Implications of Reputation Economics of Regulatory Reform of the Credit Rating Industry

Paul Lasell Bonewitz
IMPLICATIONS OF REPUTATION ECONOMICS ON REGULATORY REFORM OF THE CREDIT RATING INDUSTRY

PAUL LASELL BONEWITZ
ABSTRACT

Credit rating agencies have for years maintained that they would never intentionally issue or maintain inaccurate ratings due to the damage their reputation, and therefore their business, would suffer as a result. The reputation of credit rating agencies perhaps never suffered more than when thousands of structured debt securities proved to hold inflated ratings in the run-up to the credit crisis. Yet credit rating agencies remain as engrained as ever in the global financial system. What is more, Congressional testimony shows that credit rating agencies had the ability to rate more accurately than they did, but intentionally failed to do so. Therefore, credit rating agencies inwardly believed that their reputation with investors was not nearly as valuable as they outwardly claimed. Their ability to thrive while their reputations languish proves that they were right.

Reputation mechanisms theoretically operate in the credit rating industry to solve problems of information asymmetry. Whereas investors cannot trust issuers to truthfully convey their own credit risk, a credit rating agency must guard its reputation and the related promise of future business due to the comparatively small fee it earns for each opinion it provides. The actual credit rating industry, however, differs from the model in several ways that have the potential to undermine reputational incentives. Regulations tied to credit ratings give Nationally Recognized Statistically Rating Organizations (“NRSROs”) the power to sell cost-reducing and demand-increasing regulatory compliance to issuers. Further, regulatory and market factors may increase the short-term profitability of falsifying ratings or diminish the long-term profitability of reputation-building.

The current statutory and regulatory regime governing credit rating agencies ignores these barriers to accuracy. The Credit Rating Agency Reform Act of 2006 (“CRARA”) and the SEC regulations thereunder instead assume that making the credit rating industry more transparent, more competitive, and less conflicted will restore the quality of credit ratings. By providing investors with more information and more choices, the CRARA largely aims to enable investors to accurately assess agencies’ reputations and hold them accountable for issuing or maintaining inaccurate ratings. Despite the manifest failings of credit rating agencies since 2006 and the unaddressed theoretical barriers to an effective reputation mechanism in the credit rating industry, the Treasury Department recently endorsed continuing to regulate credit rating agencies under the current system.

In place of these measures, successful reform efforts must either restore the role of reputation in the credit rating industry or obviate the need for it. Proposals in the latter category face difficulties that make them either impracticable or ineffective. Dismantling the NSRSO superstructure, meanwhile, would remove the principal barrier to reputation economics. To fill the void left by ending ratings-based regulation, regulated investors would be given primary responsibility to certify risk, but would be allowed to rely on credit spreads as a safe harbor. Such a solution would both produce accurate ratings and protect investors without overburdening regulated institutions.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>I. The Reputation Mechanism</td>
<td>4</td>
</tr>
<tr>
<td>A. Information Asymmetry and Signaling Solutions</td>
<td>5</td>
</tr>
<tr>
<td>B. Challenges to Reputation Economics in the Credit Rating Industry</td>
<td>7</td>
</tr>
<tr>
<td>1. The Value of Regulatory Licenses</td>
<td>7</td>
</tr>
<tr>
<td>2. Reputation-building and the Balance of Short-Term and Long-Term Profit Motives</td>
<td>13</td>
</tr>
<tr>
<td>II. Reform Efforts</td>
<td>15</td>
</tr>
<tr>
<td>A. From Enron to the CRARA: 2001–2006</td>
<td>18</td>
</tr>
<tr>
<td>1. The Need to Reform the Credit Rating Agencies</td>
<td>18</td>
</tr>
<tr>
<td>2. The Credit Rating Agency Reform Act of 2006</td>
<td>20</td>
</tr>
<tr>
<td>3. The Collapse of Structured Debt and Subsequent Reform Efforts</td>
<td>22</td>
</tr>
<tr>
<td>B. Assessing the CRARA</td>
<td>28</td>
</tr>
<tr>
<td>1. Whether the CRARA Achieves Competition, Transparency, and Accountability</td>
<td>28</td>
</tr>
<tr>
<td>2. Whether the CRARA Can Produce Accurate Ratings</td>
<td>30</td>
</tr>
<tr>
<td>III. Recommendations</td>
<td>34</td>
</tr>
<tr>
<td>A. Abandoning Reputation: Using the NRSRO Designation to Control Rating Agency Behavior</td>
<td>35</td>
</tr>
<tr>
<td>1. Prohibiting the Issuer-Pays Business Model</td>
<td>35</td>
</tr>
<tr>
<td>2. Regulating Accuracy Directly</td>
<td>36</td>
</tr>
<tr>
<td>B. Restoring the Reputation Mechanism: Abandoning the NRSRO Designation</td>
<td>38</td>
</tr>
<tr>
<td>Conclusion</td>
<td>41</td>
</tr>
</tbody>
</table>
INTRODUCTION

From the outset of the financial crisis, the credit rating agencies have been among the institutions most targeted for heightened regulatory oversight. While efforts to restore liquidity to credit markets largely overshadowed regulatory reform for months, recent relative stability has allowed renewed focus on financial regulation. Chief among new proposals is the Treasury Department’s June 2009 plan to rebuild regulation of financial institutions, which suggests reforming credit rating agencies by continuing and strengthening the regulatory tools the SEC already possesses, under a statute Congress enacted in 2006.¹ The plan is therefore remarkable for relying on the wisdom of a statute that predates the crisis to which it is responding.

That statute, the Credit Rating Agency Reform Act (“CRARA”), assumes that making the credit rating industry more transparent, more competitive, and less conflicted will restore the quality of credit ratings. By providing investors more information and more choices, the CRARA aims to enable investors to hold rating agencies accountable for issuing and maintaining inaccurate ratings. While the power of reputational concerns to influence the behavior of informational intermediaries such as credit rating agencies is well established, the means the CRARA employs deserve scrutiny. The CRARA focuses on important objectives, but it ignores factors that diminish the value of reputation in the credit rating industry. Most significantly, regulations tied to credit ratings issued by SEC-designated rating agencies make such ratings valuable regardless of their accuracy, which entices issuers to purchase ratings even if investors do not trust them. In addition, market and regulatory forces that drive up the short-term profitability of selling credit ratings or drive down long-term rents reduce the value of reputation-building activity. As a result, credit rating agencies have strong incentives to

maintain compensation systems, business models, and even rating methodologies that produce inaccurate ratings. Evidence that Moody’s for years intentionally failed to implement a model its executives knew more accurately reflected the risk of structured debt products supports this view.

Rating agencies have shown that they are both able and willing to conceal inaccuracy in their rating methodologies. The CRARA, however, not only fails to address the incentives that distort the reputation mechanism, it expressly proscribes the SEC from regulating rating agency procedures or methodologies. The Treasury Department also adopted the CRARA’s position in August of 2009 when it asserted that whatever the administration might do, it would not seek to regulate the business model, the methodologies, or the performance of the credit rating agencies.\(^2\)

This article agrees with the prudence of this limitation and the related proposition that the SEC is not equipped to mandate methodologies, but asserts that successful reform must then remove or override the perverse incentives that currently infect the industry. Both regulatory and deregulatory approaches could accomplish this objective. New reforms could condition SEC certification of rating agencies directly on accuracy. In the alternative, dismantling the certification process could restore an efficient reputation mechanism. This article addresses these options in turn and concludes that restoring the economic incentives that successfully animate informational intermediaries in other industries to strive for accuracy would be more effective than imposing new rules that certified rating agencies would have both the motivation and the capacity to circumvent.

Part I of this Article describes first the problem of information asymmetry generally and second the ability of reputed intermediaries to credibly signal product quality. This Part

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\(^2\) See Examining Proposals to Reform the Credit Rating Agencies, Before the S. Comm on Banking, Housing & Urban Affairs, 111th Cong. 3 (2009) (Statement of Michael S. Barr, Assitant Sec’y for Financial Institutions).
proceeds to discuss informational asymmetry in the credit rating industry and the role of credit rating agencies in credibly signaling the quality of bonds to prospective investors. Part I concludes by discussing the two primary factors that disrupt the reputation mechanism in the credit rating industry: the value of regulatory licenses and the delta between long-term returns and short-term returns necessary to incentivize reputation-building activity.

Part II begins by tracing efforts to reform the credit rating industry from the failures of corporate bond ratings 2001 and 2002 through the enactment of the CRARA. It then describes the collapse of structured debt products beginning in the spring and summer of 2007 and the studies, Congressional hearings, and SEC rule proposals that followed. Part II evaluates the extent to which the CRARA and the rules promulgated under it achieve their intermediate goals of competition, transparency, and accountability, and the extent to which these intermediate goals, even if they are achieved, are likely to produce accurate ratings.

