A Conceptual Framework for Imposing Statutory Underwriter
Duties on Rating Agencies Involved in the Structuring of Private
Label Mortgage-Backed Securities

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A CONCEPTUAL FRAMEWORK FOR IMPOSING STATUTORY UNDERWRITER DUTIES ON RATING AGENCIES INVOLVED IN THE STRUCTURING OF PRIVATE LABEL MORTGAGE-BACKED SECURITIES

The mortgage-backed security has evolved, in only thirty years, from a virtually non-existent investment vehicle into such a common investment alternative that today the market for these securities is characterized as a "mature market." This market has been traditionally dominated by government sponsored enterprises such as The Federal National Mortgage Association ("Fannie Mae") and The Federal Home Loan Mortgage Corporation ("Freddie Mac"). Since 1982, however, the issuance of private label mortgage-backed securities has grown dramatically.

A catalyst for the rapid growth of the private label mortgage-backed securities market has been the involvement of rating agencies. In fact, due to investor reliance on ratings and a host of ratings-dependent rules used by financial regulators,

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1 See KENNETH LORE, MORTGAGE-BACKED SECURITIES—DEVELOPMENTS AND TRENDS IN THE SECONDARY MORTGAGE MARKET 2-1 (1995). "The mortgage-backed security ("MBS") is an investment security representing an undivided interest in a pool of loans secured by mortgages or trust deeds." Id. at 1-1.

2 Id. at 1-2 (describing Fannie Mae and Freddie Mac as "titans of the secondary mortgage markets").

3 Id. at 1-17 ("Private label mortgage-backed securities are defined by the absence of any government guarantees."); Richard Cantor & Frank Packer, The Credit Rating Industry, FED. RESERVE BANK OF N.Y. Q. REVIEW, June 22, 1994, 1994 WL 13019235, at *19 (stating private label issues securitize jumbo mortgages, commercial mortgages, and other non-conforming mortgages not securitized by government sponsored enterprises). The mortgage-backed securities market has grown rapidly since 1989. Id. The years 1993 and 1994 were the "watershed years when institutional investors, banks and mutual funds finally warmed to securitized commercial mortgage pools and accepted them as legitimate fixed-income investments." Steve Cocheo, Sea Change for Real Estate Finance?, A.B.A BANKING J., Apr. 1, 1995, at 48.

4 Tamara L. Adler & Robyn L. Ballard, Mortgage Pool Technology Tests New Frontiers: Commercial and Multifamily Loans are the Latest Type of Collateral, Apr. 27, 1989, available in WESTLAW, 639 PLI/Corp 221; LORE, supra note 1, at 1-11.

5 See generally K. Susan Grafton, The Role of Ratings in the Federal Securities
rating agencies have become essential market participants for mortgage-backed securities.

As will be shown, the mortgage-backed securities rating process has lead rating agencies to assume an active role in the mortgage-backed securities arena, with rating agencies essentially dictating the structure of these securities. Yet, despite this active role, and the reliance placed upon the rating agencies by financial regulators utilizing ratings-dependent rules, the ratings industry has remained largely unregulated. Principally, this has occurred because the traditional activity of the rating agencies has generally fallen outside the scope of federal securities laws and because the current application of common law principles has acted as a virtual shield against liability to investors relying on negligently assigned ratings.

This Note, however, suggests that under current interpretation of federal securities laws, rating agencies involved in the structuring of mortgage-backed securities may be deemed "statutory underwriters" and therefore subject to regulation. First, this Note will examine the role of the rating agencies in the structuring of mortgage-backed securities, and the criticism that market pressures may be impacting rating objectivity. This Note will then discuss the traditional impediments to liability imposed by the common law. Finally, this Note will provide a conceptual framework for imposing statutory underwriter duties on rating agencies involved in the structuring of mortgage-backed securities.

BRIEF DEVELOPMENT OF THE RATING INDUSTRY

John Moody first started the securities rating industry in 1909 when he began rating United States railroad bonds. Over the remainder of the twentieth century, various independent ratings companies entered the market, and through subsequent

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Cantor & Packer, supra note 3, at *5. "Class action suits have been brought against the rating agencies following major failures -- such as the Washington Public Power Supply System default in 1983 and the Executive Life bankruptcy in 1991 - but the cases were dropped before verdicts were reached." Id.

Id. at *2; House, supra note 6, at 245.
mergers and acquisitions, the United States ratings industry expanded and consolidated into four major players; Moody's Investors Service ("Moody's"), Standard & Poor's Corporation, Fitch Investors Service, Inc. ("Fitch"), and Duff & Phelps, Inc. Today, the rating agencies rate a variety of instruments in addition to long term corporate bonds, including municipal bonds, commercial paper, and asset backed securities.

Initially, the ratings industry was financed through the sale of the agencies' various publications and investor materials, with the ratings assigned independent of fees to the issuers. However, as the demand for rating services increased, the imposition of charges to issuers became commonplace, with Standard & Poor's first charging municipal bond issuers in 1968. Both Fitch and Moody's began charging corporate issuers in 1970. Currently, approximately eighty percent of Standard & Poor's revenue is generated from issuer fees.

