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Rating the Regulation of Rating Agencies: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis

by

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INTRODUCTION

Even as we wait for the dust to settle after the onset of the global financial crisis (GFC), we have been eager to look for causes and to identify ways to prevent future crises. We have looked for villains to blame. We have blamed borrowers, who borrowed more money than they could ever hope to repay; we have blamed unethical residential mortgage originators who offered unsophisticated home purchasers deals that were too good to turn down; we have blamed those entities that bundled and re-bundled those mortgages into pools and sold them to unwitting investors as securities;¹ we have blamed greedy investors who fueled the bubble by buying these mortgage-backed securities.² In a story with seemingly unlimited villains, we have an almost unlimited number of proposals for regulatory responses. In this article, we will consider the misunderstood credit risk that was at the heart of the crisis and will examine the role that credit rating agencies (CRAs) played in causing the crisis and argue for their increased regulation.

CRAs provide a crucial role as “gatekeepers” to the public securities markets.³ As gatekeepers, they have an obligation to ensure that the ratings they assign are accurate so that the investing public can make fully informed investment decisions. Moreover, financial institutions rely on these ratings to determine the appropriate securities for their investment portfolios. If ratings are not accurate assessments of the credit risk, the solvency of such financial institutions is at stake, and as we saw with the GFC, national and global economies are placed in peril.

Investors trusted that the high ratings assigned by CRAs to complex securities marketed during the time leading up to the GFC meant something – that these securities were safe investments. Unfortunately, “this bond of trust was badly broken” by CRA behavior.⁴ There is, in fact, mounting evidence that CRAs failed to fulfill their gatekeeper obligation and such failure allowed the crisis to develop and intensified its impact.⁵ Instead of acting as gatekeepers protecting the market, they acted as “financial alchemists” turning worthless issues into gold.⁶
We are not the first scholars to direct blame toward credit ratings and the CRAs. 7 Certainly, CRAs have been vilified in the popular press, especially following Standard & Poor’s downgrade of the U.S. credit rating.8 Some have gone so far as to suggest that Standard & Poor’s downgrade was based on an ulterior motive, such as revenge or a preemptive move to halt regulatory reforms.9 Unfortunately, while the recently enacted financial reform regulation established a consumer financial protection agency, and imposed stricter monitoring on financial institutions and regulated derivatives, it failed to adequately address the role that CRAs played in causing the crisis.

This article will argue for increased regulation of the CRAs. To support our argument, we will first outline the role that CRAs played in the GFC. We will demonstrate how CRAs fueled the housing bubble by overly optimistic ratings assigned to mortgage-backed securities (MBS) created primarily with subprime mortgages, and in doing so, they garnered huge revenues from issuers of the MBSs. We will then discuss the lack of existing regulation of CRAs and discuss the limits of civil liability as an effective deterrent to prevent abuses by CRAs. This section will examine the recent case of California Public Retirement System v. Moody’s Corporation (CalPERS) in depth. We will trace the historical regulatory treatment of CRAs including the difficulty in attaching civil liability and the protection afforded to CRAs under the First Amendment.

At this point, we will turn our attention to the recently enacted financial reform legislation. We will briefly outline the Dodd-Frank Wall Street Reform and Consumer Protection Act 10[hereinafter Dodd-Frank] and the provisions that relate to CRAs. We will then discuss various issues related to CRAs. Specifically, we will discuss the failure of the reputational capital theory, problems caused by overdependence on ratings, issues related to the
lack of transparency, issues related to conflicts of interest and issues related to civil liability. Because these issues are interrelated, it is impossible to formulate a coherent public policy response without considering and addressing all issues related to CRAs. In this section, we will consider how well the financial reform legislation addresses each concern. We will, unfortunately, conclude that while the Dodd-Frank Act is a laudable first step it fails to adequately deal with CRA abuses. Last, we will offer an alternative regulatory response. In this section, we will propose an alternative business model to CRAs being funded by issuer fees. We believe the present model poses inherent and intractable conflicts of interest that inevitably color the ratings provided by CRAs. We believe that the largely self-regulatory model currently in place is inadequate. Hence, we are suggesting in this article 1) that the Office of Credit Ratings be given primary responsibility for regulating CRAs; 2) that the “issuer-pays” model be replaced with a “fees from proceeds” model as a way to deal with conflicts of interest; and 3) that CRAs face civil liability for inaccurate ratings.

PART I: CREDIT RATING AGENCIES AND THEIR ROLE IN THE GFC

The availability of credit is crucial to the smooth functioning of financial markets. Within any economy, there are participants who are savers (those whose financial inflows exceed outflows) and borrowers (those whose financial outflows exceed inflows). It benefits the economy in general if savers can invest their unused funds in the borrowing firms, which the borrowers can then use to generate greater future returns. This benefits the borrowing firm and its owners, the investors and society through the creation of additional jobs and services. When capital markets are well functioning, and the flow of funds from savers to borrowers takes place in an efficient manner, resources get allocated to their best use throughout the economy. Borrowers, however, often know more about their business operations and the prospects for
future investment projects than the savers/lenders, and as such, are in a position to take advantage of the lenders by not disclosing relevant information.\textsuperscript{13} This creates a situation of asymmetric information,\textsuperscript{14} which hinders the efficient transfer of funds from lenders to borrowers. For example, if the project is a risky project, the investor would set a higher interest rate than if the project were relatively safe. The investors though, would in most cases not be sophisticated enough to understand fully every business, and if they were required to analyze the creditworthiness of every investment opportunity, they might simply assume that all borrowers were risky and demand an exorbitant interest rate on all loans.\textsuperscript{15} The flow of credit would be excruciatingly slow and potentially more expensive for both borrowers and lenders. Worse still, savers might simply choose not to lend unless borrowers were willing to pay the high rate they demanded to adequately compensate them for the perceived risk. Also, if borrowing were relatively expensive, borrowers would be less willing to borrow to finance investment opportunities. In essence, there is potential for a breakdown in capital flows and overall economic activity with the result being that economic growth would be severely impeded.

**The Credit Rating Agency Industry**

Economists have long recognized that because of the information asymmetries described above, intermediaries are necessary to ensure a smooth flow of credit throughout the economy.\textsuperscript{16} Banks and CRAs fulfill this role. In theory, CRAs act as neutral third-parties providing information with respect to the creditworthiness of investments offered.\textsuperscript{17} They have the expertise to understand businesses and their growth opportunities as well as other economic factors that could impact businesses and their ability to repay the debt they issue. CRAs use their expertise to evaluate, rank and group various firms and businesses based on their level of credit risk.\textsuperscript{18} This allows investors with varying risk preferences to decide how they would like to
invest their money, and to better determine a fair level of compensation for the risk that they bear.\textsuperscript{19} Hence, CRAs have an important quasi-public function\textsuperscript{20} to perform within the economy, and as we will see from the GFC, when their evaluation of creditworthiness is incorrect, the result can be the formation of asset price bubbles that eventually deflate and can potentially devastate the global economy.

CRAs have existed since the early 1900’s. Prior to 1970, they generated their revenue through the sale of their publications and related materials.\textsuperscript{21} The revenue gained through the so-called “subscription based method” was arguably inadequate to justify comprehensive coverage of issuers. In the early 1970s, the CRAs transitioned to an “issuer-pays” business model. They realized that they could generate greater revenues by charging the issuers a fee for rating their debt instead of requiring the investors to pay a subscription fee for using their ratings.\textsuperscript{22} Moreover, the subscription based method was becoming increasingly impractical as technology made it impossible to prevent subscribers from sharing rating information with non-subscribers.\textsuperscript{23} Proponents of the issuer-pays model argue that this model provides CRAs with larger revenues that then allow them to provide more intensive coverage of issuers.\textsuperscript{24} Although CRAs still offer subscription services, it is estimated that today between 80 to 90 percent of CRAs’ revenues are generated by fees paid by issuers seeking ratings.\textsuperscript{25}

It is also important to note that the credit rating industry is a highly concentrated oligopoly. Three main competitors dominate the global marketplace – Moody’s, Standard & Poor’s and Fitch. These so-called “Big Three” CRAs control 98 percent of total ratings assigned worldwide.\textsuperscript{26} As we shall see, the lack of competition in the CRA market is an important and complicated consideration with respect to any public policy formulated to address CRAs.
The GFC and the Role that Credit Ratings Agencies Played

The GFC which began in 2007 was caused by various factors. Arguably, however, CRAs ensured that the buildup to the eventual crash proceeded smoothly. To understand the role CRAs played in the creation of the GFC, we must first understand the nature of the crisis. The GFC began as a housing crisis. In the years prior to the GFC, borrowing rates were low and credit was easy to obtain. Enticingly low interest rates associated with the early years of adjustable rate mortgages fueled demand for housing purchases, and therefore, set the stage for an unprecedented appreciation of house prices. Essentially, homebuyers using adjustable rate mortgages purchased homes that were more expensive than they could afford because the rates for the initial years of the mortgage were set to artificially low levels. As a result, the real estate market grew at exponential rates from 2000 to 2006.

Most importantly for the purpose of this article, mortgages on these homes were securitized. Through the securitization process, mortgage originators could decouple the lending and servicing of mortgages by selling individual mortgages into a pool of mortgage backed securities (MBSs). Afterward, mortgage originators did not bear the credit risk of the mortgages that they issued. The mortgages were sold as MBSs or as collateralized debt obligations (CDOs) and then housed in special purpose vehicles (SPVs) that created and issued new debt securities with the mortgages serving as collateral. The SPV sliced the debt into smaller pieces and issued securities; the cash flows from the underlying assets (mortgages) were passed through to the SPV. The securities were typically issued in three “tranches,” with the first tranche bearing the most credit risk and subsequently carrying the highest rate of return. The third tranche was the most insulated from the risk of default and, hence, carried the lowest return. The CRAs played a critical role because they rated each tranche to allow investors to
gauge the credit risk involved. The ratings were determined using statistical models supposedly
designed to measure the likelihood of default in each tranche.\textsuperscript{34} Moreover, given the inherent
information asymmetry, the marketability of these securities was dependent upon the rating
assigned by the CRA.\textsuperscript{35} Because the rating is essential to the marketability of the tranches,
CRAs have been described as “de facto gatekeepers” of this market.”\textsuperscript{36} Unfortunately, CDOs
comprising the riskiest tranches were created and re-bundled in a way that still allowed the upper
80\% of the structure to be rated AAA and this disguised the fact that the underlying assets were
largely subprime credit quality.\textsuperscript{37}

After housing prices rose, there was increased pressure on mortgage originators to get
contracts signed and securitize even more mortgages.\textsuperscript{38} The increased pressure to originate and
securitize more mortgages resulted in mortgage originators becoming lax with respect to credit
checks of applicants,\textsuperscript{39} and often, loans were extended without verifying an applicant’s income,
employment or assets.\textsuperscript{40} As subprime lending became the norm,\textsuperscript{41} mortgages were issued to
borrowers who would have not previously qualified. Moreover, in the years leading up to the
GFC, the practice of requiring a 20\% down payment towards the purchase of a house was
virtually abandoned. In addition, interest only and balloon payment mortgages became
popular.\textsuperscript{42} Hence, the origination-securitization frenzy sparked the classic asset price bubble
which caused credit standards to ease as lenders became “less concerned about the ability of the
borrowers to repay the loans and instead rel[ied] on further appreciation of the asset to shield
themselves from losses.”\textsuperscript{43}

CRA analysis and ratings of these complex CDOs could, and should have, prevented the
bubble from expanding. Unfortunately, the riskiness of the mortgages and mortgage tranches on
which the CDOs were written during the origination-securitization frenzy was not accurately
reflected in the credit ratings assigned by the CRAs. Instead, CRAs evaluated the securities and assigned them unjustifiably high ratings relative to their default risk. Favorable ratings, in turn, exposed the greater economy to these toxic securities because institutional investors, like pension funds and banks, could add them to their portfolios, which they did. The CRAs fueled the bubble because they endorsed the securitization process through their overly optimistic ratings. The money that was received by the MBS issuers from securitizing mortgages was funneled back to mortgage lenders and mortgage brokers who were then underwriting increasingly risky mortgages. The credit quality of the mortgages underwritten was of no concern to the mortgage companies because the credit risk was transferred to the SPV. The origination fees received for every additional mortgage issued were, however, a driving force behind the mortgage originators’ behavior.

As we now know, the housing market bubble burst in 2007; as housing prices began to plunge, many subprime borrowers could not make their payments and defaulted on their mortgages. This caused a ripple effect with the holders of asset backed securities losing their promised payments and their investment. Hence, contrary to the widely-held belief that mortgage defaults would likely be localized, the defaults were nationwide and triggered the GFC. Many mortgage lenders were forced to close immediately as the MBS market stalled. Furthermore, as investors moved their investments away from housing-based investments and into safer investments, it became increasingly difficult for mortgage originators to securitize their loans and therefore obtain new capital from investors. The CDO market was decimated, and by October 2007, 186 CDOs with over $200 billion in assets had failed. The credit crisis spilled over into other financial markets around the globe and adversely affected numerous financial institutions. For example, in a single month in 2008, the Dow Jones Industrial
Average fell over 1500 points.\textsuperscript{50} By early 2009, there had been more than $800 billion in asset write-downs and credit losses had been announced at more than one hundred of the world’s largest banks and securities firms.\textsuperscript{51} Some of the most prominent financial services firms had large holdings of asset backed securities, credit default swaps and other derivatives, and were among the hardest hit by the subprime crisis. Among the most notable casualties, Bear Stearns was eventually taken over by J.P. Morgan Chase; Lehmann Brothers filed for bankruptcy; AIG was bailed out by the Federal Reserve. \textsuperscript{52}

The GFC resulted in a historic restructuring of the American financial system,\textsuperscript{53} and an immediate quest to pinpoint the causes of the crisis. In searching for causes of the GFC, some have blamed derivatives while others have argued that the overly optimistic ratings assigned to CDOs by CRAs were the real culprit.\textsuperscript{54} Although the traditional methods for rating debt were not applicable to rating securitized instruments,\textsuperscript{55} the credit rating system was arguably more important to the marketability of CDOs and other asset-backed securities than traditional debt instruments. Moreover, the impact of overly optimistic ratings was more severe in the cases of CDOs and other asset-backed securities.\textsuperscript{56} First, recall that CDOs, and in particular MBSs, were backed by a pool of mortgages. However, information asymmetry meant that investors lacked sufficient information to be able to evaluate the likelihood of default of the mortgages within the pool. Specifically, investors knew nothing about the quality of the underlying assets and had no way of obtaining that information.\textsuperscript{57} Hence, investors had no choice but to rely on the CRAs’ assessment of the credit risk of the investment.\textsuperscript{58} Second, the derivatives associated with the mortgage market were increasingly complex.\textsuperscript{59} This complexity made it difficult for even sophisticated investors to properly assess their credit risk. Therefore, neither the bank risk managers nor the regulators questioned the large number of optimistic ratings assigned to CDOs.
Even more troubling is the fact that securitizing firms were not only paying a CRA to rate the securities they were planning on issuing, but in some instances, they were also paying the same CRA for advisory services associated with the design of the securities that same CRA would eventually rate.60

Recall, that although many underlying assets were subprime mortgages, CRA models suggested very low chances of default and the CDOs were assigned investment grade ratings. CDOs comprised of the riskiest tranches were re-bundled in ways that allowed the upper 80% of the structure to be given the highest rating, thereby disguising the fact that the underlying assets were largely subprime. In many ways, “the essential question which underlies the credit crisis is how loans to individuals with poor credit histories (which often originated without credit checks or down-payments) were transformed into investments that the market trusted as being as reliable as government securities.”61 This transformation was facilitated by the favorable ratings assigned by the CRAs to CDOs and other asset-backed securities.

It is clear that CRAs failed to provide accurate assessments of the credit risks associated with CDOs and other asset-backed securities. It is less clear, however, as to why CRAs failed so miserably. Much of the criticism surrounding CRA performance has centered on the models they used to assess the credit risk of the CDOs. To predict the likelihood of default, CRAs use statistical models, based in large part on the historical performance of a class of assets.62 In the early 2000s, CRAs, relying on historical default and recovery data, rated CDOs and MBSs highly, even those comprised primarily of bundled subprime mortgages. In the case of the MBSs, the pool consisted of newly issued mortgages with no payment history.63 Characteristics, like teaser interest rates with automatic reset provisions, were not considered.64 Unfortunately, CRA models were based on optimistic assumptions about continued appreciation of housing
prices and about borrower defaults, and were not modified as the housing and credit market conditions changed significantly. In fact, even as the GFC began, CRAs failed to promptly downgrade the ratings of troubled securities. In addition, the models did not reflect the possibility of “default dependence.” Otherwise termed “default contagion,” this concept recognizes the fact that sometimes the default of one borrower increases the possibility that other borrowers would default. Further, recall that the “Big Three” CRAs control over 98% of the share of the credit rating market. The lack of competition meant there was no competitive pressure to update outdated statistical models used to evaluate the CDOs. To further complicate the issue, CRAs most often relied on the information provided to them by the issuers and performed no independent due diligence. For example, they failed to even check for adequate documentation for each mortgage. Some have attributed CRA failures to “overreliance on the ‘math’” which created a situation where the CRAs relied on the output from their models and failed to take into consideration relevant subjective factors. Others have opined that CRAs exhibited “plain bad judgment.” For example, there is evidence in some instances that CRAs reduced their loss estimates and issued higher ratings than justified even by these flawed quantitative models.

Moreover, as was noted above, the debt instruments involved were increasingly complex. Oddly enough, the complexity of the CDOs being issued made them difficult to understand even by the CRAs. This meant that often the CRAs themselves found it difficult to judge the value of the investment. As the complexity of the instruments increased, the financial analysis sophistication and expertise needed to accurately rate them also increased, and some CRA analysts simply lacked the expertise needed to properly perform this function. In addition, the increased business that resulted from the housing bubble stressed CRA staff and made it more
difficult to issue accurate ratings. Moreover, when housing prices were rising and the complex instruments were performing as hoped with high yields, CRAs and investors were lulled into an illusion of “complacency.”

Given the importance of CRAs to the smooth functioning of credit markets throughout the economy, we would expect that they would be highly regulated. Our expectations, however, are incorrect. In the next section, we explore why CRAs were able to operate largely unregulated.

PART II: REGULATION OF CREDIT RATING AGENCIES

Historically, CRAs have faced minimal regulation and it has been politically difficult for the government to impose regulations on them despite the recognition that regulation is needed to advance public policy that is in the best interests of financial market participants. This lack of regulation has helped shape the largely self-regulatory environment that has emerged for the CRA industry. In the context of the CRA industry, the notion of self-regulation is closely tied to the reputational capital theory. According to the reputational-capital theory, regulation of CRAs has been considered unnecessary because it is thought that an agency’s interest in maintaining a reputation or track record of issuing accurate ratings is a sufficient incentive to ensure reliable ratings. Rating agencies are thought to “prosper based on their ability to acquire and retain reputational capital” and trust. In other words, CRAs have an economic incentive to exercise care when assigning ratings in order to maintain public trust in the integrity of their ratings. Theoretically, no additional regulatory incentives are thought necessary because CRAs are motivated to protect their reputation to prevent the economic losses that would result from investors seeking an alternative information source with respect to the determination of creditworthiness. The extent to which reputation provides a sufficient incentive to warrant
self-regulation is, however, hotly debated.\textsuperscript{84} Regardless, the theory of reputational capital has governed the public policy landscape.

\textbf{Statutory Regulation}

CRAs were largely unregulated until passage of the Credit Rating Agency Reform Act of 2006 (CRARA)\textsuperscript{85} and today they are still subject to little oversight.\textsuperscript{86} The CRARA was designed to increase competition among CRAs, limit potential conflicts of interest and ensure adequate disclosure.\textsuperscript{87} It provides for a process by which a CRA can become registered as what is termed a Nationally Recognized Statistical Rating Organization (NRSRO) and requires that NRSROs reveal their general methods and procedures as part of the registration process, but provides for little monitoring.\textsuperscript{88} There are no requirements that CRAs adopt credible performance measurement models, methodologies or procedures.\textsuperscript{89} Moreover, notably absent is any requirement that CRAs disclose the data underlying the statistical models employed or other facts relevant to the methodology adopted to rate the CDOs. In fact, the CRARA actually prohibits the SEC from regulating any aspect of the rating process including the methods used by CRAs to rate securities.\textsuperscript{90} Moreover, the CRARA requires that CRAs establish written policies to address any conflicts of interest, but does not prohibit the “issuer-pays” model.\textsuperscript{91}

In November 2009, the SEC amended its rules applying to NRSROs to require that NRSROs comply with the conflicts of interest rules provided under Rule 17g-5 of the Securities Exchange Act of 1934. In particular, the amendments are intended to increase the number of credit ratings assigned to structured finance products such as mortgage-backed securities and CDOs. The amendments are also intended to increase competition within the CRA industry by promoting the assignment of credit ratings by one or more CRAs not hired by the arranger of the debt issue. Arguably, the increased competition will lead to more accurate credit ratings. The
amendments also require the arranger of a debt issue to set up a password protected website that is accessible to all NRSROs that are qualified to rate the debt issue. This is designed to facilitate the ability of other NRSROs to assign credit ratings on issues that their services have not been retained. Moreover, the website must provide all material information, including non-public information, so that NRSROs other than the one hired by the arranger can provide unsolicited ratings if they would like to do so.

Civil Liability

As we have seen, there has been historically little regulation of CRAs. In the absence of statutory limitations, the threat of civil liability can act as a powerful deterrent on firm behavior. In the case of CRAs, however, the threat of civil suit has proven to be an equally inadequate regulator. One commentator has remarked that in the few cases brought against CRAs, “the only common element…. is that the rating agencies win.” CRAs have been protected from civil liability based upon securities regulation. They are expressly insulated from liability based on Section 11 of the 1933 Act because their statements are not considered a part of the registration statement. As such, they face liability under securities laws only if plaintiffs can prove fraud.

Cases asserting liability based on common law have, however, been brought by issuers who have alleged that CRA ratings are too low and by investors alleging that the ratings are too high. Alternative grounds for suits against CRAs are tortious (negligent misrepresentation, negligence or fraud) or contractual in nature. For a variety of reasons, CRAs have, for the most part, prevailed in these suits. The GFC has obviously resulted in the second kind of suit. Scores of investors have filed suit in wake of the GFC and many of these lawsuits have been against CRAs. However, it remains to be seen whether or not investors will be successful. This
section will briefly examine the basis for one such lawsuit, gauge its likelihood of success and weigh the effectiveness of civil liability as an incentive to encourage more accurate ratings. The question is whether the threat of civil lawsuit provides a sufficient deterrent or if additional regulation is needed.

Historically, plaintiffs have faced a variety of obstacles in civil litigation. First, proving the elements necessary for a cause of action has been problematic. While a detailed discussion of the basis for civil liability against CRAs is beyond the scope of this article, there have been a few common obstacles. Plaintiffs have faced problems proving the scienter necessary to bring a fraud action; plaintiffs have faced problems proving the requisite duty of care to successfully bring a negligence action; plaintiffs have faced problems proving that they have the requisite privity of contract to bring a contract action;\textsuperscript{98} plaintiffs have faced problems proving the requisite degree of reliance necessary to be successful in a fraud or negligent representation case.\textsuperscript{99}

One aspect of the prima facie case merits more detailed discussion. To bring a cause of action based upon fraud or negligent misrepresentation, plaintiffs must prove that the CRA made statements of fact as opposed to statements of opinion. CRAs have long argued that ratings are not factual statements, but are instead non-actionable predictions into the future. Many courts have agreed. For example, the court in \textit{Jefferson County School District v. Moody’s Investors Services},\textsuperscript{100} found that while ratings are not quite opinions, they are not factual assertions either. Only statements which can be proven false are actionable.\textsuperscript{101} Similarly, in \textit{Compuware Corp. v. Moody’s Investor Services}, the court concluded that the rating at issue was a mere prediction about the financial future of the issuer and not a statement with a “provably false connotation…

\textsuperscript{98} \textsuperscript{99}

\textsuperscript{100} \textsuperscript{101}
[and] such inferences could not be proven false because of the inherently subjective nature of Moody’s ratings calculations." Thus, liability was denied.

Even when plaintiffs are able to allege sufficient facts to get over the hurdles imposed in proving the prima facie case, CRAs have been able to successfully assert defenses insulating them from common law liability. For example, CRAs typically disclaim contractual liability making it clear that they rely solely on information provided to them by others and they bear no responsibility for errors or omissions based on such information. More importantly, the First Amendment has historically provided a privilege which operates to insulate CRAs from civil liability. The First Amendment "was fashioned to assure unfettered interchange of ideas for the bringing about political and social changes desired by the people." In claiming First Amendment protection, CRAs have likened themselves to members of the financial press, terming the rating “the shortest editorial ever written.” They have successfully argued that their function is journalistic in nature – that they gather and analyze financial information and that ratings are hence opinions on matters of public concern and entitled to the First Amendment protection afforded to members of the press. Under the New York Times test, journalists are liable for such false statements only if the statements were made with knowledge of falsity or reckless disregard of the truth (i.e., actual malice). Hence, CRAs have been granted limited immunity, overcome only by a showing of actual malice. A number of courts have upheld this argument and the general expectation is that immunity will be granted. A few cases provide illustration. In the case of Jefferson County School District v. Moody’s Investment Services, Inc., Moody’s offered an unsolicited negative rating that allegedly caused the plaintiff to incur additional costs related to a bond issue. The court held that the First Amendment insulated the defendant from liability for claims of intentional interference with contractual relations and
defamation. In the case of *Newby v. Enron Corp.*, the court granted First Amendment protection dismissing negligent misrepresentation claims.

Whether or not a First Amendment privilege should attach to CRA ratings has been the subject of intense academic debate. Some have challenged the comparison that equates CRAs with financial journalists, equating a CRA instead to “a chef rating his own food” or “a newspaper journalist charging a high fee to provide an ‘independent’ rating of an exclusive hotel in New York City and then publishing the review in the Travel portion of the newspaper.” Some recent court cases offer support for arguments against applying the grant of immunity. The Court in *Dun & Bradstreet, Inc., v. Greenmoss Builders, Inc.* defined the limits of the privilege and found that the credit reports issued in that case were matters of “private concern” rather than “public concern.” The court emphasized the limited number of people to whom the report was distributed and explained that First Amendment immunity was inapplicable in cases where the speech was only “in the individual interest of the speaker and its specific business audience.” Moreover, the Court distinguished credit reporting agencies from the traditional media because, unlike the traditional media, they are “in the business of selling financial information to… subscribers who have paid substantial fees for their services” and the speech was, thus, “solely motivated by the desire for profit.”

In *in re Fitch*, the Second Circuit expanded on this reasoning. This case involved a subpoena request issued against Fitch (in a lawsuit against UBS PaineWebber). UBS PaineWebber had paid Moody’s and Fitch to issue ratings on a number of securities pooled and sold to the plaintiff. When the client learned that Fitch had been involved in structuring the product to achieve the investment grade rating, it requested the subpoena; Fitch sought to quash the subpoena under New York State’s Shield Law. The Court found that Fitch had failed to
establish that “the information it sought to protect [from the subpoena] was gathered pursuant to
the newsgathering activities of a professional journalist.” In denying First Amendment
protection, the Court emphasized the fact that the issuer (rather than subscribers) paid for the
rating. The Court contrasted this with the financial media which decides what transactions to
cover based on their newsworthiness rather than a potential for profit. Moreover, the Court
considered the level of CRA activity in structuring the issue. Again, the Court contrasted this
with the traditional media highlighting the fact that a regular journalist rarely has a close
relationship and involvement with the “story.”