Part III categorizes solutions to the failure of reputation as falling within two categories: those that abandon the Nationally Recognized Statistical Rating Organization (“NRSRO”) designation entirely and those that use the NRSRO designation to coerce NRSROs to submit themselves to regulations likely to produce accurate ratings. This Part finds that the first category is theoretically viable but is likely to encounter practical impediments. Within the second category, this Part argues that only conditions that remove the need for the reputation mechanism, such as proscribing the issuer-pays conflict, and those that directly condition NRSRO status on credit rating accuracy are viable alternatives. This Part discusses the major benefits and drawbacks of each tenable proposal and concludes that abandoning the NRSRO could best produce accurate ratings.
I. THE REPUTATION MECHANISM

In generally accepted economic theory, reputation mechanisms operate to reduce information asymmetry between prospective buyers and sellers. Through signaling, a third party facilitates a transaction, telling the buyer something the buyer couldn’t trust the seller to tell him or her. Such problems exist throughout the economy. To name just a few examples, economists have identified information asymmetries in the markets for used cars, long-term life insurance policies, coffins, and ballet instruction. In the credit rating industry, a rating agency reduces an issuer’s cost of capital by providing a signal of creditworthiness—the rating—to prospective investors. Rating agencies have for years maintained—in Congressional hearings, to media outlets, and in their own publications—that they would never risk the certain and devastating damage to their reputation—their most valuable asset, their franchise, their brand—that would result from issuing or maintaining false ratings.

But in markets generally, and the credit rating industry in particular, a number of factors can disrupt the incentive for the intermediary to protect its reputation. For rating agencies, these influences come largely in two forms: 1) the regulatory value of credit ratings, which competes with and may even displace the informational value of ratings, and 2) the gradual nature of reputation-building activity, which requires that rating agencies forego certain short-term profits for uncertain but theoretically larger returns that building and preserving a strong reputation.

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would produce. This Part describes how reputation mechanisms work generally, how reputation
works in the credit rating industry, and the impediments particular to the credit rating industry
that may cause credit rating agencies to subordinate their reputation to other considerations.

A. Information Asymmetry and Signaling Solutions

Reputation mechanisms theoretically operate in the credit rating industry solve the
problem of information asymmetry. Nobel Prize winning economist George Akerlof explained
the potential destructive power of information asymmetry on markets in his seminal 1970 paper
on the market for used cars. When one party to a potential transaction, the seller in the case of
used cars, knows information about a product’s quality that he or she cannot credibly convey to
the buyer, the buyer is forced to assume the product is of average quality. All products in such a
market will therefore trade at the same price. Would-be sellers of above average cars will know
this and remove their cars from the market. The result is that only the lemons sell, and only
then at basement prices. In a market of continuous product quality, the bad will drive out
mediocre, which will drive out the so-so, which will drive out the pretty good, which will drive
out the good. In the extreme case, the market will collapse entirely.

Co-Nobel Prize winner Michael Spence provided a partial solution to the information
asymmetry problem in his 1973 article, Job Market Signaling. In Spence’s model scenario,
prospective employees and employers are sellers and buyers of labor. Good employees know
that they are worth more than average, but need a way to credibly signal this information to

\[6\] Id. at 490 (“[T]he bad cars sell at the same price as good cars since it is impossible for a buyer to tell the difference
between a good car and a bad car; only the seller knows.”)
\[7\] Id. at 489.
\[8\] See id.
\[9\] Id. at 490.
\[10\] See id.
\[12\] See id. at 357.
employers. Spence argues that the signal of education can bridge this gap. Education credentials credibly signal an ability to learn and are therefore valuable regardless of whether graduates in fact learned or retained any information pertinent to their subsequent employment. The educational institution by issuing a degree in effect certifies the graduate’s ability to learn. The employer in turn trusts the certification, knowing that the harm to the institution’s reputation would be far greater than any benefit it could reap by issuing an unearned degree.

Credit rating agencies operate in a similar theoretical framework. Issuers are selling bonds, investors are considering purchasing bonds, and the credit agency serves as the reputed intermediary providing a credible signal of the issuer’s creditworthiness. In the unadulterated setting, credit rating agencies operate as informational intermediaries between debt issuers and investors. The problem for both sides is that the claim of creditworthiness itself does not carry any reliable information; signaling is only effective to the extent that the signal is trustworthy. Issuers cannot signal their own credit risk credibly due to the strong incentive they have to misrepresent or withhold information about an offering. A rating agency, on the other hand, receives a comparatively small fee for each opinion it provides, a fee that pales in comparison to

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13 See id. at 357–58.
14 See id.
15 See Frank Partnoy, How and Why Credit Rating Agencies are Not Like Other Gatekeepers in Financial Gatekeepers 627–33 (Yasuyuki Fuchita & Robert E. Litan eds. 2006) [hereinafter Gatekeepers]. In addition, ratings are valuable for reasons apart from their ability to produce unique informational content. By performing rating analysis in volume, credit rating agencies benefit from economies of scale. Id. at 634. By incorporating information not disclosed under the securities laws and using secret procedures and methodologies, rating agencies arguably perform default risk analysis more accurately than the market. Id. So long as ratings are accurate and analyze default risk more efficiently than can either investors or issuers, they reduce the cost of capital to issuers and the cost of information to investors.
17 Id.
18 Id. "The issuer, however, is not able to cheaply convey his information about his own credit risk to the investor. Because he may profit from supplying the investor with wrong information, investors will generally not trust the reliability of this information." Id.
the damage its reputation would suffer if the agency provided a demonstrably false opinion. Credit rating agencies are therefore trustworthy informational intermediaries because they cannot afford to give false signals.\textsuperscript{19}

B. \textit{Challenges to Reputation Economics in the Credit Rating Industry}

The actual credit rating industry differs from the model in several ways that have the potential to undermine reputational incentives. First and most notoriously, the industry operates in a regulatory regime that gives certified rating agencies the power to sell cost-reducing and demand-increasing regulatory compliance to issuers. The regulatory component of credit rating value gives issuers an incentive to purchase untrustworthy ratings even though investors would not value them for their informational content.

Second, regulatory and market factors may increase the short-term profitability of falsifying ratings or diminish the long-term profitability of reputation-building, distorting the balance of incentives necessary to promote rating agency investment in reputation. Building a reputation is a slow process that requires foregoing certain near-term profits for larger but uncertain long-term profits. Rating agencies fearing an impending market collapse, a regulatory crackdown, increased competition, or any other factor that would diminish the prospect of future economic rents reduces an agency’s incentive to invest in reputation and may even induce it to jeopardize its reputation.

1. The Value of Regulatory Licenses

In 1975, the SEC created a new and powerful element of credit rating value—the regulatory license.\textsuperscript{20} The SEC wanted to limit broker-dealer holdings of risky debt. Sensing it lacked competence to assess risk itself, the SEC delegated this function to credit rating agencies

\textsuperscript{19} Id.
\textsuperscript{20} See, e.g., SEN. REP. NO. 109-326, at 4.
it trusted to provide accurate and reliable assessments. The SEC termed these chosen agencies Nationally Recognized Statistical Rating Organizations (“NRSROs”). At first, the SEC used this designation only for the Net Capital Rule, Rule 15c3-1 of the Investment Company Act, which required broker-dealers to carry a specified minimum ratio of capital to debt, but allowed a lower ratio when the debt in question was investment grade, as determined by an NRSRO.\textsuperscript{21} Rule 2a-7 of the Investment Company Act, adopted later, limited money market funds to investing in the two highest rating categories for short-term debt, again as rated by an NRSRO.\textsuperscript{22} Rule 415 of the Securities Act and the related instructions for forms S-3 and F-3 allowed issuers to register for the shelf primary offerings of non-convertible securities if they were rated investment grade by at least one NRSRO.\textsuperscript{23} Today, NRSRO ratings have been incorporated into “hundreds of rules, releases, and regulations, in various substantive areas, including securities, pension, banking, real estate, and insurance regulation.”\textsuperscript{24} The net effect of this regulatory web is that “almost all regulated financial institutions—banks, insurance companies, pension funds, etc.—must heed the NRSROs’ ratings in deciding which bonds they can hold in their portfolios.”\textsuperscript{25}

Despite the volume of ratings-based regulation, nearly all fit into one of three areas: “disclosure requirements, investment restrictions, and capital requirements.”\textsuperscript{26} Turning to the

\textsuperscript{21} See SEC Rule, 17 C.F.R. § 240.15c3-1 (2008).
\textsuperscript{22} See SEC Rule, 17 C.F.R. § 270.2a-7 (2008); SEN. REP. NO. 109-326, at 4.
\textsuperscript{24} Partnoy, supra note 15, at 690; see also Dittrich, supra note 16, at 16, 2007 (“By 2002 there were at least eight federal statutes and 47 federal regulations, along with over 100 state laws and regulations, reference NRSRO ratings as a benchmark…”).
\textsuperscript{25} Dittrich, supra note 16, at 16.
\textsuperscript{26} Id.