While the fees vary, the agencies typically charge the issuers a spread on the principal rated and sometimes, other additional fees. Although charging issuers could seemingly influence an agency's objectivity when assigning ratings to client products, the agencies insist that the overriding need to maintain investor confidence through high quality, accurate ratings, provides a sufficient deterrent against adjustments to ratings based upon undue issuer influence.

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9 Cantor & Packer, supra note 3, at *3. "The four major ratings agencies face additional competition from more specialized agencies." Id.
10 Id. at *2. Ratings have also been applied to other types of risks, including derivative products companies, claims paying ability of insurance companies, and performance risks of mortgage services. Id. Ratings agencies have also expanded their reach overseas. Id.
11 Cantor & Packer, supra note 3, at *4. As the publications were easily copied, the yield to rating agencies was insufficient to justify intensive coverage. Id.
12 Id. at *4. The demand for ratings increased significantly with default of Penn Central on $82 million of commercial paper in 1970. After the default, many issuers actively sought credit ratings to reassure potentially nervous investors. Id. at *4-5.
13 Id.
14 Cantor & Packer, supra note 3, at *5; cf. House, supra note 6, at 245 (stating 95 percent of Moody's and Standard & Poor's revenues come from issuer fees).
15 Cantor & Packer, supra note 3, at *5; House, supra note 6, at 245.
16 Cantor & Packer, supra note 3, at *5. "If investors were to lose confidence in an agency's ratings, issuers would no longer believe they could lower their funding costs by obtaining its ratings." Id. The agency system "appears to have been effective, with no major scandals in the ratings industry" so far. Id.
REGULATORY RELIANCE

The use of ratings-dependent rules in the federal securities regulatory scheme began in the 1930s and has expanded to the extent that virtually all financial regulators rely on some ratings-dependent rules.17 As with most securities, issuers of mortgage-backed securities seek higher ratings in order to ease the burden of complying with federal securities laws or to make the instruments available to investors who would otherwise be prohibited from trading the product.18

While it is generally presumed that most mortgage-backed securities are “securities,” as defined by federal securities laws, there is little case law directly addressing the issue.19 Instead, the attention has focused mostly upon how the various securities laws and rules apply to mortgage-backed securities.20 Indeed, Congress’ adoption of the Secondary Mortgage Market Enhancement Act of 1984,21 (“SMMEA”), and various actions by the Securities and Exchange Commission, (“SEC”), such as the promulgation of Rule 3a-7,22 seem to support the presumption that mortgage-backed securities are “securities” within the meaning of federal securities laws.

17 Id. at *6 (“The reliance on ratings extends to virtually all financial regulators, including the public authorities that oversee banks, thrifts, insurance companies, securities firms, capital markets, mutual funds, and private pensions.”); Grafton, supra note 5, at 1.
18 Grafton, supra note 5, at 1.
19 LORE, supra note 1, at 4-11. “Virtually no case law or administrative decisions exist that address the narrow question of whether mortgage-backed certificates are securities.” Id.; see also Mary Margaret Kuck, Mortgage-Backed Securities And Consumer Related Receivables: A Lesson From The Past With An Eye Toward The Future, 50 U. PITT. L. REV. 227 (1988) (discussing interpretation of mortgage-backed securities as “securities” under the Glass-Steagall Act).
20 LORE, supra note 1, at 4-10. Because it is generally assumed that mortgage-backed securities are “securities” under the law, most authorities are concerned with whether they are exempt from the registration provisions of the 1933 Act. Id. at 4-11.
22 Exclusion From the Definition of Investment Company for Structured Finance, 57 Fed. Reg. 56,248 (1992). The rule adopted by the SEC excludes issuers that pool income-producing assets and issue securities backed by those assets from the definition of “investment company” under the Investment Company Act of 1940. Id.
Easier registration under the 1933 Securities Act\textsuperscript{23} is among the preferences that the federal securities regulatory scheme confers upon higher rated issues. The 1933 Act requires most non-exempt mortgage-backed securities to use Form S-11 when registering.\textsuperscript{24} In contrast, an investment grade asset-backed security, that is an asset-backed security rated in one of the four highest rating categories by at least one Nationally Recognized Statistical Rating Organization ("NRSRO"),\textsuperscript{25} may use Form S-3,\textsuperscript{26} a shortened form which simplifies the registration process, thus reducing the cost of compliance.\textsuperscript{27} Furthermore, issues fitting the definition of a mortgage-related security\textsuperscript{28} may qualify for shelf registration.\textsuperscript{29}

Similarly, under Rule 3a-7 of the Investment Company Act of 1940, the SEC has excluded certain structured financings from the definition of the term "investment company."\textsuperscript{30} To qualify for the Rule 3a-7 exemption, the security must be rated in one of the four highest rating categories by at least one NRSRO.\textsuperscript{31} In promulgating this rule, the Commission recognized that "[t]he involvement of the rating agencies represents one of the most significant attributes of the structured finance market ... [and that the] ratings appear to have been a major factor in investor acceptance of structured financings."\textsuperscript{32}

\textsuperscript{23}See LORE, supra note 1, at 4-27; Grafton, supra note 5, at 1.

\textsuperscript{24}LORE, supra note 1, at 4-30 ("Registered offerings of mortgage-backed pass-through certificates and mortgage-backed bonds frequently use [Form S-11].").