There are two recent district court cases which rejected the First Amendment defense for
CRAs and, therefore, offer the potential of civil liability in the wake of the GFC and beyond.
The court, in both *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* and *In re National
Century Enterprises, Inc., Investment Litigation*, held that ratings on instruments sold in
private placements did not constitute matters of “public concern.” The *Abu Dhabi* case is
particularly instructive. Relying on the *Dun & Bradstreet* case, the court in *Abu Dhabi* rejected
the “public concern” argument based on a three-prong rationale: 1) how widely the report was
disseminated; 2) state of mind and knowledge of the CRA; and 3) the conflicts of interest that
existed.

In the *Abu Dhabi* case, two institutional investors sued Moody’s, Standard & Poor’s and
Morgan Stanley following the collapse of a SPV. Plaintiffs based their claim for relief upon
negligence, negligent misrepresentation and fraud. In rejecting the CRAs’ First Amendment
defense, the court emphasized that the instruments were sold to a limited number of targeted
investors rather than to the public at large. The court stated that “where a rating agency has
disseminated their ratings to a select group of investors rather than to the public at large, the
rating agency is not afforded the same protection.”128 Similarly, the court in *National Century*, in a case which pre-dated the GFC, rejected the First Amendment argument because of the limited dissemination of the rating. Under this line of reasoning, whether immunity is granted or not, turns on how widely the rating is distributed.129 If the rating has a limited distribution to a select group of investors, the First Amendment defense does not apply and malice is irrelevant.

The second point emphasized by the *Abu Dhabi* court justifying disallowance of the First Amendment defense was the state of mind and knowledge of the CRAs. Here, the court held that even if the statements were classified as opinions they were still actionable because the CRAs had knowledge that these opinions were misleading investors.130 Specifically, the Court found that because the CRAs “knew that the ratings process was flawed, knew that the portfolio was not a safe, stable investment, and knew that Rating Agencies could not issue an objective rating because of the effect it would have on their compensation, it may be plausibly inferred that… the Rating Agencies knew they were disseminating false and misleading ratings.”131

Last, the *Abu Dhabi* court emphasized the conflicts of interest that existed. The Court stressed the fact that CRAs played a role in structuring the note prior to its issue and were compensated for their role. For example, the CRAs received approximately $6 million upon issue and approximately $1.2 million per year for continuing services, such payment due only “upon the receipt of desired ratings” and “only in the event the transaction closed with those ratings.”132 The Court found that the CRAs were motivated by these conflicts to assign high ratings.133 Although the Court notes that the “existence of conflicts of interest alone typically is not sufficient to establish that defendants ‘knowingly’ made a false and misleading statement,” it is important when coupled with other factors.134
As noted above, there have been several lawsuits filed against CRAs in the wake of the GFC.\textsuperscript{135} Because virtually all MBSs were sold in private placement, the rationale from Abu Dhabi could have significant ramifications. One of the most notable of these cases is the case of \textit{California Public Employees' Retirement System v. Moody's} [hereinafter CalPERS].\textsuperscript{136} The California Public Employees’ Retirement System invested a total of $1.3 billion in three SPVs which collapsed in 2007 and 2008 resulting in $1 billion loss for CalPERS. CalPERS alleges that in each case the CRAs were actively involved in the “creation and ongoing operation” of the SPV, as well as in the creation of the structured financial assets held by the SPVs.\textsuperscript{137} The Complaint describes the active role that the CRAs took in structuring the issues: “The Rating Agencies no longer played a passive role, but would help the arrangers structure their deals so that they could rate them as highly as possible.”\textsuperscript{138} In each case, the CRAs were paid by the issuers of the SPVs and paid lucratively. It is alleged that the typical fee was from $300,000 to $1 million per issue. This was in addition to fees that the CRAs charged for rating the underlying assets. Moreover, these fees were paid only if the SPV was offered to investors. Therefore, it is alleged that the CRAs “had a contingent fee interest and thus every incentive to give high ‘investment grade’ ratings, or else they wouldn’t receive their full fee.”\textsuperscript{139} All SPVs were rated AAA; unfortunately, it appears that these ratings were unjustified. Alleging that the models used to rate the SPVs were “seriously flawed in conception and incompetently applied,” CalPERS has sued for negligent misrepresentation and negligent interference with prospective economic advantage.

Specifically, CalPERS alleges that the CRAs miss-rated the SPVs in the following ways. First, the models used assumed that the SPVs were “virtually impervious to default” and failed to “take into account the foreseeable scenario that the SIVs would be unable to liquidate the assets
Moreover, these models failed to take into account the large concentrations of underlying assets from the same geographic region. Second, the CRAs used their own ratings of the underlying assets as a basis to rate the CDOs. In other words, “the input for the SIV investment parameters was based on the output of the Rating Agencies’ faulty models.”

It appears that CalPERS has alleged sufficient facts to establish a cause of action based on negligent misrepresentation. Moreover, it appears likely that plaintiffs in CalPERS can meet the three-prong test set forth in Abu Dhabi and avoid the First Amendment bar to liability. In fact, they successfully overcame their first hurdle when Judge Richard Kramer of the Superior Court of the State of California dismissed the motion to dismiss and allowed the case to continue. The Superior Court concluded that the ratings were not matters of public concern and, hence, not entitled to First Amendment Protection. The Court quickly concluded that the CRAs were “not akin to members of the financial press.” By contrast, the Court found the rating activity to be an “economic activity designed for a limited target for the purpose of making money.”

While the court did not address the First Amendment argument with any detail, given the facts of the case as alleged it appears that the First Amendment would not afford defendants protection under the Abu Dhabi test. Because the CalPERS case is typical of other cases pending against CRAs, it is useful, at this point, to examine the facts of CalPERS in light of the Abu Dhabi holding. Under the three-prong test, the first relevant factor is the extent of distribution of the rating. In the CalPERS case, it is clear that the ratings were prepared as part of a private placement issuance. Hence, the rating was not made widely available to the public. In fact, it is alleged that the ratings were available only as part of the private placement memoranda,
briefly available on the CRAs’ websites and as part of the information provided by financial reporting services such as Bloomberg and Reuters. While the Abu Dhabi court never made clear the exact number of investors that separates wide dissemination (which is a matter of public concern) from a more narrow dissemination (which is “in the individual interest of the speaker and its specific business audience”),\textsuperscript{149} the narrow dissemination alleged in CalPERS is almost identical to the dissemination outlined in the Abu Dhabi case.

Under the second prong, the state of mind and knowledge of the CRA is relevant. Recall that the Abu Dhabi court found the ratings were actionable because the CRAs in that case had knowledge that their ratings were misleading investors, and that knowledge was inferred from the fact that CRAs knew the rating process was flawed and the issue was not a safe investment. In the CalPERS case, plaintiffs allege that the CRAs lacked a reasonable basis for assigning the high ratings. They cite flawed structural tests, models that failed to recognize the lack of geographic, investment class and industry diversity in the asset pools, models that used ratings outputs as inputs to the models, and the use of inaccurate asset correlation models.\textsuperscript{150} They allege models that rely on historical data,\textsuperscript{151} models that failed to recognize the large amount of sub-prime mortgages issued with little screening, failure to differentiate between first and piggyback second mortgages. They allege that the CRAs failed to maintain enough competent personnel to competently issue and monitor the ratings.\textsuperscript{152} Moreover, they allege that CRA executives were aware that their ratings were likely inaccurate. They quote an analyst at Standard & Poor’s who “expressed concern that her firm’s model did not capture ‘half’ of a particular deal’s risk, but that ‘it could be structured by cows and we would rate it,’” and an analyst who acknowledged that the “Rating Agencies were creating an ‘even bigger monster – the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards
falters. :o.” In summary, CalPERS alleges that “The Rating Agencies thus used *inadequate* models, premised on useless or outdated data to structure and rate RMBS deals, which had severe effects for SIVs’ credit worthiness. They also used *fanciful* asset correlation values in their CDO and SIV models. As a result, the Ratings Agencies also allowed *unreasonable* amounts of concentration of underlying assets in specific kinds of investment, such as RMBS and CDOs.” (emphasis added). This degree of negligence and knowledge, coupled with the conflicts of interest discussed next, is exactly what the *Abu Dhabi* court found persuasive.

Last, the *Abu Dhabi* court emphasized the conflicts of interest that existed. Recall that the *Abu Dhabi* court stressed the fact that the CRAs in that case were active participants in structuring the note prior to its issue. That same degree of participation is alleged by CalPERS. Although the complaint fails to offer details as to the role of the CRAs in creating the issues, the plaintiff does allege that “The Rating Agencies, much like their role with MBS and CDOs, helped set up SIVs through the same ‘iterative’ process with the issuers. The Rating Agencies would create or approve investment parameters that mandated the type, geography, tenor, and size of the assets that the SIV could contain.” Moreover, recall that *Abu Dhabi* placed emphasis on the fee structure associated with its issue. For example, in the *Abu Dhabi* case, CRAs received substantial fees which were paid only if the rating was actually used in the offering. The *Abu Dhabi* court inferred that the substantial contingent fees provided an improper motivation for high, and inaccurate, ratings. The same type of fee arrangement is alleged by CalPERS. Although the amounts paid for this specific SPV are not alleged, the plaintiff does allege that the CRAs employed lax rating standards in rating the three SPVs at issue and that “they did so to ensure the SIVs could be successfully pedaled to primarily institutional investors like CalPERS, thus permitting the Rating Agencies to be paid their contingent fee.”
PART III: FINANCIAL REFORM

Financial Reform as it relates to CRAs.

Following a crisis, it is common for regulatory reform to be sought.\textsuperscript{156} Reform initiatives have focused on regulation of derivatives, mortgages and other financial products, the safety of banks, and the ability of the government to take over financial institution holding companies when an institution is in financial distress. In addition, CRA behavior has come under intense scrutiny. Because of a perceived gap between the power of CRAs and their accountability, increased regulation of CRAs has been considered.\textsuperscript{157}

One of the first reform proposals came in June, 2009, when the Obama Administration offered a proposal [hereinafter the “Obama Proposal”] developed in response to the GFC and addressing perceived regulatory weaknesses across a number of areas within the U.S. financial markets, including regulation of CRAs.\textsuperscript{158} With respect to CRAs, the Obama Proposal provided that the “SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to require that firms have robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise promote the integrity of the ratings process.”\textsuperscript{159} Subsequently, in July 2010, Congress passed Dodd-Frank which was intended to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services, and for other purposes.”\textsuperscript{160} As such, Dodd-Frank is arguably the most comprehensive piece of financial reform legislation since the Great Depression\textsuperscript{161} and its regulatory provisions encompass five broad categories,\textsuperscript{162} with CRAs being a subset of its regulations aimed at reducing systemic risks that may exacerbate asset price bubbles.
The Dodd-Frank Act and CRAs

With respect to CRAs, Dodd-Frank contains a number of provisions that are intended to limit the aspects of CRAs’ behavior that arguably facilitated the GFC. We will briefly outline the broad provisions here and address the specifics in the next section.

1. Office of Credit Ratings

Dodd-Frank strengthens the SEC’s ability to regulate CRAs by creating an Office of Credit Ratings within the SEC [hereinafter “The Office”].163 The purpose of the Office is to promulgate and administer SEC rules designed to protect users of ratings and the public interest, to promote accuracy in the ratings and to ensure that ratings are not unduly influenced by conflicts.164 To accomplish this broad goal, the Office is required to conduct an examination of each NRSRO at least yearly.165 Following the annual review, the Office is required to produce a publicly available report for each CRA describing the results of the annual examination. If concerns are found during the annual examination, the Office should make recommendations to rectify the situation and then follow-up with the CRAs to see that the concerns are appropriately addressed.

2. Disclosures

Dodd-Frank is intended to improve the disclosure of information within the CRA industry as a means to allow “the users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different nationally recognized statistical ratings organizations.”166 Dodd-Frank explicitly gives the SEC rulemaking authority to ensure that CRAs with NRSRO status disclose information in such a manner that the users of ratings are able to make comparisons across NRSROs and are able to evaluate and compare the performance of NRSROs.167
3. **Consideration of Independent Information**

Dodd-Frank amends Section 15E of the Securities Exchange Act of 1934 by requiring CRAs to consider information from third parties (i.e., entities other than the issuer or underwriter) that comes to their attention as long as it is credible and significant with respect to a ratings assignment.\(^{168}\)

4. **Conflicts of Interest**

Dodd-Frank prohibits CRA compliance officers from involvement in the ratings determination process and in the development of ratings methodologies. It also requires the SEC to promulgate rules that will ensure that the CRAs’ sales and marketing personnel refrain from influencing the ratings process or methodology.\(^{169}\) In addition, it requires NRSROs to employ a one-year look-back review when a NRSRO employee leaves the NRSRO and goes to work for an obligor or underwriter of a security or instrument, subject to rating by the CRA. Moreover, Dodd-Frank requires the SEC to assess the compensation models of CRAs and to investigate an alternative means of compensating NRSROs so that the conflicts of interest arising from the “issuer-pays” model are eliminated.\(^{170}\) The intent is to change the existing compensation system so that CRAs have an incentive to assign accurate credit ratings. The SEC is required to complete its assessment of the compensation models and make recommendations by mid-2012.

5. **Liability**

Dodd-Frank creates a private cause of action under which investors can sue CRAs for knowingly or recklessly failing to conduct a reasonable investigation of the facts or for failing to obtain an analysis from an independent source.\(^{171}\) In addition, NRSROs will be subject to “expert liability” with the nullification of Rule 436(g) which had provided an exemption for credit ratings by NRSROs from being considered part of the registration statement. In other
words, CRAs are no longer shielded as experts from liability for misleading statements in Registration Statements under Section 11 of the 1933 Securities Act.

6. **Reliance on Ratings**

    Dodd-Frank Act amends the Federal Deposit Insurance Act, the Federal Housing Enterprises Financial Safety and Soundness Act, the Investment Company Act, and the Securities Exchange Act by requiring the removal of regulatory references to credit ratings.\(^{172}\) Specifically, text containing the term “not of investment grade” must be replaced within existing federal regulatory statutes with the language: “that does not meet the standards of creditworthiness established by the Corporation.” The removal of references to credit ratings and credit quality ascertained from credit ratings is intended to reduce over-reliance on ratings and encourage investors to conduct their own analysis. Moreover, Dodd-Frank instructs the SEC to conduct further study on the feasibility of standardization.\(^{173}\)

**Issues**

    Commentators have identified several issues related to the failure on the part of CRAs to adequately assess risk. These issues include: 1) failures of the reputational capital model as applied to complex financial instruments; 2) regulatory dependence on the ratings; 3) lack of transparency regarding rating procedures and methodologies; 4) conflicts of interest arising from the business model of issuers paying the CRAs to rate debt instruments; and 5) lack of civil liability.\(^{174}\) Dodd-Frank, and subsequent SEC rules, has fashioned a public policy reform designed to address each of these issues. In this section, we will outline the issues related to CRA regulation, Dodd-Frank’s response and consider how well Dodd-Frank addresses each issue.
1. **Failure of the Reputational Capital Model**

   The importance of reputational capital has been recognized by economists as an effective motivation for ensuring that CRAs act in the best interest of market participants.\(^{175}\) Presumably, each CRA has a reservoir of reputational capital.\(^{176}\) CRAs are incentivized by the profit motivation to carefully evaluate and assign accurate ratings, because if they issue inaccurate ratings, investors will stop relying on those ratings, CRAs will lose business and ultimately will lose profits.\(^{177}\) It is theorized that CRAs would, for example, resist any pressures created by the conflicts of interest under the “issuer-pays” scheme of compensation, because otherwise they would lose the faith and trust of investors and ultimately their business. Hence, the long-term reputational benefits of issuing accurate ratings are thought to always outweigh the short-term benefits of inaccurate certification.\(^{178}\) Moreover, CRA motivation to maintain their reputation is seen as sufficient incentive to require due diligence and careful risk analysis.\(^{179}\)

   However, there is empirical evidence that the importance of reputational capital has been overstated.\(^{180}\) There are several reasons that might explain why reputation is not a sufficient regulator of CRA behavior. First, it has been argued that the economic incentives relied on as the foundation of the reputational capital theory are less important in an environment of regulatory dependence on CRAs. Given the high barriers to entry, the fact that there are relatively few certified agencies, and the fact that rating by a credit rating agency is required, the penalties for poor performance in terms of reputational damage are arguably slight.\(^{181}\) In other words, some argue investors, particularly mutual funds and other institutional investors who are statutorily required to purchase only investment grade issues, are not relying on ratings for their accuracy. In an environment shaped by regulatory dependence on ratings, the demand for ratings by a CRA is driven by the statutory mandate regardless of the reputation for accuracy of any
Under this view, CRAs serve as regulatory licenses rather than information intermediaries. If this is the case, the accuracy or inaccuracy of the ratings is largely irrelevant. Demand for the licenses will remain constant regardless of the accuracy of the ratings.183

Second, the reputational capital model ignores the differences between short term and long term incentives. The damages to reputation suffered from inaccurate ratings are long-term consequences. The short-term gains that can be made from such inaccurate ratings can overwhelm any long-term barriers to misbehavior.184 Some commentators have concluded that leading up to the GFC, “short-term competitive pressures and profitability outweighed the need for reputational protection, and the threat of reputational harm did not deter these rating agencies from engaging in a fly-by-night, race-to-the-bottom strategy regarding MBS credit enhancements. Rating agencies took full advantage of their reputational standing to engage in activities to derive short-term profits.”185

Third, the reputational capital theory is based on a belief that whether a CRA properly rates a particular issue will be known by the market, and that knowledge will affect its reputation. Some have argued that “reputational information markets may not work as perfectly as imagined”186 especially given the lack of transparency in the structured financial products market.187 Some argue that the market is not sensitive to inaccurate ratings by CRAs; others argue that given the fact that a rating is a prediction of an uncertain future, it is difficult to even gauge what an inaccurate rating might entail.188 Moreover, because many of the structured finance instruments being rated were novel, CRAs arguably did not have a reputation in rating such instruments. Without a reputation to damage by inaccurate ratings, the reputational capital theory fails to provide a sufficient incentive to guarantee accuracy.189 Moreover, failure to issue
accurate ratings in the structured finance market appears to have little effect on the overall CRA reputation.\textsuperscript{190}

Fourth, there are two different reputations that CRAs might want to protect. CRAs presumably wanted to protect their reputation as prudent, careful, diligent and accurate in assigning ratings. However, they might also wish to protect a reputation as “creative, inventive and problem solving.”\textsuperscript{191} Unfortunately, in the structured finance market, these two reputational objectives were in conflict.

Last, the reputational capital theory fails to recognize the fact that a reputation for accurate ratings (upon which investors can rely) means nothing if issuers fail to bring business to a CRA with a reputation for issuing low ratings. In other words, there are two reputations that matter here – one that investors can rely on in terms of the accuracy of the rating and one the issuers can rely on in selecting the CRA.

As we will discuss below, given the constraints in the market for structured financial products, reputational capital does not provide a sufficient incentive for accurate and unbiased ratings in the absence of regulatory mandates.\textsuperscript{192}

2. \textbf{Regulatory Dependence on Ratings}

Regulators began incorporating ratings into the regulatory scheme as early as the 1930’s.\textsuperscript{193} Over time, banks, insurance companies and pension funds were prohibited from purchasing securities carrying noninvestment grade ratings or those that were unrated.\textsuperscript{194} Gradually, an increasing number of regulations at both the state and federal levels provided favorable treatment to purchasers of highly rated securities. In 1975, the SEC approved the use of ratings by NRSROs as a basis for evaluating the quality of securities that broker-dealers used to satisfy capital requirements.\textsuperscript{195} Since then, other federal and state regulators have followed
suit by requiring NRSRO ratings.\textsuperscript{196} This has led to top-tier ratings being essential to the marketability of virtually every security.\textsuperscript{197}

Given the regulatory reliance on ratings issued by NRSROs, it is highly desirable for a CRA to gain NRSRO designation. This, however, not an easy process, and has resulted in a highly concentrated industry.\textsuperscript{198} At this point, there are only ten NRSROs.\textsuperscript{199} The concentrated nature of the industry has obviously affected the extent to which competition influences CRA behavior. Some have argued that “if there were more competition, rating agencies should be motivated to do a better job.”\textsuperscript{200} By contrast, some have noted that more competition would make CRAs more vulnerable to the competitive pressures of the issuer-pays model.\textsuperscript{201} Arguably, more agencies would allow increased ratings shopping which would, in turn, impose increased competitive pressures on CRAs.

Moreover, although there is a set of steps that the SEC staff will follow when they receive an application for NRSRO designation, there is no clear test to determine whether an agency is nationally recognized. The primary test applied is whether the agency is recognized “\textit{nationally by the predominant users of ratings in the United States as an issuer of credible and reliable ratings}.” This creates a “Catch-22” situation where an agency must be “nationally recognized” to qualify as an NRSRO, and must qualify as a NRSRO to become nationally recognized.\textsuperscript{202} Scholars have argued that specific guidelines and easily quantifiable requirements should be established.\textsuperscript{203}

Critics argue that with the regulatory reliance on NRSRO credit ratings, CRAs are able to generate revenue even when they perform poorly and even when the poor performance should reduce the reputational capital of the CRA. It is argued that ratings provide little or no informational value and instead serve only as a vehicle for obtaining favorable regulatory
treatment. In other words, the value of ratings is that they serve as a “key” to the gate which allows favorable treatment in the investors’ portfolios rather than a true measure of the value of the issue. This, coupled with the highly concentrated nature of the industry, means that there is little incentive to upgrade services, to hire the best analysts or to provide the best analysis. Hence, some commentators argue that regulators should abandon reliance on NRSROs and, instead, place the responsibility for judgments about the value and safety of the investment on the investing institution.

Evidence from the events that led up to the GFC seems to provide some support for this argument. The increased volume of structured finance products that needed to be rated led to an increase in CRA business. Unfortunately, this increased business meant that CRAs were rating a greater number of issuers and the resources devoted to each rating declined. There is evidence that CRAs were “cutting corners” and that the cursory overviews contributed to the inaccurate ratings assigned to MBSs during the years leading up to the GFC. Moreover, regulatory dependence on ratings might have led investors to rely too heavily on ratings as the sole measure of investment risk.

The issue of regulatory dependence on ratings has come to the forefront of public policy rhetoric as implementation of Dodd-Frank has begun, and has complicated attempts to regulate CRAs with any degree of rigor. By removing reference to ratings in regulations related to creditworthiness, Dodd-Frank takes an important first step in addressing issues related to CRA performance. Dodd-Frank addresses this issue in several ways. It has removed reference to ratings from several statutes that had included rating requirements. It accomplished this by amending statutes to substitute language requiring “investment grade” investments with language prohibiting the purchase of an issue “that does not meet the standards of creditworthiness
established by the Corporation.”\textsuperscript{211} This should reduce over-reliance on ratings and encourage investors, especially institutional investors, to conduct their own analysis. In addition, Dodd-Frank instructs each agency that administers rules or regulations to examine those regulations. Specifically, each agency is instructed to “remove any reference to or requirements of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate.”\textsuperscript{212} Hence, Dodd-Frank requires consideration of alternatives to credit rating regulation.\textsuperscript{213} Although analyzing specific alternatives is beyond the scope of this paper, policymakers must be careful as they chose alternatives to remember the function ideally served by ratings is two-fold. First, as discussed above, ratings address information asymmetry issues and encourage investment with minimal transactions costs. Second, and more importantly, for the purposes of this section, references to credit ratings were designed to control the safety of investments and, thus, the stability of the portfolio of investments of institutions with public trust, like banks, insurance companies, and pension funds. All such institutions are separately regulated and required to adopt safe and sound investment practices. As such, Dodd-Frank’s action in removing statutory language that explicitly limits purchases to investment grade issue and replacing it with a reminder that all purchases should meet certain tests of creditworthiness seems like sound public policy if we trust such institutions to maintain a sufficient “margin of safety.”\textsuperscript{214} Even if regulatory dependence is removed, ratings are such an “in grained” part of the financial system that there will likely be continued reliance on them as measures of credit-worthiness.

3. \textbf{Lack of Transparency}

Regulatory dependence on ratings is in marked contrast to the disclosures typically required under SEC regulation.\textsuperscript{215} In fact, the SEC has encouraged the use of ratings by
unregulated CRAs as a *surrogate* for the full disclosure that is normally required to ensure transparency. In other words, the credit ratings substitute for mandatory disclosures about the issue or the issuer. Recall, that CRAs are required to disclose general information about the methodologies used to rate offerings. However, they are not required to disclose the data underlying the statistical models and data entered into these models is typically private information the CRAs obtain from issuers. Hence, the lack of mandated disclosures by the issuer is problematic when coupled with a lack of disclosure by the CRA with respect to what information they rely on in determining their ratings. This leads to a lack of transparency which makes it impossible for the market and individual investors to understand the basis for the ratings.

CRAs have been criticized for a lack of transparency and this lack of transparency has been highlighted as a contributing factor in the GFC. It is argued that the lack of transparency, along with the complexity of the instruments involved, led to a level of “opaqueness [that] created huge information asymmetries and failures” and prevented the market from being able to effectively price and monitor derivatives. Therefore, the general question becomes whether credit ratings are an effective substitute for mandated full disclosure. If credit ratings are used instead of mandating full disclosure, what, if any, additional disclosures should be required?

There are two aspects of the lack of transparency. The first is a question of “methodological transparency.” In other words, how do CRAs assign the ratings that they assign? In part, the credit rating process lacks transparency because of the proprietary nature of the data and exact statistical models used to assess risk. The statistical models are proprietary and the CRARA actually prohibits the SEC from regulating any aspect of the rating process including the methods used by CRAs to rate securities. Moreover, CRAs do not disclose
specifics of the underlying data that they use as inputs to these models. Related to this is the fact that CRAs do not independently verify the information provided to them by the issuers and, in some cases have failed to perform even the bare essentials of due diligence. They then proceed to make all rating determinations in secret. The secretive nature of the evaluation process is arguably required because otherwise, competing CRAs would duplicate the CRA rating technology and methodology. However, because of the secretive nature of the evaluation process, it is difficult to independently evaluate the ratings themselves. This means that there is no real oversight of the CRAs and the methodologies employed in assigning their ratings.

The second issue is one of “performance methodology” or disclosure with respect to how well the CRAs have performed when rating issues. In other words, when relying on a CRA to rate an issue with any degree of confidence, it would be helpful to know the CRA’s track record. If a rating offers a prediction as to expected default, how often has this CRA been correct in the past when offering similar predictions? Dodd-Frank addresses both aspects of the transparency issue.

Dodd-Frank recognized that the lack of transparency was a major issue and has mandated certain disclosures related to methodology and performance. In this section, we will briefly discuss those mandates. Dodd-Frank imposes on the SEC an obligation to exercise its rulemaking authority to require disclosure of certain information related to rating determinations. The intent of these disclosures is to allow the “users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different” CRAs. While the specific content of the disclosures remains to be outlined in the rulemaking process, Dodd-Frank provides that the disclosures required must be comparable among CRAs, be “clear and informative”, include performance information over a wide range of years, be published and freely available.
and be appropriate to the CRA business model. Dodd-Frank instructs the SEC to temporarily suspend or permanently revoke the registration of an NRSRO if it finds that the NRSRO does not have sufficient resources to produce reliable ratings on a consistent basis. To determine whether the resources are sufficient, the SEC will consider whether or not the NRSRO has issued accurate ratings on a consistent basis. Here, Dodd-Frank emphasizes the importance of performance transparency.

