PLEXUS CONSULTING

DIRECTORS HAVE SOME ROLE IN THE OVERSIGHT OF THE RATINGS IN THEIR FUNDS

The comment letters from the industry questioning the abilities of directors to replace the rating agencies are informative unless they are an attempt to avoid any responsibility for the validity of the ratings. Fidelity notes they have a separate responsibility for the credit worthiness but we suggest they if they want to continue using the rating agency references they must oversight them.. If the directors have no responsibility and the rating agencies have no liability, who exactly are the gatekeepers for the funds use of the ratings and what good are the references to the ratings? Former Chairman Levitt's book suggests a solution to research analyst conflicts that is equally relevant to fund rating agency references in this context.. At page 83 he suggests that the stock exchanges could require an independent rating before a stock issue and that the audit committees would be responsible for doing so. He uses the bond market rating agency process as an example but we have no evidence that fund audit committees review the rating agencies for their evaluation of securities in their respective funds because the presumption is that they are independent and that's enough for the directors. However their independence is now questioned and audit committee involvement would go a long way toward eliminating those concerns. If the audit committee reviewed rather then replaced the rating agency process for the securities in the fund and signed off on the rating analysis it would also be a check on the entire ratings process.. The requirement for audit committee involvement can be justified by showing that the agencies play a role similar in part to research analysts, investment advisors and underwriters and because the rating agencies are gatekeepers similar to the auditors and lawyers. Whether the directors replace or review the rating agencies or use the ratings as they are now used, the key point is that they have some responsibility to oversee the selection and use of the ratings for the securities in their funds especially if the funds are using asset backed securities to enhance performance. Fund directors cannot turn their eyes from the conflicts in the asset backed rating process that have been revealed in the last year.

RATING AGENCY CONFLICTS

The use of audit committees in selecting auditors has been widely discussed and is included in the Sarbanes legislation for independent auditors. Levitt believes those committees should also be involved in the selection of an independent research analyst. Levitt complains “most audit committees rarely met with outside auditors…these committees should be able to question auditors not only on the acceptability of a company’s financial reporting, but on its quality as well.” Levitt at p.220 .A previous BMA (SIFMA) comment letter on previously proposed analyst rules states that "investors in the bond market typically rely more heavily on rating agencies then on research analysts." In reality the rating agency performs the same function as the analyst and faces the same conflicts. .

While the rating agencies are not formally affiliated with the investment banks who market the ABS, their issuer clients come to them after consultations with an investment bank and are referred by the banks. Moreover some of the Investment bank customers may be able to influence the choice of an agency. There is a continuing informal affiliation. Once the banker chooses an agency the issuer, banker and agency's interests are aligned in bringing a bond offering to market. At least one commentator has suggested that the rating agency should be subject to underwriter's liability because it participates in the "direct or indirect underwriting of a security. Uzzi Gerard," *A Conceptual framework For Imposing Statutory Underwriter Duties On Rating Agencies Involved In The Structuring Of Private Label Mortgage -Backed Securities,* 70 St. John's L. Rev. 779(1996). This alignment of interests and active participation is especially true in the asset- backed area where the rating agency structures the offering. As one scholar has noted, Standard & Poor's, in its property specific model for commercial mortgage securitization, essentially acts as the underwriter for the mortgage loan. Kenneth Lore, Mortgage-Backed Securities-Developments and Trends In the Secondary Mortgage Market (1995) at 9-57.

The rating agencies approach to asset- backed securities is important in terms of whether they are acting as underwriters and giving personalized advice. "The differences in rating methodology are not, however, evident in the ratings themselves, because issuers structure their securities to meet the desired rating requirements of the particular rating agency hired, with often only one agency retained to assign the rating. Notably, this practice has led to the direct involvement of the rating agencies in the structuring of mortgage-backed securities, as the issuers have consulted them in order to determine how to structure the mortgage-backed security to receive the desired rating. The active role assumed by the rating agencies in the structuring of mortgage-backed securities, and the fact that rating methods differ, leads one to wonder whether any particular rating method is superior, or alternatively, inadequate to protect investor needs when compared with the other rating methods. Indeed, the answer may undermine the entire premise of regulatory reliance on the rating agencies - that investor needs are sufficiently protected by the attainment of a particular rating.