\textsuperscript{25}Most ratings-dependent rules require a rating by a NRSRO. For a general discussion of NRSRO designation and associated problems, see Cantor & Packer, supra note 3.

\textsuperscript{26}See LORE, supra note 1, at 4-31; Grafton, supra note 5, at 1.

\textsuperscript{27}See LORE, supra note 1, at 4-31; Grafton, supra note 5, at 1.

\textsuperscript{28}See LORE, supra note 1, at 4-32 to 4-33. The precise definition of 'mortgage-related security' as used in this context has never been determined, however, it seems certain that the term includes those securities that qualify as mortgage-related securities as defined in the ratings-dependent definition under SMMEA. \textit{Id.}; see also \textit{infra} notes 35-38 (discussing mortgage-related securities with respect to SMMEA).

\textsuperscript{29}For a general discussion of the use and benefits of shelf registration for mortgage-backed securities, see LORE, supra note 1, at 4-32 to 4-37.

\textsuperscript{30}57 Fed. Reg. 56,248 n. 37 (1992). The rule was intended to remove some of the barriers to the use of structured financings. \textit{Id.} at 56,249. It "excludes from the definition of investment company any issuer who is engaged in the business of acquiring and holding eligible assets ... and who does not issue redeemable securities." \textit{Id.}

\textsuperscript{31}\textit{Id.} at 56,251 n. 41. Paragraph (a) (2) of the rule sets forth this requirement and the rating must exist at the time of initial sale of the security. \textit{Id.}

\textsuperscript{32}\textit{Id.} at 56,252. "The rating requirement is incorporated in the rule as a means
Perhaps the adoption of SMMEA in 1984 created the most significant ratings-dependent rule.\(^3\) Relying on ratings, Congress amended Section 3(a) of the 1934 Exchange Act by requiring a “mortgage related security” to be “rated in one of the two highest rating categories by at least one NRSRO.”\(^3\) The stated purpose of SMMEA was to “encourage the broadening of the market for mortgage-backed securities by encouraging more extensive involvement of the private sector ....’”\(^3\) Towards that end, SMMEA preempts certain state legal investment and blue sky laws so as to permit state regulated institutions, such as pension funds, to invest in mortgage related securities.\(^3\) Similarly, the Act permits national banks, federal credit unions, and federal savings and loan associations to participate in private issue mortgage-backed securitization.\(^3\) Thus, to the extent that a structuring relies on SMMEA provisions for mortgage related securities, the rating agencies become essential participants to the transaction.

**THE ROLE OF THE RATING AGENCIES IN STRUCTURING MORTGAGE-BACKED SECURITIES**

The development of ratings standards and the general availability of ratings have facilitated the growth of the mortgage-backed securities market by making the securities more acceptable to investors and by enhancing the liquidity of the investment.\(^3\) Furthermore, several ratings-dependent rules have rendered the rating agencies essential players in the issuance of many mortgage-backed securities.\(^3\)

\(^3\) See Cantor & Packer, *supra* note 3, at *8. “In addition to essentially creating the nonagency mortgage-backed securities market, ... [the Act] established a new regulatory cutoff rating.” *Id.*


\(^3\) 15 U.S.C. § 77r-1(a) (1994). SMMEA permits the states to opt out of the preemption provisions. 15 U.S.C. § 77r-1(c) (1994). Several states have opted out completely, and others have opted out of specific portions dealing with investments by insurance companies. See LORE, *supra* note 1, at 4-101 (listing States that have overridden federal pre-emption).


\(^3\) LORE, *supra* note 1, at 9-1.

Nevertheless, notwithstanding the reliance by both investors and financial regulators, the methods used by the various rating agencies to rate mortgage-backed securities differ. 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

1689 (1984) (requiring securities to be rated in one of two highest ratings category by at least one NRSRO).

40 LORE, supra note 1, at 9-3; see also Cantor & Packer, supra note 3, at *10 (noting SEC does not require uniform rating standard).

41 Cantor & Packer, supra note 3, at *19; Abby Schultz, S & P Faces Criticism in the Mortgage Area, WALL ST. J., Jan. 4, 1994, at A7A (“The lower support levels aren't evident to most investors, who often don't know exactly how a rating is arrived at.”). But see Cantor & Packer, supra note 3, at 18 (noting issuers sometimes obtain multiple ratings if they receive mixed or substandard ratings).

42 Cantor & Packer, supra note 3, at *19; House, supra note 6, at 245.

43 Cantor & Packer, supra note 3, at *19 (“Market observers have expressed concern that competitive pressures have led agencies to compete on ratings criteria, potentially undermining the reliability of the ratings.”).

44 See NAIC Cites Limited Role of Rating Agencies, THE INSURANCE REGULATOR, Apr. 10, 1995, at 3. “Reliance on an NRSRO credit rating as a trigger for more lenient regulatory treatment may inadvertently mask critical distinctions about which risk is most relevant for financial solvency monitoring.” Id. (quoting Report of the Securities Valuation Office of the National Association of Insurance Commissioners).

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.