Dodd-Frank does not entirely ignore, however, issues with respect to methodological transparency. It mandates that NRSROs disclose 1) the assumptions underlying the rating methodology; 2) the data that were relied upon to determine the credit rating; 3) how, and how often the NRSRO conducts surveillance of the credit rating; and 4) other information that can be used by users of the rating to better understand the rating. In addition, each NRSRO must disclose 1) assumptions used in constructing the models including assumptions about the “correlation of defaults across obligors used in rating structured products”; 2) the potential limitations of the ratings and the types of risk excluded from the rating, including market, liquidity and other risks; 3) information on the uncertainty of the rating, including information on the reliability and quality of the data relied on in determining the rating, any limits on the scope of historical data and any limits in accessibility to certain documents and other types of data that would have been informed the rating; 4) whether and to what extent third party due diligence services were used, a description of the information such party received and a description of the third party conclusions; 5) a description of the data about the issuer or instrument that were relied on; 6) a statement containing an overall assessment of the quality of the information available and considered in determining the rating; and 7) information related to conflicts of interest. In addition to the qualitative disclosures mandated, certain quantitative disclosures are set forth.
The NRSRO must include in its disclosures: 1) an explanation or measure of the potential volatility of the rating including any factor that might lead to a change in the rating and the magnitude of the change expected; 2) information on the content of the rating including the historical performance, the expected probability of default and the expected loss in the case of default; and 3) information on the sensitivity of the rating to the assumptions outlined. 233

Thus, in terms of methodological transparency, Dodd-Frank requires that the CRAs disclose information related to construction and application of the model, including assumptions, limitations and exclusions; Dodd-Frank requires that the CRAs disclose information about the underlying data, including what data was relied on, whether third-party due diligence was conducted and judgments about the quality of the data; Dodd-Frank requires disclosures about monitoring of the rating; Dodd-Frank requires disclosures about potential conflicts of interest. 234

Another issue related to methodological transparency concerns the question of due diligence. Recall that prior to the GFC, CRAs used quantitative models to rate the tranches marketed as structured financial instruments. The models themselves have been criticized as flawed. 235 Moreover, CRAs relied on the data supplied to them by issuers without performing independent due diligence to generate the ratings. 236 Hence, it has been alleged that CRA failure to perform this due diligence before assigning credit ratings was a contributing factor to the GFC. 237 There was no requirement of CRAs to perform due diligence; there was nothing that required them to verify the information provided to them by issuers or to verify that the issuers had performed due diligence. 238 This lack of regulatory protection is shocking. Dodd-Frank does not mandate due diligence, but it does mandate disclosure of any due diligence services obtained for asset-backed securities. 239 In addition, the SEC is charged with the responsibility of establishing an appropriate content and format for a written certification by the due diligence
service provider. The purpose of this certification is to “ensure that providers of due diligence services have conducted a thorough review of data, documentation, and other relevant information necessary” for the NRSRO to provide an accurate rating.240

One of the primary purposes of any mandated disclosures should be to allow transparency needed for proper valuation and risk assessment. There are limits, however, on what material can be required to be disclosed. There are dangers to regulations that would increase transparency. For example, it has been argued that mandating increased transparency would diminish the value of CRAs’ intellectual property, thus, discouraging innovation.241 We want issuers to make relevant, often confidential, information known to the CRAs.242 If we are over-inclusive with respect to what we mandate is disclosed, issuers might respond by withholding relevant, confidential information from CRAs. That would result in ratings that are less, rather than more, reliable. In addition, models are understandably proprietary. Again, if we mandate detailed disclosures of the models employed, we might discourage CRAs from spending time and money developing workable models. Moreover, arguments for increased disclosure are based on the premise that sophisticated investors need information so that they can judge the value of the rating and the value of the potential investment wisely. Given the complexity of structured financial instruments, it is, however, unlikely that even a reasonably prudent investor would be able to judge the risk and value of the investment. Recall that there is some evidence that even CRA analysts charged with rating the financial instruments involved in the GFC often failed to understand completely the nuances and risks involved. Somehow the disclosures required must, then, strike a balance between disclosures too detailed and difficult to understand and those so superficial as to be meaningless.
Some have argued that at a minimum, financial institutions should disclose to examiners Value-At-Risk (VAR) related measures, robust worst case estimates and stress tests. We believe that the following disclosures should be required. End-users need to know the pricing mechanism and inputs employed for valuation of the issue. Without knowing the pricing mechanisms adopted and the inputs employed the purchaser has no way to adequately value or assess the risks involved in the derivative. In addition, investors need to be able to obtain at least summary of the information used by CRAs in rating the issue. This would include information with respect to the type of loan level date relied upon. It appears that Dodd-Frank has mandated sufficient disclosures. By requiring disclosures concerning construction and application of the models as well as information related to the underlying data relied on, Dodd-Frank provides information to investors that should enable them to assess risk. The problems, of course, lie in implementation of these disclosure requirements. First, it is unclear how specific disclosures must be with respect to underlying data. Because of the proprietary nature of the underlying data, it is possible that requiring detailed data would mean that the issuer would withhold the data, making the ratings less reliable. This could be problematic. Second, given the complexity of structured finance instruments, it is plausible that investors will lack the ability to assess credit risk even with these disclosures.

4. **Conflict of Interest**

Recall that CRAs originally rated issuers on their ability to repay the debt at issue and were paid from investor subscriptions. This changed in the 1970’s as CRAs adopted an issuer-pays model which based CRA revenues on fees charged to the issuers of the securities that they rated. Today, CRAs receive between 90% and 95% of their annual revenues from issuer fees. Moreover, CRAs frequently offer issuers that they rate, ancillary services, such as
consulting and subscriptions to information services. The conflict of interest in such an arrangement is obvious. The issuers who pay the bills want credit ratings that are high; investors who rely on the ratings, but who do not pay for these ratings, want accurate ratings. Some have argued that these incentives create “an inherent tendency for optimism.” Based on the issuer-pays model, CRAs have a clear incentive to give their customers favorable ratings in order to generate additional revenue and little incentive to provide post-issuance monitoring and to downgrade securities when warranted. Some have characterized the CRA as a “watchdog paid by the persons they are to watch.”

The existence of a substantial degree of “rating shopping” supports this conclusion with respect to CRA incentives. Rating shopping occurs when the issuer “shops” its security to multiple CRAs and selects the CRA assigning the highest rating. In addition, the issuer-pays business model is potentially complicated by CRAs’ frequent practice of assigning unsolicited ratings. A rating is considered unsolicited when it is assigned by a CRA even though an issuer has not requested the rating. Unsolicited ratings are almost always lower than solicited ratings. Arguably unsolicited ratings are a means for CRAs to encourage issuers to hire them to assign solicited ratings which would then be higher than the unsolicited ratings. The fact that CRAs issue unsolicited ratings would potentially allow them to exert pressure on the issuers that do not pay them for credit ratings. Whether unsolicited ratings are actually used to exert such pressure is the subject of debate. However, it is clear that much like ratings shopping, this practice makes the validity of the ratings assigned questionable because the impression is created that favorable solicited ratings are for sale.

Regardless of potential conflicts, CRAs have seen their business become exponentially more profitable under the issuer-pays model. Moreover, there is empirical evidence that ratings
have risen in general since the switch from the subscription model to the issuer-pays model, and evidence that some CRAs changed ratings in response to pressure from issuers. This supports a conclusion that the conflicts of interest inherent in the issuer-pays model undermine rating reliability.

On the other hand, CRAs and some commentators have disputed the fact that the conflicts of interest outlined above fatally compromise the independence and integrity of the ratings. There is some empirical support for this viewpoint. Proponents of this view assert that no one suggests that CRAs have rated traditional bonds more highly in response to issuer pressure. Yet, the conflicts argument applies to traditional bonds equally; CRAs could not operate without a reputation for independence and that they are careful not to damage that reputation. Fees from one issuer and one rating would be an insignificant contribution to revenue and, therefore, would never provide sufficient incentives for a CRA to risk the damage to its reputation that would result from intentionally over-rating the issue. Interestingly enough, the fact that the credit rating agency market is so concentrated actually supports this argument. Given the practice of obtaining at least two ratings, and the fact that Moody’s and Standard & Poor’s control such a substantial portion of the market, the threat by an issuer to withhold its business if not given a high rating is just not credible.

Similarly, it has been argued that the issues and issuers rated are relatively transparent so that ratings that were unreasonably high would be noticed and the reputation of the agency issuing the high ratings would be damaged irreparably. Moreover, some commentators argue that CRAs are not unduly influenced to give high ratings by their desire to sell their ancillary products. CRAs earn substantial profits from issuing ratings and their focus on ancillary products has, in fact, been ancillary to their main business. Thus, where accounting firms were
susceptible to pressure with respect to their audits in a desire to sell consulting services, CRAs do not face similar pressures.\textsuperscript{264}

Last, the compensation structure for executives within CRAs typically does not reward an executive for client retention or for the amount of business obtained.\textsuperscript{265} In fact, most CRAs have strict guidelines applicable to analyst compensation and have installed firewalls between those employees rating issues and those compensated by selling CRA services, attracting or retaining business.\textsuperscript{266}

It is generally accepted, however, that problems related to conflicts of interest are exacerbated in the case of structured finance products such as CDOs.\textsuperscript{267} In other words, pressures to “over-rate” the issue are more intense in the case of structured products. In the case of corporate bonds, for example, the pressure of any single issuer on a CRA is minimal. There are thousands of bond issuers\textsuperscript{268} and the loss of business from any single issuer would have a miniscule effect on the revenue of a CRA.\textsuperscript{269} By contrast, there were only a few major investment banks in the business of assembling and selling MBSs and derivatives\textsuperscript{270} and those few major players brought deals to the CRAs on a monthly basis.\textsuperscript{271} Losing the business of one of these investment banking firms would have had a substantial impact on the CRAs revenue especially considering the percentage of revenue attributed to rating of such instruments.\textsuperscript{272}

Moreover, issuers of CDOs generate much higher fees than corporate clients and as such have “much more leverage to use in an effort to force rating agencies to issue the ratings they desire[d]”.\textsuperscript{273} In fact, in the case of CDOs, a single investment bank can generate up to 10% of a credit rating agency’s structured finance revenues.\textsuperscript{274} In addition, although there appears to be little competitive incentive to overrate to obtain business in traditional markets, some commentators have argued that competition among CRAs encourages overrating in new markets,
such as in the case of structured financial instruments. In addition, the process by which ratings are assigned to structured finance products allows for greater influence to be exerted. Recall, that it is not unusual for the rating firm to advise the issuer on the structure of the product so as to allow the rating desired. During this back and forth negotiation, it is easy for the issuer to threaten to remove its business if the desired rating is not granted. Last, because the volume of debt issued in asset-based securitizations has grown exponentially in the last fifteen years, these pressures are significant.

There is at least anecdotal evidence that conflicts of interest influenced CRA behavior and contributed to the lack of reliable ratings leading up to the GFC. Ratings shopping was a common occurrence in the CDO market prior to the GFC. In addition, there is evidence that leading up to the GFC, CRAs frequently made adjustments and issued higher ratings than dictated by even their outdated statistical models. Some have argued that CRAs “deliberately underestimated the risks of mortgage backed securities in pursuit of their own self interests and to the detriment of investors, and ultimately the market.” According to a Moody’s managing director, “[t]hese errors made us look either incompetent at credit analysis or like we sold our soul to the devil for revenue, or a little of both.”

Arguments discounting the effect of conflicts of interest ignore, for the most part, the differences between the traditional market and the market for structured securities. First, recall that the two ratings norm applies to traditional offerings. This practice was not, however, generally followed in the case of specialized structured finance instruments. Second, the potential for “repeat business” is stronger in the case of structured finance than for traditional offerings. Third, the percentage of revenue and the potential for ancillary services, such as consulting to create and structure the instrument, are much higher in the case of structured
finance than in traditional markets. Fourth, the structured financial instruments that were involved in the GFC were complex and opaque rather than simple and transparent.\textsuperscript{284} This reduces the impact on reputation from overrating the security and, thus, mitigates application of the reputational capital theory.

Whether or not Dodd-Frank and SEC rules sufficiently address these differences is doubtful. Current SEC policy requires that NRSROs “establish, maintain and enforce policies and procedures reasonably designed to address and manage conflicts of interest,”\textsuperscript{285} but continues to allow the issuer-pays model which is fraught with conflicts of interest. The SEC has promulgated rules which expressly prohibit NRSRO employees from being involved both in fee discussions and ratings decisions and prohibit a CRA from being involved in the creation of the same structured product that it rates.\textsuperscript{286} Clearly, these rules were inadequate to prevent the role of conflicts in the GFC. Dodd-Frank attempts to buttress these rules addressing conflicts by being premised on the belief that “[i]n certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored.…”\textsuperscript{287} Dodd-Frank leaves unchanged the issuer pays model, but imposes additional requirements on the SEC and on NRSROs. First, Dodd-Frank imposes on the SEC a responsibility to promulgate “rules to prevent the sales and marketing considerations of a nationally recognized statistical rating organization from influencing the production of ratings…”\textsuperscript{288} It expressly prohibits CRA compliance officers from working on ratings, methodologies, or sales. In addition, it requires NRSROs to employ a one-year look-back review when a NRSRO employee leaves the NRSRO and goes to work for an obligor or underwriter of a security or instrument subject to rating by the CRA. Significant penalties are imposed for violations.
The SEC has already proposed rules that attempt to implement the mandates of Dodd-Frank. First, the proposed rules would amend the NRSRO conflict of interest Rule 17g-5 (c) which currently prohibits a person within an NRSRO from having a conflict relating to the issuance or maintenance of a credit rating. The proposed rule would expressly prohibit conflicts where a person within a NRSRO participates in sales or marketing of a product, and in determining the credit rating or developing processes or methods used in determining the credit rating. These rules are designed to address concerns about situations where individuals involved in marketing have the ability to influence the ratings assigned.289

Existing SEC rules attempt to manage conflicts of interest by a disclosure model. In other words, the CRARA requires that NRSROs disclose any potential conflicts of interest.290 In theory, if potential conflicts are disclosed investors can choose for themselves what value to place on the credit rating.291 There are questions, however, about the extent to which investors are able to evaluate the risks posed by the conflicts of interest disclosed and, more importantly, the extent to which the issuer-pays model creates inherent conflicts that are not disclosed.292

The SEC has also attempted to address the conflicts of interest by promoting competition within the CRA industry. Specifically, Rule 17g-5(a)(3) encourages NRSROs not retained by an arranger of a debt issue to provide an unsolicited rating of an issue based on information made available by the arranger on a website. With increased competition, the thought is that credit ratings will be more accurate. However, Rule 17g-5(a)(3) does not address the “issuer-pays” business model and the likelihood of an NRSRO issuing an unsolicited rating is small unless the NRSRO sees a great potential for future fee paying business. Moreover, to attract future fee paying business, some analysts argue that the problem of assigning overly optimistic ratings will be exacerbated.
The proposed rules are laudable first steps. For example, clearly the same people should not be allowed to market credit rating services to issuers and then rate those same products. However, the effectiveness of such firewalls has been questioned in the past. More importantly, the rules fail to address satisfactorily the underlying conflicts. The rules state that the addition of references to methodologies was meant to address a situation where “employees responsible for obtaining ratings business would notify other employees, including those responsible for criteria development, about business concerns they had related to the criteria.” It is, however, unclear how these rules would prevent that exact occurrence. Moreover, it is more likely that such notifications would not even be needed or explicit. In other words, in a situation where the analyst knows that firm success depends upon a high rating, rather than an accurate one, the firewall is unnecessary and wholly ineffective. More importantly, the proposed rules seem to focus on conflicts of interest at the individual analyst level and ignore conflicts of interest at the agency level.

Hence, the question becomes whether CRAs should be permitted to continue with the issuer–pays business model or whether it creates insurmountable conflicts of interest that undermine the integrity of the ratings assigned. Commentators have offered several alternatives. In spite of the problems with the issuer-pays model, few seriously suggest returning to the days of subscription credit rating services. The fact that any information provided by credit rating agencies would be freely available poses a serious obstacle to mandating that payment model. There are other solutions, however, proposed as alternatives to mandated disclosure-based regulations. Some commentators have proposed 1) “performance-based sanctions;” 2) increased ex ante disclosures about conflicts of interest; 3) credit ratings paid for by the general public; 4) eliminating the use of rating dependent regulation; and 5) increased civil
liability. Others have suggested that credit ratings perform a quasi-governmental task, benefitting the economy and, as such, should be generated and paid for by the general public.299

5. Lack of Civil Liability

Recall that plaintiffs have rarely, if ever, been successful in attaching civil liability to CRAs for faulty credit ratings. Statutory liability has been difficult because of exemptions built into security laws that protect CRAs. Common law liability has largely been unsuccessful because of First Amendment immunity. Dodd-Frank changes this in some significant ways. It is based on the premise that CRAs perform essential gatekeeper functions that are “fundamentally commercial in nature and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers.”300 This basic premise is clearly set forth in the Statute:

“(1) IN GENERAL. – The enforcement and penalty provisions of this title shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws….”301

Hence, the provisions that provided protection to CRAs from Section 11 liability for misstatements in the registration statements and prospectuses have been removed. This is a significant change from prior law. While a detailed discussion of Section 11 is outside the scope of this article, Section 11 imposes a liability that in the case of experts can only be overcome by a showing that the expert met its due diligence requirement. An expert can meet its due diligence defense by showing that it “had, after reasonable investigation, reasonable ground to believe and did believe” that there were no misstatements or omissions of material facts in the portions of the
In the case of experts, like accountants and now CRAs, this means that the expert must demonstrate that it made a reasonable investigation and that based on that investigation it had reasonable grounds to believe that the statements made were true.  

Moreover, Section 933 of Dodd-Frank amends the State of Mind requirement of Section 21D of the Securities Exchange Act of 1934 to specifically address CRA liability. Section 21D applies to securities fraud actions. In Subsection (2), the statute outlines the requisite state of mind of a defendant in a fraud action based on materially misleading statements. In such a case, the plaintiff typically must allege that the defendant acted with a “particular state of mind.” Dodd-Frank provides for an inference to satisfy this state of mind in the case of CRAs. Subsection (2) provides that the state of mind requirement can be met by a pleading that the CRA recklessly or knowingly failed to conduct a reasonable investigation or failed to obtain a reasonable verification of facts provided by third parties.

There are several issues with respect to civil liability of CRAs that must be considered. Most notably, Dodd-Frank creates a private cause of action based on inaccurate ratings in certain circumstances. Under Dodd-Frank, CRAs face possible liability for misstatements in the registration statement, subject to the due diligence defense applicable to all experts; plaintiffs can meet the scienter requirement necessary to prove a cause of action for securities fraud by proving that the CRA acted recklessly or “knowingly” failed to conduct a “reasonable” investigation.” Hence, the first question concerns what standard of liability is imposed and whether this is the appropriate standard. There are three choices as to the appropriate liability standard: strict liability, negligence or an intentional standard. By attaching liability to CRAs under Section 11, Dodd-Frank has adopted a negligence standard (the due diligence standard applicable for Section
11 liability). Scholars have long debated whether public policy objectives with respect to gatekeeper behavior, like CRAs, are best served by negligence or strict liability standards. Some have argued that strict liability is a better way to regulate gatekeeper behavior. Others have argued that imposing strict liability on gatekeepers, such as CRAs, is not the best public policy choice, advocating either a negligence or knowledge-based standard. The debate around the appropriate standard surrounds the relative costs and merits of the strict liability approach. Strict liability is thought to be advantageous because it 1) provides incentives for gatekeepers to exercise due care; and 2) relieves the judicial system of the burden of determining what is “reasonable care” in each case and, thus, eliminates administrative costs. On the other hand, some fear that strict liability might lead to excessive deterrence which would in fact drive CRAs from the market.

There are clear advantages to a strict liability standard. It would make liability certain in the case of inaccurate ratings. It would remove the burden of proving breach of due care from plaintiffs seeking relief, and provide incentives to CRAs to issue accurate ratings. Nevertheless, Dodd-Frank has adopted a negligence standard and we support that decision for a number of reasons. First, imposition of a negligence standard is consistent with the negligence standard imposed on other gatekeepers and experts in Section 11. There are no persuasive public policy rationales for treating CRAs differently from other gatekeepers or to impose a higher standard. Second, concerns about imposing undue recordkeeping requirements on CRAs are exaggerated. Any additional documentation needed to prove reasonable care would be minimal. CRAs are already required to gather and maintain most of the information under the CRARA or under other provisions of Dodd-Frank. Third, at the same time as Dodd-Frank imposes a negligence standard by way of Section 11 liability, it lessens the scienter standard from intentional
wrongdoing to “reckless and knowing” under Section 21D. While most attention has focused on the imposition of §11 liability, this section certainly makes it easier for a plaintiff to attach liability to a CRA under the anti-fraud provisions and, as such, is a significant deterrent to CRA misconduct.

The question also arises as to whether the First Amendment would, and should, provide a defense to liability. Dodd-Frank imposes liability in fraud cases against CRAs in a situations where they “recklessly or knowingly” fail to conduct a reasonable investigation and in Section 11 cases where they fail to meet the due diligence standard. The extent to which this imposition of liability would withstand a First Amendment challenge is unclear. No case thus far has discussed the extent to which First Amendment protections would apply to securities regulations, but the First Amendment is clear that “Congress shall make no law ... abridging the freedom of speech, or of the press.” (emphasis added). It seems likely, however, that in the case of securities fraud if a plaintiff can prove “reckless or knowing” breaches of CRA defendant behavior, the plaintiff could prove the actual malice needed to overcome the privilege. In such situations, plaintiffs would be successful under common law provisions, under current law and the statutory provision just adds one more weapon in the already existing arsenal. In case of Section 11 liability it appears likely that, under the Abu Dhabi line of cases, plaintiffs could also withstand the First Amendment challenge at least in the type of cases that formed the basis for the GFC. Recall that courts have traditionally granted CRAs limited immunity based on belief that ratings are akin to editorials and that CRAs, as the “authors” of ratings are performing an essentially journalistic function by reporting the ratings. Recent courts (and commentators) have, however, been reluctant to apply First Amendment protection to CRAs when conflicts of interest have influenced the rating. As is discussed above, conflicts are inherent with the issuer-
pays model and played a role in rating structured finance instruments leading up to the GFC. The kinds of things that courts have focused on (e.g., was the CRA involved in structuring the deal? Was the CRA only paid if the rating was used?;) are all applicable in the issues involved in the GFC. The conflicts of interest make it difficult for CRAs to argue persuasively that they are akin to independent, unbiased journalists deserving of First Amendment protection.312

Moreover, the foregoing discussion begs the question of whether increased liability is desirable. Those who oppose the imposition of increased civil liability argue first, that increased liability will inevitably lead to increased costs in terms of monitoring and recordkeeping by CRAs. These costs, along with the costs of any judgments, will, of course, be passed on to the issuers leading to an increased cost of ratings.313 Thus, exposing CRAs to liability for negligence would financially cripple CRAs and, given the regulatory requirements discussed above, would in turn cripple the economy. Second, opponents argue that the increased scrutiny required to meet the negligence test will require more time. Under this line of reasoning, it is argued that CRAs will delay issuing ratings, as they spend more time and effort preparing ratings, all to avoid potential liability.314 Even if this is true, encouraging more time and care in issuing ratings is a laudable goal. There is clear evidence that in the time leading up to the GFC, CRAs did not spend the appropriate amount of time evaluating the complex instruments that they rated. Some have argued, however, that one of the benefits of the status quo is dissemination of credit risk information quickly.315 Third, some have argued that any movement to allow increased civil liability has the potential to lead to an increase in frivolous lawsuits.316 This argument is, however, too simplistic and ignores the fact that merely eliminating the protection imposed on Section 11 liability, or changing the scienter requirement for securities fraud would not mean victory for every disappointed investor. Any potential plaintiff would still have to
prove that the CRAs’ statements were materially misleading in light of the information available to the CRA using due diligence or, in the case of securities fraud, would still have to prove that CRAs acted either recklessly or with knowledge of wrongdoing.317

The road implementing these provisions has not been a smooth one and that difficulty highlights another problem with imposing civil liability upon CRAs. The 1933 Act provides that an expert has liability under Section 11 only if it consents for its expert opinions to be part of the registration statement.318 Almost instantly after Dodd-Frank was signed, CRAs began withholding this permission.319 As a result, the market for asset-backed securities was sent into gridlock. The SEC issued a no-action letter which applied until January 24, 2011 and was then extended indefinitely.320 That is the short run. In the long-run, what are likely to be the effects of increased exposure to civil liability? Some CRAs have begun to include indemnification clauses in their contracts with issuers.321 While indemnification clauses operate as a way to shift liability away from CRAs and onto the issuers, this is not necessarily a bad thing. It might mean CRAs will at least be careful to select issuers that they believe will be solvent in the event of a civil suit.

As this section has shown, Dodd-Frank considered CRAs’ role in the GFC and addressed the issues presented by their actions in a comprehensive manner. Moreover, subsequent SEC action taken as part of their rulemaking authority has supplemented the provisions of Dodd-Frank. In this section, we have analyzed those provisions as they relate to five crucial issues. We concluded that the rules proposed by the SEC relating to regulatory dependence on ratings must be promulgated, and approve of eliminating regulatory licenses; we approved of the actions related to lack of transparency. Moreover, we approve of the imposition of civil liability on CRAs and believe that at this point the appropriate standard imposed should be the negligence
standard included in Dodd-Frank. Unfortunately, we also argued that Dodd-Frank’s treatment of the conflicts of interest issue is wanting. We believe that problems created by the issuer-pays model are fatal and intractable, and that any reform that fails to address these concerns is inadequate. In the next section, we will propose more comprehensive reform that addresses the conflicts problem.

PART IV: A CALL FOR INCREASED REGULATION

The perfect storm of disaster that led to the GFC has been characterized as a “dual failure of market discipline and government supervision.”322 It is interesting to note that the GFC is not the first time in recent years that attention has turned to CRAs in wake of a scandal. CRAs were criticized during the Asian crisis for maintaining an investment grade rating on Thailand until five months after the crisis began. In another example, following the collapse of Enron, it was widely believed that CRAs failed to adequately assess the risk.323 However, while Sarbanes-Oxley placed additional regulatory requirements on corporations and accounting firms, and charged the SEC with studying the function and role of CRAs,324 the operation of CRAs was largely unchanged. Without CRAs, the information asymmetry problems involved in marketing securities, particularly complex securities, would be exacerbated and the costs to the market would be unacceptable. Because of this, CRAs serve an important public policy function that justifies governmental involvement. At the same time, however, any proposed public policy response must be carefully tailored so as not to interfere with the smooth functioning of capital markets. In the previous section, we considered specific issues related to CRA performance and how Dodd-Frank addresses those concerns. Here, we will take that analysis a step further by offering a comprehensive proposal for reform. This section will first consider the broad question
of whether governmental regulation of CRAs would be beneficial. After we conclude that increased governmental regulation is appropriate, we will offer some specific suggestions.

To Regulate or Not to Regulate

In this section, we will consider the broad question of whether or not increased regulation of CRAs is desirable. Specifically, we will consider three approaches: 1) the market (or no governmental regulation); 2) the self-regulatory model; and 3) increased governmental regulation.

1. The Market

Some have argued that less regulation, rather than more, is the appropriate response to the criticisms of CRA behavior. Under this view, there is no need for governmental regulation. Opponents of government regulation favor letting market forces police improprieties associated with CRA behavior and further argue that any increased regulation will exacerbate problems with CRAs. The most notable of the proponents of “market” regulation is Lawrence White. Professor White asserts that any proposals for increased regulation are misguided “political urges” that “ignore seven decades of history of the prudential regulation of financial institutions’ bond holdings.” White argues that increased regulation of the CRAs would do more harm than good and contends that increased regulation would reduce competition within the CRA industry and only serve to protect the existing CRAs and elevate their importance. White also maintains that increased regulation would create a rigid operating environment and discourage the innovation which could lead to better ways of producing analyses regarding credit and information. Hence, the sum and substance of this argument is that, first, increased regulation is unnecessary and that, second, it would impose additional costs that would be detrimental to the smooth functioning of the market.
Proponents of the market approach argue that increased regulation is unlikely to make ratings more accurate. They point to the “remarkable track record of success” in accurate ratings and credit reputational incentives with incentivizing these accurate ratings. They dismiss concerns about conflicts of interest and assert that the issuer-pays models “opened the door to the possibilities of conflicts of interest” that “did not become actualities” in the first thirty years of the model; they argue that regulation actually exacerbates problems with CRAs.