In the first area, credit ratings serve to define disclosure requirements. An appropriate credit rating may lower legislative obligations, or may even be a path to completely avoid supervision. Ratings can also be a requirement for using special financial products. The goal is to free low-risk companies for unnecessary regulatory scrutiny. Secondly, regulators use credit ratings to impose investment restrictions on certain financial institutions. By prohibition the holding of unrated or low-rated investments, the riskiness of the overall portfolio can be limited. The third category comprises all rules concerning capital requirements. Private credit ratings are used in this context
three rules discussed above, the Net Capital Rule is—as its name makes obvious—a capital requirement, Rule 2a-7 is an investment restriction, and Rule 415 is a disclosure requirement. This structure makes investment grade ratings from NRSROs highly valuable to issuers, since capital requirements and investment restrictions greatly expand the market of potential buyers for highly-rated bonds while reduced disclosure requirements for highly-rated bonds lower issuance costs.\footnote{It cannot be seriously disputed that these regulations produce great value for NRSROs. But the first and dominant articulation of this view, advanced by Frank Partnoy in his “highly influential”\footnote{28} 1999 article, goes further and argues that the regulatory value of credit ratings dwarfs their informational value.\footnote{29} This implies that if issuers had to choose between sending credible signals to investors with accurate, lower ratings and reaching a large market of institutional investors with inflated, investment grade ratings, they would choose the latter with ease. It follows that issuers will principally seek the services of NRSROs not as reputed intermediaries, but as regulatory licensors. As a result, agencies' incentives to help issuers achieve their regulatory needs will displace their incentives to maintain their reputation for producing accurate and reliable ratings, at least where these interests conflict. Credit rating agencies will be concerned first with receiving and retaining the coveted NRSRO designation, second with maintaining their reputation\textit{ among issuers} for facilitating regulatory compliance, to determine the riskiness of single assets and the appropriate capital needed to insure against default.}

\footnote{\textit{Id.}} See Tumoil in U.S. Credit Markets: The Role of the Credit Rating Agencies Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. 3 (2008) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School) [hereinafter \textit{Statement of Professor Coffee}] (“[E]ven if their views were not respected or their ratings were known to be inflated, they would still be retained to grant ‘regulatory licenses.’”), available at http://banking.senate.gov/public/_files/OpgStmtCoffeeSenateTestimonyTurmoilintheUSCreditMarkets.pdf (last visited Jan. 20, 2009); \textit{see also} Partnoy, supra note 15, at 682–83.\footnote{\textit{Sen. Rep. No. 109-326, at 7 n.21 (2006).}} See Partnoy, \textit{supra} note 15, at 623–24.\footnote{\textit{Id.}}
and only third with maintaining their reputation among investors for accuracy. Where these interests do not conflict, NRSROs will act on all three incentives. Where they do conflict, as around the investment grade barrier, NRSROs will act on the stronger incentive.

Partnoy’s position has its critics. Aside from the NRSROs, who claim that their “continued reputation for objective and independent ratings is essential” to their success, Partnoy has also encountered resistance in the academic literature. While not arguing that regulatory licenses are meaningless, some allege that Partnoy “overstates his case” and that regulatory licenses cannot constitute all or “even most” of ratings’ value. The main points in favor of this contention are that issuers almost always 1) pay for non-investment grade ratings, 2) seek ratings from at least two NRSROs, and 3) get at least one rating from one of the two most venerable NRSROs.

Two of these points indicate that ratings contain some non-regulatory value. Purchasing non-investment grade ratings does not provide favorable regulatory treatment. Therefore, issuers purchasing these ratings must believe that they contain some non-regulatory value. Similarly, since investment grade ratings contain the same regulatory value regardless of which NRSRO issues them, choosing to pay more for a rating from a prestigious NRSRO demonstrates that issuers value reputation.

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32 Paying for two ratings has a regulatory explanation since some regulations require at least two investment grade ratings. See id. at 66.
33 Issuers may also pay more as a means of signaling to issuers their ability to pay more, and therefore their financial health. Economists have theorized that this type of signaling explains massive advertising campaigns. What, after all, is the information contained within a soft drink advertisement? “Coca-Cola. Real.” Pardon? The only information that potential customers can glean from such an
The problem with the critics’ argument is that issuers might act this way even if regulatory value dominates. The existence of informational value does not negate the dominance of regulatory value. It’s quite possible, for example, that issuers pay for investment grade ratings because of their superior regulatory value and for lower ratings because of their residual informational value. The incentives simply do not conflict in these situations. The above-cited behavior therefore fails to establish that one or the other incentive is greater.

Prominent empirical studies support the conclusion that the regulatory value of credit ratings exceeds their informational value. Two recent major studies have analyzed rating behavior by NRSROs and non-NRSROs, examining trends in their upgrading and downgrading decisions. Together these studies have examined the timing of rating changes by 1) comparing upgrades to downgrades to see whether agencies tended to act in a more timely manner in one or the other situation, 2) comparing the NRSRO rating changes to non-NRSRO rating changes to see whether the regulatory power of NRSROs affects the speed of their decisions, and 3) comparing NRSRO downgrades across the investment-grade barrier to other NRSRO downgrades to see whether the regulatory consequences of the former reduce NRSRO willingness to maintain accurate ratings.

Specifically, a joint study by the business schools of the University of Michigan and Stanford University compared upgrades and downgrades of non-NRSRO rating agency Egan Jones with those of NRSRO Moody’s and found that 1) Egan Jones upgraded and downgraded ratings in a more timely manner than did Moody’s; 2) Moody’s generally downgraded in a more

[advertisement is that it was expensive to make, and that therefore the Coca-Cola company plans to stick around with the same commitment to high-quality products that it always had.]

timely manner than it upgraded; and 3) Moody’s lagged in downgrading at the investment grade cutoff more than it did for other downgrades.\textsuperscript{35} A study by the Federal Reserve Bank of Kansas City strengthened the third finding of the Stanford-Michigan study. It examined downgrades from the lowest investment grade rating for each of the largest three NRSROs—Moody’s, Standard & Poor’s, and Fitch—and found a tendency for large downgrades to begin from the lowest investment grade.\textsuperscript{36}

Non-NRSROs are quicker than NRSROs to make rating changes, suggesting that NRSROs are more concerned with serving the regulatory interests of issuers than they are with serving the informational needs of investors. Second, NRSROs delaying downgrades from the lowest investment grade or making larger downgrades from the lowest investment grade could suggest—as the Stanford-Michigan study found—that NRSROs require more evidence to downgrade across the investment grade barrier than they do to make other rating changes. Alternatively, it could suggest—as the Federal Reserve Bank study concluded—that NRSROs define their lowest investment grade broadly.\textsuperscript{37} Both of these possibilities suggest that NRSROs are basing rating changes on regulatory value. Third, NRSROs generally upgrading faster than they downgrade indicates that they are more concerned with their reputation where a failure to act is likely to garner negative publicity with both investors and regulators.\textsuperscript{38}

Moreover, the data supports the hierarchy of NRSRO incentives described above. Non-NRSROs monitor and update ratings in a timelier manner than do NRSROs, which makes sense

\textsuperscript{36} See Richard Johnson, Federal Reserve Bank of Kansas City, Economic Research Department, An Examination of Rating Agencies’ Actions Around the Investment-Grade Boundary, 1–3 (2003).
\textsuperscript{37} Id. at 3.
\textsuperscript{38} This finding does not distinguish between rating changes that implicate regulations and those that do not. Therefore it cannot be a basis to draw broad conclusions about the relative informational and regulatory values of credit ratings. A more targeted study would examine whether upgrades are faster than downgrades around the investment-grade barrier.
if NRSROs are more concerned with helping issuers comply with regulations than they are with bolstering their reputations with investors. NRSROs are slower than non-NRSROs to downgrade ratings across investment grade barrier, since these downgrades harm NRSROs’ reputation with issuers for maintaining regulatory compliance. Apart from the investment grade barrier, however, NRSROs incorporate bad news into ratings faster than they incorporate good news, likely both because failure to incorporate bad news will garner negative publicity, putting NRSROs at increased risk of oversight, and because the reputation mechanism still functions when regulations are not implicated.

2. Reputation-building and the Balance of Short-Term and Long-Term Profit Motives

Reputation-building activity is costly. It requires that an entity forego certain short-term profit in return for expected long-term gain. Therefore, where the prospect of long-term profit decreases or the prospect of short-term profit increases, rating agencies have less incentive to invest in reputation. Many factors can affect this balance. In the credit rating industry these have recently included the rise and subsequent fall of structured debt products, the continuing prospect of impending costly regulation, and increased competition.

From 2000 until 2007, the growth of structured finance drove an exponential increase in revenue for the major rating agencies. Moody’s—the only agency that is also a reporting company—had its net income rise “from $159 million in 2000 to $425 million in 2004, while its stock price increased by 300% between 2001 and 2006.” Over roughly the same period, the share of Moody’s revenue generated by structured finance rose to 44 percent.

39 See, e.g., BECKER, supra note 2, at 2 (finding that sellers will produce high quality goods “when the value of expected future rents exceeds the temporary profit gains from delivering lower quality goods”) (citing Benjamin Klein and Keith B. Leffler, The Role of Market Force in Assuring Constructual Performance, 89 J. OF POL. ECON. 551 (May 1984))
While profits were booming, rating agencies came under increased scrutiny from Congress and the SEC. Efforts to reform the industry proceeded continuously from the 2001 collapse of Enron forward, focusing on laws that would impose disclosure and investigatory compliance costs on NRSROs. Reform efforts also threatened increased competition, which would decrease the oligopolistic rents that Moody’s, S&P, and to a certain extent, Fitch, had long enjoyed.\footnote{For a discussion of how Moody’s and S&P especially have dominated the industry, see infra, notes 50–52 and accompanying text.} Significantly, empirical research has directly connected increased competition in the credit rating industry to weakening of the reputation mechanism. A study from Harvard Business School found that competition among credit rating agencies leads to ratings of poorer quality for two reasons. First, reputation-building only makes sense if there are expected future rents. Since competition tends to reduce rents, the incentive to invest in reputation is similarly reduced.\footnote{\textsc{Becker}, supra note 2, at 2.} Second, pressure to maintain market share in a more highly competitive setting may induce participants to attract business in the near term, again at the expense of reputation-building activity.\footnote{See id. at 2–3.} The study produced three findings that support these hypotheses: 1) ratings issued by S&P rose as competition increased; 2) the correlation between bond yields and ratings fell as competition increased; and 3) declines in equity prices grew larger in response to downgrades as competition increased.\footnote{See id. at 5; see also id. at 15 (stating with respect to the second finding that “the magnitude of this effect is economically large”).} All three findings supported the study’s conclusion that “equilibrium in the ratings industry relies on rents to reward reputation-building activities which are costly in the short run, and that the absence of such rents reduces the amount of reputation-building.”\footnote{See id. at 6. “Encouraging competition may reduce monopolistic (or in the case of ratings, oligopolistic) rents, but it is not likely to improve quality.” \textit{Id.} at 5.}
In addition, fear that fundamentally unsound financial products were generating their fastest-growing source of revenue also caused rating agencies to value their long-term profits less. Internal documents released during the most recent House Committee on Oversight and Government Reform hearing and related testimony show just this sort of internal concern about the then soon-to-be imploding market for structured finance products. Specifically, analysts at S&P were aware that the products they were being asked to rate were far riskier than the model reflected and top executives had known for years that the model they were using failed to reflect much of the risk in structured products, evidenced by the fact that they had developed but not implemented a much more accurate model. Bolstering this circumstantial evidence, insiders confirm that during this period the major rating agencies shifted from long-term reputational focus to a short-term revenue focus. In sum, these years presented rating agencies with a combination of massive short-term profits from the rise of structured finance and an expectation of greatly diminished long-term profits due to both anticipated regulation and the anticipated collapse of the very products that were generating their short-term wealth.

