Testimony of
Jonathan R. Macey
Yale Law School

Before the House Committee on Financial Services

on

The Credit Rating Agency Duopoly Relief Act of 2005

I am the Sam Harris Professor of Corporate Law, Corporate Finance and Securities Law at Yale University. I am submitting this testimony in response to this Subcommittee's request that I discuss my views of H.R. 2990, the Credit Rating Agency Duopoly Relief Act of 2005.

Let me begin by saying that I am pleased to be here and that I commend Congressman Michael G. Fitzpatrick for introducing this important and timely legislation. The statute he is proposing provides a valuable legislative framework that will foster more vigorous competition in the rating agency business, and provide not only better ratings but also provide strong protections for individual investors.

H.R. 2990 is based on the time-honored principle of disclosure and takes the SEC out of its current, ill-fated role as substantive regulator of credit rating agencies fortunate enough to be designated by the Commission staff as "NRSROs" The proposed legislation, which I support, would amend the eight federal statutes that contain the term NRSRO to replace the term currently used "recognized" with a new term "registered." The "Credit Rating Agency Duopoly Relief Act" was introduced in the House. The legislation is intended to enhance competition, transparency and accountability in the credit ratings market. The Act would eliminate Nationally <u>Recognized</u> Statistical Rating Organizations. The Act would require the SEC to rely upon Nationally <u>Registered</u> Statistical Rating Organizations. This change would eliminate the ambiguous process of recognizing rating agencies through SEC staff no-action letters and would require all rating agencies that issue publicly available ratings to register.

Credit ratings play a major role in the securities market; investors rely on credit ratings when making investment choices. Credit rating agencies rate companies, countries, debt obligations such as bonds, asset-backed securities, commercial paper, private placements, certificates of deposits, and other securities, such as preferred stock, medium-term notes, and shelf registrations. The Credit Rating Agency Duopoly Relief Act of 2005 would eliminates the current, ambiguous designation “Nationally Recognized Statistical Rating Organization” (NRSRO) currently in use in favor of a more transparent registration process, that would enable market participants to register as “Nationally Registered Statistical Rating Organizations.” This simple change will foster in a new era of meaningful competition in the credit ratings market.

The new legislation would replace the SEC’s current anti-competitive designation process and prohibit anti-competitive industry practices. More controversially, in my view, the legislation would require reporting and recordkeeping requirements for registered firms and give inspection, examination and enforcement authority to the SEC.

It is bizarre, in my view that to receive the NRSRO rating from the SEC a company must be ‘nationally recognized’ or, their ratings must be widely used and generally accepted in the financial markets. I agree with Congressman Fitzpatrick that the current NRSRO designation creates an artificial barrier to entry that “has created a chicken-and-the-egg situation for non-NRSRO credit rating agencies trying to enter this industry, thus fostering a duopoly” and that the lack of competition in the credit rating industry has lowered the quality of ratings, inflated prices, stifled innovation and allowed anti-competitive industry practices and conflicts of interest to go unchecked.”

My law professor colleague Frank Partnoy has observed that the credit rating agencies pose an interesting puzzle for those of us who study financial markets. On the one hand a great deal of evidence indicates that their product, information, is not particularly inaccurate and, to the extent that it is accurate, by the time it reaches investors it is so stale as to be useless to the investors for whose ostensible benefit it is produced. The credit rating agencies dismal performance in their work on Orange County, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom, and most recently General Motors and Ford suggest that credit rating agencies aren't doing the job that the public thinks they do. A plethora of academic studies showing that credit ratings changes lag the market support this intuition.

The best explanation for this puzzle of the credit rating agencies' simultaneously enjoying great success while providing no information of value to the investing public is that the SEC inadvertently created this problem regulation when it misguidedly invented NRSRO designation. This designation has, over time, caused an artificial demand for ratings, despite their lack of usefulness to investors. Thousands of regulations, like Rule 2a-7 of the Investment Company Act of 1940 limit the ability of regulate financial intermediaries and other financial institutions to invest in companies that lack NRSRO ratings.

The Credit Rating Agency Duopoly Relief Act of 2005 would eliminate the role of the SEC staff in designating credit rating agencies as nationally recognized statistical rating organizations (NRSROs). This is a role that they never should have had in the first place.

The proposed legislation has many features that I support and some that I do not. I fully support the proposal to prohibit tying, which means forcing rated companies to purchase other services; and notching, which means lowering the ratings on asset-backed securities unless a substantial portion of the assets making up those securities are also rated by the agency. The

Credit Rating Agency Duopoly Act of 2005 would also direct the SEC to develop other reporting requirements and recordkeeping as it deems appropriate in the interest of investors and require registered credit rating agencies to have systematic procedures in place to manage conflicts of interest and prevent the misuse of non-public information. I support these aspects of the proposed legislation.

On the other hand, while I agree that, in the current regulatory environment, the giant credit rating agencies like Moody's Standard & Poor's should not be able to issue unsolicited (free) ratings. On the other hand, I see no problem in having credit rating agencies do this in the new, unregulated environment envisioned in this bill. I do think that there are problems with unsolicited ratings, however. In particular, there is the concern that rating agencies engage in "shake downs" of companies and municipalities in the market for credit. Do rating agencies demand payment by companies and municipalities for ratings? Is it true that, if ratings aren't bought, an unfavorable unsolicited rating may be issued as retribution and warning to others? Criminal sanctions should attach to such conduct, in my view. Rating agencies should be required to disclose when the ratings they are issuing are unsolicited. They also should be required to disclose whether they offered their services on a fee basis to the entity being rated but were declined. Finally, rating agencies should be required to disclose whether the information on which they are basing an unsolicited rating is as complete as the information they ordinarily possess when generating solicited ratings.

The proposed regulation would require that Statistical Rating Organizations disclose: (A) the conflicts of interest they face; (B) the procedures and methodologies used in determining ratings; (C) their ratings performance as reflected in statistical data showing their performance over short-term and long-term periods; and (D) the procedures they put in place to prevent the misuse of non-public information. I support the disclosure of conflicts of interest (A), as well as the disclosure of ratings performance measurement (C), and procedures to prevent the mis-use of inside information (D). However, I oppose the requirement (B) that credit rating agencies disclose the procedures and methodologies that they use in determining ratings. I view this sort of information as being in the nature of proprietary trade secrets, which would be of great interest to rivals of rating agencies in what will, hopefully, be a competitive environment.

In general, however, I view H.R. 2990 as an important statute that will improve the quality of the information provided by credit rating agencies, and establish rating agencies as an important component in the U.S. system of corporate governance and investor protection.