While a comprehensive discussion of the mechanics of rating mortgage-backed securities by Moody’s and the other agencies is beyond the scope of this paper, some general observations can be made. In general, rating procedures include a review of all aspects of the transaction including underwriting criteria, servicing procedures, and legal implications. The rating analysis generally focuses on two primary credit risks; the risk of non- or partial payment and the risk of late payment, both of which impact an investor’s expected return. Moody’s asserts that it “attempts to make sure that the structure, the legal risks, and the credit risks result in a composite risk level to the investor

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46 Id. at App. 9-2.
47 Id.
48 Id. at App. 9-2 to App. 9-3.
49 Id. at App. 9-3 (emphasis added).
51 See generally Adler & Ballard, supra note 4 (describing approaches used for rating large pools of commercial mortgages); LORE, supra note 1, at 9-1 to 9-73 (discussing various rating methods); Rhodes, supra note 50 (explaining rating systems); Ron J. Wechsler, Rating Single-Borrower Commercial Mortgage Transactions, Nov.-Dec. 1994, available in WESTLAW, 704 PLI/comm 25 (describing Fitch’s rating method).
52 See LORE, supra note 1, at 9-3.
which is consistent with the rating requested," however, the precise definition of a composite risk level is unclear. What is clear, on the other hand, is that perhaps the greatest risk inherent in mortgage-backed securities, the risk of prepayment, is not considered in the rating analysis.

To further complicate matters, highly volatile securities have been created by stripping the entity into various principle-only, interest-only, and residual pieces. Although the holders of interest-only strips risk the extinction of their investment upon prepayment, the security may still receive an AAA rating. The sensitivity to market risks of certain mortgage-backed securities products raises questions as to the value of the current rating analysis and leads one to wonder whether the assignment of any rating at all to these products is inherently misleading.

Indeed, the SEC has recognized the potentially misleading nature of assigning credit ratings to interest-only ("IO") and principle-only ("PO") securities. In the original proposed version of Rule 3a-7, the SEC excluded IO's and PO's from the definition of fixed income securities, effectively precluding the sale of these securities to the general public by any seller relying on the rule. In the SEC's request for comment on the appropriateness of the restriction, the SEC noted that, despite their extreme volatility, IO's and PO's could still receive high credit ratings be-

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53 Rating Structured Finance, supra note 45, at App. 9-3 (emphasis added); see also Laura Jereski, Alice in Mortgageland. (Wall Street Brokers Using Mortgage-Backed Securities in Complex Ways), FORBES, Mar. 1, 1993, at 46 [hereinafter Alice in Mortgageland] ("Where there is complexity there can be hidden risk, and structured mortgage-backed securities are so complex it sometimes takes a mathematician to explain them.").

54 See Exclusion From The Definition Of Investment Company For Certain Structured Financings, 57 Fed. Reg. 23,980, 23,982 n.28 (1992) ("A rating does not address market risks to investors that may result from changes in interest rate levels or from prepayments on the assets in the underlying pool."); LORE, supra note 1, at 9-70.


56 See Alice in Mortgageland, supra note 53, at 46. "Wall Street has taken a triple-A product and injected market risk into it. People don't understand that at all." Id. (quoting Robert Phelan, director of market risk products at Fitch Investors Service).

57 LORE, supra note 1, at 9-71.


59 Id.
cause prepayment risks are not addressed by credit ratings. Fearing that the unsophisticated investor may be misled, the SEC stated that “[u]nsophisticated investors ... may not appreciate the risks associated with IO and PO securities, and sales of these instruments to such investors may raise suitability concerns.” Nevertheless, the SEC, responding to commenters who opposed the restriction, subsequently included IO’s and PO’s in the final definition of fixed income securities.

Examining some of the differences in the rating methods may also highlight the appropriateness of relying on the rating agencies. For example, while Moody’s assigns a quality rating to each loan when analyzing a commercial mortgage pool, Standard & Poor’s utilizes an actuarial model based upon aggregate pool statistics. The use of actuarial models in the analysis of commercial mortgage pools has been criticized because of the lack of homogeneity between commercial mortgages. As opposed to analyzing residential mortgage pools which are very homogeneous and extremely predictable, at least one commentator has observed that the actuarial approach cannot be applied to commercial mortgage pools with “any level of confidence,” because commercial mortgages are too complex to “permit blanket assumptions about their performance.”

Similarly, the rating agencies have been generally criticized for their own reliance on legal opinions when assessing credit risks. The concern is that although a rating has been assigned in reliance on a legal opinion, investors relying on the rating itself may not understand that all risks have not been eliminated

60 Id.
61 Id.
62 See SEC Structured Finance Regulation Raises Opponents, MORTGAGE-BACKED SECURITIES LETTER, Aug. 10, 1992, 1992 WL 2747064. The Public Securities Association stated that “[u]ndoubtedly, IOs and POs can have considerable price volatility .... However, we question the need to prohibit outright the sale of those securities to individuals and to severely restrict the number of institutions that can purchase them.” Id.
63 See Adler & Ballard, supra note 4 (detailing rating agency methods of assessing mortgage-backed securities).
64 See Lloyd Lynford, Too Much, Too Soon: Money is Rushing Blindly Back into Commercial Real Estate, BARRON’S, July 4, 1994, at 40.
65 Id.
despite the existence of the legal opinion.\footnote{Id.}{7}