II. REFORM EFFORTS

The effort to reform the credit rating industry began in 2001 and 2002 with the collapses of Enron, WorldCom, and several other large, prominent companies. Investors suffered massive losses as a result of the failure of these rating agencies to accurately assess the risk of these products. In the now infamous instant message between two S&P structured finance analysts, the same analyst who said that a deal “could be structured by cows, and [they] would rate it” also acknowledged that S&P’s “model definitely does not capture half the risk.” Instant Message Conversation between Shannon Mooney and Ralul Dilip Shah, http://oversight.house.gov/documents/20081022112325.pdf (Apr. 5, 2007) (last visited Jan. 20, 2009).

Frank Raiter asserted that S&P did not adopt a model that would more accurately reflect the risk in structured products because “improving the model would not add to S&P’s revenues.” Credit Rating Agencies and the Financial Crisis Before the H. Comm. On Oversight and Gov. Ref., 111th Cong. 6 (2008) (statement of Frank Raiter, former executive, Moody’s Corporation) [hereinafter Statement of Frank Raiter].

Frank Raiter, former Managing Director and Head of Residential Mortgage Backed Securities Ratings at Standard & Poor’s observed that “the three primary rating agencies, Moody’s, S&P and Fitch . . . have concentrated on maximizing short-term profits rather than maximizing longer term financial benefit from accuracy of their credit ratings and surveillance reviews.” Id. at 1, 8–9. Raiter, however, sees this “complacency” as a result of insufficient competition. See id. As will be shown in more detail in Part II.B, competition will only lead to accuracy, if ever, in the presence of a properly function reputation mechanism, one that compels agencies to compete to produce accurate ratings.
losses in part, they alleged, because credit rating agencies delayed downgrading many issuers
despite overwhelming evidence that they were at severe risk of defaulting on their bond
obligations. The resulting political pressure resulted in various studies, reports, hearings and
concept releases focusing on the oligopolistic nature of the NRSRO industry, the potential for
conflicts of interest inherent in the NRSRO business model, and the lack of transparency in the
rating process.50 As a result, Congress passed the CRARA in the fall of 2006, which sought to
improve rating quality through increased competition, accountability, and transparency. The
CRARA both left the rating agency business model intact and proscribed the SEC from
regulating agency procedures and methodologies.

In September 2007, just a year after passing legislation intended to improve the accuracy
of credit ratings, Congress held hearings on the role of credit rating agencies in the collapse of
the subprime securities market.51 While unsurprising in light of widespread investor complaints
that credit rating agencies delayed downgrading debt clearly at heightened risk of default, these
hearings were exceptional in addressing the adequacy of a thoroughly considered but newly
adopted statute. The hearings focused on issues familiar to the previous reform efforts, paying
special attention to the issuer-pays conflict. In the spring, reformers found new areas of concern.
Three studies—all of which the SEC participated in—found that flawed methodologies and
undue investor reliance on NRSRO ratings contributed to agencies selling low quality ratings.
The Senate Committee on Banking, Housing, and Urban Affairs held a hearing in April 2008 on

50 See SEN. REP. NO. 109-326, at 5–6.
sections of 15 U.S.C.); The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets, Hearing
Before the S. Banking, Housing, and Urban Affairs Comm., 110th Cong. 1 (2007); The Role of Credit Rating
the role of the rating agencies in the collapse of the U.S. credit markets that also identified these problems.\textsuperscript{52}

Subsequent SEC rulemaking proposals addressed structured finance-specific problems through the SEC’s power under the CRARA to improve agency accountability and transparency. In addition, the SEC sought to decrease investor reliance on NRSRO ratings by removing references to NRSROs in various SEC rules and regulations, relying on authority granted under the CRARA but left unexercised under the SEC’s 2007 rulemaking initiatives. Despite the findings in reports it helped to create, the SEC did not directly address failings in agency procedures and methodologies, as the CRARA expressly blocked that path. In the face of broad opposition, the SEC dropped its second proposal and adopted only modest amendments to existing rules under its first proposal. Congress, meanwhile, took no legislative action, leaving reform of the credit rating industry to the incoming administration.

This Part describes these developments in some detail and argues that if the arguments made in Part I are correct, improving transparency and competition are the wrong means to achieve rating accuracy around the critical investment grade barrier. In addition, while in theory accountability could reduce some causes of inaccuracy, the CRARA defers to the NRSRO business model and limits its reach to specific acts and practices instead of addressing the systemic causes of inaccuracy. This Part further finds that failings in the reputation mechanism can and have caused agencies to intentionally adopt procedures and methodologies that produce inaccurate ratings, hiding poor quality in the one area Congress forbade the SEC from regulating.

A. From Enron to the CRARA: 2001–2006

1. The Need to Reform the Credit Rating Agencies

The widespread failures of NRSROs to downgrade corporate bond issuers in 2001 and 2002 have been well documented.\(^{53}\) Most dramatically, the NRSROs rated Enron investment grade until four days before its bankruptcy.\(^{54}\) Almost as stunning were defaults by WorldCom, Global Crossing, AT&T Canada, and the California utilities, weeks to months after having investment grade ratings.\(^{55}\) Dilatory downgrades allowed money markets, pension funds, mutual funds, insurance companies and other financial institutions to remain invested in risky positions where applicable ratings-based regulations would have required them to divest.\(^{56}\) Other investors lost money by directly relying on inaccurate ratings.\(^{57}\) The Sarbanes-Oxley Act of 2002 responded to these failings by requiring the SEC to produce a report addressing, among other things, the lack of competition among NRSROs, the potential for abuse inherent in the NRSRO business model, and the need for increased disclosure about ratings decisions.\(^{58}\) At the same time, academic interest in credit rating agencies spiked.\(^{59}\)

Before the SEC instituted a new application procedure under the Credit Rating Agency Reform Act, it had recognized seven rating agencies as NRSROs.\(^{60}\) Of these, Moody’s and S&P


\(^{54}\) Id.

\(^{55}\) Id.

\(^{56}\) See supra Part I.B.i (explaining the link between investment restrictions and NRSRO credit ratings).

\(^{57}\) It is well established that the investing public trades in part on the basis of credit ratings, since a change in a bond’s credit rating drives a change in the price of the bond. See, e.g., BondsOnline, What Factors Affect Bond Prices?, at http://www.bondsonline.com/Educated_Investor_Center/WHAT_FACTORS_AFFECT_BOND_PRICES.php.


\(^{59}\) For example, the first versions of both of the studies discussed in Part I.C were published in 2003.

held 80 percent of the market share by revenue.\textsuperscript{61} In addition, Moody’s and S&P together rated over 99 percent of all debt issues in the United States.\textsuperscript{62} Most agreed the NRSRO application process directly caused this extreme market concentration.\textsuperscript{63} NRSRO designation depended on many factors, the most important of which was whether the agency was “nationally recognized” as determined by the SEC.\textsuperscript{64} The Department of Justice believed the national recognition requirement created a “nearly insurmountable barrier to new entry into the market for NRSRO services”\textsuperscript{65}; the Senate Report on the CRARA described the system as presenting an “obvious Catch 22.”\textsuperscript{66} In short, the NRSRO designation provided guaranteed demand for rating services while the designation process effectively excluded other players.

Within this environment, NRSROs developed a business model focused on issuer service. Since the 1970s, major rating agencies have operated under an issuer-pays fee model, abandoning their earlier investor-pays subscription fee model.\textsuperscript{67} Issuer fees now constitute upwards of 90 percent of NRSRO revenue,\textsuperscript{68} which represents fees from both ratings and from ancillary, consulting-type services.\textsuperscript{69} The remaining NRSRO revenue comes from subscription fees issuers pay for access to full rating reports.\textsuperscript{70} A review of ancillary services reveals several potential conflicts.

