TESTIMONY OF FLOYD ABRAMS

BEFORE

THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

UNITED STATES HOUSE OF REPRESENTATIVES

September 24, 2009

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

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

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

Pending Litigation Against NRSROs

S&P is currently facing a number of litigations related to its ratings, including its ratings on certain mortgage-backed securities. These cases have been brought in state and federal courts around the country and have included a wide array of claims based on a wide range of theories. Cases rooted in federal law have been brought under statutes as distinct as the federal securities

laws and ERISA. Cases commenced under state or common law seek recovery on grounds ranging from negligent misrepresentation to breach of contract to fraud. And lots of other theories as well. I may disagree with plaintiffs' lawyers on a lot of subjects but no one can deny their creativity in conjuring up theories upon which to base lawsuits.

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

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

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

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

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

Proposals to Amend The Pleading Standard in Cases Against NRSROs

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

Before discussing this potential change in the law, I think it is important to address briefly the current state of the law on securities fraud and how it treats NRSROs and other defendants. Under the Private Securities Litigation Reform Act, passed in 1995, a plaintiff seeking to recover against *any* defendant for securities fraud under Rule 10b-5 must allege particular facts providing a strong inference that the defendant acted with "scienter," which is another way of saying that the defendant acted in bad faith. This standard was imposed by Congress in a uniform manner in order to prevent strike suits, in which plaintiffs' lawyers file weak, sometimes frivolous, claims that are designed to extract settlements from defendants that

would rather avoid the high cost and inherent risks of large litigations, even if they are entirely without merit. Congressional support for the PSLRA's heightened pleading standard was strong and came from both sides of the aisle.

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

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

Potential Harms Resulting From An Amended Pleading Standard

Any law that subjected NRSROs to the prospect of liability by way of hindsight for opinions issued in good faith would be affirmatively harmful to the markets. In this respect, it is important to focus on what a credit rating really is and what it is not. A rating is not a statement

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

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

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

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

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

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

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

Let me be clear. I am not urging that S&P should receive any special treatment in a securities fraud suit brought under Rule 10b-5. I am simply saying that there is no basis for — and there

would be harmful consequences resulting from — any effort to subject NRSROs to a different, more relaxed, pleading standard than the one that applies to all other defendants.

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

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

Rating Agencies and the First Amendment

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

The First Amendment provides no defense against sufficiently pled allegations that a rating agency intentionally misled or defrauded investors. Thus, the First Amendment would not

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

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

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

[2] 2009 WL 2828018, at *9.

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

Conclusion

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