In 1983, Moody's distinguished between "reasoned" opinions and "unqualified" or "unequivocal" opinions and asserted that an unqualified opinion equates with all risks being "substantially eliminated."\footnote{Id.}{6} In studying the issues, the Tribar Opinion Committee, a professional group,\footnote{Id. at 735 (citations omitted).}{6} severely criticized Moody's "reasoned" versus "unqualified" dichotomy stating:

[T]here is no basis for the proposition that an unqualified/"unequivocal" opinion, even in clean (as opposed to reasoned) form, means that all risks have been substantially eliminated. A lawyer is not an insurer or a guarantor of opinions. A lawyer is not liable for the "true state of the law," as long as the opinion is based on the reasonable exercise of informed judgment. Moreover, all lawyers understand that the law is not changed by whether a lawyer's opinion is expressed as unqualified.\footnote{See Schultz, supra note 41, at A7A (remarking that rating agencies are competing for "lucrative fees ... receive[d] when they issue ratings of [mortgage-backed] securities.")}{70}

The active role that the rating agencies have assumed in the structuring of mortgage-backed securities, coupled with the use of rating-dependent rules, has lead to a concern that rating agency objectivity may be compromised. Indeed, this fear grows more acute as the competition for market share intensifies.\footnote{See Cantor & Packer, supra note 3, at *19 (noting specifically the particularly high competition in the ratings of mortgage-backed securities); House, supra note 6, at 246 (stating "some agencies have moved from a traditional arm's length role as judges of credit quality to practically helping to initiate securitization transactions"); see also Grafton, supra note 5, at 6 (citing SEC Commissioner's remarks that rating agencies should be subject to formal regulation); cf. Schultz, supra note 41, at A7A (recognizing that some investors prefer competition to previous near monopolies of Moody's and Standard & Poor's).}{71}

**THE RATINGS MARKET DRIVING LOOSER STANDARDS**

In recent years, many commentators have expressed the concern that the competition in the ratings industry may be leading to lower ratings standards.\footnote{See The Tribar Opinion Committee, Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions, 46 BUS. LAW. 717, 734 (1991) (citing Moody's Approach to Rating Bank-Supported Debt Securities, MOODY'S BOND SURVEY, Jan. 3, 1983, at 3979).}{72} This concern is particularly
acute in the mortgage-backed securities arena because of the pivotal role that the rating agencies play in structuring these securities, due in part to regulatory reliance, and because of the enormous potential market available for mortgage-backed securities ratings. Indeed, there is approximately two trillion dollars of outstanding mortgage and asset-backed financing in the United States today.

Perhaps the greatest criticism of the rating agencies' role in the structuring of mortgage-backed securities is generally related to the agencies' adjustments to credit enhancement requirements. Nearly all mortgage-backed securities require some form of credit enhancement such as bank letters of credit, guarantees, or senior/subordinate financing. Since all forms of credit enhancement are costly and potentially reduce the profitability of the deal to the issuer, issuers often seek those rating agencies with the most lenient standards with respect to credit enhancement. Upon examination of the development of mortgage-backed securities rating standards, there appears to be some correlation between less stringent credit enhancement requirements and a greater rating agency market share.

Initially, Standard & Poor's was the only agency rating mortgage-backed securities, thus Standard & Poor's credit enhancement requirements set the industry standard. However, in 1986, Moody's entered the market with different ratings cri-

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73 See House, supra note 6, at 245; Schultz, supra note 41, at A7A.
74 David S. Schaefer, Comment: A Jump-Start for the Mortgage-Backed Market?, AM. BANKER, Oct. 24, 1995, at 38 (stating that outstanding commercial mortgage loans are in substantial excess of $1 trillion and only two per cent have been securitized).
75 See Cantor & Packer, supra note 3, at *19 (observing that rating agencies disagree on necessary criteria for establishing the amount of credit enhancement required for specific ratings); see also Schultz, supra note 41, at A7A (reporting Standard & Poor's adjustment of ratings criteria which resulted in 30% reduction of requisite credit report).
76 See Cantor & Packer, supra note 3, at *19 (stating that mortgage-backed security structures need to maintain highly-rated issues due to investor concern about quality of collateral as well as investor unfamiliarity with overall structure of the securities); Schultz, supra note 41, at A7A (observing that investors want protection against foreclosure of mortgages).
77 See Cantor & Packer, supra note 3, at *19 ("Issuers prefer structures that achieve a given rating with the smallest enhancements and choose rating agencies with the most lenient credit enhancement requirements, provided the agencies' ratings carry sufficient weight in the capital market.").
78 Id.
teria. Although Moody's requirements were stricter in some respects, Moody's credit enhancement standards were lower than Standard & Poor's for certain types of mortgage pools. As a result, Moody's gained market share for those types of issues with lower credit enhancement standards.

In 1990, Fitch developed a model for evaluating mortgage-backed securities that resulted in a further reduction of credit enhancement requirements, by as much as fifty percent compared to Standard & Poor's or Moody's. Currently, Fitch dominates the mortgage-backed securities ratings market with over a seventy percent market share.

