A Pattern of Unaccountability: Rating Agency Liability, The Dodd-Frank Act, and a Financial Crisis That Could Have Been Prevented

Stephen P Alicanti
Stephen P. Alicanti

A PATTERN OF UNACCOUNTABILITY: RATING AGENCY LIABILITY, THE DODD-FRANK ACT, AND A FINANCIAL CRISIS THAT COULD HAVE BEEN PREVENTED

ABSTRACT

By opining on the credit quality of structured debt products, credit rating agencies guide investment decisions and facilitate the debt capital markets. In the years leading up to the financial crisis of 2007, loans were commonly issued to individuals with poor credit histories and insufficient income. After those loans were originated, investment banks packaged them into securitized debt products and sold sections (tranches) to investors. Many of those products received credit rating agencies’ highest endorsement of creditworthiness. Despite their high ratings, those products failed during the financial crisis and devastated individual investors, investment banks, and insurance companies. The financial shockwaves spanned the globe.

In the wake of one of the worst financial crises in our nation’s history, credit rating agencies have been subjected to scathing allegations. Some suggest that credit rating agencies lacked qualified personnel to properly scrutinize the massive quantity of loans. Perhaps credit models were inadequate. Others suggest a more nefarious intentional disregard of credit quality as part of a collusive effort with investment banks. Even if the worst accusations are true, investors generally have had little recourse against credit rating agencies. The investing public demands that credit rating agencies be held accountable.

This article examines past civil lawsuits against credit rating agencies, the obstacles that plaintiffs frequently encounter, and how the Dodd-Frank Act removes many of those impediments. Credit rating agencies may argue that certain sections of the Dodd-Frank Act violate the First Amendment because of its regulation on the agencies’ “free speech.” At the time of this writing, the Supreme Court has not addressed this issue. Throughout my analysis of the Dodd-Frank Act, I argue that it should be upheld and that the judiciary should force rating agencies to defend the quality of their work instead of hiding behind the First Amendment.

Additionally, I propose oversight reforms in coordination with the Dodd-Frank Act’s proposed studies. Specifically, I argue for immediately segregating rating and consulting functions, maintaining the issuer-pay model, and creating an independent analyst organization. I conduct a substantial portion of my analysis and recommendations from the unique perspective of the credit rating industry’s comparability with the audit industry. In doing so, I consider how the Sarbanes-Oxley Act of 2002 identified problematic issues within the credit rating industry, but failed to act on them—effectively missing a chance to prevent the recent credit crisis.
## I. Background