For example, placing increased regulation on NRSROs would raise the cost of being a NRSRO and, in effect, provide additional barriers to entry in an already concentrated industry. Moreover, increased regulation would impose increased costs on issuers and could, thus, discourage issuers from obtaining multiple ratings. This would, it is argued, lead to less reliable, rather than more reliable, ratings. Proponents of the market view are also adherents of the reputational capital model. In other words, they see no need for regulation because CRAs are adequately deterred from poor behavior by the fear of the damage to their reputation that would result from such behavior. While admitting that the model did break down during the GFC, they characterize the call for increased regulation as the “politically obvious one” and, instead, issue a call for less regulation.

In this article, we argue for increased regulation of CRAs, rejecting both the market approach and the reputational capital model as they pertain to the type of structured financial products that were involved in the GFC. While we are tempted to argue that the reputational capital model is inherently flawed, such an argument is not necessary for this article. As was discussed above, there are significant differences between reputational capital, as it pertains to the traditional bond market and the structured financial products market. Because of those differences, regulation is needed at least as it pertains to structured finance. Moreover, there are
risks in failing to regulate, including the risk of systemic failure of the financial markets and misallocation of capital within the economy.

2. **Self-regulatory model**

   An alternative to the “do nothing” or “market” approach outlined above is a self-regulatory model. Although deemed “not politically popular,” some scholars believe that Congress should facilitate the establishment of a self-regulatory organizational scheme, perhaps along the lines of the Financial Industry Regulatory Authority (FINRA). One scholar argues that the circumstances are conducive to effective self-regulation. The self-regulatory model is seen as advantageous over governmental regulation by those who fear that given the complexity of financial products and activities, governmental legislation and rulemaking will inevitably encourage innovation designed to get around those regulations. This, it is argued, would lead to an inevitable cycle of rulemaking, innovation, followed by more rulemaking.

   Those who favor the self-regulatory model assert that “the government should not be in the business of acting as an NRSRO, and trying to dictate the daily work of the rating agencies would be fiscally and politically irresponsible.” Clearly, the government should not be in the business of acting as a NRSRO. That, however, is not the issue. An argument in favor of self-regulation ignores the mixed record of SROs in general and the FINRA specifically. Commentators have debated the viability of the SRO model in the financial area for years. Moreover, financial economists have demonstrated that self-regulation of an industry requires two necessary elements. One is a competitive industry and the other is the ability for competitors to easily enter the market. As previously noted earlier, the credit rating industry is essentially an oligopoly of three. Additionally, it is difficult for a firm to obtain NRSRO designation due to the way the designation is defined. Ultimately, both of the elements for
successful self-regulation are lacking in the credit rating industry.\textsuperscript{342} Hence, the effectiveness of the model of self-regulation within the CRA industry is questionable.\textsuperscript{343}

3. **Increased governmental regulation**

Hence, we believe that neither the market approach nor a model based on self-regulation provide sufficient incentives for CRA behavior and instead believe that the government should be involved in ongoing monitoring of CRAs.

**A Model for CRA Regulation**

Following crises, it is common for public policy decision-makers to move quickly to reform. To some extent, Dodd-Frank is an example of that reform. Moreover, recent public backlash against CRAs following Standard & Poor’s downgrade of the United States has led to more calls for reform. We must be careful, however, to avoid “knee-jerk” public policy responses and to, instead, consider well reasoned policy proposals. As this article has demonstrated, there are several separate but related issues relevant to CRA behavior as a contributing factor to the GFC. Any public policy proposal must attempt to address all of these interrelated issues, or it will be ineffective, or perhaps even worsen the situation. Moreover, any effective public policy must recognize the global implications of its implementation.\textsuperscript{344}

It has been asserted that the effectiveness of any CRA reform should be measured by how well it meets three objectives. First, does it increase the reliability and accuracy of ratings, particularly with respect to structured financial instruments? Second, does it increase competition within the market and decrease incentives for behaviors fraught with conflicts of interest? Third, does it enhance market transparency and allow investors ease in conducting independent due diligence?\textsuperscript{345} A fourth relevant criterion would question the cost of these enhancements. In other words, there are inevitable costs of regulation. Are the costs of reform
outweighed by the benefits? In this section, we will consider the actual costs imposed by regulation, including administrative and enforcement costs. In addition, we will consider “costs” in terms of the negative consequences of the regulation. In considering these costs, we will attempt to be cognizant of the role that CRAs play in the global economy.\textsuperscript{346} We offer the following suggestions. For each proposal advocated, we will consider how well it meets the objectives discussed above and outlined in Table 1.

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<th>Proposed Reform</th>
<th>Increased accuracy of ratings</th>
<th>Increased competition and decreased conflicts of interest</th>
<th>Enhanced transparency</th>
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<td>Eliminate Issuer Pays</td>
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As discussed, Dodd-Frank has offered a regulatory response to the various and complex issues related to CRA behavior. In the previous section, we examined each issue, outlined Dodd-Frank’s approach and attempted to analyze the statutory response. We approved of Dodd-Frank’s elimination of the regulatory dependence on ratings and have urged administrative agencies responsible for formulating alternatives to consider policy that will assure safety and soundness to the extent possible. We applauded Dodd-Frank’s approach to increased transparency and look forward to seeing the specifics. In addition, we approved of the civil liability scheme created by Dodd-Frank. There is, however, room for improvement. In this section, we propose comprehensive reform designed to supplement the provisions of Dodd-Frank. There are three essential features to this reform. First, we propose a single regulator within the SEC, with increased enforcement powers charged with the responsibility of
monitoring CRAs. Second, we propose that the issuer pays model be abandoned and replaced with a “fee from proceeds” model. Third, we see the potential for increased civil liability as a crucial aspect of regulatory reform.

1. The SEC as the Regulator of CRAs

Section 932 of Dodd-Frank establishes the Office within the SEC with the intent of giving the SEC strong regulatory authority over CRAs. Moreover, Dodd-Frank charged the SEC with the task of conducting an investigation to pinpoint which behaviors of CRAs may have caused or exacerbated the GFC. Upon completion of the study, the SEC was to engage in rulemaking designed to eliminate improprieties of the CRAs and make financial markets safer. Although the SEC has produced this report and has initiated the rulemaking process, the Office within the SEC has not yet been established. We believe establishment of the Office is imperative and critical to restoring the integrity of credit ratings.347 Moreover, it is critical that adequate resources be allocated to allow the Office to fulfill its statutory mandate, to engage in rulemaking and monitoring of CRAs.

Recall that the purpose of the Office is threefold. One, the Office of Credit Ratings is responsible for protecting users of credit ratings and the public interest. Two, the Office is responsible for promoting accuracy of the ratings assigned by NRSROs, and three, the Office is supposed to ensure that ratings are not influenced by conflicts of interest inherent in the CRAs’ business model. Moreover, the Office is mandated to conduct annual examinations of the CRAs with an NRSRO designation and summarize its findings in a publicly available annual report.

As we advocate for increased regulation of CRAs, we believe that an essential component of regulatory monitoring of CRAs should be an annual examination by Federal regulators. This annual review would allow identification of potential problems at an early date and provide an
opportunity to address potential problems before there is a disastrous impact.\textsuperscript{348} Part of the annual regulatory exam should address the CRAs ability to monitor and review the ratings of the issuers they rate. One of the issues identified following the GFC was that the CRAs have difficulty conducting an ongoing review of the hundreds of thousands of ratings they have assigned because they are understaffed.\textsuperscript{349} An adequate number of well-trained ratings analysts are necessary for ensuring that the CRAs can monitor and review ratings after they have been assigned.\textsuperscript{350} Hence, we recommend that one component of the annual examination be that regulators consider the volume of ratings that have been assigned by CRAs relative to the number of analysts employed, determine a minimum ratio of analysts to ratings needed, and require CRAs to meet the ratio.

Any analysis of the effect of the Office would be speculative and could be dependent on the specific rules relative to CRAs promulgated by the SEC. However, based on the SEC’s longstanding experience in serving as a watchdog for the financial markets and the intent of the Office specified in Dodd Frank, we would expect that placing the CRAs under the direct regulation of the SEC would produce positive benefits to the financial markets, and in particular to the fixed income sectors. The SEC as the primary regulator of the CRAs would mean that there is a regulator that could intervene and reign in the excessive power and alleged abuses of CRAs.\textsuperscript{351} As such, there is potential for increased accuracy of ratings, increased competition and increased transparency. Moreover, the SEC is the ideal choice because the SEC has regulatory purview over U.S. financial markets and participants, and therefore is in a good position to analyze the full potential impact of rulemaking applied to CRAs. Financial markets are increasingly integrated and complex and we often see contagion effects across markets stemming from problems originating in a single market. Hence, placing the CRAs under the SEC’s
regulatory umbrella may improve the stability of markets and reduce the impact of contagion effects throughout the financial marketplace on both the domestic and international levels. The establishment of the SEC as the primary regulator of CRAs would be costly; however, we estimate it would be a significantly lower cost than that of the GFC.

2. **Eliminate the Conflicts of Interest**

   The issuer-pays business model is the present business model utilized by CRAs and it is wrought with conflicts of interest. Mere tinkering with the current business model will not effectively address the intractable conflicts of interest arising from the issuer-pays model. Therefore, we believe the existing business model of CRAs has to be dramatically changed as an important component of any regulatory reform for such reform to be effective and offer the following proposal.

   First, it is essential that there be a separation within the CRAs of ratings services and “Other” services. The conflict of interest concern discussed above is exacerbated by the fact that CRAs’ revenue is produced by advisory services to issuers, as well as from ratings analyses and assignments. There have been many documented instances where CRA staff has been involved in advising issuers as to how to structure a planned debt issue and then the same rating agency has been involved in assigning the credit rating on the deal. Issuers know that the marketability of their debt will depend on the rating assigned by the CRA. It is possible for issuers to structure a deal with the objective of achieving a particular rating and heed the advice of the CRA staff in exchange for obtaining the desired rating. Moreover, should the desired rating not be obtained after implementing the advice of the CRAs’ advisors, issuers can threaten to go elsewhere to attempt to obtain their desired rating. Also, CRA personnel involved in ratings estimation may feel obligated to assign the rating sought by an issuer, even if new information that would result
in a lower rating, is made available. Hence, there is almost irresistible temptation provided for CRA advisory staff to strongly encourage CRA ratings staff to assign a particular rating based on the advisory services that have been provided to issuers.

To eliminate the intermingling of advisory services and ratings assignments, regulators must require CRAs to separate their ratings services from their other lines of business.\textsuperscript{352} This would improve the ratings accuracy because there would be no pressure to assign a particular rating to a particular issue. To eliminate the conflict of interest and increase the integrity of ratings, CRA staff in the “other services” unit must not be involved in the ratings analysis performed by the staff in the ratings services unit. There is a precedent for the business line separation we are advocating for credit rating agencies. Specifically, this separation is analogous to the separation of investment and commercial banking under the Glass-Steagall Act and the separation of auditing and consulting services of accounting firms following the Enron debacle.

By forcing the credit rating business to be separate from the other advisory activities, ratings would be more accurate because the potential for contamination of relevant information from advisory services would be reduced. Moreover, the separation of the ratings services and the other advisory activities would be an effective way to eliminate the numerous potential conflicts of interest that arise with the intermingling of all the business units.

However, the separation of ratings services and other lines of business is a necessary but not sufficient means to address the conflicts of interest concern. Even with the business line separation, the issuer-pay model as it is currently practiced offers intractable conflicts of interest. Therefore, we propose replacing the “issuer-pays” model with a “fee from proceeds” model\textsuperscript{353} under which CRAs are compensated from the proceeds of the bond deal.
Under a “fee from proceeds” model, the cost for initial ratings would be based on a fee assessed on new issues. Specifically, we propose that the fee for the initial credit rating would be determined as a percentage of the total dollar value of the new debt issue. For example, if the new debt issue totaled $30 million and the fee of .5% was applied, the fee for the initial rating would be $150,000. This $150,000 fee would be split between the issuer and the investors on a per bond basis. In addition, a similar percentage fee would be levied on secondary market transactions and paid by investors at the time of the transaction to compensate CRAs for ongoing reviews of the initial rating assigned. By explicitly providing for compensation for ongoing ratings reviews during the life of outstanding debt issues, CRAs should be incentivized to improve their ongoing ratings review. Our “fee from proceeds” compensation model differs from the issuer-pays model because both issuers and investors would be paying the initial ratings fee for a given bond issue. Moreover, because investors would be paying the fee for the ongoing ratings review in the secondary market, CRAs would become more accountable to investors who are the end users of credit rating information.

To facilitate the “fee from proceeds” model, we propose that a U.S. Credit Ratings Fund be established. We believe the U.S. Credit Ratings Fund should be overseen by the Office established within the SEC. The ratings fees collected at the time of new debt issuances and as part of the ongoing ratings review process would be deposited in the ratings fund and payments would be disbursed from the fund to the CRAs. Fees for ratings would be established by the governing body of the ratings fund and the fee levels would be periodically reviewed and revised as deemed necessary. Moreover, the ratings fund would create a queuing system to assign CRAs to rate new debt issues coming to market and then provide the ongoing review of the ratings during the time the debt issue is outstanding. At its discretion, the governing body of the ratings
fund could also assign more than one CRA to rate an upcoming new debt issue. Under this approach, the ratings fund should be responsible for documenting the track record of CRAs with respect to the accuracy of their ratings and reporting this information on an annual basis to the SEC and the public. Because the queuing system could be structured to consider the ratings accuracy track record of CRAs, it would be possible for CRAs demonstrating the best track records to be awarded additional ratings assignments, and hence, earn greater fee income.

We believe the “fee from proceeds” model we propose has a number of benefits. Most importantly, our model eliminates the conflicts of interest arising from the current “issuer-pays” model. Because the ratings agency fund would be responsible for allocating ratings business to CRAs on a rotating basis, the current intermingling of ratings services and other services of CRAs would be less likely to lead to pressure for a CRA to assign a particular rating. Moreover, by having the ratings fund allocate ratings business to CRAs, the ability of issuers to engage in ratings shopping would be eliminated. Another benefit of the “fee from proceeds” model we propose is that credit ratings should be more accurate. By creating an incentive for CRAs to be eligible for the allocation of additional ratings business due to a track record of high accuracy, CRAs should make accuracy of ratings the highest priority. Improved ratings accuracy, especially in the structured debt products sector, will restore confidence in the CRAs and the ratings they assign. It then follows that improved ratings accuracy will result in better determinations of appropriate default risk premia within the securities markets and result in debt yields that adequately compensate investors for the risk they bear. Hence, when credit ratings can be trusted, investors can trust the prices of debt within the market.
3. **Subject CRAs to the Potential of Civil Liability**

The threat of civil liability has proven to be an effective deterrent in regulating gatekeeper behavior in the case of underwriters, accountants and other gatekeepers. CRAs contend that they are unlike other gatekeepers because the ratings they produce represent merely their opinion of the creditworthiness of the issues they rate and that they are, as such, more like journalists than the other financial gatekeepers. The argument that ratings by CRAs are opinions and that CRAs are akin to journalists is flawed. Rating agencies are doing more than offering opinions. They are involved at early stages in the deals, often helping to craft the offering. They receive fees for each stage of their involvement.\(^3\) Although the CRAs contend that their ratings constitute an opinion, their business operations are arguably analogous to those of accountants supplying an audit opinion and functions performed by investment advisors. Professionals in both of these examples are subject to the threat of liability. Because the CRAs have a profile that is more similar to financial services firms, we support Dodd-Frank’s amendment of Section 11 of the Securities Act of 1933 to include CRAs as defendants. In addition, we also support making CRAs subject to a private cause of action per the anti-fraud provisions of the securities laws and application of a “knowing and reckless standard.” However, subsequent to enactment of Dodd-Frank, as noted above, the SEC has, by way of a no-action letter, effectively delayed implementation of this provision indefinitely. We believe the threat of private litigation would encourage appropriate behavior so that the regulators would not have to spend an inordinate amount of time and resources promulgating rules ex ante. Hence, we view subjecting the CRAs to the threat of liability as being less costly to the public than imposing regulations because judges and private litigants would be involved in establishing an understanding of appropriate CRA behavior. In spite of CRA claims to the contrary, it will not be the death knell of CRAs if
they are subjected to the civil liability that attaches to all other gatekeepers. We see the threat of civil liability as an essential component to any serious regulatory reform of CRAs. Without the threat of possible civil liability, there is little incentive to issue accurate ratings and no liability for failure to do so.

CONCLUSION

Historically, the CRAs have enjoyed a privileged operating environment due to regulatory requirements for issuers to obtain credit ratings, the minimal regulations imposed on them, the limited competition within the CRA industry and their relative immunity from civil liability. This operating environment has allowed the CRAs to become a very powerful force within the financial markets, both domestically and globally. Issuers of debt realize that the marketability of their issues may be contingent upon the assignment of a favorable credit rating by one of the “Big Three” CRAs. However, there is significant evidence suggesting that the CRAs’ business practices led to widespread assignments of overly optimistic credit ratings that had an instrumental role in facilitating the GFC in 2008.

The behavior and business practices of the CRAs have been scrutinized for many years. A number of issues such as the conflicts of interest and lack of accountability for inaccurate ratings have been widely acknowledged as just a couple of areas that need regulatory attention. The numerous analyses examining the causes of the GFC have only hastened the desire of a number of financial market constituents to seek increased regulation of the CRAs. We count ourselves among those urging increased regulation of the CRAs. In this article, we have examined the need for regulation of the CRAs, explored possible regulatory models and described possible regulatory actions. Through our analysis, we have described multiple issues within the CRA industry, and we therefore believe a multi-faceted regulatory approach is needed
to restore integrity, improve accountability, eliminate or reduce the improprieties within the CRA industry, and reduce the likelihood of the GFC being repeated.

First, and foremost, we believe the CRAs should be subjected to the potential for civil liability and we advocate the negligence standard imposed by the Dodd-Frank Act rather than strict liability. We believe this is a critical first step in the regulatory process and is needed to improve accountability. If CRAs are subject to the threat of civil liability, we envision that their concern for determining accurate ratings would be improved and the amount of ex ante rulemaking by federal regulators would be reduced. The threat of civil liability would serve as a deterrent to bad behavior.

A second step in improving regulation of the CRA industry, is to have one federal regulator with purview over the CRAs. We recommend that the Office be established within the SEC to oversee the individual CRAs and the CRA industry. Moreover, adequate funding has to be provided to the SEC both initially and on an ongoing basis to ensure the regulatory ability of both the SEC and the Office.

Although there are a number of issues that need to be addressed within the CRA industry, we believe the highest priority issues to be addressed by regulation are the conflicts of interest that arise from the existing business model and the lack of accountability. To address the conflicts of interest, we propose changing the current “issuer-pays” business model to one of “fees from proceeds.” Under our proposed model, a credit ratings fund would be established and fees from the proceeds of new debt issues to cover the cost of credit ratings would be deposited into the fund and then disbursed to CRAs for their ratings services. A queuing system would be established by the fund to allocate ratings business to CRAs. The ratings fund would also monitor the ratings accuracy track record of CRAs and could award additional business to CRAs
that demonstrate the highest accuracy records. Our proposed model eliminates the conflicts of interest that arise under the “issuer-pays” model by eliminating the incentive for debt issuers to engage in ratings shopping. Moreover, the “fees from proceeds” model we propose increases accountability by rewarding CRAs for providing accurate credit ratings. Under our “fee from proceeds” model, investors are bearing the majority of the cost of credit ratings and CRAs are therefore more accountable to investors. Hence, we see the “fees from proceeds” business model as being complimentary to our proposal of making CRAs subject to liability given the CRAs additional accountability to investors provided by the “fee from proceeds” model. Moreover, if CRAs are striving for the positive rewards available from assigning accurate ratings that are associated with proposed “fees from proceeds” model, then the chances of actually facing a liability suit are likely slim.
Endnotes

1. See e.g., Brady Dennis, Steven Mufson & Zachary A. Goldfarb, U.S. Suing Banks for Nearly $200 billion, WASH. POST, Sept. 3, 2011, at 1 (discussing lawsuit brought by Federal Housing Finance Agency alleging defendants falsely represented quality of loans that were bundled and sold to investors).

2. Professor Coffee calls the Global Financial Crisis a “story of greed, rationalization, and sloth; it is a tragedy…” John C. Coffee, What Went Wrong? A Tragedy in Three Acts, 6 U. THOMAS L. J. 403 (2009). See also, David Schmudde, Responding to the Subprime Mess: The New Regulatory Landscape, 14 FORDHAM J. CORP. & FIN. L. 709, 725 (2009) (“[T]he subprime mortgage crisis is a failure of responsibility (sic) at every level: borrowers, lenders, investment banks, appraisers, rating agencies, investors, and undoubtedly, the regulators. In a rush to follow greed at every level, all the normal protections broke down.”); Arnold Kling, The Financial Crisis: A Moral Failure or Cognitive Failure?, 33 HARV. J. L. & PUB. POL’Y, 507, 507 (2010)(questioning whether the GFC was brought about by moral failures, such as greed, or cognitive failures).

3. Joshua D. Krebs, The Rating Agencies: Where We have Been and Where Do We Go From Here?, 3 J. BUS. ENTREPRENEURSHIP & L. 133, 134 (2009); Sulette Lombard, Credit Rating Agencies as Gatekeepers: What Went Wrong? (2009), available at www.clta.edu.au/professional/papers/conference2009/LombardCTLA09.pdf (“[C]redit rating agencies seem to fit Kraakman’s definition of a gatekeeper as a ‘professional who is positioned so as to be able to prevent wrongdoing by withholding necessary cooperation or consent.’”) (quoting Reinier Kraakman, Gatekeepers: The Anatomy of a Third Party Enforcement
Strategy, 2 J. OF L., ECON. & ORG. 53, 53 (1986)). In this context, the rating serves as the key to the gate. See Kia Dennis, The Ratings Game: Explaining Rating Agency Failures in the Build up to the Financial Crisis, 63 U. MIAMI L. REV. 1111, 1130 (2009)(“Obtaining this certification is the ‘gate’ that issuers must pass through in order to gain entrée to the securities markets.”); Sung Hui Kim, Gatekeepers Inside Out, 21 GEO. J. LEGAL ETHICS 411, 415 (2007)(“Thus, by withholding the firm’s certification, the gatekeeper warns the market and shuts the gate, effectively foreclosing the issuer’s access to the capital markets.”).


5 Professor Kim argues that in order to be a successful gatekeeper, the gatekeeper must be: 1) willing to interdict; 2) willing to monitor; 3) able to monitor; and 4) able to interdict. See Kim, supra note 3, at 414. Arguably, CRAs failed on all accounts. Representative Henry A. Waxman has been quoted as saying, “The story of credit-rating agencies is the story of a colossal failure.” See Amit R. Paley, Credit-Rating Agencies Firms Grilled Over Conflicts: Risks Were Known, Documents Show, WASH. POST, Oct. 23, 2008, at A1 (quoting Representative Henry A. Waxman, The Chairman of the House Committee on Oversight and Government Reform).

See e.g., John Crawford, *Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry*, 42 CONTEMPLATIONS 13 (2009) (“Broad reliance on excessively optimistic credit ratings of structured financial products helped ignite and spread the recent financial crisis.”); Elizabeth Devine, *The Collapse of an Empire? Rating Agency Reform in the Wake of the 2007 Financial Crisis*, 16 FORDHAM J. CORP. & FIN. L. 177 (2011); Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE WESTERN RESERVE L. REV. 227 (2009); Krebs, *supra* note 3, at 137-138 (“Failure by the credit rating agencies to assign accurate MBS and collateralized debt obligation (“CDO”) ratings was a key contributor to the current economic crisis.”); Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. ILL. L. REV. 1359, 1363 (2009) (“This happened because a system largely outside the bounds of securities regulation – the ratings issued by private rating agencies – largely displaced the structured disclosure requirements of securities law as the primary basis for investors’ purchase of the securities.”); Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What can be Done to Protect Investors*, 50 B.C.L. REV. 1275 (2009) (“The Nation’s credit rating agencies, however, are, and will remain on the receiving end of much of the finger pointing.”); Frank Partnoy, *Overdependence on Credit Ratings was a Primary Cause of the Crisis*, (U. San Diego, Research Paper No. 09-015, 2009), available at http://ssrn.com/abstract= 1430653 1 (“A primary cause of the recent credit market turmoil was overdependence on credit ratings and credit rating agencies. Without such overdependence, the complex financial instruments, particularly Collateralized Debt Obligations (CDOs) and Structured Investment Vehicles (SVs), which were at the center of the crisis could not, and would not, have been created or sold.”);
Lawrence J. White, *Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response*, available at http://w4.stern.nyu.edu/economics/docs/workingpapers/2010/White_Credit%20Rating%20Agencies%20for%20JIBLR.pdf, at 13 (2010)(“There is little question that the three major credit rating agencies were central parties in the subprime mortgage lending boom.”). *See also*, Krebs, *supra* note 3, at 134-135 (“With the recent explosion of unregulated securities and the ensuing near collapse of the financial markets, it seems these agencies are perhaps not gatekeepers, but rather mechanics, greasing the wheels of a giant runaway train of dangerous financial products”). See also WILLIAM H. GROSS, PIMCO INVESTMENT OUTLOOK, July 2007, at 1 (arguing that CRAs were deluded by investments in “hooker heels” bearing “tramp stamps”).


12 Economists refer to the optimal allocation of resources throughout the economy as “allocational efficiency.” For more details, see ANTHONY SANTOMERO AND DAVID BABBEL, FINANCIAL MARKETS AND INSTRUMENTS 36 (2000).

13 Stephanie Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L. J. 617, 622 (2006)(“Inevitably, information
asymmetry exists in the debt market because issuers have superior information regarding their creditworthiness than do investors.”); White, *supra* note 7, at 4(“The critical problem is one of asymmetric information: The borrower usually knows more about the prospects for repayment than does the lender.”).


15 Rousseau explains that one result of this information asymmetry is that it can lead to “an adverse selection problem in that the debt of issuers with good credit quality will be undervalued, thereby undermining the viability of the market.” Rousseau, *supra* note 13, at 623.

agencies enhance the capital market infrastructure by distilling a great deal of information into a single credit rating for a security… Such information is frequently critical to potential investors and could not be acquired otherwise, except at substantial cost.”); White, supra note 7, at 5 (“Credit rating agencies are one potential source of help for piercing the fog of asymmetrical information…”). The first credit rating agency was founded in 1909 by John Moody. Claire A. Hill, Regulating the Rating Agencies, 82 WASH. U. L. Q. 43, 46 (2004). Because this was before the creation of the Securities and Exchange Commission and securities regulation that required disclosure of financial information, CRAs served an important need for gathering and disseminating financial information. White, supra note 7, at 7. It wasn’t until after the Penn Central default of the 1970’s that ratings became the norm. Hill, supra note 16, at 47. Interestingly prior to creation of the modern CRA, mercantile credit agencies assessed the ability of merchants to honor their financial obligations and sold these assessments to merchants who used this information to decide whether to extend credit to other merchants. See Lynch, supra note 7 at 237.

17 Krebs, supra note 3, at 134. A credit rating agency is defined to be a person (a) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (b) employing either a quantitative or qualitative model, or both, to determine credit ratings; and (c) receiving fees from either issuers, investors, or other market participants, or a combination thereof.” SECURITIES AND EXCHANGE COMMISSION, Oversight of Nationally Recognized Statistical Organizations (2009), available at http://www.sec.gov/divisions/marketreg/tmcompliance/nrsro-secg.htm. Lombard tells us that the “function of credit rating agencies is to ‘rate’ investment and credit instruments to make it easier
for non-specialist investors to determine the risks inherent to particular investments.” Lombard, supra note 3, at 2.