Under intense criticism from the financial industry, Standard & Poor's, in December 1993, lowered its credit enhancement requirements by thirty percent and has since seen a substantial increase in market share. Critics have charged that both Standard & Poor's and Fitch's relatively lower credit enhancement standards are driven purely by a desire to increase market share. Indeed, Duff & Phelps, which maintains that its standards are more realistic, enjoys the smallest market share for mortgage-backed securities ratings.

On the other hand, Moody's has been criticized for assigning unsolicited ratings. Unsolicited ratings tend to be substantially lower than solicited ratings, because unsolicited ratings are generally based only upon available public information where as solicited ratings are based upon information obtained directly from issuers. In 1987 and 1988, Moody's assigned lower unsolicited ratings that caused yields to rise and ultimately lead some issu-
ers to change their mortgage-backed security structures and hire Moody's. The perception is that Moody's lower unsolicited ratings are coercive to those issuers who choose not to hire Moody's. Nevertheless, proponents of unsolicited ratings claim that these ratings provide an important check against issuers using solely those agencies with more lenient standards.

Clearly, issuers are motivated to use those rating agencies that offer the most favorable treatment, and various actions and adjustments to rating standards have had some impact on market share. To what extent the desire to increase market share has impacted the agencies' actions, one can only speculate. To be sure, reductions in credit enhancement requirements may be merely the result of a better understanding of the risks and complexities of mortgage-backed securities structures. Nonetheless, the rating agencies remain the only major market participants that are not subject to regulation and, as we will see, under the current state of the law, the agencies freely operate with little threat of liability.

**Traditional Impediments to Imposing Liability on the Rating Agencies**

While the actual standard of care imposed on the rating agencies is somewhat unclear, some commentators have suggested that liability depends upon a distinction between ordinary negligence and recklessness based on general tort law principles and First Amendment grounds. This reasoning and the problems plaintiffs confront when attempting to impose liability on

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89 Id. at 20; House, supra note 6, at 245.
90 See Cantor & Packer, supra note 3, at 6; House, supra note 6, at 245 ("Unsolicited ratings are tantamount to blackmail.") (quoting Paul Taylor, managing director of Duff & Phelps Credit Rating Company in Europe).
91 See House, supra note 6, at 245; Cantor & Packer, supra note 3, at 6.
92 See Cantor & Packer, supra note 3, at 20 ("Analysts and agencies note that [the decline in credit enhancement levels] in part reflects a progression along the learning curve ....").
93 See, e.g., Francis A. Bottini, Jr., Comment, An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies, 30 SAN DIEGO L. REV. 579, 609 (1993) (discussing potential problems if rating agency standard of care is increased from reckless to negligent); Gregory Husisian, Note, What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability, 75 CORNELL L. REV. 411, 413-14 (1990) (employing both economic and First Amendment analysis to determine rating agencies' standard of care).
the rating agencies are illustrated by First Equity Corp. v. Standard & Poor's Corp.\textsuperscript{94}

In First Equity, Standard & Poor's was sued because of factual errors contained in Corporation Records, one of Standard & Poor's investor publications.\textsuperscript{95} First Equity, claiming losses in reliance of the errors, brought an action alleging both negligent misrepresentation and fraud against Standard & Poor's.\textsuperscript{96} On a motion to dismiss, Judge Goettel of the United States District Court for the Southern District of New York ruled in favor of Standard & Poor's on the negligent misrepresentation claim. Judge Goettel, applying the Jaillet\textsuperscript{97} rule, stated:

\begin{quote}
It is widely recognized that in the absence of a contract, fiduciary relationship, or intent to cause injury, a newspaper publisher is not liable to a member of the public for a non-defamatory negligent misstatement of an item of news, 'unless he willfully ... circulates it knowing it to be false, and it is calculated to and does ... result in injury to another person.'\textsuperscript{98}
\end{quote}

Judge Goettel expressed two reasons for the rule. First, perfection in the publishing business is impossible to attain.\textsuperscript{99} Second, allowing the plaintiff to prevail would expose Standard & Poor's to "the spectre of unlimited liability."\textsuperscript{100}

On the fraud claim, the plaintiff argued that the applicable law allowed scienter to be established without proving actual knowledge or intent to harm but instead by merely proving what the defendant and the court characterized as negligent misrepresentation.\textsuperscript{101} Judge Goettel stated that, while in some circumstances a fraud claim may be based upon negligent misrepresentation, proof of mere negligence is insufficient when the defendant is a newspaper publisher or other party "in a comparable position."\textsuperscript{102} To hold otherwise "would severely restrict the ideas they distribute."\textsuperscript{103}