Moody's has recognized that its own role in the rating of mortgage-backed securities differs from the traditional role of the agency in rating corporate debt issues. Moody's states that its analysis of corporate debt issues is based upon the input of data that cannot be substantially altered in the short term for that particular debt issue, such as the present financial condition and performance of a company. Thus, with corporate debt issues, the agency's role is a passive one.

In contrast, with mortgage-backed securities the starting point is typically the desired rating, with the security then structured to conform to that rating. Moody's admits that "in this type of environment, [the agency] cannot simply react to input, but must take a more active role in these transactions, representing the interests of the investors. In assigning its rating, Moody's [works] with the issuer, attorneys, investment bankers and other participants involved in the transaction, in most cases from the very early stages of the transaction." Moody's further characterizes its role as "an advocate for the investor." The question then becomes whether Moody's, with its level of involvement in the

structuring of mortgage-backed securities and its own characterization of itself as an advocate for the investor, has actually assumed a duty to the investor." Uzzi at 785-787.

While the agencies are more actively involved in the asset backed rating, the same underwriters are involved in both corporate and asset backed underwritings. Therefore the underwriter who can refer asset- backed business has to be in a favorable position when he refers a corporate offering. These entities are providing a rating/recommendation in connection with a distribution and being paid a percentage of that distribution thereby going beyond the impersonal publisher advice. This is especially true in connection with their structuring of asset-backed securities where they move from a passive role to an active role.). But even for corporate offerings the agencies proclaim their nexus to investors. On page 7 of a former letter to shareholders Moody's notes "For investors, Moody's ratings provide objective insight into the credit quality of specific financial instruments, providing an important means of differentiating among the many investment opportunities available. Since Moody's products serve both borrowers and investors, we are well positioned to prosper from the continued growth and evolution of public debt markets worldwide" This statement is very different then previous statements which suggest that investors should not rely heavily on ratings because ratings are only one of many factors to rely on.

Recent articles on the process suggest that the agencies do not often deny the desired rating and that when they do they do not get paid. Furthermore, the relationship of the banker to the agency needs to be explored. The promise of more referrals especially in the asset-backed area presents a potential conflict? A number of the agencies have competed in the AB area by severely reducing costs thru the acceptance of lower credit enhancements. Uzzi at 789-792. This suggests that the agencies cannot prosper on their reputations alone but are engaged in a bitter cost cutting struggle to obtain clients and subscribers similar to the research analysts in equity underwriting.

Once the bond offering is brought to market the analogy to the research analyst becomes even more pronounced. The compensation system is front- loaded and there is little incentive to aggressively monitor just as there is little incentive for an analyst to back off the rating that brought the IPO deal. However as Levitt points out this dynamic might change if the agency was responsible to the audit committee. "The imprimatur of a neutral rating service would go a long way toward restoring the faith of investors at a time when many are wary of the stock market and dubious behavior of ...corporate managers."

FUND AUDIT COMMITTEE REVIEW

The fund audit committee would also be able to bring together a number of other gate-keepers by consulting with the rating agency regarding its initial and ongoing ratings. The committee itself would benefit by inquiring in the ratings process and learning about the company's financial health from another source beyond its own required analysis. The oversight of the audit committee might allow for more flexibility in the NRSRO process, as it would provide an additional check on the agencies. A continuing role for the

committee after the initial rating is also desirable. Once a year the above referenced gatekeepers should meet with the rating agency to review the current rating.

The participation of the audit committee should also offer protection to the rest of the board against claims of negligence. A significant problem for the agencies and indeed the board in being more aggressive is that their liability actually increases if they fail to uncover a problem. Right now they are held to a standard of recklessness with respect to those who might reasonably rely on them. This is basically the standard, which the press is held to. Audit -committee participation, included as an NRSRO mandate, should allow directors to show that they had vetted their conclusions with all the gatekeepers in the Fund. While this suggested oversight requires much from the audit committee, that committee can hire others to make the assessment, indeed it could hire other rating agencies to do so. Whatever final decision is reached ,the Commission should be clear that the board cannot rely entirely on the ratings of its securities but must to some degree vet the rating agency itself or not use the references- in addition to its stated duty to go beyond the rating agencies.Can a board ignore securities in its portfolio rated by a rating agency that has been consistently wrong?Would it be too much to ask the audit committtee to discuss such a problem with the rating agency?

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