18 Krebs, supra note 3, at 136 (CRAs “provide self-described ‘opinions’ in the form of ratings on creditworthiness.”). CRAs offer assessments of the creditworthiness of the issuer (how likely that issuer is to repay the debt) as well as ratings of specific securities (probability of default of that instrument). Lois R. Lupica, Credit Rating Agencies, Structured Securities, and the Way out of the Abyss, 28 REV. BANKING & FIN. L. 639, 639-640 (2009)(“[C]redit rating agencies have provided opinions about the creditworthiness of securities issuers and the quality of their issuances.”); Rousseau, supra note 13, at 622. For much of their history, CRAs rated bonds that were simple promises to repay. Claire A. Hill, Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?, 71 U. PITT. L. REV. 585, 588.

19 There is debate in the academic community, however, surrounding whether or not credit ratings are of any informational value. Some have argued that credit ratings are of “scant informational value.” Frank Partnoy, The Paradox of Credit Ratings, (U. San Diego, Research Paper No. 20, 2001) 1, available at http://papers.ssrn.com/abstract=285162). Partnoy relies on the fact that ratings changes typically lag the market. Galen Hite & Arthur Warga, The Effect of Bond-Ratings Changes on Bond Price Performance, 1997 FIN. ANALYSTS J. 35 (1997). Others have argued that ratings changes are correlated with default experience. See generally Rousseau, supra note 13, at 631 where she discusses the academic literature (“[S]everal studies have found a high correlation between credit quality as determined by the rating and default rates.”).

20 Lupica, supra note 18, at 653 (“The criteria developed and operationalized by rating agencies influence the level of activity of finance markets, the allocation of capital, as well as the cost of credit.”). Professor Schwarcz equates ratings with “public goods.” See Steven L.

Thomas Friedman recognized the importance of CRAs when he asserted that there “are two superpowers in the world today…. There’s the United States and there’s Moody’s Bond Rating Service. The United States can destroy you by dropping bombs, and Moody’s can destroy you by downgrading your bonds. And believe me, it’s not clear sometimes who’s more powerful.” PBS Online, Free Market Society, THE ONLINE NEWS HOUR, Feb. 13, 1996, available at http://www.pbs.org/newshour/gergen/friedman.html.

21 Hill, supra note 16, at 50; Krebs, supra note 3, at 140.

22 Rousseau, supra note 13, at 625.

23 Hill, supra note 18, at 588 (“The agencies switched to an ‘issuer pays’ model when photocopying and other technology made it impossible for them to stop subscribers from sharing information with non-subscribers.”).

24 But see Partnoy, supra note 7, at 3 where he questions the effectiveness of this model (“As the credit rating agency model shifted from investor-pay to issuer pay, the conditions necessary for the existence of a well-functioning information intermediary faltered. The rating agencies faced little or no risk of loss from inaccurate ratings, while the potential gains from inaccurate ratings increased.”).

25 Deryn Darcy, Credit Rating Agencies and the Credit Crisis: How the “Issuer Pays” Conflict Contributed and What Regulators Might Do About It, 2009 COLUM. BUS. L. REV. 605, 622 (2009); Lynch, supra note 7, at 239-240. In the CalPERS complaint, plaintiffs estimate that

26 Darcy, supra note 25, 612; Claire A. Hill, Rating Agencies Behaving Badly: The Case of Enron, 35 CONN. L. REV. 1145, 1146 (2003); Krebs, supra note 3, at 136 (“Moody’s and S.& P. are the largest, with each respectively owning about forty percent of the credit rating markets.”); Mulligan, supra note 7, at 1279; Rousseau, supra note 13, at 627. The lack of competition in the CRA industry is staggering. Standard & Poor’s and Moody’s dominate the market with Fitch’s a distant third. The market has in fact been termed a “government-created … near-duopoly.” See Hill, supra note 26, at 1152.

27 See generally Moran, supra note 4, at 42.

28 Adjustable rate mortgages (ARMs) typically start with a low (teaser) interest rate that allows borrowers to qualify for a larger loan that they might have if they had decided to select a fixed rate loan. Coffee, supra note 2, at 406; Mendales, supra note 7, at 1394. The fixed rate loans are riskier for lending institutions since such loans would leave them exposed to rising interest rates. ARMs, on the other hand, leave the borrowers exposed to the risk of rising interest rates which could cause the mortgage rates to set higher. A majority of the subprime loans discussed below at infra note 41 and accompanying text were ARMS. Moran, supra note 4, at 22.

29 Between the years 2000 to 2006, the median sale price of homes in the U.S. increased by 45%, from $169,000 to $246,500. Between 1997 and 2006, home prices actually rose by 124%!
Moran, *supra* note 4, at 20. The speed of the appreciation can be gauged by the fact that it took double that time for prices to increase by that percentage prior to the year 2000. Data available at [http://www.census.gov/const/uspriceann.pdf](http://www.census.gov/const/uspriceann.pdf).

30 See Dennis, *supra* note 3, at 1118-1122; Mendales, *supra* note 7, at 1364-1368 (discussing the growth of the MSB market as first established by Fannie Mae under Congressional and Treasure sanction). The practice of securitization became so prevalent that over two-thirds of all mortgages were securitized in 2005. This contrasts with less than 20 percent of mortgages being securitized in 1999. Nicole B. Neuman, *A ‘Sarbanes-Oxley’ for Credit Rating Agencies? A Comparison of the Roles Auditors’ and Credit Rating Agencies’ Conflicts of Interest Played in the Recent Financial Crises*, 12 U. PA. J. BUS. L. 921 (2010).


33 This was accomplished largely through the process of subordination, in which if the debtor defaulted on the loan, the lowest tranche absorbed all the loss until that tranche was empty. Any additional losses were allocated to the next lowest tranche and so on. Brooke A. Murphy, *Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies led to the Subprime Credit Crisis and the Need for Greater Accountability*, 62 OKLA. L. REV. 735, 743. This has been termed “the waterfall effect.” Mendales, *supra* note 7, at 1376. To
illustrate the complexity of these instruments, some pools were sliced in even more exotic ways, creating “strips” within and between the tranches. Mendales, id, at 1376. The task of deciding how much principal was allocated to each tier was a complicated task accomplished by using models based on “quantitative finance.” John Patrick Hunt, Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, 2009 Colum. Bus. L. Rev. 109, 118 (2009).

34 Crawford, supra note 7, at 13; Mendales, supra note 7.

35 Coffee, supra note 2, at 409 (“In overview, investment banks bought unsound loans because they knew they could securitize them on a global basis if – and only if – they could obtain investment-grade ratings from major credit rating agencies. Without that rating, the debt was unmarketable”); Darcy, supra note 25; David J. Matthews, Ruined in a Conventional way: Responses to Credit Ratings’ Role in Credit Crises, 29 NW. J. INT’L & BUS. 245, 250 (2009); Mendales, supra note 7 at 1367; White, supra note 7, at 12 (“And crucial to the ability of these packages to sell the securities was the process of obtaining favorable ratings on the securities.”). Ratings are particularly important in the case of structured financial transactions like those described here. Hill, supra note 16, at 49 (“[A] structured finance transaction will almost never go forward unless some of the securities sold in the transaction achieve a high investment grade rating.”); Matthews, id., at 250 (“With respect to structured finance issuances, however, the CRA rating takes on a gatekeeper role akin to audits and analyses performed in connection with equity financings because informational asymmetry hampers an investor’s effective evaluation of underlying mortgage pools.”).

36 Dennis, supra note 3, at 1122. Because of the importance of credit ratings to structured finance products, Professor Partnoy concludes that “the agencies have become more like ‘gate

37 Aaron Unterman, Innovative Destruction – Structured Finance and Credit Market Reform in the Bubble Era, 5 HASTINGS BUS. L. J. 53, 69 (2009) (“This magical transformation was achieved in spite of the fact that the underlying securities belonged largely to the lowest rated tranches of the original subprime securitizations.”). See also Michel G. Crouhy, Robert A. Jarrow & Stuart M. Turnbull, The Subprime Crisis of 07 (Working Paper, 2008), available at http://ssrn.com/abstract=1112467, at 7 (“[T]he rating agencies assigned AAA ratings to CDOs senior bond tranches that did not reflect the CDO bond’s true credit risk.”). See also id., where the authors describe the lucrative process of repackaging CDOs into CDO squared trusts.

Professors Partnoy and Skeel predicted this possibility when they discussed what they termed a “ratings ‘arbitrage’ opportunity.” They stated that “once the rating agencies fix a given set of formulas and variables for rating CDOs, financial market participants will be able to find a set of fixed income assets that, when run through the relevant models, generate a CDO whose tranches are more valuable than the underlying assets.” Partnoy & Skeel, supra note 31, at 1042. CRAs viewed bundling MBSs as “statistical problems” and did not think it was necessary to analyze the underlying mortgages. Schmudde, supra note 2, at 747.

38 Damon Silvers and Heather Slavkin, The Legacy of Deregulation and the Financial Crisis—Linkages between Deregulation in Labor Markets, Housing Finance Markets, and the Broader Financial Markets, 4 J. BUS. & TECH. L. 301, 302 (2009). Moreover, as the MBSs were themselves repackaged for more than their underlying value, there was increased pressure to both originate new mortgages and to create and sell additional derivatives. Hill, supra note 18, at 590
(“[W]ith someone to sell the loans to, lenders discovered a new enthusiasm for making them.”); Partnoy, supra note 7, at 5 ("These transactions, too, persisted over time, so much so that the appetite for second-level mortgage securitizations drove financial intermediaries both to originate new and increasingly risky mortgages, and to create synthetic exposure to mortgages, which then could be resecuritized through tranched special purpose entities, again at higher prices than the underlying mortgage-backed securities were trading in the market.").

39 Coffee, supra note 2, at 406 ("[S]ecuritization led to lax screening by the loan originator."). Coffee describes this as “a classic moral hazard problem. Because you do not bear the risks, you will expend little time or effort on precautions, such as screening borrowers.” Id., at 406.

40 The “no doc” loans often led to fraudulent loan applications and some of them were termed “liar loans.” Matthews, supra note 35, at 252; Mendales, supra note 7, at 1394-5. Some have reported an “explosion in mortgage fraud. Andrew J. Ceresney, Gordon Eng & Sean R. Nuttall, Regulatory Investigations and the Credit Crisis: The Search for Villains, 46 AM. L. REV. 225, 236-237 (2009)(“Given its prevalence and scope, many commentators have speculated that such fraud was at least partly to blame for the collapse of the mortgage market, and in turn for triggering the credit crisis.”). Moreover, the numbers of such loans grew. Darcy, supra note 25, at 614-615 (“In 2001, 28.5% of subprime borrowers could not verify information about employment, income, or other credit-related data. This figure increased to nearly 51% in 2006.”). In addition, subprime mortgages without documentation of the borrower’s income, assets or employment grew to 44% of the subprime market by 2005. Silvers & Slavkin, supra note 38, at 328.
Subprime loans are loans made to people where the potential for default is higher than other mortgages. Matthews, supra note 35, at 246 (“The term connotes lending to borrowers whose employment history, savings, credit history, or other characteristics create a higher expectation in the lender of loan default as compared to prime borrowers.”). Subprime lending grew substantially during this period. Crouhy, Jarrow & Turnbull, supra note 37, at 4 (“By 2006, subprime mortgages represented 13% of all outstanding mortgage loans with origination of subprime mortgages representing 20% of new residential mortgages compared to the historical average of approximately 8%.”); Darcy, supra note 25, at 614 (“[S]ubprime mortgages accounted for 2%, or more than $600 billion, of all mortgages originated in 2005.”); Moran, supra note 4, at 20; Silvers & Slavkin, supra note 38, at 328 (“In 2001, subprime lending represented 7.2% of mortgage originations but exploded over the next five years until they reached 20% of mortgage originations in 2006.”).

For example interest only loans increased from zero percent of housing loans in 2001 to 23 percent in 2006. Coffee, supra note 2, at 407.

Unterman, supra note 37, at 54. See also Matthews, supra note 35, at 251 (“securitization encouraged origination volume over quality…”); Mendales, supra note 7, at 1393 (“This led to a vicious circle like those seen in prior bubbles, in which the greater availability of mortgages increased the demand for homes, pushing up the prices at which they were sold and in turn pushing up the amounts lent to their purchasers.”); Murphy, supra note 33, at 739 (“In an attempt to keep up with the high demand for RMBSs, mortgage lenders began implementing increasingly unsound lending practices, which allowed more people to qualify for home mortgages, thereby generating more mortgages and RMBSs.”); Schmudde, supra note 2, at
712 (describing this as a typical bubble, like a Ponzi scheme in which “nobody gets hurt” as the bubble is forming, followed by the “necessary reckoning – the collapse of prices”).

44 The justification for these higher than merited ratings was that “all housing is local.” Moreover, it was believed that any risk was lessened by the broad diversity of loans contained in each pool. Moran, supra note 4, at 47. See id., where Moran equates this to a game of Russian roulette where the likelihood of a disastrous outcome appeared to be so low that it was ignored by CRA models. In other words, CRAs believed that the pool of mortgages reaped the benefits of geographic diversification, and therefore, it was highly unlikely that all the mortgages in the pool would default in unison because any downturn in housing would be localized. Moreover, it was assumed that housing prices would continue to rise; hence, even if the borrower defaulted, it was assumed that property values would still be assumed to appreciate. Coffee, supra note 2, at 407.

45 Murphy, supra note 33, at 740 (“The originator, therefore, has no incentive to maintain prudent lending standards, since its profits derive solely from transactional fees, and not from the eventual repayment of the mortgage.”).

46 The housing crisis became a credit crisis amplifying the crisis. SEC Chairman Cox recognized this connection in his testimony before Congress, stating,

“The packaging of risky mortgages into complex structured securities with AAA ratings spread the risks into the securities markets, and what significantly amplified this crisis around the globe was the parallel market in credit default swaps, which is completely unregulated. Credit default swaps multiplied the risks of the failure of bad mortgages by orders of magnitude. And they ensured that
when housing prices collapsed, the effects cascaded throughout the financial system.”

_The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight & Gov’t Reform_, 110th Cong. 149 (2008), at 22 (Statement of Christopher Cox, Chairman, Sec. & Exch. Comm’n). The crisis was so bad that many commentators referred to 2008 as “_annus horribilis._” See Ceresney, Eng & Nuttall, _supra_ note 40, at 225. See also, _id._, at 231-234 for a summary of the events of the crisis.

47 By the latter part of 2006, 346 major U.S. lending operations had closed. See Mortgage implode meter, _available at_ [http://ml-implode.com](http://ml-implode.com). Mortgage related losses have been estimated to exceed $1.1 trillion. Murphy, _supra_ note 33, at 744.

48 Finance literature refers to this as the _flight to quality_. Flight to quality or the contagion effect is used to describe the actions of investors in a market that is beset with uncertainty. Investors will sell risky holdings and move their money to safer securities like Treasuries. See Ben Bernanke, Mark Gertler & Simon Gilchrist, _The Financial Accelerator and the Flight to Quality_, 78 Rev. of Econ. & Stat. 1 (1996).

49 Unterman, _supra_ note 37, at 71.


51 Ceresney, Eng and Nuttall, _supra_ note 40, at 229. It has been estimated that losses could total $3.6 trillion for U.S. institutions. Dennis, _supra_ note 3, at 1113.

52 Large losses from CDOs were implicated in both the AIG and Lehmann Brothers failures. In fact, the CDO losses represented 94 percent of AIG’s total loss. See Lynton Jones, _Current Issues Affecting the OTC Derivatives Market and its Importance to London_ 9 (City of
Ceresney, Eng & Nuttall, supra note 40, at 230 (“The American financial system has undergone an historic restructuring, as ‘the big five’ independent investment banks have essentially disappeared…”).

Darcy, supra note 25, Hunt, supra note 33; Lupica, supra note 18; Manns, supra note 9; Partnoy, supra note 7.

See Murphy, supra note 33, at 744-751 where she contrasts the traditional process with the process employed in rating CDOs and other MBSs.

Mendales, supra note 7.

Crouhy, Jarrow & Turnbull, supra note 37, at 9 (“Investors in complex credit products had considerably less information at their disposal to assess the underlying credit quality of the assets they held in their portfolios than the originators.”); Mendales, supra note 7, at 1376; Partnoy, supra note 7, at 6 (“Investors typically did not examine the underlying assets of a synthetic CDO or SIV in any detail or at all. One might criticize them for not doing so, except that the underlying assets were frequently not even specified when the deal was sold.”).

CalPERS alleges in their lawsuit that “Other than the Rating Agencies’ evaluation and subsequent credit rating of an SIV, an investor had no access to any information upon which to base a judgment of a SIV’s creditworthiness.” CalPERS Complaint, supra note 25, at ¶ 19.

By contrast, prior to 1996, buyers of asset-backed securities hired due diligence firms. These firms sent experts to the loan originator and screened a sample of the underlying assets. In 1996, it was not uncommon for the due diligence firm to sample 30 percent of the underlying
loans; that amount fell to 20 percent, to 5 percent and then the practice was discontinued.

Coffee, supra note 2, at 408.

58 Coffee, supra note 2, at 404 (“[T]his financial technology depended very heavily on gatekeepers – that is, on professionals that investors trust to do what investors cannot do for themselves.”): Lisbeth Freeman, Who’s Guarding the Gate: Credit Rating Agency Liability as “Control Persons” in the Subprime Credit Crisis, 33 VT. L. REV. 585, 591 (2009)(“Mortgage-backed securities, though, contain special features that distinguish them from conventional investment bonds and make accurate valuation a more difficult task for investment professionals.”); Moran, supra note 4, at 40 (“[A]s very complex instruments, even the most sophisticated investors sometimes fail to appreciate their risks and substitute the rating supplied by the credit rating agency for the investors’ own independent risk analysis.”).

59 Ceresney, Eng & Nuttall, supra note 40, at 228 (“The financial instruments and arrangements at issue in the credit crisis investigations are highly complex”); Hill, supra note 18, at 590 (“[T]hese structures were highly complex and, ultimately, not well understood.”).

60 MICHAEL C. EHRHARDT & EUGENE F. BRIGHAM, CORPORATE FINANCE: A FOCUSED APPROACH 40 (2009)(“Rating agencies were paid to investigate the details of each bond and to assign a rating which reflected the security’s risk. The securitizing firms paid the rating agencies to do the ratings. For example, Lehman Brothers hired Moody’s to rate some of their CDOs. Indeed, the investment banks would actually pay for advice from the rating agencies as they were designing the securities. The rating and consulting activities were extremely lucrative for the agencies, which ignored the obvious conflict of interest: The investment bank wanted a high rating, the rating agency got paid to help design securities that would qualify for a high rating, and high ratings led to continued business for the raters.”); Coffee, supra note 2, at 410 (“These
investment banks are repeat players, who also hire the rating agency as their consultant to teach them the rating agency’s own methodology and thus help them design a product that can get an investment-grade rating.”); Krebs, supra note 3, at 139 (“[T]he rating companies profited by advising issuers on how to squeeze the most profit out of these securities by maximizing the ratings on tranches.”); Lynch, supra note 7, at 280 (“[I]ssuers typically consulted and worked directly with the credit rating analysts to find out how their MBSs and other asset backed securities could be structured to obtain the highest rating for the largest possible pieces of the asset pool…”); Murphy, supra note 33, at 746 (Murphy describes how after an initial rating, the “issuer is then given an opportunity to restructure the subordination scheme of the RMBS in order for the highest tranche to receive the most elevated rating. In restructuring the RMBS, the NRSRO actively advises the issuers regarding which structure and which credit enhancements will yield the highest rating.”). See also Partnoy & Skeel, supra note 31, at 1044 where they describe the roles played by the issuer and the CRA (“The process of rating CDOs becomes a mathematical game that smart bankers know they win. A person who understands the details of the model can tweak the inputs, assumptions, and underlying assets to produce a CDO that appears to add value, when in reality it does not.”). The interaction between the issuer and CRA is hardly consistent with the view of CRA as an independent auditor.

61 Unterman, supra note 37, at 58. Coffee opines that “the true mystery here is not why loan originators made unsound loans, but why investment banks bought them.” Coffee, supra note 2, at 408. The answer, of course, is that CRAs reassured them the assets were sound.

62 Crawford, supra note 7, at 16; Lynch, supra note 7, at 264. Arguably, the use of quantitative models is more important in the rating of structured financial products than in the case of corporate debt ratings. Crouhy, Jarrow & Turnbull, supra note 37, at 28 ([T]he rating of
CDO tranches relies heavily on quantitative models while corporate debt ratings rely essentially on the analyst judgment.”).

The Financial Crisis and the Role of Federal Regulators: Hearing before the Comm. of Government Oversight and Reform, 110th Cong. 3-4 (2008)(testimony of Alan Greenspan, Former Chairman of the Federal Reserve)(“the whole intellectual edifice [underpinning the advances in derivatives markets] …. Collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today…); Dennis, supra note 3, at 1123-125 (discussing problems with relying on historical data to rate MBSs comprised of subprime mortgage pools); Lupica, supra note 18, at 659 (“[T]he mathematical models commonly used reflected risk based on short-term, rather than long-term historical data”); Murphy, supra note 33, at 747-748 (“[M]any of the risk assumptions made by the NRSROs were based on historical records rather than current data. The NRSROs’ models, therefore, did not sufficiently account for the riskier form of loans that were being generated, such as adjustable rate loans and ‘no income, no asset’ loans.”); Partnoy, supra note 7, at 4 (“[I]n the early 2000s, rating agency models, and assumptions about historical default, recovery, and correlation, suggested that extant mortgage-backed securities could be repackaged and resold in ways that would outperform, not only the mortgage-backed securities themselves, but other comparably rated securities.”). See also Darcy, supra note 25, at 636-7 where she discusses the fact that subprime mortgage loans performed strongly between 2001 and 2005. Therefore, models that relied on historical data underestimated the risk of default. One problem is relying on historical data gathered during times of housing appreciation to estimate default in
times of housing depreciation without recognizing the distinction. Because in times of housing depreciation, borrowers who could not pay simply sold their houses rather than default, default rates would be an inherently bad predictor of default during times of housing depreciation.

64 Lupica, supra note 18, at 660 (“Further, CRAs’ quantitative models failed or were slow to consider the impact of changed underwriting practices on the part of front line lenders.”); Moran, supra note 4, at 49.

65 Crawford, supra note 7, at 16 (“In hindsight, the rating agencies fed the models unrealistically optimistic assumptions about continuing house price appreciation, the probability of borrower defaults, and correlations among defaults.”); Murphy, supra note 33, at 747 (“[T]he models did not address basic and crucial issues related to the investment decision process, including the price, term likelihood of prepayment, liquidity risk or relative valuation of particular securities.”).

66 Dennis, supra note 3; Mendales, supra note 7, at 1380; Moran, supra note 4. In fact, as Partnoy, supra note 7, at 7 points out, as housing prices began to fall, but the models used to rate the MBSs did not, this made securitization actually more attractive (“Paradoxically, when housing prices began to fall but ratings on first-level securitizations did not, the historical rating methodology made second-level securitizations increasingly attractive. If one could buy AAA-rated mortgage-backed securities that had fallen in price, but still use the same historical default, recovery, and correlation assumptions associated with AAA ratings in the relevant model, one could create a highly rated, high-yielding set of second-level transactions.”).

67 Ceresney, Eng & Nuttall, supra note 40, at 265 (The CRAs “were too slow in correcting the excessively high ratings that had been placed on many cases of bonds backed by subprime mortgages during the housing boom.”); Krebs, supra note 3, at 137.
Lupica, supra note 18, at 660 (“As the current economic environment is demonstrating, risk can be both interconnected and contagious.”).

Lombard, supra note 3, at 3 (“[T]he lack of competition raises the concern that credit rating agencies will have little incentive to upgrade their services and that it could contribute to general laxity.”); Mendales, supra note 7, at 1377.

Lupica, supra note 18, at 656 (“Rating agencies have been criticized for not conducting independent diligence in connection with their structured securities rating analysis.”); Moran, supra note 4, at 49 (discussing CRA claims that they had no responsibility to evaluate the quality of the bundled mortgages). See infra notes 235-240 and accompanying text where problems with the lack of due diligence by CRAs are discussed.

Moreover, investors relied on CRA instead of performing any due diligence of their own. Krebs, supra note 3, at 139 (“These institutions often relied on ratings so heavily that due diligence was overlooked or thought unnecessary.”). The fact that investors purchased interests in tranches comprised of a diverse pool of assets made it, however, almost impossible for even the most sophisticated investor to perform its own due diligence. Silvers & Slavkin, supra note 38, at 337. The fact that the data upon which the CRAs relied was not transparent made it more difficult for investing institutions to judge the accuracy of these ratings or to perform due diligence. See infra notes 215-245 and accompanying text where the lack of transparency is discussed.

There is some evidence that the issuers actually refused to provide the relevant data with asked. Hill quotes a Moody analyst’s report of asking for the data necessary to assess the creditworthiness of the underlying mortgages and being told, “Any request for loan level tapes is TOTALLY UNREASONABLE!!!” Hill, supra note 18, at 592. See also Ceresney, Eng &
Nuttall, supra note 40, at 265 (“[I]ndustry practice was to give the rating agencies only limited information, while the most detailed date concerning loan pools were not disclosed.”).

72 Lupica, supra note 18, at 661 (“Over-reliance on the ‘math’ to the exclusion of consideration of subjective factors impacting credit quality such as the issuer’s management quality, competitive market position, financial policy, capital structure, cash flow protection, accounting practices, and the general economic environment led to inaccurate conclusions about levels of risk. Analysts cast aside their judgment in favor of the illusion of an objective risk numerical.”); Partnoy & Skeel, supra note 31, at 1044 (“The mathematical precision of the models is illusory because numerous subjective factors enter into the process as well.”).

73 Ceresney, Eng & Nuttall, supra note 40, at 228 (“In many areas being investigated, there simply may not have been intentional misconduct or criminally negligent behavior, but rather plain bad judgment on the part of market actors.”).

74 Dennis, supra note 3, at 1137 (describing an SEC report which found “that one agency regularly lowered the loss estimates that were indicated by their statistical models and did not disclose this practice.”).

75 Lupica, supra note 18, at 649 (“A central failing of the market is directly tied to the ‘too-clever-by-half’ structure of many of these complex transactions: few truly understood these transactions, the nature of the investments being sold, and how to evaluate the risk associated with the underlying asset.”); Moran, supra note 4, at 40 (“The complexity of CDOs often rendered them opaque even to the credit rating agencies, making the ratings suspect.”).

76 See e.g., Hill, supra note 16, at 82 (“[T]he rating agencies’ level of financial sophistication did not rise with the level of things about which they had to become sophisticated…”).
Mendales, supra note 7, at 1380 (“[I]n the increasing frenzy of the housing bubble, credit analysts at the rating agencies cut more corners as the volume of issues exceeded their capacity to examine offerings presented to them for analysis.”). Hence, the SEC Summary Report concludes that ratings were issued in spite of inadequate staffing who in many cases lacked the expertise to deal with the complexity of the structured financial instruments being rated, and models that admittedly did not capture risk well. Securities Exchange Commission, Summary Report of the Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies (2008) at 12, available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf [hereinafter Summary Report].

Lupica, supra note 18, at 649 (“While minimizing risk and making money is what the finance industry does…, with escalating profits comes the risk of complacency. Bankers and CRAs fell into this complacency by failing to recognize and address some of the securitization’s fault lines.”).