\begin{footnotes}
\textsuperscript{94} 670 F. Supp. 115 (S.D.N.Y. 1987), aff'd, 869 F.2d 175 (2d Cir. 1989).
\textsuperscript{95} Id. at 116.
\textsuperscript{96} Id.
\textsuperscript{97} Jaillet v. Cashman, 189 N.Y.S. 743 (Sup. Ct. 1921), aff'd., 194 N.Y.S. 947 (App. Div. 1st Dep't 1922), aff'd mem., 139 N.E. 714 (1923).
\textsuperscript{98} First Equity, 670 F. Supp. at 117 (citations omitted).
\textsuperscript{99} Id.
\textsuperscript{100} Id.
\textsuperscript{101} Id. at 118-19 (discussing New York and Florida law).
\textsuperscript{102} First Equity, 670 F. Supp. at 119.
\textsuperscript{103} Id. (quoting Cardozo v. True, 342 So. 2d 1053, 1057 (Fla. 1977)).
\end{footnotes}
In a subsequent hearing on the fraud claim in front of Judge Mukasey, summary judgment was granted in favor of Standard & Poor's. Basing the decision on constitutional grounds, Judge Mukasey applied the *New York Times v. Sullivan* standard which interprets the First Amendment as requiring a showing of "actual malice" to hold a newspaper liable for its publication. To show "actual malice," the plaintiff must prove: "Standard & Poor's published the description with actual knowledge of its falsity or with reckless disregard of its truth or falsity. To show reckless disregard, [t]here must be sufficient evidence to permit the conclusion that the defendant in fact entertained serious doubts as to the truth of his publication."

On appeal, the United States Court of Appeals for the Second Circuit agreed with Judge Goettel's original reasoning, disposed of the case on tort law grounds, and declined to address the constitutional issue. The court found support for the Jaillet rule by analogizing it to accountants liability for negligent misrepresentation and by refusing to expand Standard & Poor's liability "to a potentially 'indeterminate class of persons who, presently or in the future, might ... rely' ... on ... negligently inaccurate [information]." The court stated that *Corporation Records* is "often only the starting point for research rather than the finish line." And as such, users of *Corporation Records*:

- can easily protect themselves from misstatements or inaccuracies by examination of the original documents or federally required prospectuses. In such circumstances, we believe that the user is in the best position to weigh the danger of inaccuracy and potential loss arising from a particular use of a summary against the cost of verifying the summary by examination of the

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105 Id. at 256.

106 Apparently, there was a dispute over the scope of Judge Goettel's prior fraud ruling, thus Judge Mukasey avoided the controversy by ruling on constitutional grounds. *First Equity*, 690 F. Supp. at 258-59.


108 Id. at 259 (quoting St. Amant v. Thompson, 390 U.S. 727, 731 (1968)) (emphasis added).

109 *First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 869 F.2d 175, 176 (2d Cir. 1989).

110 Id. at 179 (quoting *Ultramares Corp. v. Touche*, Niven & Co., 174 N.E. 441, 446 (N.Y. 1931)).

111 Id. at 180.
original documents or prospectus .... That being the case, the user should bear the risk of failing to verify the accuracy of a summary in the absence of proof of a knowing misstatement.\textsuperscript{112}

Notably, the court recognized that while \textit{Jaillet} is generally used in the context of newspaper liability, the \textit{Jaillet} defendant was actually a provider of a stock ticker service and the \textit{Jaillet} court had "merely analogized stock tickers to newspapers without equating them."\textsuperscript{113} The court stated that it was not convinced that Standard & Poor's situation more closely resembled that of a newspaper than of an accountant, however, the \textit{Jaillet} rule was applicable nonetheless.\textsuperscript{114}

Thus, when attempting to apply common law remedies, plaintiffs face a significant hurdle in imposing liability on the rating agencies, even if the rating agency is negligent. Indeed, the plaintiff's burden is so high that regardless of whether the courts apply common law tort principles or constitutional principles, the rating agencies are, in essence, effectively shielded from all liability and free to impose any rating standards they wish.

\textbf{A BASIS FOR IMPOSING STATUTORY UNDERWRITER DUTIES ON THE RATING AGENCIES}

Section 11 of the 1933 Securities Act imposes liability on a series of parties for misstatements or omissions of material facts made in connection with a registration statement.\textsuperscript{115} Among those parties who are potentially liable under Section 11 are underwriters. At common law, and as generally understood in the securities industry, an underwriter was any person that purchases from an issuer with a plan to distribute the security.\textsuperscript{116} The 1933 Act defines an underwriter as:

any person who has purchased from an issuer with a view to, or

\textsuperscript{112} \textit{Id.} (citations omitted).
\textsuperscript{113} \textit{First Equity Corp. of Fla.}, 869 F.2d at 180.
\textsuperscript{114} \textit{Id.}
\textsuperscript{115} "Where the Issuer of a security is engaged in interstate commerce or in a business affecting interstate commerce, or its securities are traded by the use of the mails or any means or instrumentality of intrastate commerce, and in addition the issuer has assets exceeding a specified amount and a class of equity security held by a specified number of persons, registration by filing a statement with the Commission is required, unless specified exceptions apply." 79A C.J.S. Sec. Reg. § 112 (1995).
\textsuperscript{116} 69 AM. JUR. 2D Sec. Reg. Fed. § 69 n.82 (1993).
offers or sells for an issuer in connection with, the distribution of any security, or has direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.\textsuperscript{117}

Thus, as defined in federal securities laws, the term "underwriter" is significantly broader than the term's common definition as used in the securities industry.\textsuperscript{118}

Because rating agencies neither buy, purchase, nor sell securities for distribution, whether a rating agency falls within the definition of a statutory underwriter turns upon the meaning of the language "participation in the direct or indirect underwriting." A recent Seventh Circuit decision, \textit{Harden v. Raffensberger, Hughes & Co.},\textsuperscript{119} interpreting the statutory definition of underwriter seems to support the proposition that the rating agencies involved in the structuring of mortgage-backed securities are statutory underwriters.