\textquote{[C]redit rating agencies market pre-rating assessments and corporate consulting. For an additional fee, issuers present hypothetical scenarios to the

\textsuperscript{61} \textsc{Sen. Rep.} No. 109-326, at 4.
\textsuperscript{62} \textit{Id.} at 4.
\textsuperscript{63} \textit{See id.} at 5–6.
\textsuperscript{65} 2003 SEC \textsc{Report}, supra note 58, at 37.
\textsuperscript{66} \textsc{Sen. Rep.} No. 109-326, at 6 (“[T]o get the designation you must be nationally recognized, but you cannot become nationally recognized unless you get the designation.”).
\textsuperscript{67} 2003 SEC \textsc{Report}, supra note 58, at 41.
\textsuperscript{68} \textit{Id.}
\textsuperscript{69} Moody’s asserts that its pre-rating assessment service is an “integral part of the rating process” and therefore does not subject this service to its conflicts management policy for ancillary services. Moody’s Investors Service, \textit{Moody’s Non-Rating Service Policy}, at http://www.moodys.com/non_rating_service_policy (last visited November 5, 2007).
\textsuperscript{70} 2003 SEC \textsc{Report}, supra note 58, at 41.
rating agencies to understand how a particular transaction . . . might affect their ratings. . . .

In addition, Moody’s, S&P, and Fitch each offer risk management consulting services. According to the SEC, the products and services offered include 'public and private firm credit scoring models, internal ratings systems services, and empirical data on default incidence, loss severity, default correlations, and rating transitions.'

The SEC believed these services “exacerbated” the conflict of an issuer-pays system. In pre-rating assessments, an NRSRO might promise a particular rating and then feel bound to adhere to its preliminary decision during the actual rating process. Similarly, NRSROs could bait issuers into purchasing other consulting services with the carrot of a favorable rating. Ancillary services provided additional opportunities for issuers to unduly influence NRSRO ratings.

Finally, investors criticized NRSROs for their opaque rating processes. Ratings incorporated both publicly available information and information issuers selectively disclosed to the NRSRO during the rating process. NRSROs excluded investors other than paying subscribers from the reasoning behind rating decisions and even these few could not tell how the NRSROs weighed different factors. Without adequate transparency, investors argued that they would be unable to adequately “judge [the] credibility and reliability” of ratings when making investment decisions.

2. The Credit Rating Agency Reform Act of 2006

The Credit Rating Agency Reform Act of 2006 (“CRARA”) is, as stated by its informative long title, an act to “improve ratings quality for the protection of investors and in the

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71 Partnoy, supra note 15, at 59, 70.
73 See id. at 33–44.
74 Id. at 36.
public interest by fostering accountability, transparency, and competition in the credit rating agency industry.” The act functions by replacing the anti-competitive NRSRO designation standards with an application process that conditions SEC registration as an NRSRO on an agency’s disclosing specified information and on its adopting and enforcing policies to manage potential conflicts of interest and abusive practices. In addition, the agency must have been in the business of producing credit ratings for at least three consecutive years immediately preceding the date of application and must “maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.” Within the section covering the registration of NRSROs, the Act also gives the SEC the authority to amend or revise rules and regulations that reference NRSROs “in accordance with the purposes of this section.” The CRARA further requires that the SEC adopt rules supplementing Congress’s requirements, but proscribes the SEC from “regulat[ing] the substance of ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings” and requires that the SEC’s rules and regulations be “narrowly tailored” to the requirements of the Act.

Applicants must disclose, among other things, performance measurement statistics, procedures and methodologies used in determining ratings, conflicts of interest and, on a confidential basis, a list of the twenty largest issuers and subscribers that use the credit rating services by net revenue received. The SEC’s final rules, adopted in June of 2007, require NRSROs to make and retain detailed financials, records of past ratings and ancillary service

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activity, internal records, nonpublic work papers, and various other documents. The mix of public and nonpublic information makes it clear that disclosures and record-keeping requirements are meant to serve the dual purposes of increasing transparency to investors and facilitating accountability.

SEC oversight under the CRARA focuses on two things: whether NRSROs are adhering to their disclosed rating procedures and methodologies and whether they are following the Act’s conflicts-management provisions. Specifically, NRSROs must “establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such [NRSRO] . . . to address and manage any conflicts of interest that can arise from such business.” SEC rules prohibit a few particularly blatant conflicts, but allow disclosure and management of all conflicts common to credit rating agency business model.

3. The Collapse of Structured Debt and Subsequent Reform Efforts

While corporate bond defaults spurred the reform efforts leading to the CRARA, downgrades of collateralized debt obligations (CDOs) have driven them since. In the summer of 2007, just as the SEC adopted final rules in furtherance of the CRARA, major credit agencies

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83 For instance, NRSROs may not receive 10 percent or more of their revenue from a single issuer or have a director in common with an issuer. 17 C.F.R. § 240.17g-5(c)(1) (2007). The first of these is especially irrelevant to the current NRSROs since NRSROs have long disclosed that even their largest clients provide little more than 1 percent of an their revenue. 2003 SEC REPORT, supra note 58, at 23 n.62. As for the conflicts common NRSRO to the business model, the SEC stated:

These are the types of conflicts that commonly arise from the business of providing credit rating services. Prohibiting these types of conflicts outright may adversely impact the ability of an NRSRO to operate as a credit rating agency. Nonetheless, the conflicts must be managed through policies and procedures and disclosed so that users of credit ratings can assess whether the conflict impacts the NRSRO’s judgment.

were rapidly accelerating their downgrades on a range of structured debt products.\textsuperscript{84} Moody’s alone downgraded over 5,000 mortgage-backed securities through the end of 2007.\textsuperscript{85} Bloomberg reported that the three largest NRSROs “began cutting in July [2007] and have since either downgraded or put on review a total of 38,000 subprime bonds . . . . Moody’s and S&P combined have downgraded more than 9,513 of these securities dating from 2005.”\textsuperscript{86} These actions combined with the deepening credit crisis prompted a second cycle of hearings, reports, and rule proposals.

In September, 2007 both the Senate Banking Committee and the Capital Markets Subcommittee of the House Financial Services Committee held hearings, bringing renewed scrutiny to both conflicts in the issuer-pays business model and to the opacity of agency procedures and products.\textsuperscript{87} The following spring, three reports brought attention to two

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\item "Last year, Moody's had to downgrade more than 5,000 mortgage securities—a tacit acknowledgment that the mortgage bubble was abetted by its overly generous ratings." Roger Lowenstein, \textit{Triple-A Failure}, \textit{N.Y. Times Magazine}, Apr. 27, 2008, available at http://query.nytimes.com/gst/fullpage.html?res=9900EFDE143DF934A15757C0A96E9C8B63&sec=&spon=&page wanted=all.

\item See \textit{Tumoil in U.S. Credit Markets: The Role of the Credit Rating Agencies Before the S. Comm. on Banking, Housing, and Urban Affairs}, 111th Cong. 3 (2008) (statement of Chris Dodd, Chairman, S. Banking Comm.).

\item See Labaton, supra note 84, at C4. Senator Menendez (D. N.J.) accused rating agencies of “playing both coach and referee.” \textit{Id.} Senator Shelby (R. Ala.) complained that issuers, rather than investors, paid agency fees. \textit{Id.} Representative Kanjorski. \textit{The Role of Credit Rating Agencies in the Structured Finance Market Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises}, 110th Cong. 2 (statement of Paul Kanjorski, Chairman, Subcomm. on Capital Markets) (“Some of the policy options that we could consider include requiring more disclosure for rating agencies like those required of auditors.”) Executives from both S&P and Moody’s, as they had in the past, denied that the conflict had caused inaccurate ratings. Vickie Tillman, then Executive Vice President for Credit Market Services at Standard Poor’s defended the rating agency business model. "Some have questioned whether the 'issuer-pays' model has led S&P and others to issue higher, or less rigorously analyzed, ratings so as to garner more business. There is no evidence—none at all—to support that contention with respect to S.&P." Labaton, supra note 84, at C4 Michael Kanef, Group Managing Director of Moody’s Asset Finance Group similarly defended Moody’s business model. \textit{Id.} (“Kanef . . . said his company likewise had no conflicts of interest that led to inflated ratings.”).
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problems unaddressed in the reform efforts leading to the CRARA: failed rating agency models and undue investor reliance on NRSRO credit ratings. The reports issued from the President’s Working Group on Financial Markets (“PWG”), the Financial Stability Forum (“FSF”), and the International Organization of Securities Commissions (“IOSCO”); as a member agency of each group, the SEC contributed to all three reports. The PWG report found that the complexity of asset-backed securities overwhelmed the rating agencies, leading to flawed methodologies.\(^88\)

The FSF report also blamed poor credit assessments on flawed models, but did so without attributing the failings to rating agency incompetence.\(^89\) In addition, the FSF report found that official recognition in ratings policies had caused investors to unduly rely on credit ratings.\(^90\) The IOSCO report supported this finding, concluding that the regulatory use of credit ratings gave NRSRO credit ratings a governmental “seal of approval.”\(^91\) In a contemporaneous Senate hearing, ranking committee members Senators Shelby and Dodd also identified flaws in agency models as well as investor over-reliance on ratings as major problems.\(^92\)

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\(^{89}\) “The severe underestimation by CRAs of the credit risks of instruments collateralised by subprime mortgages resulted in part from flaws in their rating methodologies.” Financial Stability Forum, supra note 84, at 32 (“Poor credit assessments by CRAs contributed both to the build up to and the unfolding of recent events. In particular, CRAs assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models.”).

\(^{90}\) Id. at 38 “such official recognition in regulation and/or supervisory policies may have played a role in encouraging investors’ over-reliance on ratings, by discouraging some investors from playing close attention to what the ratings actually mean;” see also id at 37 (“[S]ome institutional investors have relied too heavily on ratings in their investment guidelines and choices, in some cases fully substituting ratings for independent risk assessment and due diligence.”).