It is well-documented that the CRAs have expended millions of dollars in lobbying against governmental regulation. Combined, the “Big Three” ratings agencies have spent over $16 million on lobbying expenses over just the past decade to influence legislation aimed at greater regulatory oversight of the CRA industry. Moreover, they have been described as being “quasi-governmental” entities due to their ability to influence government policy. Daniel Eggan, Standard & Poor’s, Others Lobby Government while Rating its Credit, WASH. POST, August 10, 2011 (“S&P wields a huge club over Congress and the president because the company can simply dictate public policies that have huge ramifications for the country and for the government. Its influence over the government’s purse can easily be employed as a powerful
tool to win concessions from the federal government that are in S&P’s own interest rather than in the public’s interest.”)(quoting Craig Holman of the Public Citizen advocacy group).


Dennis, *supra* note 3, at 1114 (“The dominant view concerning regulation of the rating agencies is based upon the ‘reputational-capital’ theory, which holds that an agency’s success is primarily a result of the agency’s track record in issuing accurate ratings.”); Krebs, *supra* note 3, at 134 (“This is due to the thought that any resulting reputational damage from non-neutral opinions would severely damage long-term profitability, in exchange for mere short-term profits.”).

Partnoy, *supra* note 19, at 4. Partnoy explains that in order for a credit rating to be credible to third parties the CRA must have reputational capital at stake. Partnoy, *supra* note 7, at 2 (“In other words, the certifying agent credibly must be able to pledge that it will suffer a loss, related either to litigation or declining reputation, if its certification is systematically biased or false.”).

Rousseau, *supra* note 13, at 637-8 (“If a CRA has a reputation for erratic or biased analysis, investors will discount the value of the ratings assigned. If investors doubt the accuracy or independence of the ratings of a particular CRA, issuers will seek a more credible agency to signal their creditworthiness.”).

See Rousseau, *supra* note 13, at 637-640 where she discusses the debate.

Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 *Carozo L. Rev.* 1553, 1674 (2008)(“[I]n 2006 federal legislation imposed a small measure of regulatory oversight on rating agencies, which until then were essentially unregulated.”); Mendales *supra* note 7, at 1375 (“The rating agencies… were largely unregulated until 2006.”).


Hill, *supra* note 16, at 44 (“Favorable treatment for securities highly rated by NRSROs is the principal feature of the regulatory regime; the NRSROs themselves are not subject to substantive monitoring.”); Mendales, *supra* note 7, at 1386 (“CRARA requires an agency to discuss its general methods and procedures in its registration application, but does not require it to disclose the data underlying its statistical models or other aspects of its methodology as applied to individual securities being rated.”).

Lynch, *supra* note 7, at 268.


15 U.S.C. § 78o-7(h)(1)(2006)(requiring CRAs to develop written policies “to address and manage any conflicts of interest that can arise from such business.”).

Kim, *supra* note 3, at 426 (arguing that the threat of civil liability can incentivize firms to act as effective gatekeepers by “raising the costs of complicity). See also David A. Maas,


94 Kettering, supra note 86, at 1688 (quoting Professor Partnoy).

95 “[T]he security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization… shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act.”


96 Kettering, supra note 86, at 1689. See Hunt, supra note33, at 190-195 where liability for security fraud is discussed including some suits stemming from the GFC.

97 Nagy, supra note 16 (“[A] surge of litigation flowing from the financial crisis had begun to flood the United States.”); Unterman, supra note 37, at 79 (“As of July 2008, at least 132 subprime and [structured-finance] related class action lawsuits have been initiated…”).

98 A problem facing investors bringing claims against CRAs for negligence involves the extent to which the CRA owed investors a duty of care. Similarly, investors suing based on breach of contract have faced lack of privity defenses. In other words, CRAs have successfully argued that investors are not in privity of contract with the CRA and that they are not intended
third-party beneficiaries entitled to sue for breach of any contract. See e.g., Quinn v. McGraw-Hill, 168 F.3d 331 (7th Cir. 1999)(contract between issuer and CRA not intended to benefit investor); First Equity Corp. v. Standard & Poor’s Corp., 869 F.2d 175, 179 (2d Cir. 1989)(finding lack of privity); Jaillet v. Cashman, 189 N.Y.S. 743, 744 (Sup. Ct. 1921)(“There is no privity between this plaintiff and the defendant. He is but one of a public to whom all news is liable to be disseminated.”). Moreover, courts have denied liability based on negligent misrepresentation finding the absence of the requisite “special relationship.” See e.g., First Equity Corp. v. Standard & Poor’s Corp., 869 F.2d 175 (2d Cir. 1989). See generally, Murphy, supra note 33, at 777-779 where the issue of privity is discussed.

99 Plaintiffs have found it difficult to prove justifiable reliance. The court, in the case of Quinn v. McGraw Hill held that investor reliance on the rating was unreasonable absolving the CRA from liability. Quinn v. McGraw-Hill, 168 F.3d 331 (7th Cir. 1999). The Court relied on boilerplate language warning the investor that the rating was not a recommendation to buy or sell. Hence, the Court found that these statements “should have alerted Quinn to the fact that he was responsible for doing his own homework about the risks he was assuming.” Id., at 336. Arguably, this is at least in part, based on the court’s view that ratings are mere opinions. See Caleb Deats, Talk that Isn’t Cheap: Does the First Amendment Protect Credit Rating Agencies’ Faulty Methodologies from Regulation?, 110 COLUM. L. REV. 1818, 1854 (2010)(“If the Court expects readers to approach opinions skeptically…, those who seek to rely on predictive opinions likely must demonstrate a similar skepticism.”). But see Murphy, supra note 33, at 780-782 (arguing that ratings impact the market and, thus, meet the reliance standard).

100 Jefferson County School District v. Moody’s Investors Services, 175 F.3d 848, 856 (10th Cir. 1999).
The Jefferson court offered a distinction between “evaluative opinions,” or opinions which cannot be proven false, and “deductive opinions,” or opinions which “state or imply assertions that maybe proven false.” Jefferson County, 175 F.3d 848, 853. The requirement that the statement be “provably false” also relates to the First Amendment defense discussed below. Because the First Amendment qualified privilege can only be overcome by a showing of malice and in order to prove malice one must show knowledge of falsity, courts have held that only statements that are “provably false” can withstand First Amendment protection. See e.g., Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990). See generally Deats, supra note 99, at 1833-35 where this is discussed.

102 Compuware Corp. v. Moody’s Investors Services, 499 F.3d 520, 529 (6th Cir. 2007).

103 Krebs, supra note 3, at 156; Sullivan, supra note 92, at 2151.

104 See Jefferson County Sch. Dist. v. Moody’s Investor’s Servs., Inc., 988 F.Supp. 1341, 1348 (D. Colo. 1997), aff’d 175 F.3d 848 (10th Cir. 1999). See also Crawford, supra note 7; Freeman, supra note 58; Thomas J. Pate, Triple-A Ratings Stench: May the Credit Rating Agencies be Held Accountable?, 14 BARRY L. REV. 25, 44 (2010)(“Most of the cases brought against CRAs have failed on the basis of the argument that they are members of the press and that their ratings are protected under the heightened actual malice standard.”).


106 The phrase “world’s shortest editorial” was coined in a law review note. Gregory Husisian, supra note 93, at 446.

107 See e.g., Nagy, supra note 16, at 141-2 (“Despite harboring enormous influence in all areas of the financial markets, rating agencies have deflected liability for their inaccurate ratings by claiming that their core function is journalism – that they serve to gather and analyze
newsworthy financial information and then disseminate opinions about this information to the public”). The Court in *Dun & Bradstreet, Inc., v. Greenmoss Builders, Inc.*, 472 U.S. 749, 763 (1985), explained that the First Amendment creates a privilege applicable to “expression on a matter of undoubted public concern.” Whether something is deemed to be a matter of public concern “must be determined by the content, form, and context of a given statement…” *Connick v. Myers*, 461 U.S. 138, 147-48 (1983).

108 New York Times v. Sullivan, 376 U.S. 254, 279-80 (1964)(defining actual malice as a statement made “with knowledge that it was false or with reckless disregard of whether it was false or not.”). The Court justified this protection by stating that “erroneous statement is inevitable in free debate, and … must be protected if the freedoms of expression are to have the ‘breathing’ space that they ‘need to survive.’” *Id.*, at 271-272.

109 *Crawford*, *supra* note 7, at 19; Jonathan W. Heggen, *Not Always the World’s Shortest Editorial: Why Credit-Rating-Agency Speech is Sometimes Professional Speech*, 96 IOWA L. REV. 1745, 1755 (2011). See *Murphy*, *supra* note 33, at 776-777 where she discusses the fact that the New York Times test was designed to immunize reporters from defamation claims not claims based on negligence, fraud or negligent misrepresentation (the claims typically asserted against CRAs).


111 *Jefferson County*, 175 F. 3d 848 (10th Cir. 1999).

See e.g., Noemi Blumberg, Johanna Wirth & Nikita Litsoukov, The Liability of CRAS to Investors: A Review of the Current Liability Regime and Recent SEC Proposals, 16 J. OF STRUCTURED FIN. 34 (2011); Crawford, supra note 7 (arguing that the First Amendment should apply in the case of traditional corporate finance but not in structured finance); Deats, supra note 99 (arguing that CRA ratings should be considered commercial speech); Parisa Haghshenas, Obstacles to Credit Rating Agencies’ First Amendment Defense in Light of Abu Dhabi, 8 FIRST AMEND. L. REV. 452 (2010)(arguing CRAs should be denied First Amendment protection); Heggen, supra note 109 (arguing CRA ratings should be classified as commercial speech); Nagy, supra note 16 (First Amendment should not shield CRAs from liability): Kristofer W. Nelson, Rough Waters for the Ratings Companies: Should the Securities Ratings Companies be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007-2008?, 63 U. MIAMI L. REV. 1177 (2009)(CRAs should face civil liability): Jonathan Sack and Stephen M. Juris, Rating Agencies: Civil Liability Past and Present, 238 N.Y. L. J. 88 (2007), available at http://www.maglaw.com/publications/data/00144/_res/id=sa_File1/0701107002morvillo.pdf (arguing that First Amendment rights should be afforded CRAs).

Haghshenas, supra note 113, at 457.

Haghshenas, supra note 113, at 460.

One early court that refused to apply the First Amendment bar was the court in Commercial Financial Services v. Arthur Anderson, 94 P.3d 106 (Okla. Civ. App. 2004). In this case the court highlighted the fact that the defendant CRA was paid by the issuer to issue the rating stating “If a journalist wrote an article for a newspaper about the bonds, the First Amendment would presumably apply, but if [a company] hired that journalist to write a
company report about the bonds, a different standard would apply.” *Id.*, at 109. This distinction will also be important in the *Abu Dhabi* case discussed below. See *infra* notes 126-134 and accompanying text.


118 It should be noted that this case dealt with credit reporting agencies, not credit rating agencies. Subsequent courts considering immunity in the case of CRAs have, however, used this case as precedent.

119 Dun & Bradstreet, 472 U.S. at 762. In the Dun & Bradstreet case the report only went to five subscribers who were prohibited from passing on the information.

120 Dun & Bradsteet, 472 U.S. at 753. They are, therefore, not the type “of media worthy of the First Amendment protection.” *Id.* The Court in *New York Times v. Sullivan*, however, made it clear that the Constitutional protection was applicable to speech published as part of a paid advertisement. *New York Times*, 376 U.S. 254, 266.

121 Dun & Bradstreet, 472 U.S., at 762. The Court concluded that the profit motive reduced any “incremental ‘chilling effect’ that government restriction might impose.” *Id.*, at 763. See Murphy, *supra* note 33 at 772 where this language is discussed to support her conclusion that credit ratings should be considered as commercial speech and, thus, not granted the actual malice protection (“*[T]he rationale in Dun & Bradstreet suggests that the actual malice standard should not be applied to NRSROs at least in part because of the verifiable and profitable nature of the speech.*”).


123 In re Fitch, 330 F.3d at 111.
In re Fitch, 330 F.3d at 109 (“Unlike a business newspaper or magazine, which would cover any transactions deemed newsworthy, Fitch only ‘covers’ its own clients. We believe this practice weighs against treating Fitch like a journalist”). Other courts also relied on the compensation scheme to deny First Amendment protection. See e.g., Commercial Financial Services Inc. v. Standard & Poor’s, 94 P.3d 106, 110 (Okla. 2004)(The court compared the CRA to a journalist hired to “write a company report.”).

The Court highlighted the fact that Fitch had recommended “changes to the deal’s structure [that] would be required to achieve the desired rating.” In re Fitch, 330 F.3d at 107. Moreover, it stated that the actions by the CRA in structuring the transaction showed a “level of involvement with the client’s transactions that is not typical of the relationship between a journalist and the activities upon which a journalist reports.”). Id., at 110-111. See also LaSalle National Bank v. Duff & Phelps Credit Rating Agency, 951 F. Supp. 1071 (S.D. N.Y. 1996).

Here, the court also emphasized the fact that the CRA had a “substantial influence in the drafting” of the issue in rejected First Amendment protection. Id., at 1076. See generally, Murphy, supra note 33, at 775-776 where the details of CRA involvement in the LaSalle case are highlighted.


Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d at 176 (comparing the rating of the private placement issues to the “specific business audience” discussed in the Dun & Bradstreet, Inc. v. Greenmoss case.)
Heggen terms this a “single factor inquiry.” Heggen, supra note 109, at 1757. Courts since Abu Dhabi have followed this reasoning. See e.g., LaSalle National Bank v. Duff & Phelps Credit Rating Co., 951 F.Supp. 1071 (S.D.N.Y. 1996) (holding that the rating assigned to an issue sold through private placement was not of general interest to the public and, hence, denying First Amendment protection).

Some commentators have questioned a distinction based on breadth of dissemination. See e.g., Deats, supra note 99, at 1822-3 (arguing that courts should reject the dissemination test and instead view ratings as commercial speech because such as approach would provide “a standard for private liability that neither immunizes egregious conduct nor threatens the financial viability of the rating industry.”). At least one scholar has argued that if the court is concerned with damage to investors from a limited placement (arguably injuring a small number of investors), it should be more concerned with a broader offering, arguably injuring the general public. See Haghshenas, supra note 113, at 479 (arguing that CRAs should be treated the same as the other participants in the bond transaction because the ratings “affect all those who have an interest in the financial sector. This occurs in any transaction between the issuer and the rating agency where their private contract, clouded with motivation (by both parties) for financial benefit, invites the presumption that the rating is not an accurate, independent assessment of the underlying risk and thereby can have detrimental effects in the marketplace”). Haghshenas, id., at 482. This argument has some initial appeal. It is true that the general public might suffer more from broader dissemination of a rating. However, it ignores the fact that First Amendment protection is afforded to the press whose statements get broad dissemination.

Instead, the rationale for making the extent of distribution a litmus test is apparently based on the assumption that public discourse will result from the wide distribution of statements
of public concern and that public discourse will mitigate the consequences of any inaccuracies in the statement. Thus, courts have placed importance on the ability of readers to independently verify the claims made. See Va. State Bd. of Pharmacy v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 771-772 (1976). See also Deats, supra note 99, at 1852 (“[T]he Court’s citation to Virginia State Board of Pharmacy indicates that it is concerned with the relative abilities of speakers and listeners to verify the relevant claims.”). However, if the readers’ ability to independently verify the statements made is important, ratings of the structured finance products that are the subject of this article should not be afforded First Amendment protection regardless of the extent of the distribution of the rating. In the case of MBSs, typical investors lacked both access to relevant information and the expertise to evaluate and form their own judgments as to the risk and value of the investment. See supra notes 57-59 and accompanying text.

Moreover, courts have failed to draw a line between the public at large and a “select group of investors.” How many investors must be involved before the rating becomes a matter of “public concern?” To some extent, the number of investors seems to be an almost irrelevant concern. Given the public impact and GFC crisis that was the result of the inaccurate ratings, it seems counter-intuitive to argue that they were not a matter of public concern. Similarly, it is contradictory to recognize on the one hand the quasi-public role that CRs play as gatekeepers, and on the other hand, to conclude that ratings are not a matter of public policy. In addition, if the question is one of whether the rating is a matter of public v. private concern, it seems odd that the court focuses on its distribution rather than its content. See Deats, supra note 99, at 1842 where he raises these questions.
Abu Dhabi, 651 F. Supp. 2d at 176 (‘[T]he Rating Agencies did not genuinely or reasonably believe that the ratings they assigned to the Rated Notes were accurate and had a basis in fact.”). The Court relied on the fact that the CRAs knew that the portfolio was comprised of more than 55% of MBSs and this “made the SIV a risky investment and certainly not deserving of high ratings.” Id., at 178.

Abu Dhabi, 651 F. Supp. 2d at 179.

Abu Dhabi, 651 F. Supp. 2d at 167.


Abu Dhabi, 651 F. Supp. 2d at 179.


CalPERS Complaint, supra note 25. See generally Nagy, supra note 16, at 147 where this complaint is discussed.

CalPERS Complaint, ¶ 40.

The Complaint quotes a former Chief Operating Officer of Moody’s stating, “You start with a rating and build a deal around a rating.” Complaint, ¶ 47.

CalPERS Complaint, ¶ 42.

CalPERS Complaint, ¶ 64.

CalPERS Complaint, ¶ 65.
The portion of their complaint based upon interference with prospective economic advantage was dismissed by the Superior Court of the State of California. CalPERS v. Moody’s Investors Service, Inc., Case No. CGC-09-490241, Order Overruling in Party and Sustaining in Part Defendants’ Demurrers to Complaint (June 1, 2010), available at http://ratingagencylawblog.files.wordpress.com/2010/06/calpers-v-moodys.pdf. [Hereinafter CalPERS Order]. The Court upheld the claim based on negligent misrepresentation stating that, “Having considered all of the allegations of the Complaint, the Court finds that Plaintiff has properly and full alleged, with specificity, each and every element of a cause of action of negligent misrepresentation against each Defendant.” Id., at 10.

CalPERS Order, supra note 143.

Id., at 8 (“The issuance of these SIV ratings is not, however, an issue of public concern”).

Id.

Id.

The Superior Court of California relied on Abu Dhabi and “concluded that where a credit rating is directed not to the public at large but ‘provided instead in connection with a private placement to a select group of investors,’ that rating is not a matter of public concern. That is the case here.” Id., at 8-9. (Citing Abu Dhabi, 651 F. Supp. 2d 155 at 175-176).

Dun & Bradstreet, 472 U.S. at 762.

CalPERS Complaint, ¶ 63-68.

CalPERS Complaint, ¶ 78. The complaint cites a New York Times article in which Mark Adelson, former managing director for Moody’s remarked that using historical data was “like observing 100 years of weather in Antarctica to forecast the weather in Hawaii.” Id.
152 CalPERS Complaint, ¶ 74.
153 CalPERS Complaint, ¶ 72.
154 CalPERS Complaint, ¶ 79.
155 CalPERS Complaint, ¶ 68.
157 Rousseau first coined the term accountability gap and termed the gap “worrisome.” See Rousseau, supra note 13, at 643.
159 For commentary on the Obama Proposal, see generally Black, supra note 87; Frank D’Souza, Nan S. Ellis & Lisa M. Fairchild, Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market, (2010).
160 Dodd-Frank was, at least in part, the Congressional response to the Obama Proposal.
161 It has already begun to be the source of comment by scholars. See e.g., Benjamin H. Brownlow, Rating Agency Reform: Preserving the Registered Market for Asset-Backed
The areas of regulation covered by Dodd-Frank are: 1) consumer protection; 2) resolution authority of the government to seize failing financial institutions that are deemed to pose a systemic risk to the economy; 3) systemic risk regulation; 4) limits to banks’ trading risks (a.k.a. “the Volker Rule”); and 5) regulation of derivatives. See Mishkin & Eakins, supra note 11, at 448-449.

Dodd-Frank § 932 (A)(6).

(i) With respect to the practices of nationally recognized statistical rating organizations in determining ratings, for the protection of users of credit ratings and in the public interest;

(ii) To promote accuracy in credit ratings issued by nationally recognized statistical rating organizations; and

(iii) To ensure that such ratings are not unduly influenced by conflicts of interest.

Section §15E(p) of 1935 Act, as amended by Dodd-Frank § 932. See generally, Linda Singer, Zachary Best & Nina Simon, Breaking Down Financial Reform: A Summary of the Major
The annual examinations are intended to focus on whether the CRA follows policy when conducting business, a review of how the CRA manages its conflicts of interest, the implementation of ethics policies, internal supervisory controls, governance, other business activities of the NRSRO, the process by which the CRA handles complaints and how the CRA governs the activities of its former employees. Dodd-Frank, §932.

Moreover, the information must be made freely available and each NRSRO must provide an attestation with any credit rating it assigns indicating that the rating was determined without influence from other business activities, was based on the characteristics of the rated instrument, and the rating represents and independent assessment of the risks and characteristics of the instrument. Dodd-Frank, § 932(F). This relates to the conflicts of issue problem discussed infra.

Moreover, further study by other affected administrative agencies is mandated. § 939A.

A possible sixth issue is the lack of competition in the industry. See supra note 87 where the fact that one of the foci of the CRARA was this lack of competition. We have chosen not to
include this as a separate issue but will be cognizant of the concentrated nature of the market as we discuss proposals for reform.

175 It has been seen as especially effective in regulating gatekeeper behavior. See e.g., Stephen Choi, Market Lessons for Gatekeepers, 93 NW. U.L. REV. 916, 934-49 (arguing against imposing gatekeeper liability on underwriters); Howell E. Jackson, Reflections on Kay, Schoder: Enlisting Lawyers to Improve the Regulation of Financial Institutions, 66 S. CAL. L. REV. 1019, 1049-72 (1993)(arguing against imposing gatekeeper liability on attorneys). Both Choi and Jackson argue that incentives to protect reputational capital are sufficient and further liability is unnecessary.

176 The notion of reputational capital has been applied to other financial market participants such as investment banks. See Randolph P. Beatty and Jay R. Ritter, Investment Banking, Reputation, and the Underpricing of Initial Public Offerings, 15 J. FIN. ECON. 213 (1986); Richard Carter and Steven Manaster, Initial Public Offerings and Underwriter Reputation, 45 J. OF FIN. 1045 (1990).

177 Richard Cantor & Frank Packer, The Credit Rating Industry, FRBNY Quarterly Review/Summer-Fall 1994, available at: http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n2article1.pdf; Dennis, supra note 3, at 1114 (“Thus, the agency’s interest in maintaining a reputation for accurate ratings will be sufficient incentive to insure accurate ratings and regulation is unnecessary.”); Hunt, supra note 33, at 113 (“[I]f investors determine that a rating agency’s ratings are of low quality, they will stop creating the ratings, and the agency’s business will lose value.”); Jonathan R. Macey, Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation, 65 U. CHI. L. REV. 1487 (1998).
See Lynch, supra note 7, at 250-251 (“[A]ny agency which persistently issued inaccurate ratings, for whatever reason, … would tarnish its reputation and not survive in the marketplace.”): Kim, supra note 3, at 424 (“Because reputation is hard to gain but easy to lose, these intermediaries are viewed as ideal market gatekeepers because they already ‘face powerful private incentives to prevent misconduct.’”)(quoting Reinier H. Kraakman, Gatekeepers: the Anatomy of a Third-party Enforcement Strategy, 2 J.L. ECON. & ORG. 53, 62 (1986)). Kim, supra note 3, at 424 (“[T]he empirical data raise questions about the importance of reputational capital to effective gatekeeping.”). Kim relies on studies of accounting firms and lawyers, but the results should be equally applicable to CRAs. By contrast, see e.g., Schwarcz, supra note 20, at 26 (“Historical data confirm that reputational motivation is sufficient.”). Frank Partnoy, Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime, 79 WASH. U.L. Q. 491, 509-510 (2001)(“Because of the wide range of regulation that depends substantively on specified credit ratings, the assumption that credit rating agencies have survived and prospered based on a reputation for quality simply does not hold.”).

Dennis, supra note 3, at 1131.

See Lynch, supra note 7, at 250-251 (“[A]ny agency which persistently issued inaccurate ratings, for whatever reason, … would tarnish its reputation and not survive in the marketplace.”): Kim, supra note 3, at 424 (“Because reputation is hard to gain but easy to lose, these intermediaries are viewed as ideal market gatekeepers because they already ‘face powerful private incentives to prevent misconduct.’”)(quoting Reinier H. Kraakman, Gatekeepers: the Anatomy of a Third-party Enforcement Strategy, 2 J.L. ECON. & ORG. 53, 62 (1986)). Kim, supra note 3, at 424 (“[T]he empirical data raise questions about the importance of reputational capital to effective gatekeeping.”). Kim relies on studies of accounting firms and lawyers, but the results should be equally applicable to CRAs. By contrast, see e.g., Schwarcz, supra note 20, at 26 (“Historical data confirm that reputational motivation is sufficient.”). Frank Partnoy, Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime, 79 WASH. U.L. Q. 491, 509-510 (2001)(“Because of the wide range of regulation that depends substantively on specified credit ratings, the assumption that credit rating agencies have survived and prospered based on a reputation for quality simply does not hold.”).

Dennis, supra note 3, at 1140; Partnoy, supra note 16, at 653.

Crawford, supra note 7, at 17. Crawford cites a Wall Street Journal editorial as asking, “how badly do the major credit-rating firms have to perform before investors stop using their services? That’s a trick question, because investors aren’t allowed to stop using them.” Editorial, The Ratings Racket, WALL ST. J., June 25, 2008, at A14.

Crawford, supra note 7, at 17. A former Moody’s executive describes the intense short term pressures as a factor in decision making. He states, “It is argued that building a stellar reputation requires a long-term horizon and view. Yet managers of publicly owned rating
agencies are subject to intense short-term pressure to demonstrate earnings growth. It takes
tremendous discipline to turn away business, particularly when competitors are building market
share.” Id. Lynch, supra note 7, at 252-253 (“Without premiums for high quality items, sellers
would find that a fly-by-night strategy of quality reduction would be profit-maximizing. The
reason is that, in markets with reputations, sellers can always increase profits in the short-run by
reducing the quality of their products. After all, quality reductions will yield immediate cost
savings, while the adverse effect on reputation will arise only in the longer run.”)(quoting Carl
Shapiro, Premiums for High Quality Products as Returns to Reputations, 98 Q.J. ECON. 659, 660
(1983); Hill, supra note 18, at 592-593 describes a situation where Moody rated a CDO.
Subsequently it was discovered that there had been an error in the computer coding in the model
that threw the results way off. However, after correcting the error and rating the issue using the
new model, it still earned a AAA rating. Hill concludes that, “Moody’s had been too eager to
find a way for the instruments to be AAA; confronted with the discovery that their model that
supported the AAA rating was flawed, rather than adjusting the ratings, they ‘fixed’ the model so
the instruments could continue to ‘be’ AAA.” Hill, id., at 593.

185 Lynch, supra note 7, at 267. During the period of time from 2002 to 2007, CRA
revenues doubled from $3 billion to $6 billion. Pate, supra note 104, at 261. See also Dennis,
supra note 3, at 1133 where he concludes that “[t]he rapid increase in demand for ratings of
mortgage-backed securities and CDOs created an environment in which the benefits of
inaccurate ratings outweighed the potential costs.”

186 Kim, supra note 3, at 425.

187 Partnoy, supra note 181, at 502 (asserting that the reputational capital “argument breaks
down if buyers cannot verify the quality of a product ex post.”).
Lynch, supra note 7, at 253 ("Additionally, it is not evident that the market is or has been particularly sensitive to any rating agency capture by issuers or to the rating agencies’ failure to issue accurate ratings.") ("Indeed, it is difficult enough to determine what an ‘accurate’ rating would be, given the fact that it is a prediction of the uncertain future. So, there is immediately reason to doubt that investors would be particularly sensitive to any but the grossest inaccuracies.").

Darcy, supra note 25, at 643 ("[T]he CRA would need to anticipate that the inflated ratings would impact its reputation for rating other types of products; since many of the securities at issue in the Credit Crisis were novel, the CRAs did not have reputations for rating them and thus had no reputation to damage."); Dennis, supra note 3, at 1134; Hunt, supra note 33, at 114 ("It is not plausible to argue that rating agencies have a valuable reputation for rating instruments they have never rated before."). See also Hunt, id., at 155-181 where he concludes that reputation is unlikely to constrain CRA behavior with respect to novel products.

