ORAL TESTIMONY OF FLOYD ABRAMS

BEFORE

THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

UNITED STATES HOUSE OF REPRESENTATIVES

September 30, 2009

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

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

This hearing had initially been scheduled for last week and I had expected to offer some thoughts on the liability provisions of a bill introduced in the Senate that dealt, in part, with that subject. In the interim, Representative Kanjorski

released a Discussion Draft of a bill containing some of the same language as the previous Senate bill, as well as additional language relating to liability for CRAs, so I will address those matters now.

The Securities Exchange Act of 1934 relates to securities fraud. I believe the liability section of any bill amending that law with respect to NRSROs should have three characteristics. It should leave unchanged the core limitation of the Act, specifically that liability may only be imposed for knowing or reckless and not negligent misconduct. It should treat all potential defendants equally. And it should be pro-competitive in nature. So viewed, the Discussion Draft has some useful provisions but some deeply troubling ones as well.

Under current law, a plaintiff seeking to recover against any defendant for securities fraud under the 1934 Act must allege particular facts providing a strong inference that the defendant acted with "scienter", which is another way of saying that the defendant acted intentionally in bad faith. This standard was imposed by Congress in the PSLRA in order to protect against lawsuits that are weak substantively but could still lead to large settlements from defendants that would rather avoid the high costs and inherent risks of a large litigation, regardless of its merit.

The Discussion Draft points in opposite directions on this issue. It first provides, in a manner that appears to be flatly at odds with the PSLRA, that the requirement of pleading scienter may be met by claims that a defendant "knowingly or recklessly failed . . . to conduct a *reasonable* investigation . . .." Since negligence cases, not fraud cases, focus on "reasonableness", I can hear a plaintiffs' lawyer arguing to a court that the section imposes a negligence test. But the Discussion Draft then provides, far more reassuringly and in accord with the stated intent of the Senate bill, that nothing in the draft "shall be construed as altering the requirements" of the PSLRA, which focus not on "reasonableness" at all but on bad faith. We urge Congress to be still clearer that it is not imposing any sort of negligence test.

As regards treating all defendants equally, the Discussion Draft again appears to point in divergent directions. One section, under the heading "Accountability", contains the welcome conclusion that the enforcement and penalty provisions of the Act should be applied similarly to the treatment of accountants or securities analysts. Yet *every* other defendant charged, including accountants and securities analysts, with federal securities fraud is protected by the requirement that they are only liable if they intentionally act in bad faith. But the Discussion Draft, as I have said, at least permits the argument that NRSROs -- and

NRSROs alone -- could be sued on the basis that their investigation was "unreasonable."

Another section of the Discussion Draft goes even farther. It contains a startling provision that would make every NRSRO potentially "jointly liable" to act as an insurer and pay any judgment entered against any of its *competitors* if that entity cannot do so. Of course, it would be unthinkable to hold auditors or issuers liable for the misconduct of their competitors and there is no justification for doing so.

The very notion of imposing liability for conduct not even engaged in by an NRSRO is also deeply anti-competitive. What could better deter new NRSROs from entering the competitive fray than importing into the law undeserved, unpredictable, and, incidentally, uninsurable liability based upon the misconduct of others?

A number of other proposed sections of the Discussion Draft can be read to send the same message. NRSROs would be obliged to share with their competitors all information gathered that bore upon ratings issued by them; to review the information gathered by competitors; even, it appears, to investigate their competitors' information. Here, the Discussion Draft not only requires conduct not

required of *any* other entity than an NRSRO, but is at odds with the very notion of competition.

That said, I appreciate that the Draft is not only explicitly offered for discussion purposes but that many sections are bracketed for particular review. I understand that S&P will be providing its views on the entirety of the Discussion Draft in the coming days. For myself, the most important thing for Congress to seek to accomplish in whatever form legislation ultimately may take is consistency with the pre-existing statutory framework, equality in treatment and pro-competitiveness in effect.

Thank you for the opportunity to participate in this hearing.