\(^{92}\) See Turmoil in the U.S. Credit Markets: The Role of the Credit Rating Agencies Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. 1 (statement of Richard C. Shelby, Ranking Member, S. Comm. on Banking, Housing, and Urban Affairs), http://banking.senate.gov/public/_files/ShelbyCreditRatingAgencies42208.pdf (“It seems that the rating agencies grossly underestimated the risks associated with these securities.”); Statement of Chairman Christopher Dodd, Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies, Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. 2 (statement of Christopher Dodd, Chairman, S. Comm. on Banking, Housing, and Urban Affairs), available at http://banking.senate.gov/public/_files/042208DoddOpeningStatement.pdf.
During this period the SEC was preparing for a second round of rulemaking under the CRARA. Chairman Christopher Cox discussed the Commission’s ongoing efforts in his prepared statement at the April 2008 Senate hearing. He noted that the staff “[was] observing that the rating process used to rate these [structured] products may have been less quantitatively developed.” However, Cox urged Congress not to require the SEC to “engage in substantive regulation” of procedures and methodologies as it would be “antithetical to the Commission’s traditional disclosure-based mission.” In drafting new rules, the SEC therefore was focusing on the CRARA’s “important objectives” of accountability, transparency, and competition. In addition to disclosure and conflicts management rules largely tailored to structured finance, the SEC exercised its previous unused authority to reconsider its “extensive reliance on, and reference to, NRSRO credit ratings in its own rules.” The SEC believed this change would promote competition by persuading market participants to conduct their own diligence, thus becoming more discerning consumers of credit ratings who would demand higher quality from their rating agencies.

The SEC followed the Chairman’s outline with two rulemaking initiatives in June and July of 2008. The first sought to “address concerns about the integrity of [] credit rating procedures and methodologies” through enhanced disclosure requirements pertaining to credit rating performance statistics, structured finance products, and procedures and methodologies.

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93 See Turmoil in the U.S. Credit Markets: The Role of the Credit Rating Agencies Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. 3 (statement of Christopher Cox, Chairman, U.S. Securities and Exchange Commission).
94 Id.
95 Id. at 3, 8.
96 Id. at 8 (“Investors would use NRSRO ratings that they deemed to be credible, along with other information, in conducting their due diligence. This could induce greater competition among rating agencies to produce the highest quality, most reliable ratings.”). The SEC’s June 2008 report required under the CRARA further clarifies the rationale behind this part of the reform effort. “Finally, the Commission could reduce the artificial barrier to competition and ratings quality by removing from its rules references to NRSRO ratings, which effectively grant a regulatory ‘seal of approval’ to NRSROs.” U.S. SECURITIES AND EXCHANGE COMMISSION, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 44 (2008).
and conflict management rules specific to structured finance products. The second initiative, sought to reduce “undue reliance” on NRSRO ratings by removing the term from various Commission rules and forms. In all the second initiative sought to increase competition by removing NRSRO references from over fifteen rules, nine forms, four line items and one schedule under a total of four statutes. Among these were proposed amendments to The Net Capital Rule, Rule 2a-7, and Rule 415. The proposed rules would have amended Rule 2a-7 to rely solely on money market fund boards of directors to determine that a portfolio investment presents minimal credit risks, eliminating a holding permission based on NRSRO ratings. Similarly, the amendment to Rule 415 would have disallowed previously acceptable shelf offerings for certain investment-grade securities, replacing credit ratings with issuer quality criteria. Finally, the proposal would amend The Net Capital Rule—Rule 15c3-1—to no longer allow a more lenient ratio of debt to capital when the debt is rated “in one of the three highest rating categories by at least two NRSROs,” instead using a requirement that the instrument be subject to a minimal amount of credit risk and have sufficient liquidity such that it can be sold at or near its carrying value almost immediately.

Comment letter reaction to the SEC’s NRSRO-related rulemaking proposals was largely ambivalent to the first rulemaking initiative but strongly opposed the second. The most

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strenuous objections attacked the proposed amendments to the money market investment guidelines and the shelf registration issue qualifications. Law firms attacked the proposed shelf issuance restrictions they feared would adversely affect deal volume, calling the measure “an over-reaction” that would prevent quality debt issuances “for no reason.” Money market funds voiced strong opposition to amending Rule 2a-7, ostensibly supporting the existing NRSRO reference as a beneficial investor-protective measure that provided an important “floor,” “minimum standard,” and “independently established baseline” for investment risk. Two Prudential money market fund boards of directors were incredulous that the SEC believed they had “the necessary expertise” to evaluate the risk of portfolio investments.

Aside from specific market participants protecting their particular interests, there were two broader objections. Commenters from multiple industries cautioned that the ongoing economic crisis counseled against changes that could impose additional barriers to capital formation. Even commoner were facial attacks to the major premise underlying the proposals: that references to NRSRO caused undue investor reliance on NRSRO ratings. Entities raising this point included ASF, a credit rating agency industry body, law firms Clearly Gottleib and

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Dechert, and the ABA’s Section of Business Law. In the face of this resistance, the SEC abandoned its second rulemaking initiative.

B. Assessing the CRARA

1. Whether the CRARA Achieves Competition, Transparency, and Accountability

The CRARA will likely allow more agencies to receive the NRSRO designation, thereby increasing competition in the credit rating industry. The new barriers to entry, while substantial, are relatively definite and depend on an objective assessment of the applying agency’s resources instead of the subjective criteria of how users of ratings perceive the agency. Since the inception of the CRARA, the SEC has recognized four NRSROs not recognized under the previous application process. On its face the act seems to provide greater access to NRSRO status and to date the number of market participants has increased significantly. It remains to be seen what effect this will have on the oligopolistic market share enjoyed by Moody’s, S&P and, to a lesser extent, Fitch.

Since the SEC has already certified eleven NRSROs on the basis of their applications, the contents of disclosures and policies deemed sufficient under the CRARA shed light on whether

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107 See Kara Scannell, SEC Looks to Limit Rating-Firm Conflicts, THE WALL STREET JOURNAL, Nov. 13, 2008, available at http://online.wsj.com/article/SB122653699587722741.html#articleTabs%3Dcomment (“The Securities and Exchange Commission is expected to vote for rules next week aimed at limiting conflicts of interest at credit rating firms, but it isn’t expected to adopt for substantial changes for the time being.”). “The SEC isn’t expect to take up two other rules proposed earlier this year. One would reduce companies’ and mutual funds’ reliance on credit ratings, which are embedded in SEC rules….Both ideas met with strong opposition from industry.” Id. On December 3, 2008, the SEC announced that is was considering whether to adopt final rules from some proposals in its first initiative. See Final Rules and Proposed Rules relating to Nationally Recognized Statistical Rating Organizations and Credit Ratings, at http://www.sec.gov/news/press/2008/nrsrofactsheet-120308.htm (last visited, Jan. 24, 2009).
the act is likely to achieve transparency and accountability. Transparency both allows investors to develop informed opinions and facilitates accountability. This section addresses each function in turn. Based on the information in Moody’s application, the Act’s disclosure requirements will allow investors to assess the accuracy of an NRSRO’s past ratings, but will do little to elucidate either Moody’s decision making process or its rating methodology. Currently available disclosures of past performance provide default rates of different asset classes over short, mid and long-term time frames. This information provides a basis for investors to determine whether a particular NRSRO deserves their trust and provides a basis for comparison between NRSROs. On the other hand, the disclosures provide little insight as to either how Moody’s makes particular ratings decisions or how it decides to monitor or reevaluate a rating. Moody’s lists many “qualitative and quantitative” factors that it typically considers, but notes that the list is “neither mandatory nor exhaustive.” As for ensuring that ratings are current, Moody’s provides simply that it “will monitor the credit rating, as deemed appropriate . . . .” Therefore, NRSRO disclosure under the CRARA will serve as a useful means to evaluate past performance, but will not allow investors to assess the accuracy of any specific present rating.

The continued opacity of rating agency decisions also informs a discussion of accountability. Since the act only requires NRSROs to abide by the procedures and methodologies it says it will use and proscribes the SEC from regulating an agency’s procedures or methodologies, NRSROs can effectively avoid oversight by maintaining sufficiently abstract rating and monitoring criteria. By allowing itself to consider any factor and by not requiring

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108 This article uses information provided by Moody’s NRSRO application. To the extent that the SEC approved applications that contained less information than Moody’s, the requirements of the CRARA may be lower than represented in this discussion.
110 Id. at Exhibit 2.
111 Id.
consideration of any factor, Moody’s has given itself room to justify any rating decision. What is more, Moody’s retains complete discretion to monitor or not monitor its ratings and the SEC is powerless to require more.

As was known well before the passage of the CRARA, NRSROs maintain detailed conflicts management procedures that require reporting up, removing conflicted analysts from rating committees, and separating compensation from rating decisions. The act will likely allow the SEC to oversee and enforce these policies. Nonetheless, it is worth noting that Moody’s conflict management policies do recite some particularly toothless language. For example, Moody’s asserts that it “will not forbear or refrain from taking a Credit Rating action based on the potential economic effect of the action” and that the determination of a credit rating “will be influenced only by factors relevant to the credit assessment.”

Given Moody’s opaque rating methodologies, transgressions from these assurances will likely be difficult to discover through SEC investigation. In addition, information made public through NRSRO registration provides only a partial picture of the SEC’s enforcement tools as NRSROs retain and disclose large amounts of information on a confidential basis.