Dennis, supra note 3, at 1134.

Coffee, supra note 2, at 409. Coffee argues that CRAs were apparently more concerned with protecting their reputation as innovative as opposed to accurate.

See e.g., Hunt, supra note 33, at 131 where he concludes that “reputational constraints on low quality are fundamentally insufficient in some situations – such as in rating novel financial products – and that no amount of tinkering will cause the reputational mechanism to work in those circumstances.”).

In 1931, the U.S. Comptroller of the Currency set forth a rule by which bonds that were rated BBB or high could be carried in a bond account by a national bank at cost. By contrast, bonds with lower ratings required a fractional write-off. Partnoy, supra note 19, at 8-9. See also
Ceresney, Eng & Nuttall, supra note 40, at 264 (“The modern role that credit agencies play in financial markets can be traced to a U.S. Treasury Department decision in 1931 to adopt credit ratings as the appropriate measure of quality for the bond accounts of nationally regulated banks.”). The Banking Act of 1935 imposed this restriction limiting purchases by national banks to “investment grade.” Brownlow, supra note 161, at 115; Dennis, supra note 3, at 1117; Devine, supra note 7, at 180. In 1936, a prohibition was imposed on the federal level which prevented banks from investing in “speculative investment securities” as determined by “recognized rating manuals.” White, supra note 7, at 7. On February 15, 1936, the Comptroller issued the following:

“(3) The purchase of ‘investment securities’ in which the investment characteristics are distinctly and predominantly speculative, or ‘investment securities’ of a lower designated standard than those which are distinctly and predominantly speculative is prohibited.*”

* The terms employed herein may be found in recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two rating manuals.”

Partnoy, supra note 19, at 9, (citing Regulations Governing the Purchase of Investment Securities, and Further Defining the Term “Investment Securities” as Used in Section 5136 of the Revised Statutes as Amended by the “Banking Act of 1935,” Sec. II, issued by the United States Comptroller of the Currency, Washington, February 15, 1936). See generally White, supra note 7, at 6-10 where the move toward regulatory dependence on ratings is outlined and Sy, supra note 80, at 9-11 where the rationale behind regulatory dependence on ratings is discussed.
Dennis, supra note 3, at 1117; Krebs, supra note 3, at 137 (“A large amount of government regulation mandates ratings assigned by these agencies to be considered to meet official regulatory requirements. These requirements are extensive and include rating thresholds for banks, trust companies, pension funds, insurance companies, and money market funds.”); Partnoy, supra note 19, at 10 (“After 1936, these regulations essentially prohibited banks, pension funds, insurance companies and other institutions from holding low-rated bonds altogether.”).

Mendales, supra note 7, at 1374; Mulligan, supra note 7. In 1973, the SEC adopted Rule 15c3-1. In Rule 15c3-1, the SEC recognized the usefulness of NRSROs as a basis for “establishing a dividing line for securities with a greater or lesser degree of market volatility.” See Notice of Revision Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934, Release No. 34-10,525, 1973 SEC LEXIS 2309 (Nov. 29, 1973). See also Darcy, supra note 25, at 624 where she explains how Rule 15c3-1 allowed securities rated by NRSROs to qualify under the “hair cut” rule.

Partnoy, supra note 19, at 13 (“Since 1973, there have been credit-rating dependent rules and regulations promulgated under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and various banking, insurance, pension, and real estate regulations.”). See also Crawford, supra note 7, at 14 (“A raft of federal regulations restrict what securities banks and various investment vehicles may hold based on credit ratings.”); Darcy, supra note 25, at 625 (“According to the SEC, at least forty-four of its rules and forms incorporate references to credit ratings.”); Peter J. Justensen, Ratings Recall: Will New Reform Proposals Make Lasting Impact? 35 J. CORP. L. 193 (2009); Mulligan, supra note 7. Internationally, most countries have adopted the Basel II Revised International Capital
Framework that also relies on credit ratings. See Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 13 N.Y.U. J. LEGISL. & PUB. POL’Y 253, 255 (2010)(“The implementation of Basel II means that credit ratings have become an integral part of the methodology used to determine many financial institutions’ net capital reserve requirements worldwide.”); Pate, *supra* note 104, at 40 (“The consequence of this is that it allows regulated institutions to rely on ratings for the purpose of determining capital adequacy requirements, on some occasions replacing the need for the banks to assess the risks themselves.”).

Crawford, *supra* note 7, at 14 (“Sufficiently high ratings from an approved agency are prerequisites to the broad salability of most debt instruments.”); Mendales, *supra* note 7.

Actually, the extent to which the SEC is responsible for the highly concentrated industry is the subject of some debate. See Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis* (2001), available at: [http://papers.ssrn.com/paper.taf?abstract_id=267083](http://papers.ssrn.com/paper.taf?abstract_id=267083)(“A striking fact about the structure of the industry in the U.S. is its persistent fewness of incumbents. There have never been more than five general-purpose bond rating firms; currently there are only three. Network effects -- users' desires for consistency of rating categories across issuers -- are surely part of the explanation. But, for the past 25 years, regulatory restrictions (by the Securities and Exchange Commission) on who can be a "nationally recognized statistical rating organization" (NRSRO) have surely also played a role.”). See also Furchtgott-Roth, Hahn & Farrar, *supra* note 16, at 80 (“On top of these market forces already at work, it seems clear that the SEC has further limited entry.”).


Hill, *supra* note 26, at 1152. See also Mulligan, *supra* note 7, at 1296 (concluding that “[n]ew competitors could improve the current agencies’ performances by providing better
ongoing monitoring, which might improve the overall quality of ratings. In increasing the number of ratings agencies that the SEC designates as NRSROs, the market could become more specialized as agencies would work in particular industries; this, in and of itself, would improve the quality of ratings through increased expertise.”).

201 This argument is basically that if there were more competitors the CRA would run a greater risk of losing the issuer’s business if it provided a low credit rating. Mulligan, supra note 7, at 1296.

202 See e.g., Hill, supra note 18, at 626-7. Hill quotes a principal with the Egan-Jones rating agency as saying that an SEC told him, “We won’t tell you the criteria [for obtaining NRSRO designation], otherwise you might qualify.” Hill, supra note 16, at 55.

203 SEC Standards for Designating Nationally Recognized Credit Rating Organizations, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH (2002), available at http://www.aei.org/article/25 (“[T]he SEC’s "national recognition" criterion is too exclusionary and has little to do with the ability of a new rating firm or an established foreign rating firm to provide informative and reliable credit ratings. … The SEC should propose regulations that make explicit its criteria for designating and monitoring NRSROs and these criteria should have as their focus the ability of rating firms to provide credible and accurate credit ratings. A "national recognition" standard should not be part of these criteria.”); Rousseau, supra note 13, at 627 (“The problem is exacerbated by the relative lack of formality and transparency of the recognition process.”).

204 Partnoy, supra note 7, at 1; Partnoy, supra note 36, at 60-61 (“Part of the reason is that the most successful credit rating agencies have benefited from an oligopoly market structure that is reinforced by regulations that depend exclusively on credit ratings issued by Nationally
Recognized Statistical Rating Organizations (NRSROs). These regulatory benefits—which I call “regulatory licenses”—generate economic rents for NRSROs that persist even when they perform poorly.”); Thuy-Nga T. Vo, Rating Management Behavior and Ethics: A Proposal to Upgrade Corporate Governance Rating Criteria, 34 J. CORP. L. 1, 18 (2008)(“Empirical studies have not found a correlation between governance ratings and stockholder returns.”). Under this view, ratings are important because they reduce regulatory costs, not because they are accurate or a credible predictor of risk. Darcy, supra note 25, at 626.

Partnoy, supra note 19, at 66.

Lombard, supra note 38, at 3 (“[T]he lack of competition raises the concern that credit rating agencies have little incentives to upgrade their services and that it could contribute to general laxity.”). By contrast, see Hunt, supra note 33, at 21 ([S]ome have argued that competition can reduce rating quality given other departures from the ideal in the rating market. Agencies may engage in ‘competitive laxity.’

White, supra note 7, at 20 (arguing that regulations should “place the burden directly on the institution to justify the safety of its bond portfolio to its regulator.”). Partnoy, supra note 7, at 3. Arguably, the increased volume without an increase in staff or resources to conduct analysis was a contributing factor to the CRA failings with respect to rating MBSs. Murphy, supra note 33, at 749 (“These documents suggest that that agencies were grossly understaffed, with analysts’ average workweeks regulatory exceeding the sixty hours presumed in the agencies’ staffing models.”); Krebs, supra note 3, at 146.

Hill, supra note 18, at 591 (“The agencies were inundated with a huge volume of new structured finance deals that they were being asked to rate. At Moody’s, the flipside to the huge revenue growth was a high-pressure work environment. One analyst recalls rating a $1 billion

See also Murphy, supra note 33, at 549 where she recounts similar emails (“These conditions caused NRSROs to conduct more cursory examinations of the bonds. The substantial time constraints within the agencies also led to a relaxation of analytical standards.”). She concludes by stating, “In failing to conduct more prudent examinations, the credit rating agencies committed willful acts of blindness at the expense of unknowing investors.”


211 Senate Bill 3217, which became Dodd-Frank, had taken a more incremental approach. It would have directed the Comptroller General to review the scope of existing regulations that required the use of ratings by NRSROs. § 939 (a). Specifically, the study was to consider: 1) the necessity for an purpose of reference to ratings; 2) which rating requirements should be removed; 3) the potential impact on financial markets and investors if references were removed; and 4) whether markets and investors would benefit if the rating requirements were removed. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong., § 939 (b)(1)(A-D).

212 Dodd-Frank, § 939A (b).

213 Senate Bill 3217 specifically required consideration of “yield spreads, bond prices and credit default swap prices. S. 3217k, § 939(d)(1).

214 See John Patrick Hunt, One Cheer for Credit-Rating Agencies: How the Mark-to-Market Accounting Debate Highlights the Case for Rating-Dependent Capital Regulation, 60 S.C.L.
Federal securities law regulation is based on the premise of disclosure as the primary regulatory mechanism. Darcy, supra note 25 at 651-52 (“In the United States, disclosure is a touchstone of the federal securities laws. So long as investors receive full and fair disclosure of all relevant information regarding a security on the market, investors are considered adequately protected because they can evaluate the merits of the security for themselves.”); Thomas Lee Hazan, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling and Insurance*, 24 *Ann. Rev. Banking & Fin. L.* 375, 383 (2005); (“Disclosure rather than a merit approach remains the regulatory philosophy of the federal securities laws today.”). The theory is that if risks are made “transparent to all,” that investors would properly “price-in” all risks. Steven L. Schwarcz, *Systemic Risk*, 97 Geo. L. J. 193, 218 (2008).

Devine, supra note 7, at 178; Mendales, supra note 7, at 1361-2 (“The key to the problem is the fact that unregulated ratings for asset-backed securities became proxies for the full disclosure required by securities laws.”).

However, there is evidence that, leading up to the GFC, CRAs used undisclosed models Murphy, supra note 33, at 748. Moreover, there is evidence that they occasionally overrode the results of the models and assigned ratings higher than the models would have justified. Importantly, they failed to disclose that the ratings were determined by “out of model adjustments.” Dennis, supra note 3, at 1137; Lynch, supra note 7, at 265.
Moreover, it undermines public confidence in the ratings. Lupica, supra note 18, at 657 ("The lack of disclosure of fee structures and a lack of transparency of ratings process in general has served to undermine public confidence in their pronouncements.").

Lupica, supra note 18, at 657; Mendales, supra note 7, at 1362-3. Use of the rating system as “surrogate for due diligence” in evaluating CDOs has been identified as one of the origins of the GFC. Mendales, id.

Unterman, supra note 37, at 87. See also, Partnoy & Skeel, supra note 31, at 1036 (discussing the fact that the market for credit default swaps is “opaque” which means that the details of particular swaps are undisclosed). Moreover, they note that the International Swaps and Derivative Association has resisted calls for disclosure of credit default swap documentation.

Noah L. Wynkoop, The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives, 76 Fordham L. Rev. 3095, 3111 (2008)("Given this lack of relevant information in the credit market, traders cannot properly perform their function to create an efficient market."). See also, Silver & Slavkin, supra note 38, at 338 (“Neither regulators nor the public have access to sufficient information to assess the risk within these assets or counterparty exposure arising from participation in these opaque markets.”). Therefore, it has been argued that increased transparency is essential with respect to credit derivatives specifically. At least one commentator has noted the disparity between the increased disclosure requirements of the Sarbanes-Oxley Act of 2002 and the massive deregulation of the CFMA. See Hazan, supra note 215, at 382. Another believes that whether or not such increased transparency is statutorily mandated or voluntary is irrelevant. See generally Partnoy & Skeel, supra note 31, at 1046-47 (“We believe disclosure with respect to both credit default swaps and CDOs should improve, although we are agnostic as to whether improved disclosure requires government intervention.”).
Similar disclosure issues have been discussed relating to hedge funds. See, e.g., Jennifer Ralph Oppold, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach*, 10 U. PA. J. BUS. & EMP. L. 833 (2008).

222 See generally Hunt, *supra* note 33, at 138-142 where he outlines theories of both methodological and performance transparency.

223 For example, in the case of Enron, CRAs argued that they merely relied on the information provided to them by Enron and that they should not be responsible for rooting out fraud. However, as Professor Hill points out, “This response is persuasive when the fraud at issue is well-concealed; when the fraud is more obvious, as it was in Enron, even the company provided information arguably should have raised red flags.” Hill, *supra* note 26, at 1150. On the other hand, some have used this fact to exonerate CRAs from blame in the case of the GFC arguing that CRAs merely relied on the data furnished to them by the issuers and mortgage originators. See e.g., Editorial, *The Moody’s Blues*, WALL ST. J., Feb. 15, 2008, at A15.

224 Partnoy, *supra* note 19, at 12.


226 Following enactment of Dodd-Frank, the SEC has initiated action with respect to CRAs in light of the GFC. The SEC has promulgated regulations and has proposed additional regulations; some of the proposed rules were adopted by the SEC on December 3, 2008. Justensen, *supra* note 196. See generally, Krebs, *supra* note 3, at 142-146 where the new rules and regulations are discussed. These regulations have attempted to address the issue of lack of transparency by requiring limited disclosures by CRAs. Mulligan, *supra* note 7. In addition, the
regulations address the issues related to conflict of interest in limited ways. Other regulations have been proposed and are now out for public comment.

Section 15E (q)(1).

Section 15E (q)(2).

Dodd-Frank provides

“(A) In General. – The Commission may temporarily suspend or permanently revoke the registration of a nationally recognized statistical rating organization with respect to a particular class or subclass of securities, if the Commission finds… that the nationally recognized statistical rating organization does not have adequate financial and managerial resources to consistently produce ratings with integrity.”

Section 15E (d)(2)(A).

Dodd-Frank provides

“(B) Considerations. – In making any determination under subparagraph (A), the Commission shall consider –

(i) whether the nationally recognized statistical rating organization has failed over a sustained period of time, as determined by the Commission, to produce ratings that are accurate for that class or subclass of securities.”

Section 15E (d)(2)(B).

Even before passage of Dodd-Frank, the SEC exercised its rulemaking authority and imposed on NRSROs an obligation to disclose information about the underlying assets when
rating a structured product. Lupica, supra note 18, at 668. For example, NRSROs were required to make available to the public a random sample of ten percent of the credit ratings issued under the issuer–pays model. Neuman, supra note 30, at 937. This disclosure theoretically allows investors to judge the extent to which conflicts of interest created by the issuer-pays model impacted the credit ratings. See infra notes 246-299 and accompanying text where conflicts of interest are discussed. NRSROs must also disclose histories for each class of rating for which the NRSRO has issued 500 or more ratings. Moreover, if there are material differences between the ratings indicated by quantitative models used by NRSROs and the ratings issued, the NRSRO is required disclose its rationale for these differences. Rule 15g-2. See Neuman, id., at 937 where she discusses these rules.

235 See supra notes 62-74 and accompanying text.

236 Using issuer supplied data without verification as to the input for the models has been likened to a situation where accountant accept all figures supplied by firms without performing an auditing function. Crouhy, Jarrow & Turnbull, supra note 37, at 29. Even more shocking is the fact that in some instances CRAs inputted issuer supplied data that even they questioned. Lombard, supra note 3 at 6.

237 Krebs, supra note 3, at 146; Lynch, supra note 7, at 262.

238 Krebs, supra note 3, at 149; Pate, supra note 104, at 32.

239 Section 15E (s)(4)(A).

240 Section 15E (s)(4)(C).

241 White, supra note 7, at 18.
Lynch, supra note 7, at 275 (“It can be argued that their access to this nonpublic information and their synthesis of both public and nonpublic information into a generalized rating is the primary source of value to the investing world.”).

Partnoy, supra note 7, at 14. VAR was the most common mathematical model employed by CRAs. It attempted to measure risk boundaries in portfolio over the short run. See Green, supra note 50, at 22. Unfortunately, the typical VAR model only included known risks and rarely reported the impact of the “tail risks.” Green, id., at 23.


See generally Dennis, supra note 3 where he makes this argument.

See supra notes 22-24 and accompanying text where the issuer-pay model is outlined. This conflict has been compared to the conflict of interest auditors face when the audit the financial statements. Just like CRAs, the companies that are being audited pay the bills; just like CRAs, the auditing companies offer ancillary services. See generally, Neuman, supra note 30 where these comparisons are discussed.

See supra note 25.

Justensen, supra note 196; Lupica, supra note 18, at 662-663 (“Moreover, the emergence of CRA consulting divisions offering risk-assessment services to issuers presents further potential for conflicts of interest.”); Rousseau, supra note 13, at 629-630 (“The ratings decisions may be influenced by whether or not an issuer purchases additional services offered by a CRA.”). See also Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (2003),
available at http://www.sec.gov/news/studies/creditratingreport0103.pdf (“Issuers may feel compelled to buy ancillary services ‘out of fear that their failure to do so could adversely impact their credit rating, or, conversely, with the expectation that purchasing these services could help their credit rating.”).

249 Piekarski, supra note 87, at 272 (quoting The Role and Impact of Credit-Rating Agencies on the Subprime Credit Market Hearing before the S. Banking, SOUNDING AND URBAN AFFAIRS COMMITTEE, 110th Cong. (Sept. 26, 2007)(Statement of John Coffee)).

250 Lynch, supra note 7, at 247 (“The result is that, under the issuer-pays revenue model, the interests of issuers and the interests of credit rating agencies coalesce, and the credit rating agencies can make more money by providing the paying customers – issuers—with higher ratings. … Simply stated, the credit rating agencies have a strong incentive to issuer high ratings, whether or not the ratings are accurate.”): Rousseau, supra note 13, at 629 (“[A]gencies may be tempted to downplay the credit risk of issuers and to inflate their ratings in order to retain their business”). See Hunt, supra note 33, at 152 where he terms this a “firm level” conflict. He contrasts this with conflicts at the individual level that arise because the rating analyst might be influenced to issue a high rating to garner a promotion or lucrative compensation. Id.

251 Krebs, supra note 3, at 141 (“This is because the continuing ‘surveillance’ of the security is paid for in advance from each issue.”).

252 Turmoil in the U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 111th Cong. (2008), at 2 (Testimony of Professor John C. Coffee, Jr., Adolph A. Berle Professor of law, Columbia University law School), available at

AArgh!: Credit Rating Agencies, THE ECONOMIST, April 6 1996, at 80 (“By giving borrowers a low, unsolicited rating, the big agencies may force unwilling issuers to pay for their services in hopes of getting a better one”); Rousseau, supra note 13, at 636. See Francis A. Bottini, An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies, 30 SAN DIEGO L. REV. 579, 598 (1993)(discussing the tactic of issuing unsolicited ratings as a way to increase market share); Partnoy, supra note 36, at 60 (“In addition, credit rating agencies continue to face conflicts of interest that are potentially more serious than those of other gatekeepers: they continue to be paid directly by issuers, they give unsolicited ratings that at least potentially pressure issuers to pay them fees, and they market ancillary consulting services related to ratings. Credit rating agencies increasingly focus on structured finance and new complex debt products, particularly credit derivatives, which now generate a substantial share of credit rating agencies’ revenues and profits.”); Pinto, supra note
(unsolicited ratings present the question of whether the CRA is “attempting to illicitly increase market share.”).

See Rousseau, supra note 13, at 636-637 where she discusses this debate. Hill actually argues that the fact that unassigned ratings are a possibility provides a disincentive for a CRA to issue ratings that are too high. She argues that a CRA would be reluctant to issue a rating that is too high because there is always the possibility that another agency will offer an unsolicited rating that is substantially lower and the perception that the higher rating was inaccurate would damage the CRA’s reputation. See Hill, supra note 16, at 77 (“[T]o the extent a rating agency might be tempted to respond to issuer pressure to issue too high a rating, the possibility that another agency could render a lower unsolicited rating may serve as a disincentive.”).

Interestingly, some commentators have suggested that unsolicited ratings are offered occasionally to preserve the First Amendment defense to civil liability. See Pate, supra note 104, at 45 (“The conclusion would be that if credit rating agencies never issued unsolicited ratings, they would appear to be even less like financial publishers and therefore even less likely to be protected by free speech principles.”).

Cantor & Packer, supra note 177. See also Patrick Bolton, Xavier Freixas & Joel Shapiro, The Credit Ratings Game (Nat’l Bureau of Econ. Research, Working Paper No. 14712, 2009), available at http://www.nber.org/papers/w14712.pdf (questioning the effectiveness of the reputational capital model). In addition, it is worth noting that their profits have risen at the same time as the informational value of their ratings has declined; Partnoy, supra note 7, at 3.

Hill, supra note 18, at 593-594 (citing a study in which 11% of the investment professionals surveyed reporting seeing a CRA change a rating in response to pressure from an issuer).
See e.g., Hill, supra note 16, at 74-78; Lombard, supra note 3, at 4 (The way in which the market for credit ratings operates would indicate that this concern is more perceived than real, however.’); White, supra note 7 at 3 (“[T] focus on the issue pays business model [is] misguided. They ignore seven decades of history of the prudential regulation of financial institutions’ bond holdings….’). Darcy concludes that the general consensus prior to the GFC was that the issuer-pays model did not create fatal conflicts. Darcy, supra note 25, at 623 (“[T]he general consensus appears to be that any deficiency is CRA ratings prior to the Credit Crisis… did not result from the issuer pays conflict.”). Hill actually argues that the issuer pays model was “necessary for the rating agencies to have done as bad a job as they did rating subprime securities, but it was not sufficient.” Hill, supra note 18, at 586. She argues that instead the problem is that the agencies “drank the Kool-Aid” and convinced themselves that their assumptions were valid and that given the validity of their assumptions, their ratings were accurate.


Hill, supra note 16, at 75 (“Indeed, their reputations for independence may mean more than their reputations for expertise… Rating agencies can credibly say that they won’t readily risk their reputations.”); Neuman, supra note 30, at 943 (“Thus, a CRA’s survival is largely dependent upon its reputation for issuing credible and reliable credit ratings.”). See supra notes 175-192 and accompanying text where the reputational capital theory is critiqued.
See e.g., John C. Coffee, The Mortgage Meltdown and Gatekeeper Failure, N.Y.L.J., Sept. 20, 2007, at 2; Neuman, supra note 30, at 942; Dennis, supra note 3, at 1136.

Hill, supra note 16, at 75 (“Because of the two-rating norm, Moody’s and Standard & Poor’s are able to withstand the pressure issuers might exert to obtain higher ratings. The issuers’ threats to go elsewhere simply are not credible.”); Lombard, supra note 3, at 4-5 (“[T]here is furthermore very little competition in the credit rating market, which prevents a client from taking its business elsewhere if not satisfied with a particular rating.”). See also Bai, supra note 196 at 265-270 where the reputational argument is discussed.

White, supra note 7, at 16.

Id.; Neuman, supra note 30, at 942 (“Services other than traditional credit ratings account for only a small part of each CRA’s business.”)

Hill, supra note 16, at 77, n. 137 (quoting Vickie A. Tillman, “No portion of an analyst’s compensation is directly dependent on… the amount of fees paid by that specific company to Standard & Poor’s.”); Lombard, supra note 3, at 5 (contrasting the incentive-based compensation common in accounting firms with the compensation at CRAs). However, a recent SEC report acknowledged that analyst compensation was based on “individual performance and overall success of the firm.” Lynch, supra note 7, at 254. It is not uncommon, however, for the rating analyst’s, or his manager’s, compensation to be tied to revenue growth. Haghshenas, supra note 113, at 490. Given the huge amounts of revenue derived from the sale of MBS leading up to the GFC, this compensation scheme arguably influences ratings.

See e.g., Neuman, supra note 30 at 944.
Darcy, supra note 25 at 637-8 (“This section explores three key reasons why CRAs may have been subject to greater pressure from issuers to inflate ratings on these products than on corporate securities.”).

Moreover, even major issuers only go to the market every other year or so. Thus, no one issuer could unduly influence a CRA with a threat of a loss of business. Coffee, supra note 2, at 409-410 (“Thus, no client could dominate or credibly threaten them with a loss of significant business, and that gave them professional independence.”); Darcy, supra note 25 at 639 (“The market for rating corporate bonds consists of thousands of small issuers, each accessing the debt markets on an occasional basis.”).

The charge for rating corporate bonds is typically two to three basis points of the amount of the offering. Thus, each corporate bond rating individually provided little revenue. Darcy, supra note 25, at 639 (“Given the infrequency with which corporate issuers purchase ratings and the relatively low level of fees generated for a corporate debt issuance, each corporate issuer pays an insignificant amount of fees.”). Some reject even this argument pointing out that cumulative defection by even small issuers can add up to lost revenue. See Lynch, supra note 7, at 255 ([I]f issuers were treated with particular diligence or probed too deeply, or receive opinions which are harsher than they could receive at competitor rating agencies, issuers may take their business to other agencies – and there need not be too many ‘small’ customer defections before an agency’s overall revenues are seriously impaired.”).

Darcy, supra note 25, at 639 (“In contrast, the client base in the structured finance market is far smaller.”); Dennis, supra note 3, at 1136-7 (“While there are thousands of different entities… that comprise the universe of corporate bond issuers, issuers of mortgage backed securities are a much smaller and more homogeneous group comprised of a few very powerful
investment banks and mortgage companies.”); Lupica, supra note 18, at 662 (“[M]ost of the business originates from the finite investment banking community…”); Lynch, supra note 7, at 267 (“Because of the concentration of MBS and MBS-related CDO issuers, any one issuer could exercise considerable influence over the rating agencies; they could deliver – or withhold – a significant amount of business.”); White, supra note 7, at 16 (“There were relatively small number of mortgage securities packages (in essence, the issuers), so that the threat by any one of them that, unless they received the ratings that they wanted, they would take all of their business to a different rating agency, was far more potent.”).

Dennis, supra note 3, at 1137 (“More importantly, mortgage backed securities issuers access the credit markets on a much more frequent and regular basis than do corporate issuers.”). Partnoy emphasizes the importance of the potential for “repeat play” as diminishing the impact of the reputational capital incentive. Partnoy, supra note 118, at 500 (“The amount of expected repeat play greatly affects decisions by both issuers and gatekeepers about whether to engage in reputation-depleting activities.”).

