

# SEC TO RATINGS AGENCIES: REALLY, WE MEAN BUSINESS

Yesterday, the SEC told ratings agencies they mean business. They will prosecute agencies for fraud.

In the future.

It did so in a report of investigation into explicit fraud on the part of Moody's in which the SEC declined to prosecute for jurisdictional reasons.

At issue is a programming error that caused Moody's to give credit ratings up to four notches higher to some complex debt products than the products deserved. Moody's discovered the coding error in January 2007. But then ratings committee members in Europe decided not to downgrade the credit ratings for those products because doing so—admitting the coding error—might make Moody's look bad.

In this particular case we seem to face an important reputation risk issue. To be fully honest this latter issue is so important that I would feel inclined at this stage to minimize ratings impact and accept unstressed parameters that are within possible ranges rather than even allow for the possibility of a hint that the model has a bug.

The Financial Times learned of and reported Moody's decision in May 2008 after which, in July 2008, Moody's 'fessed up to the problem.

Internal Moody's documents seen by the FT show that some senior staff within the credit agency knew early in 2007 that products rated the previous year had received top-notch triple A ratings and that, after a computer coding error was corrected, their ratings should have

been up to four notches lower.

But in the interim period, as part of a registration application to be a recognized ratings agency, Moody's made the following representations to the SEC:

Accordingly, Exhibit 2 to the MIS application provided the procedures and methodologies used by MIS to determine credit ratings and, among other things, stated therein that the "Relevant Credit Rating Process Policies" included the MIS "Core Principles for the Conduct of Rating Committees." The actions of the rating committee that evaluated the affected credit ratings for the CPDO notes did not comply with these Core Principles. Most notably, the Core Principles stated that **"Moody's will not forbear or refrain from taking a rating action based on the potential effect (economic, political or otherwise) of the action on Moody's, an issuer, an investor, or any other market participant."** The Core Principles also stated that "[i]n arriving at a Credit Rating, the [rating committee] will only consider analytical factors relevant to the rating opinion." Because the committee allowed concerns regarding the potential reputational impact on Moody's to influence decisions not to downgrade the affected CPDOs, the process did not comply with the procedures listed in the MIS application. [my emphasis]

In other words, Moody's promised to the SEC that it did not do what it had done in 2007, choose not to downgrade the credit rating of an entity because doing so would hurt Moody's.

Financial Times first reported of SEC's investigation into Moody's in May 2010—almost two years after Moody's admitted they had been gaming their ratings. But yesterday, SEC

basically said they weren't going to prosecute Moody's for making false representations to the SEC because—given that the financial products being rated and the decisions not to downgrade their ratings all took place in Europe—it wasn't sure it had jurisdiction to prosecute.

Mind you, the Financial Reform bill has made it explicitly clear that the SEC can prosecute ratings agencies for stuff they do overseas.

The Commission notes that, in recently enacted legislation, Congress has provided expressly that federal district courts have jurisdiction over Commission enforcement actions alleging violations of the antifraud provisions of the Securities Act of 1933 or the Exchange Act involving “conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors” or “conduct occurring outside the United States that has a foreseeable substantial effect within the United States.”

So the punchline of this report—showing that Moody's clearly was cooking the books but concluding that because the books were cooked in Europe, SEC isn't sure it can do anything—is a stern warning to ratings agencies going forward:

This report serves to caution NRSROs that, where appropriate, the Commission will utilize recent legislative provisions granting jurisdiction for enforcement actions alleging otherwise extraterritorial fraudulent misconduct that involves significant steps or foreseeable effects within the United States. The Commission also cautions NRSROs that they should implement sufficient and requisite internal controls over policies, procedures, and

methodologies used to determine credit ratings.