2. Whether the CRARA Can Produce Accurate Ratings

Despite partial success in achieving competition, transparency, and accountability, these means must produce accurate ratings for the act to succeed. This section asserts that competition, accountability and transparency will lead to accuracy only if NRSROs are more concerned with preserving their reputation for accuracy than they are with serving issuers’ regulatory need for investment grade ratings. If, on the other hand, the regulatory value of ratings dominates their informational or the reputation mechanism otherwise fails, the act will do

little to promote rating accuracy. Compounding this difficulty, the need for expected future rents to drive reputation-building activity makes the CRARA’s competition-promoting provisions particularly counterproductive.

Competition among NRSROs will promote accuracy only to the extent their clients, the issuers, demand accuracy. If issuers are more concerned with receiving and retaining investment grade ratings than they are with maintaining their reputation with investors, agencies will simply not compete to provide their clients with accurate ratings near that cutoff. Similarly, transparency will lead to accurate ratings only if rating agencies compete to produce accurate ratings. Increased disclosure will doubtless allow investors to correctly assess the relative accuracy or inaccuracy of NRSRO ratings. Investors will therefore be able to decide which agency deserves their trust, but to the extent issuers choose the agency that will best serve their regulatory needs, a decline in a rating agency’s reputation for accuracy will not force a change in behavior. Furthermore, it is actual accuracy, and not the mere ability to detect inaccuracy, that is imperative to the wisdom of the NRSRO framework. While investors actively involved in assessing the risk of their investments may turn to other sources of information in the face of unreliable ratings, those invested passively in mutual funds or pension funds depend on rules that require fund managers to sell off debt obligations when the risk of default becomes too high. If the applicable NRSRO rating fails to reflect the actual risk of default, fund managers may stay invested, subjecting investors to undue risk and defeating the objective of the applicable investor-protective regulation. Competition also undermines accuracy for the reasons stated in the Harvard Business School study. More market participants create a greater supply of NRSRO rating services, which drives down profits, which reduces a rating agency’s incentive to invest in
reputation. As result, rating agencies will focus on maximizing short-term profits at the expense of ratings quality.

Accountability for the purposes of the CRARA means accountability to produce ratings using the procedures and methodologies that an NRSRO says it will use and accountability to manage the conflicts of interest it is required to manage. Plainly, holding an agency to follow its own rating procedures and methodologies will not produce accuracy unless the procedures and methodologies themselves would produce accuracy. Two of the studies described in Part I, however, suggest that NRSROs may use methodologies that reflect a bias against downgrading near the investment grade barrier. First, the Stanford-Michigan study interpreted its findings to mean that certified rating agencies required more evidence to support a rating downgrade from investment grade to non-investment grade than it did to make other rating changes.\(^\text{113}\) Second, the Federal Reserve Bank of Kansas City study found that S&P, Moody’s, and Fitch were more likely to make large downgrades from the lowest investment grade than from other grades, possibly because these agencies had decided to define their lowest investment grade quite broadly.\(^\text{114}\) While the SEC arguably lacks competence to mandate rating procedures and methodologies, these results suggest that the rating process itself could be a source of inaccuracy.

Congress would have been foolish to believe that the SEC could outperform rating agencies as risk predictors, but its current approach assumes that rating agencies would at least attempt to make their procedures and methodologies accurate. As currently constituted, however, the regulatory framework allows agencies to intentionally maintain procedures and methodologies that produce low quality ratings. As revealed in the October 2008 House Oversight Committee hearing, Standard & Poor’s had developed a superior rating model as early

\(^{113}\) See BEAVER ET AL., supra note 35, at 32–35.
\(^{113}\) JOHNSON, supra note 36, at 21.
\(^{114}\) Id. at 3.
as 2001. Senior management knew this model existed yet declined to implement it because increasing accuracy would not increase revenues.\footnote{See Statement of Frank Raiter, supra note 48, at 6.} Absent incentives for agencies to create and maintain ratings through reliable processes, ensuring that agencies comply with their stated procedures and methodologies is of negligible value.

Perhaps worse, co-opting NRSROs into a regulatory role has caused them to intentionally and expressly sacrifice rating accuracy. For example, Moody’s has, in recent years, published a “Special Comment” analyzing the “tradeoff” between accuracy and stability reflected in their ratings.\footnote{See, e.g., Moody’s Investors Service, Special Comment, Analyzing the Tradeoff Between Ratings Accuracy and Stability 1 (2006), available at http://74.125.47.132/search?q=cache:wiK4uSwPXWEJ:www.moodys.com/cust/content/content.ashx%3Fsource%3DStaticContent/Free%2520pages/Credit%2520Policy%2520Research/documents/current/tradeoff.pdf+MOODY%E2%80%99S+INVESTORS+SERVICE,+SPECIAL+COMMENT,+ANALYZING+THE+TRADEOFF+BETWEEN+RATINGS+ACCURACY+AND+STABILITY&cd=1&hl=en&ct=clnk&gl=us.} Moody’s justifies sacrificing some accuracy due to need for stability in an effective regulatory regime. For example: “volatility reduces the efficiency of ratings as tools of governance. In many of these cases, certain rating changes lead an agent to take an action that is costly to undo if the rating is subsequently reversed . . . .”\footnote{Id. at 2.} This is especially true in the case of rules such as 2a-7, which requires a portfolio manager to divest if investment grade holdings are downgraded to speculative. Having to frequently buy and sell securities due to volatile ratings would create a sizeable rise in transaction costs that would, if market swings were sufficiently severe, more than offset the rule’s intended benefits. Moreover, the Special Comments make it clear that Moody’s Investor Services in fact serves not investors with this policy, but a range of “market participants”—including regulators and issuers—who have “different needs.”\footnote{Id. at 1, 2.}

Therefore, Congress at once complained that rating changes lagged the market and then purposely avoided addressing methodologies that by their express terms produced this very
result. Finally, while the CRARA may effectively require NRSROs to manage conflicts of interest, the act defers thoroughly to the NRSRO business model and ignores the possibility that some incentives in the business model itself are inherently at odds with accuracy. Ratings will be more accurate without these conflicts than with them, but the act’s accountability provisions are at best a partial solution as they address only the specific, and not the systemic, causes of inaccuracy.

III. RECOMMENDATIONS

While numerous suggestions have been advanced to improve the accuracy of credit ratings, the options are essentially two: remove the NRSRO designation in an attempt to restore the reputation mechanism or avoid the need for the reputation mechanism by conditioning the valuable NRSRO designation, indirectly or directly, on accuracy. Congress and the SEC have chosen a variation of the second approach. Specifically, they have conditioned the NRSRO designation on rating agencies subjecting themselves to a mix of disclosure requirements, conflicts rules, and enforcement authority. These measures they believe will lead to increased competition, transparency, and accountability, which will in turn produce accuracy. As described above, there are good reasons to believe this approach will not work. Rather, any viable reform effort must either remove the NRSRO framework, remove the need for reputed intermediaries, or condition the NRSRO designation directly on rating accuracy. This Part briefly explores these options and finds that while each has significant benefits and drawbacks, eliminating the NRSRO designation will improve ratings quality and is feasible even in the near term.

119 Using a valuable carrot like the ability to grant regulatory licenses is an attractive and perhaps necessary way to induce changes in the rating agency behavior. The ability to regulate is limited in this context as several lower courts have held that credit ratings are financial opinions protected by the First Amendment. See, e.g., PARTNOY, supra note 15, at 61.
A. Abandoning Reputation: Using the NRSRO Designation to Control Rating Agency Behavior

1. Prohibiting the Issuer-Pays Business Model

Of the proposals that leave the NRSRO structure intact, prohibiting NSRSOs from receiving compensation from issuers is perhaps the most well known. Instead of assuming the reputation mechanism works, as the CRARA does, this measure obviates the need for it. Prohibiting the issuer-pays business model, the industry’s primary conflict of interest, would ensure that rating agencies were no longer financially dependent on those seeking high ratings.¹²⁰

Despite the directness and seeming simplicity of this approach, a vision for implementing this reform has not been cogently articulated, likely because there are substantial barriers to forcing a fundamental change on the credit rating business model.

As discussed above, regulations practically require certified ratings for every debt issuance. Currently, issuers can meet that need by purchasing ratings. If issuers were no longer able to purchase ratings, however, NRSROs would need either regulatory or market incentives to issue ratings for every debt product. The changes in cost structures that caused rating agencies to abandon the investor subscription model in the first place are, however, even more pronounced today. The major rating agencies switched to an issuer-pays system in the early 1970s because mutual funds changed the demand structure with their need for a broader and better-monitored supply of ratings.¹²¹ As a result, the traditional subscription fees could not offset the increasing costs.¹²² The complexity of structured products and the vast increase in the number of debt

¹²⁰ It is possible that investors paying subscription fees to credit rating agencies would also pose conflict of interest. For example, if a particular investor held a long position on a certain bond that investor would oppose any downgrade. As Sean Egan, President of Egan-Jones Rating Company, an investor-paid credit rating agency notes, though, rating agencies usually do not know whether their investor clients are long or short on a particular issue. See Comment Letter of Egan-Jones, (Sept. 5, 2008), available at http://www.sec.gov/comments/s7-19-08/s71908.shtml.
¹²¹ DITTRICH, supra note 17, at 19.
¹²² Id.
issuances since the 1970s has only increased these costs further. It is therefore unlikely that subscription services that currently constitute only 10% of NRSRO revenue could provide sufficient revenue to support rating all debt issuances over both stagnant and robust market cycles. It is even harder to imagine a way to mandate that private credit rating agencies rate every product when the market does not support it. To do this would require that the government enter the business of subsidizing credit ratings, an idea which no one supports.