A. Credit Rating Agencies’ Function ................................................................. 3

  B. Origins of the Credit Rating Agencies ....................................................... 5

    1. The Big Three: S&P, Moody’s, and Fitch .............................................. 6

    2. Current NRROS ....................................................................................... 7

    3. Rating Evaluations ................................................................................. 8

    4. Agencies as Gatekeepers ....................................................................... 8

    5. Reputational Capital ............................................................................. 9

## II. Subprime Mortgage Crisis (2007–2008) .................................................. 10

  A. Details of Crash ........................................................................................ 10

  B. Structure of Securitized Products ............................................................ 13

  C. Fatally Flawed Models ............................................................................ 14

  D. Resultant Litigation ................................................................................ 16

## III. CRA Liability in Widespread Public Issuances ...................................... 18

  A. CRAs’ First Amendment Protections ......................................................... 18

    1. First Amendment Objectives ................................................................ 20

    2. Commercial Speech Approach ................................................................ 21

    3. Commercial Speech Approach ................................................................ 23

  B. The Securities Laws ................................................................................ 24

    1. Sections 11, 12, & 15 of the Securities Act .......................................... 25

    2. Rule 10(b)-5 and Section 10(b) of the Exchange Act ............................ 29

## IV. CRA Liability in Private Placements ...................................................... 31

  A. Negligent Misrepresentation .................................................................... 32

    1. Audit Opinions ....................................................................................... 34

    2. Fairness Opinions ................................................................................ 36

  B. Common Law Fraud ................................................................................ 36

  C. Breach of Contract Claims ...................................................................... 38

## V. Sarbanes-Oxley Act Missed Opportunities ........................................... 40

## VI. The Dodd-Frank Wall Street Reform and Consumer Protection Act ...... 42

  A. Introduction ............................................................................................. 42

  B. Sections 932, 936, and 939B: Structural and Regulatory Changes .......... 43

  C. Section 933: State of Mind in Private Actions ...................................... 46

  D. Section 939G: Repeal of Rule 436(G) of the Securities Act of 1933 ....... 48

  E. Upcoming Studies and Proposed Solutions ............................................ 50

    1. Independence ......................................................................................... 50

    2. Alternate Pay Models and Assignment .................................................. 53

INTRODUCTION

In 2002, the Sarbanes-Oxley Act ("SOX") aggressively regulated conflicts of interest within the audit industry. As part of SOX, Congress ordered the Securities and Exchange Commission ("SEC") to study similar conflicts within the credit rating industry. However, SOX audit regulation was more robust than credit rating reform, and credit rating agencies ("CRAs") were left largely unregulated. By failing to correct issues that the SEC identified eight years ago, Congress missed an opportunity to prevent the credit crisis.

Audit firms and CRAs are similar in many ways. Both publish opinions about the financial condition of an entity and exercise considerable professional judgment. Auditors opine on the accuracy of an entity’s financial statements\(^1\) and whether the entity has the ability to continue as a going concern. To do so, auditors evaluate whether accounting estimates are reasonable in the context of the company’s past performance and market position. Auditors utilize ratio and trend analysis to predict whether the entity will remain financially viable in the foreseeable future. Similarly, CRA analysts evaluate the composition of structured debt products and opine on the likelihood of default. The public relies on both audit opinions and credit ratings for its investment decisions.

Admittedly, audit firms and CRAs are not completely analogous. Besides its predictive going concern analysis, an audit is primarily focused on historical financial information, while CRAs attempt to predict future default. Moreover, audits ensure that financial statements are in compliance with Generally Accepted Accounting Principles ("GAAP"), while no such standards currently exist for CRAs. Unlike audit firms that have relied on a lack of privity with investors, CRA have successfully used the First Amendment as a defense against lawsuits in widespread
public issuances. Despite their differences, I propose that similar reforms are appropriate for both industries. CRAs should be viewed as auditors of credit quality. Limited regulation and a reasonable amount of liability would ensure that CRAs appropriately consider the composition of complex debt products, especially those constructed with high-risk loans. Unfortunately, a crisis was necessary to precipitate reform in both fields.²

Throughout the first half of the 2000s, loan securitization grew at a frenetic pace. Investment banks packaged mortgages (especially subprime), credit-card receivables, and auto-loans into securitized debt products and sold them to the public. By commonly issuing their highest ratings on the first tranche of those loans, CRAs helped drive the demand for structured debt products. According to the CRAs, those products offered a high rate of return at a low risk. At the onset of the financial crisis in 2007, it became painfully apparent that credit ratings were wildly overoptimistic. Despite the strongest assurances of creditworthiness from CRAs, securitized debt products systematically collapsed. The effects of the financial crisis have had damaging global implications and the resultant deep recession still persists at the time of this writing. Theories abound as to the cause for these inaccurate ratings—inadequate staffing, problematic models, and conflicts of interest between CRAs and investment banks. In the aftermath of the housing collapse and subsequent financial crisis, many observers questioned why credit rating agencies issued such high ratings on dubious loans. I question why they have not been held accountable.

² The crisis that led to the accounting reforms involved the scandals at Enron, WorldCom, and other accounting scandals of the early 2000s. The crisis that led to the Dodd-Frank Act was the housing collapse and subsequent credit crisis. I refer to accountants and auditors interchangeable throughout this article based on the presupposition that accountants have been engaged to audit financial statements.
In response to the financial crisis, The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) addresses problematic issues within the credit rating industry that had similarly plagued the audit industry in the early 2000s. The Dodd-Frank Act establishes several concrete reforms and lays the foundation for others. The legislation implements reforms that enhance CRA accountability, transparency and independence. I explain why those reforms should be upheld by the Supreme Court, if challenged. Additionally, the Dodd-Frank Act orders several studies that could potentially overhaul the structure of the entire credit rating system. As recommendations for those studies, I propose immediately segregating CRAs’ rating and consulting functions, maintaining the issuer-pay model, and creating an independent analyst organization.

