moody’s rating of the school district’s bonds was an injurious falsehood).

⁴⁷¹ See, e.g., *In re Pan Am Corp.*, 161 B.R. 577, 581-583 (S.D.N.Y. 1993) (quashing subpoena to S&P for records of communications with Delta Air Lines based on qualified journalist’s privilege because “S&P functions as a journalist when gathering information in connection with its ratings process”).

⁴⁷² See *Rating the Raters: Enron and the Credit Rating Agencies*, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 143 (Statement of Jonathan Macey, Professor, Cornell University Law School) (“Academic studies tend to show that information in credit ratings is of marginal value at best because the information contained in the ratings had already been incorporated into share prices. One well-known study showed that the ratings provided by rating agencies lagged the information contained in securities prices by a full year.”).

⁴⁷³ 15 U.S.C. 80b-1 *et seq.*

⁴⁷⁴ *Rating the Raters: Enron and the Credit Rating Agencies*, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 136.

an exception for publishers,⁴⁷⁵ and the credit rating agencies would argue that they fit under that exception.⁴⁷⁶ To the extent that they are correct – and the case law on this point is very favorable to them – none of the requirements of the Investment Advisers Act would apply to them.⁴⁷⁷ In any event, the SEC has never taken enforcement action against the rating agencies based on their ratings, whether under the Investment Advisers Act or otherwise.

E. Conclusions and Recommendations

Although the credit rating agencies' ratings are generally right, when they are wrong, the consequences can be serious. In the case of Enron, their poor performance, along with the failures of all the other market watchdogs, has had a market-wide effect, leading investors to wonder whether they can count on the information upon which they may have previously relied in making their investment decisions. It may well be the case that most companies, particularly those with balance sheets strong enough to have an investment grade rating, are providing the investing public with a fairly accurate picture of their financial state, with disclosures that are full and fair enough to provide the credit rating agencies with the information they need to perform their analysis. We have learned, however, that when company officials are not honest, and their auditors are too entrenched or conflicted to call management out on problems, investors need someone to raise a red flag. Credit raters, with their special access, strong market power, and lack of conflicts, are in the perfect position to do this.

The problem is that the credit rating agencies have no incentive to catch the few wrongdoers, no matter how huge the consequences to the market. Duke Law School Professor Steven Schwarcz argued in his testimony at the Committee's March 20 hearing that reputational concerns are sufficient incentive for the credit rating agencies to be diligent in their work, and he

⁴⁷⁵ 15 U.S.C. § 80b-2(a)(11)(D) (exempting any publisher of "any bona fide newspaper, news magazine or business or financial publication of general and regular circulation" from coverage of the Act).

⁴⁷⁶ They rely on *Lowe v. Securities and Exchange Comm'n*, 472 U.S. 181 (1985), which held that the publisher exception, in concert with the legislative history of the Act, indicates that meaning of "investment adviser" cannot include those who do not provide personalized advice directly to clients. The Court held: "As long as the communications between petitioners and their subscribers remain entirely impersonal and do not develop into the kind of fiduciary, person-to-person relationships that were discussed at length in the legislative history of the Act and that are characteristic of investment adviser-client relationships, we believe the publications are, at least presumptively, within the exclusion and thus not subject to registration under the Act." 472 U.S. at 210.

⁴⁷⁷ It is the position of the ratings agencies that they have been providing information to the SEC over the years voluntarily, not pursuant to an examination requirement.

cited their strong track record as proof.⁴⁷⁸ Assuming that most companies are honest, however, credit rating agencies will be correct in most cases without having to go much beyond the face of financial statements. Their limited liability and their entrenched position of power means that they do not have to go to additional lengths in order to expose the outlier corporations that are not being truthful.

Under the current system, credit rating agencies arguably act in many respects like government agencies. In the March 20 hearing, Chairman Lieberman likened the role of the rating agencies to the Food and Drug Administration: the FDA does not “let a drug go out on the market . . . until [it has] gone over all sorts of investigations to guarantee it is safe, and then doctors prescribe the drug, people use it in reliance on that. To some extent, we have asked [the credit rating agencies] to play . . . a similar role with regard to corporations.”⁴⁷⁹ As with drug companies and FDA approval, corporations wishing to issue debt need ratings in most instances. But unlike FDA, which is accountable to Congress, the raters answer to no authority. In addition, unlike a government agency, they profit from every transaction they rate, thereby reaping the benefits of the capital markets without risking any capital.

Some have suggested replacing credit ratings required in regulation and statute with a market indicator,⁴⁸⁰ but no market indicators appear to be sufficiently reliable.⁴⁸¹ There have also been suggestions that the credit rating agencies be subject to additional liability for their actions.⁴⁸² Other suggestions have been that government agencies – particularly the SEC – exercise additional oversight over the credit rating agencies’ procedures and actions to ensure

⁴⁷⁸ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 170.

⁴⁷⁹ *Id.* at 30.

⁴⁸⁰ Partnoy, note 369 above, at 705.

⁴⁸¹ Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 144-45 (Statement of Jonathan Macey, Professor, Cornell University Law School).

⁴⁸² Partnoy, note 369 above, at 710-11; *see also* Comments of the Investment Company Institute in the Matter of File No. S7-33-97, Proposed Definition of Nationally Recognized Statistical Ratings Organization, dated March 2, 1998 (“ICI NRSRO Comments”) (suggesting that the Rule 436 exemption afforded NRSROs from liability under Section 11 of the Securities Act of 1933 be removed). The problem with this suggestion, of course, is that to the extent that credit ratings are constitutionally protected by the First Amendment, there is no way to impose additional liability in the courts beyond the applicable actual malice standard short of a constitutional amendment.

diligence and thoroughness.⁴⁸³ In fact, at the March 20 hearing, then SEC Commissioner Hunt testified that the SEC planned to “engage in a thorough examination, which may include hearings, to ascertain facts, conditions, practices and other matters relating to the role of rating agencies in the U.S. securities markets. . . . We believe it is an appropriate time and in the public interest to re-examine the role of rating agencies in the U.S. securities markets.”⁴⁸⁴ In addition, the Sarbanes-Oxley Act requires the SEC to conduct a study into the role and function of credit rating agencies in the securities market, including a consideration of any impediments to their accurate appraisal of the financial resources or risks of the issuers of securities that the agencies rate.⁴⁸⁵

The SEC has not finished this process, but Committee staff recommends that the SEC, in consultation with other agencies that use the NRSRO designation in their regulations – particularly banking agencies – set conditions on the NRSRO designation through additional regulation. Those conditions should include imposing a set of standards and considerations that the rating agencies must use in deriving their ratings, such as accounting issues. In addition, the SEC should also require a level of training for analysts working for credit rating agencies, including training as to the information contained in the periodic filings with the SEC and other government agencies that oversee companies in the particular sector each analyst is assigned to as well as training in basic forensic accounting. The SEC should monitor the compliance with these requirements, and in the event of a future corporate meltdown such as Enron, the SEC should investigate to ensure that the ratings were derived in accordance with those standards. If the public and the government is to rely on the ratings of these agencies, and give them legal force, then it must ensure that they are the product of diligent and effective analysis. Meaningful SEC oversight is the best way to ensure such an outcome.

⁴⁸³ See *Rating the Raters: Enron and the Credit Rating Agencies*, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 146 (Statement of Jonathan Macey, Professor, Cornell University Law School); ICI NRSRO Comments, at note 482 above.

⁴⁸⁴ *Rating the Raters: Enron and the Credit Rating Agencies*, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002) at 137.

⁴⁸⁵ Pub. L. No. 107-204 § 702.