2. Regulating Accuracy Directly

A second approach is to condition the NRSRO status directly on NRSROs maintaining a specified level of accuracy, as measured against historical averages for the same ratings grade of the same agency. Professor John C. Coffee, Jr. of Columbia University School of Law once argued to Congress in favor of regulating accuracy in this manner.\(^{123}\) Instead of conditioning NRSRO status on changes to the credit rating agency business model or on other efforts designed to address conflicts of interest, he would have given the SEC the authority to specify maximum default rates for each rating category over a five year period.\(^{124}\) If an agency’s accuracy for a particular grade fell out of the mandated range, the agency would “forfeit the ability to serve as an NRSRO for the given rating or product as to which it was demonstrably inaccurate.”\(^{125}\) The goal for professor Coffee was to “sever the link between providing information and conferring legal protection” so as to “counterbalance the current incentives for grade inflation.”\(^{126}\) The merit of this proposal is that it both provides a strong incentive for NRSROs to ensure that their

\(^{123}\) See Coffee, supra note 66, at 14. More recently, Professor Coffee has instead focused on requiring credit rating agencies to perform due diligence and subjecting them to civil liability. See Examining Proposals to Reform the Credit Rating Agencies, Before the S. Comm on Banking, Housing & Urban Affairs, 111th Cong. 3 (2009) (Statement of Professor John C. Coffee, Adolf A. Berle Professor of Law, Columbia University Law School).

\(^{124}\) Id. at 14–16.

\(^{125}\) Id. at 15.

\(^{126}\) Id.
ratings achieve a specified degree of accuracy, yet avoids regulating NRSRO procedures and methodologies.

One difficulty with this proposal is that it invites the NRSROs to game the system. By focusing on long-term accuracy, it fails to address the short-term failures to downgrade prevalent in both the 2001–2002 and 2007–2008 downturns. Rating agencies could exploit this oversight by rating conservatively during bull markets, thereby building up an accuracy reserve that they could then spend by delaying downgrades when markets turned south and defaults increased. To address this possibility, there should be varying permissible default rates over different time periods. Specifically, any similar reform measure should allow a larger variation from the historical average for a particular grade over shorter trailing timeframes, but should allow less deviation at longer historical horizons.

Second and more problematically, this proposal incorporates rating scales controlled by the rating agencies, providing incentives for rating agencies to subvert the accuracy requirement by either changing the default rates under their existing rating scales, or by changing the scales themselves.127 For example, upon learning that their AA ratings could no longer have a default rate greater than their historical three percent average, Moody’s could recalibrate its ratings to make them uniformly more conservative. Issuers and investors would adjust to the new system while the rating agencies would have bought themselves room for subsequent ratings inflation. The only way to avoid this type of manipulation in a system where credit rating agencies have incentives to rate inaccurately is to proscribe it. This would require regulating rating agency procedures and methodologies, something Congress has been loathe to do and which the CRARA prohibits.

127 It is worth remembering here that the major rating agencies provide ratings as relative measures of creditworthiness and do not reference an absolute probability of default. These figures are instead calculated in hindsight based on historical default percentages.
B. Restoring the Reputation Mechanism: Abandoning the NRSRO Designation

In the alternative, divesting NRSROs of their regulatory power could improve rating accuracy. Scholars, legislators and regulators have debated this idea, yet differences over everything from how to disconnect rating agencies from regulation, to what risk measures regulations should invoke in the absence of certified ratings, to even the fundamental rationale for this reform have impeded its progress. This part reasserts the correct theoretical underpinning of this change and describes a means of implementing it that is both politically tenable and advances the investor-protective regulatory objectives that NRSRO ratings were meant to serve.

Regulators should decouple NRSRO ratings from regulatory authority as a means of restoring the reputation mechanism. Removing regulatory value from ratings would cause issuers to purchase ratings only to the extent they could convey useful information to prospective investors. Based on this rationale, Frank Partnoy has suggested—as long ago as 1999 and as recently as April 2009—replacing current regulatory reliance on ratings with ratings triggers based on credit spreads. Since regulations subject to market volatility could impose large transaction costs by requiring regulated institutions to sell their positions frequently, he suggests using rolling averages. Using this system, regulations could maintain both accuracy and a measure of stability.

Similarly, professor Lawrence White has suggested to Congress that it dismantle the NRSRO framework. In place of NRSRO ratings, White would place the burden on regulated

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129 Id. (“The credit spread could be an average over some period (e.g. 30 to 90 days) to smooth the effect of temporary market movements based on temporary supply/demand or liquidity constraints.”).
institutions to justify that their bond portfolios are safe. While White’s reasoning was less explicit than Partnoy’s, he reasoned that removing the “force of law” that Congress and the SEC had bestowed upon NRSRO would free institutional participants in bond markets to consider a much broader range of information in assessing the risk of their investments. Therefore, White too seems to recognize that regulations force issuers to purchase certified ratings.

Ironically, even the SEC’s 2008 rulemaking proposals suggested, among other things, removing certain regulatory references to NRSROs. The rules would have largely placed the onus of risk-assessment on institutional investors and fund managers. As described above in Part II.B.3, the SEC reasoned that by removing the “official seal of approval” from NRSRO ratings, these reforms could reduce over-reliance on a few rating agencies, thereby increasing competition. At this point, Partnoy’s reasoning has all but disappeared and the central concern seems to be one not of perverse rating agency incentives, but of distorted investor perceptions. The SEC seems to argue that investors will trust NRSRO ratings because the SEC, by certifying selected agencies, has put the force of its own reputation behind their accuracy. As described above, Comment Letter reaction to this proposal was overwhelmingly negative. Commenters regularly asserted that 1) NRSRO ratings provided an important baseline of investor protection, 2) placing risk-assessment responsibility directly on fund managers was inappropriate, and 3) investors simply do not overly rely on NRSRO ratings because SEC regulations imply that such ratings are the sole source of useful credit risk information. Ultimately the SEC abandoned the proposal. While Partnoy opines that removing the NRSRO mechanism “does not appear to be

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130 See Examining Proposals to Reform the Credit Rating Agencies, Before the S. Comm on Banking, Housing & Urban Affairs, 111th Cong. 3 (2009) (Statement of Lawrence J. White, Professor for Economics, Stern School of Business New York University).

131 See supra, Part II.B.3.
possible or likely, at least in the near term,” an approach that provides a cogent, supportable rationale, replaces NRSRO ratings with an objective baseline level of risk, and avoids forcing those without adequate resources to certify risk would be both effective and less likely to encounter widespread opposition.

In short, Partnoy’s rationale is the right one. Congress and the SEC should embrace removing regulatory reliance on NRSRO ratings as a means of restoring the reputation mechanism. His solution, however, is incomplete. Market measures may not exist for illiquid securities and, as the credit crisis has demonstrated, market measures do not always exist to value every normally liquid debt product. Therefore, the judgment of regulated investors should be combined with market measures to form a cohesive approach to regulation. Specifically, regulated investors should have the primary responsibility to certify risk, but should be able to rely on credit spreads as a safe harbor. In most situations, regulated investors would inevitably rely on credit spreads. Where market measures were not available, they would have to rely on their own judgment or that of an adviser. Combining these two approaches has the tripartite benefit of enhancing baseline levels of regulatory risk protection, assuring regulated investors that their debt holdings comply with these regulations, and restoring economic incentives that will prompt credit rating agencies to produce accurate ratings.

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132 Roundtable on Oversight of Credit Rating Agencies, Statement of Frank Partnoy, available at http://www.sec.gov/divisions/marketreg/ratingagency.htm#roundtable. Despite this grim assessment, support for this position has been growing. In the October 2008 House hearing, Frank Raiter suggested scrapping the NRSRO system as part of a larger solution, Jerome Fons acknowledged that it might be a good idea, and Senator Tierney suggested that the government “get out of the business of certifying agencies.” Statement of Frank Raiter, supra note 34, at 8; Statement of Jerome Fons, supra note 2, at 6; Credit Rating Agencies and the Financial Crisis Before the H. Comm. On Oversight and Gov. Ref., 111th Cong. 6 (2008) (preliminary transcript), at 76.

133 DITTRICH, supra note 16, at 134 (“The biggest disadvantage of market-based measures is their limited reach. There are many illiquid securities and new issues cannot be rated at all. Since a full reach is a knock-out criterion for any stand-alone risk measure, there is no way to implement a system of purely market-based regulation.”).
CONCLUSION

The CRARA, while moderately proficient on its own terms, makes the more fundamental mistake of assuming that NRSROs value investor trust first and last. In reality, they value it last, if at all. As a result, competition and transparency—bulwarks of the CRARA’s structure—facilitate a market for investor service that simply doesn’t exist. NRSROs currently lack incentives to preserve their reputation for accuracy when it conflicts with selling regulatory licenses and garnering short-term profits. Replacing the NRSRO mechanism with a system that shifts ultimate responsibility from certified third parties to regulated investors, but allows such investors to largely rely on market measures of credit risk, will improve the performance of credit rating agencies, enhance the protection of investors, and encounter less credible resistance. Without further reform, inaccuracy will remain endemic to the NRSRO regime and another round of painful, dilatory downgrades should be expected with the next market downturn.