In \textit{Harden}, the defendant was retained as a "qualified independent underwriter" to assist in the preparation of a registration statement and to recommend the minimum yield rate for the issuance of twenty million dollars in short term notes.\textsuperscript{120} The defendant, however, was not the actual classic underwriter for the transaction.\textsuperscript{121} The use of a qualified independent underwriter was essential to the transaction because of certain National Association of Securities Dealers rules requiring such participation.\textsuperscript{122} A class action suit was brought against the defendant as a statutory underwriter for materially misleading statements in the registration statement in violation of federal securities laws. Rejecting the defendant’s argument that it was not an underwriter because the defendant neither purchased, offered, nor sold the notes, the Court of Appeals for the Seventh Circuit first noted the district court's observations that the defendant's "services were essential" to the distribution of the notes.\textsuperscript{123} The district court had determined that prior decisions

\textsuperscript{119} 65 F.3d 1392 (7th Cir. 1995).
\textsuperscript{120} Id. at 1394-95.
\textsuperscript{121} Id.
\textsuperscript{122} Id. at 1395 (citing NASD Compliance Manual, (CCH) 1882, Sch. E, S 3 (c)(1) (1994)).
\textsuperscript{123} Id.
interpreting the definition of underwriter had construed "participation" broadly to include activities beyond actual financial participation and concluded that because the defendant's participation was "necessary to and a substantial factor" in the distribution of the ... notes, [the defendant] 'participated,' at least indirectly in their distribution." 

The Court of Appeals essentially followed the district court's reasoning and further noted that recent Supreme Court precedent "makes clear that ... one who 'participates,' or 'takes part in,' an underwriting is subject to [underwriter] liability." The Court of Appeals also looked to its own precedent which stated that "the statutory definition [of underwriter, contained in section 2(11)] specifically covers every person who participates in a distribution of securities," and that "the term 'underwriter' is broad enough to encompass all persons who engage in steps necessary to the distribution of securities." 

The rule for "participant liability" that seems to evolve from the Harden decision is that when a party actively participates in the structuring of a securities transaction, and that party's participation is essential to the transaction, that party will be deemed a statutory underwriter, even if the participation falls short of actual classic underwriting. Notably, what is left unanswered by Harden is to what extent a party may actively participate in a transaction and escape potential underwriter liability when the participation is not essential to the transaction. 

Applying the rule for "participant liability" to rating agencies involved in private label mortgage-backed securitization, it seems clear that the rating agencies are statutory underwriters as defined in federal securities laws. By their own admissions, the rating agencies take an active role in the structuring of these securities. Furthermore, any transaction relying on SMMEA mortgage-related security provisions, or any other rating-dependent rule, makes the rating agencies essential participants in the transaction. Indeed the notion that statutory underwriter duties should be imposed upon rating agencies involved in structuring mortgage-backed securities is not all that extraordinary.

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124 Harden, 65 F.3d at 1396 (applying doctrine of participant liability).
125 Id. at 1400 (quoting Pinter v. Dahl, 486 U.S. 622 (1988)).
126 Id. (quoting SEC v. VanHorn, 371 F.2d 181, 188 (7th Cir. 1966)) (alterations in original).
127 Id. (quoting SEC v. Holschuh, 694 F.2d 130, 139 n.13 (7th Cir. 1982)).
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 ...." 

CONCLUSION

Over the course of the twentieth century, the role of the rating agency has evolved from a completely passive market participant, entirely detached financially from securities issuers, to an active market participant, soliciting business directly from the issuers and essentially dictating the structure of mortgage-backed securities. Nevertheless, while virtually all other market participants are regulated to some extent, the rating agencies remain free from regulation.

Skeptics of the rating agencies suggest that market pressure may be having an impact on rating agency objectivity and question whether regulatory reliance on the rating agencies is justified. Indeed, there appears to be a correlation between agency adjustments to rating standards and market share, leading to the conclusion that some form of regulation is inevitable.

In the interim, however, while courts have interpreted the common law to impose a very high threshold for liability on the rating agencies, there appears to be precedent to support the proposition that the rating agencies involved in the structuring of mortgage-backed securities should be imposed with statutory underwriter duties under current federal securities laws. This result is dictated by the active role that the rating agencies assume when structuring mortgage-backed securities and by the necessity of rating agency participation due to the various rating-dependent rules.

The impact of imposing statutory underwriter duties on the rating agencies is unclear, however, due to the interplay of other securities laws and doctrines not addressed by this paper. This notwithstanding, at the very least, it seems that imposing statutory underwriter duties should raise the standard of care from recklessness to negligence for rating agencies involved in the structuring of mortgage-backed securities.

Finally, a discussion of the type and extent of regulatory oversight of the rating agencies that may be necessary has been beyond the scope of this paper, and indeed, whether it is even

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128 See Lore, supra note 1, at 9-57.
socially desirable to impose liability upon the rating agencies has not been examined. Nevertheless, the mere fact that a rating agency may fit the definition of a statutory underwriter should serve as a warning that the rating agencies are no longer the passive market participants that they once were.

Gerard Uzzi