Coffee, supra note 261, at 2 (“Today, as much as half of some major rating agencies’ revenues come from structured finance; equally important, these amounts are paid by a small number of investment banks that know how to exploit their leverage and get the rating just over the line and into the promised land of investment grade.”); Coffee, supra note 2, at 410 (“For Moody’s, structured finance amounted to over 54 percent of its ratings revenue as of 2006.”); Crawford, supra note 7, at 18 (By 2006, structured finance accounted to forty-two percent of Moody’s business). Darcy, supra note 25, at 638 (“Moody’s reported that its structured finance ratings revenue … accounted for more than half of its ratings revenue in 2006. Perhaps more importantly, structured finance produced two thirds of Moody’s ratings revenue growth during
this time period.”); Freeman, supra note 58, at 601 (“This concentration translates into greater market power for the issue and potentially greater influence on the ratings their securities receive.”); Lupica, supra note 18, at 663 (“[S]tructured finance transactions have accounted for approximately 40 percent of CRA’s revenues.”); Piekarski, supra note 87, at 274 (“Losing the business of these investment banks would result in large revenue losses for the rating agency, especially considering that structured finance business accounts for most of the agencies’ total revenue.”).

273 Darcy, supra note 25, at 640 (“On top of this concentration, CRAs typically charge higher fees on asset securitization given their complexity”); Dennis, supra note 3, at 1137 (“As a result, mortgage backed securities issuers have much more leverage to use in an effort to force rating agencies to issue the ratings they desire.”); White, supra note 7, at 16 (“The profit margins on rating the mortgage securities were substantially higher than on rating the ‘plain vanilla’ bonds.”). For example, it is estimated that the CRA involved in the Abu Dhabi case discussed above received approximately $6 million upon launch of the product and ongoing fees thereafter. Haghshenas, supra note 113, at 488. Plaintiffs in the CalPERs case allege that defendants in that case received fees from $300,000 to $1 million per issue. CalPERS Complaint, supra note 25, at ¶ 42. This compares to $50,000 in fees obtained from rating a traditional municipal bond of equivalent size. Id., ¶ 43.

274 Coffee, supra note 2, at 410. Coffee relies on empirical; research which shows that the top six investment banking firms involved in structured finance controlled 50 % of the market; the top dozen firms controlled over 80%. He concluded that even the smallest of the firms controlled four times the business of the largest corporate bond issuer.
Hill, supra note 16, at 64 (“In such markets, one rating agency could actually capture business at the expense of another.”). Hill argues that there is little incentive to overrate in the case of traditional markets because the tendency is for the issuer to obtain two or three ratings. Therefore, the CRAs are, in effect, sharing the market.

Darcy, supra note 25, at 641-2 (“For the arranger, switching rating agencies is low visibility and appears nearly costless. Thus, arrangers can credibly threaten to remove business from a CRA that does not provide the customer with the high credit ratings it desires.”). In addition, it is unlikely that a CRA will provide a low rating to, or downgrade, a product it helped to create. Freeman, supra note 58, at 602 (“By providing this type of service, the danger exists that the agency will hesitate to downgrade a security once it has been issued according to a structure that it advised the issuer to adopt”).

Coffee, supra note 2, at 404 (“Fifteen years ago, they were a trivial percentage of all debt issued in the United States. However, by around 2002, the volume of debt issued in asset-based securitization exceeded the total amount of corporate bonds issued by corporate issuers in the United States. From 2002 to 2006, the volume of asset-backed offerings grew to greatly exceed traditional corporate debt.”). The pressures on the CRA to issue the rating sought by the issuer are exacerbated by the fact that the CRA is only paid if the issuer chooses to have that CRA issue the rating. Dennis, supra note 3, at 1137 (“Thus, an issuer is able to obtain a preliminary rating from each agency and then chose to publish the highest rating. The issuer can play the rating agencies against each other by threatening to take the deal to another agency if they do not receive the rating that desire.”).

Darcy, supra note 25, at 640 (“A CRA may logically choose to inflate its ratings to appease a client that provides the agency with a material amount of its structured finance
revenues, particularly as structured finance becomes a more important component of the company’s overall revenue stream.”).

Krebs cites Frank L. Raiter, former head of mortgage ratings at S. & P., as saying simply that “profits were running the show.” Krebs, supra note 3, at 140. Pate cites a Senior Analytical Manager who wrote, “I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision of assigning separate ratings to P and I.” Pate, supra note 104, at 34. Others argue that the conflicts of interest were minor and could not, therefore, have been the cause of CRA failures. See Neuman, supra note 30, at 940 (“While the CRAs initial high ratings and subsequent downgrading of subprime RMBS helped create our current economic crisis, the CRAs’ conflicts of interest are not to blame. The conflicts simply are not great enough to have caused the CRAs to issue favorable ratings when the CRAs believed otherwise.”).

Efraim Benmelech & Jennifer Clugosz, The Credit Rating Crisis (NBER Working Paper No. 15045, 2009), available at http://www.economics.harvard.edu/faculty/benmelech/files/MacroAnnual.pdf (empirical study which concludes that rating shopping played a role in the GFC); Ceresney, Eng & Nuttall, supra note 40, at 265 (“Underwriters thus were able to make data available to all three agencies, effectively getting a free preview of each agency’s evaluation of the proposed deals, enabling them to shop for the best rating being offered.”); Crawford, supra note 7, at 18 (“Rating shopping, combined with the conflict inherent in the issuer-pays model, contributed to a systemic inflation of ratings on structured products, which in turn contributed to both the real estate bubble and the pernicious consequences of its bursting.”); Darcy, supra note 25, at 641 (“Reports suggest that ratings shopping has been prevalent”); Dennis, supra note 3, at 1137 (“[T]he
prominence of rating shopping in the mortgage backed securities market suggests that reputational concerns were in fact outweighed by the agencies’ interests in maintaining their market share.”); Murphy, supra note 33, at 751 (“The opportunity to retrospectively tailor the RMBS’s structure even extends beyond the forgiving hierarchy of any single NRSRO, as issuers are free to take their bonds to other rating agencies if they cannot receive a satisfactory rating from the initial NRSRO…. [T]he practice of soliciting NRSROs for favorable ratings has created an environment in which agencies are incentivized to lower their ratings standards.”).

Crawford, supra note 7; Murphy, supra note 33, at 748 (“At least two of the rating agencies frequently made uncharacteristic ‘out of model adjustments’ without retaining records that explained why the adjustments were made.”).

Dennis, supra note 3, at 1114. See also Partnoy, supra note 7, at 6 where he asserts, “[T]hese parties faced financial incentives to use unreasonable and inaccurate assumptions and models to complete deals and thereby earn greater fees.”).

Moran, supra note 4, at 50.

See supra notes 57-59 and accompanying text. See also White, supra note 7, at 16 (“The bonds that were being rated were far more complex than the ‘plain vanilla’ bonds of corporations and governments, so that rating errors were far less likely to be quickly ‘called out’ by third parties.”).

Summary Report, supra note 77, at 43.

Lupica, supra note 18, at 668; Krebs, supra note 3, at 153.

Dodd-Frank, §931 (4).

Dodd-Frank provides that
“(3)(A) The Commission shall issue rules to prevent the sales and marketing
considerations of a nationally recognized statistical rating organization from influencing the
production of ratings by the nationally recognized statistical rating organization.”
Section 15E (h)(3)(A).

SEC, Proposed Rules for Nationally Recognized Statistical Ratings Organizations,
available at http://www.sec.gov/rules/proposed/2011/34-64514.pdf (These rules are “designed
to address situations in which, for example, individuals within the NRSRO responsible for
selling its products and services could seek to influence a specific credit rating to favor an
existing or prospective client or the development of a credit rating methodology to favor a class
of existing or prospective clients.”).


Darcy, supra note 25, at 653 (“[T]he SEC appears to believe that if an NRSRO fully and
fairly discloses a particular conflict of interest, its procedures for managing those conflicts, and
its rating methodologies, an investor should be able to adequately evaluate the risk that a given
rating is compromised by the disclosed conflict.”); Neuman, supra note 30, at 937 (“These
requirements help the investing public see for which issuers the CRAS employ the issuer-pays
model. Investors may then use their own judgment to determine whether these specific ratings
may be tainted by conflicts of interest due to the issuer-pays model.”).

See Darcy, supra note 25, at 653-658.

Lynch, supra note 7, at 255 (“[T]he mere existence of firewalls should raise doubts about
their effectiveness and the mere need for firewalls should raise doubts about the reliability of any
rating.”).
See e.g., Lynch, supra note 7 at 259 (“The effectiveness of firewalls that prevent actually analyst-issuer negotiations is questionable if analysts know the business ramifications of their analysis”).

See Bai, supra note 196, at 260-265 where this distinction is discussed.

Moreover, it is unlikely that all CRAs could remain in business if the payment model returned to the subscription model. See e.g., Bai, supra note 196, at 294 (“Rating agencies could not survive on the reduced subscription revenue.”).

Under the performance-based sanction model, the conflicts of interest would not be expressly addressed or disclosed. But, CRAs would be sanctioned after the fact if their ratings proved to be too high. While the specifics of such proposals vary, all would impose penalties if CRA ratings underperformed as compared to some preset quality measure. See Darcy, supra note 25, at 658-666 where she discusses performance-based sanction models.

See e.g., Bai, supra note 196, at 296-301 (“The current regulation can be and should be improved to enhance ex ante disclosures about conflicts of interest to the investing public.”).

See Lynch, supra note 7, at 292-304. Lynch explains that this vital public function could be accomplished in three ways. 1) A taxpayer-funded public institution could be created. The role of this entity would be to conduct risk analysis. 2) The government could pay selected private CRAs for their services. 3) Tax incentives could be provided to CRAs who provide accurate ratings. See also Neuman, supra note 30, at 935 where this alternative is listed and rejected.

Dodd-Frank, § 931 (3).

Section 15E (m)(1).

Id. § 77k(b)(3)(B)(i).
See generally William K. Sjostrom, The Due Diligence Defense Under Section 11 of the Securities Act of 1933, 44 BRANDEIS L. J. 1 (2006). In essence, this mandates that CRAs perform the due diligence that was noted as absent in our discussion of transparency. See supra notes 235-240 and accompanying text.

(B) EXCEPTION. – In the case of an action for money damages brought against a credit rating agency or a controlling person under this title, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity the facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed –

(i) to conduct a reasonable investigation of the rated security with respect to the faculty elements relied upon by its own methodology for evaluating credit risk; or

(ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.”

Section 21 D (b)(2)(B).

See e.g., Coffee, supra note 2, at 346-349; Partnoy, supra note 181, at 540-46.

See e.g., Assaf Hamdani, Gatekeeper Liability, 77 S. CAL. L. REV. 53 (2003). Hamdani argues that strict liability is appropriate for gatekeepers only when: 1) they can price-discriminate among prospective clients based on their likelihood of committing misconducts; or 2) be able to eliminate all wrongdoing by clients. By contrast, Hamdani argues that a negligence
standard is appropriate when the government has sufficient information to regulate gatekeeper policing and to determine whether gatekeepers have met that policing standard. *Id.*, at 102-103. He argues that a “knowledge based” standard, like the one imposed by Dodd-Frank in § 21D for securities fraud, is appropriate when the negligence based scheme is too costly. *Id.*, at 104. See also Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1586-1587 (2010) (arguing that where there are interdependent gatekeepers, “only a fault-based regime would induce gatekeepers to take optimal precautions.”).

307 Hamdani, *supra* note 306, at 59. See also Steven Shavel, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1 (1980); Partnoy, *supra* note 181, at 512 (“Faced with a rule requiring them to engage in reasonable monitoring of issuers or to satisfy a due diligence requirement…. gatekeepers would expend resources to engage in monitoring of issuers.”).

CRAs have argued against imposing any civil liability attacking the negligence scheme as likely “to lead to deadweight losses due to unbeneficial documentation.” Dennis, *supra* note 3, at 1147. Ironically, once one has accepted the premise that some civil liability is good, this argument can be used to argue in favor of strict liability (a higher standard of liability) as opposed to negligence.

308 Typically scholars recommend a cap on strict liability which could provide sufficient deterrence, but not drive CRAs from the market. For example, one proposal is that the CRA would agree to strict liability for ten percent of the issuer’s liability *ex ante*. The actual percentage would be determined by bargaining or market forces, with a minimum amount (such as the gatekeeper’s fee), set by statute. John C. Coffee, *Gatekeeper Failure and Reform: The Challenges of Fashioning Relevant Reforms*, 84 B.U.L. REV. 301, 349-353 (2004); Partnoy, *supra* note 181.
Moreover, some commentators have argued that the appropriate standard is not the actual malice requirement imposed in the case of journalists, but the lesser standard applied in the case of commercial speech. See generally Deats, supra note 99. See also, Murphy, supra note 33 at 767 (“Because credit ratings assist the transfer of securities, if any degree of First Amendment protection is applicable, it is likely on the limited protection afforded to commercial speech.”).

See e.g., Haghshenas, supra note 113, at 488 (“The two conflicts addressed in Abu Dhabi – the compensation received by rating agencies and the level of the agency’s participation in structuring certain products – distinguish rating agencies from journalists and justify the denial of First Amendment protection to rating agencies.”).

Hill argues that this has the potential to lead to less accurate ratings. Hill, supra note 26, at 1297.

See e.g., Brownlow, supra note 161, at 133-134 (arguing that CRA liability will increase the “time and effort necessary to rate a new security.”).

See e.g., Brownlow, supra note 161, at 134.

Hill, supra note 16, at 91 (“It is too easy to second-guess a rating; greater scrutiny would seem to invite frivolous litigation of the ‘have ratings downgrade, will sue’ variety.”); Mulligan, supra note 7, at 1297 (“[R]atings are inherently subjective, and increased scrutiny would result in a plethora of lawsuits for basic rating activities like downgrades.”).

Our intent here is not, however, to totally dismiss the very real costs that might result from lawsuits. As Partnoy acknowledges, regardless of how one feels about the potential for
frivolous lawsuits, “it is undeniable that such suits are very costly to resolve.” Partnoy, supra note 181, at 512.

318 Sjostrom, supra note 303.

319 Brownlow, supra note 161, at 111 (recounting how Ford Motor Company LLC was unable to find a single NRSRO to provide credit ratings for inclusion in their registration statement); Gretchen Morgenson, Hey, S.E.C., The Escape Hatch is Still Open, N.Y. TIMES, Mar. 5, 2001, available at http://www.nytimes.com/2011/03/06/business/06gret.html.


321 Brownslow, supra note 161, at 130.

322 Kane, supra note 6, at 405.

323 Josef Forster, The Optimal Regulation of Credit Rating Agencies (University of Munich, Discussion Paper No. 2008-14, 2008) 2; Partnoy, supra note 7, at n.6, 4 (“The following assessment from Senator Joseph Lieberman… was typical: ‘The credit-rating agencies were dismally lax in their coverage of Enron. They didn’t ask probing questions and generally accepted at face value whatever Enron’s officials chose to tell them. And while they claim to rely primarily on public filings with the SEC, analysts from Standard and Poor’s not only did not read Enron’s proxy statement, they didn’t even know what information it might contain’”)(citing Press Release, Senate Committee on Governmental Affairs, Financial Oversight of Enron: The
SEC and Private-sector Watchdogs, October 8, 2002). Little action was taken to effect any changes after Enron. The conclusion was apparently that Enron was an aberration in which the CRAs relied too heavily on company provided data and failed to properly assess risk. See generally Hill, supra note 26; Pinto, supra note 110.

Similar criticisms were waged as far back as 1993 when CRAs were criticized for failure to downgrade bonds issued by the Washington Public Power Supply System. At that time, one commentator spoke of CRA “lethargy” is failing to take action to downgrade and called for a regulatory response. Bottini, supra note 254.


325 See e.g., Husisian, supra note 93, at 426-27 (It is “not at all apparent that any system of regulation for the regulation of bond rating agencies” is needed); Stephen Choi, supra note 175, at 918-919 (“[G]atekeeper liability is too heavy-handed a response to market defects.”); Hill, supra note 16, at 89-90.

326 White, supra note 7 at 3.

327 See e.g., White, supra note 7, at 3 where he opines that increased regulation “will raise the costs of providing ratings and thus raise barriers to entry, which in turn will tend to discourage new ideas, new methodologies, new technologies, perhaps new business models; in short, they will discourage innovation. This added regulation will tend to stultify the credit rating business and entrench and encrust current practices.”

328 Schwarcz, supra note 20, at 13-14. Professor Schwarcz, however, wrote this article before the GFC and relies on CRA rating of corporate bonds not structured finance products to support his conclusion.
White, supra note 7, at 15.

See e.g., Schwarcz, supra note 20, at 14 (“Regulation… could impair the reliability of ratings by increasing the potential for political manipulation, and by diminishing the importance of reputations costs.”); White, supra note 7, at 3 (where he opines that increased regulation “will raise the costs of providing ratings and thus raise barriers to entry, which in turn will tend to discourage new ideas, new methodologies, new technologies, perhaps new business models; in short, they will discourage innovation. This added regulation will tend to stultify the credit rating business and entrench and encrust current practices.”).

See e.g., Neuman, supra note 30, at 940 (“While regulation may be viewed as a general problem, it is more specially detrimental to the CRA industry and the U.S. economy today.”).

White, supra note 7, at 17. Perversely, some in this camp argue that the recent failures on the part of CRAs means that investors will, and should, be more skeptical of ratings and that increased regulation would remove the incentives for investors to “do their homework” and investigate before investing. See e.g., Green, supra note 50, at 37 (“Indeed, regulation of credit rating agencies may do more harm than good by undermining investors’ incentives to do their homework.”).

See supra notes 189-190 and accompanying text where problems with the reputational capital theory as it applies to novel products are discussed.

Hunt calls this the “do nothing” approach. See Hunt, supra note 33, at 188-190. According to Hunt, the “do nothing” approach is typically rejected “when the value of what a party provides arises in party from a level of skill that is difficult to monitor.” Id., at 190. There also risks involved in over-regulating. We will consider these “costs” as we analyze our specific proposals. See also Evan N. Turgeon, Boom and Bust for Whom?: The Economic Philosophy
Behind the 2008 Financial Crisis, 4 VA. L. & BUS. REV. 139, 160 (2009) (arguing that government policies based on the market model have “repeatedly failed to prevent financial crises.”).


336 Mulligan argues that the key issue affecting CRA is the “decline in the accuracy of the credit ratings” and that a self-regulatory organization is the best way to improve the quality of those ratings. See Mulligan, supra note 7, at 1303. See also Mendales, supra note 7, at 1409 (arguing for a self-regulatory model similar to the regulation of accountants).

337 Omarova, supra note 335, at 415. Professor Omarova compares the financial services industry to the nuclear power and chemical industries and argues for imposition of “meaningful incentives” to encourage development of “publicly minded and socially responsible self-regulation.” Id., at 413. He rejects what he terms the “traditional top-down model of regulation, in which the power to create rules belongs exclusively to the state” instead advocating a “New Governance” model. According to Omarova, new governance scholarship posits that the traditional model of regulation is being replace “by a more flexible ‘governance’ model, in which power to set and enforce the rules is increasingly diffused among a variety of societal actors working alongside the government.” Id., at 417.

338 See Omarova, supra note 335, at 416 (“Given the complexity and global nature of the modern financial market, any government’s attempt to regulate in a purely unilateral command-and-control manner will inevitably encounter the fundamental problem of regulatory arbitrage, whereby financial institutions find new ways to get around governmental rules, thus creating a never-ending spiral of rulemaking and rule evading.”).
Mulligan, supra note 7, at 1302.

See e.g., Nan S. Ellis, Lisa M. Fairchild & Harold D. Fletcher, The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation, 7 BERKELEY BUS. L. J. 102 (2010). On the one hand, many commentators argue for an elimination of the self-regulatory model. See generally Ernest E. Badway & Jonathan M. Busch, Ending Securities Industry Self Regulation as we Know it, 57 RUTGERS L. REV. 1351, 1358 (2005) (“[R]ecent events indicate that the system of self-regulation may no longer fit the mold of our modern securities market.”); Cally Jordan & Pamela Hughes, Which Way for Market Institutions: The Fundamental Question of Self-Regulation, 4 BERKELEY BUS. L. J. 205, 208 (2007) (“[T]he prevalent self-regulatory model of exchange governance in the United States has been susceptible to abuses and scandals for decades.”); Robert Kuttner, The Big Board: Crying Out for Regulation, BUS. Wk., Oct. 13, 2003, at 26 (Quoting former Chairman Donaldson: “In the SOA era, the question has become: how much longer can we reasonably function under the current system of self-regulation? Is it becoming obvious that SROs are not capable of policing anything more than the occasional ‘small-time’ larceny?”). See also Roberta S. Karmel, The Once and Future New York Stock Exchange: The Regulation of Global Exchanges, 1 BROOK. J. CORP. FIN. & COM. L. 355, 392 (2007) (“Whether it is more efficient and effective for such regulators to be SROs rather than government agencies remains to be seen.”). Several criticisms of self-regulation have been advanced. Most importantly, for the purposes of this article, it has been asserted that SROs have an inherent self interest that makes it difficult, if not impossible, for them to effectively regulate their members. See generally Onnig H. Dombalagian, Self and Self-Regulation: Resolving the SRO Identify Crisis, 1 BROOK. J. CORP. FIN. & COM. L. 317 (2007). Conflicts between the goals of self-regulation and the profit motive have been noted. See e.g., Thomas Erickson, FUTURES

On the other hand, benefits of self-regulation have been recognized. See generally Badway & Busch, id., at 1662-1363 (Discussing the arguments in favor of self-regulation); Dombalagian, id., at 317 (“With all its shortcomings, however, self-regulation is inherently at sound – and perhaps somewhat underutilized – means of regulating securities market conduct.”); David P. Doherty, Arthur S. Okun, Steven F. Korostoff, & James A. Nofi, The Enforcement Role of the New York Stock Exchange, 85 NW. U.L. REV. 637, 651 (“An effective and aggressive enforcement program of a self-regulatory organization deters violative activity, induces compliance, and enhances investor confidence in the integrity of the market. Enforcement pursues these objectives by bringing disciplinary proceedings and sends the message to the member firm community that it is serious in its enforcement efforts.”); Keaveny, id., at 1450 (“It seems unlikely that the government could operate more efficiently as a sole regulator.”).

Commentators offer several perceived benefits of self-regulation. First, self-regulation may avoid the slowness of bureaucracies. MICHAEL CROZIER, THE BUREAUCRATIC PHENOMENON 3 (1964), the danger of rigid rules, Steven M.H. Wallman, Competition, Innovation, and Regulation in the Securities Markets, 53 BUS. LAW. 341, 356 (1998). Second, SROs may understand the securities industry better than governmental regulators. Charles H. Kock, Jr., Control and Governance of Transmission Organizations in the Restructured Electricity Industry,
27 Fla. St. U.L. Rev. 569, 602 (2000); Paul G. Mahoney, The Exchange as Regulator, 83 V. L. Rev. 1453, 1455 (1997) ([E]xchanges should be the primary writers and enforcers of rule relating to disclosure by listed companies, standards of conduct for member broker-dealers, and market structure.”). Professor Mahoney argues that government regulators “start from a substantial disadvantage in information, experience, and incentives compared to an exchange.” Mahoney, id., at 1462. Similarly, some have asserted that SROs technical expertise allows them to better respond to some regulatory problems. Keaveny, id., at 1451 (“The SRO system is preferable to a pure government regulatory scheme because it defrays much of the costs onto the market users, and makes efficient use of the expertise at the exchange”); Jonathan R. Macey, Options for Future Regulation of Financial Planners, Part II, 15 J. Fin. Plan. 90 (2002) and that they may operate more fiscally efficiently. Sam S. Miller, Self-Regulation of the Securities Markets: A Critical Examination, 42 Wash. & Lee. L. Rev. 853, 855 (1985); Third, self-regulation avoids the governmental costs of SEC oversight. Dombalagian, id., at 317 ([T]here are many SROs that provide the critical infrastructure needed to ensure fair and efficient markets while sparing the SEC and the public the cost of securities oversight.”).

341 Forster, supra note 323, at 33.

342 Id.

343 Notwithstanding the criticisms of the SRO model, there is some evidence that CRAs have responded by implementing a “litany of voluntary policy changes” addressing the issues discussed in this article. First, NRSROs have adopted internal policies requiring a qualitative review of loan originators, including underwriting policies, property valuation procedures, funding procedures, credit risk management processes. Moreover, CRAs have imposed divisions
between the credit analysis and business development divisions designed to address potential conflict of interest issues. Lupica, *supra* note 18 at 664-666.


346 One criticism of Dodd-Frank is that it focuses too much on domestic issues and “fails to confront the realities of the emerging global financial markets. Chaffee, *supra* note 160, at 1432.


348 Ideally, the Office would assume the responsibility for these examinations.
One could also conclude that the CRAs primary concern is earning the revenue from the initial rating and the ongoing review is not as lucrative.

Section 936 of Dodd-Frank addresses the qualifications of ratings analysts. However, the Act stops short of addressing the need for CRAs to have enough analysts to be able to monitor initially assigned ratings on an ongoing basis. Although the CRAs employ sizable staff, they readily admit that it is difficult for them to monitor all of the issues they rate.

See e.g., Lynch, supra note 31, at 1435 (proposing a single regulator, overseeing all financial markets, who would delegate authority to formulate rules and practices to market participants). See also Jonathan G. Katz, Reviewing the SEC, Reinvigorating the SEC, 71 U. Pitt. L. Rev. 489 (2010)(offering a critique of SEC performance handling the scandals of the last decade).

The theoretical evidence of Forster supra note 323, at 31, supports our recommendation to separate the ratings business from the other lines of business. Forster shows “If the potential bribe is large enough, it is optimal to restrict the activities of the CRAs, as the negative effects of collusion dominate” when the ratings business and other lines of business are not separate within CRAs.”

Manesh Kotecha, Roy Weinberger, and Michael DiGiacomo also propose a business model for CRAs that establishes a ratings fund and has ratings fees paid by debt issuers and investors. For more information, see Alicia Goldin, Public Comment on Dodd-Frank Implementation Title IX: Credit Rating Agencies Review and Rulemaking, available at www.sec.gov/comments/df-title-ix/.../creditratingagencies-16.pdf. See also, Yair Listokin & Benjamin Taibleson, If you Misrate, Then you Lose: Improving Credit Rating Accuracy Through Incentive Compensation, 27 Yale J. on Reg. 91 (2010)(proposing a model under which CRAs
are paid with the debt that they rate); Jeffrey Manns, *Rating Agency Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. Rev. 1011 (2009) (proposing a user fee system administered by the SEC which would require CRAs to bid for the rate to rate debt issues).

354 Assuming the par value of each bond was $1,000, this would mean 30,000 new bonds would be issued, and if the fee for the initial rating cost was equally split between the issuer and the investors, investors would be paying a fee of $2.50 per bond to cover the cost of the initial rating and issuers would be paying an equivalent fee on a per bond basis.

355 The establishment of a credit ratings fund is somewhat analogous to the deposit insurance fund that banks are required to contribute premiums to that would be used to pay off depositors in the event that the bank becomes insolvent.

356 We believe that this “fee for proceeds” model is a better alternative than the credit spread model proposed by Partnoy. Credit spreads are computed as the yield difference between a risky bond and a risk-free bond such as a U.S. Treasury bond having the same maturity as the risky bond. The credit rating is a determinant of the yield of the risky bond. Hence, if the credit rating is inaccurate, the credit spread will be inaccurate and not useful for determining compensation to CRAs. See e.g., Partnoy, supra note 19.

357 See e.g., Partnoy, supra note 7 at 13-14. (“[R]ating agencies are doing much more than merely speaking. They have a high level of initial and ongoing involvement in these deals, at early and later stages, and receive significantly higher fees for them. Rating agencies determine the capital cushions that are required for particular tranches; they provide capital matrix parameters that govern the operation of special purpose entity issuers; they are involved in the operation of the issuers on an ongoing basis; they instruct the asset manager regarding the kinds
of assets the issuer can acquire, both initially and over time; and the deal documentation for these transactions typically includes descriptions of the simulation models the rating agencies use to determine the relative proportions of an entity’s capital structure, as well as the necessarily overcollateralization ratios and triggers…”