I. BACKGROUND

Over the past thirty-five years, loan securitization has grown drastically, especially within the mortgage market. Mortgage backed securities facilitated a shift in home financing from local savings and loans (commonly known as thrifts) to the public markets, inspired by the models of Fannie Mae and Freddie Mac. Political pressures, avarice among loan originators, and

---


In 1976, the amount of securitized home mortgages was $28 billion; by the end of 2003, the total amount of securitized home mortgages had grown almost 150 times, reaching $4.2 trillion. Over the same period, the amount of home mortgages outstanding grew from $489 billion to $7.3 trillion. By comparison, there was no securitization of commercial mortgages, business loans, or consumer loans in 1976. By the end of 2003, $294 billion of commercial mortgages, $104 billion worth of C&I loans and $658 billion worth of consumer loans were securitized.

Id.
compliance from CRAs facilitated loans to increasingly less-qualified borrowers, which ultimately landed in pools of securitized loans.

Unfortunately, the credit crisis rapidly eviscerated the value of many securitized debt products, especially those that were substantially comprised of subprime mortgages. The experience of the New Jersey Carpenters Vacation Fund was typical of the financial crisis:

Upon issuance, the great majority of Certificates originally received high credit ratings from the Rating Agency Defendants—Moody’s assigned its highest investment grade, “Aaa,” to 92.7% of the Certificates it rated, while S&P assigned its highest grade, “AAA,” to 92.2% of the Certificates it rated. None initially were rated below “investment grade” (“Ba1” for Moody’s, “BB+” for S&P). Shortly after their sale, however, defaults and delinquencies on the underlying mortgage collateral quickly piled up, and as a result, “the value of the Certificates collapsed.” As a result of the “massive increases in borrower delinquency, foreclosure, repossession and bankruptcy in the underlying Certificate collateral” [The New Jersey Carpenters Vacation Fund] claim[s] the Certificates have lost “[a] combined 68% of their initial value.” Today, over 39% of the underlying loans are delinquent, or in default, foreclosure or bankruptcy. In mid-2007, both Moody’s and S&P revised their rating method, re-analyzed the Harborview Trusts, and downgraded almost all of the Certificates, some many levels below their original rating. . . . More than 95% of the Certificates have been “downgraded to speculative junk bond investments.”

In the following pages, I discuss how CRAs reached this point and what is being done to reform
the system.

A. CREDIT RATING AGENCIES’ FUNCTION

Credit ratings are critical “to capital formation, investor confidence, and the efficient performance of the United States economy.”7 CRAs opine on the creditworthiness of “bonds, preferred stock, and commercial paper.”8 Accordingly, CRAs assign a letter grade based on the likelihood of default and financial loss in the event of such default.9 In rating agency parlance, AAA through BBB ratings are considered “investment grade”, while BB and below are considered speculative quality.10

B. ORIGINS OF THE CREDIT RATING AGENCIES

Rating agencies originated during the latter part of the 19th century, when investors were focused on the railroad industry.11 While railroad construction and development was advancing the capital markets, information about the railroads was “costly to gather, difficult to interpret and often inaccessible to the public.”12 This situation presented a classic collective action problem that persists to this day. Individual investors have weak incentives to gather costly information, and dispersed investors have no way to organize, collectively appoint, and pay for

---

9 Id. Grading systems differ slightly among agencies. Id.
10 Id. Corinne Crawford & Josh Wolfson, Lessons From The Current Financial Crisis: Should Credit Rating Agencies Be Re-Structured?, 8 J. BUS. & ECON. RES. 85, 86 (July 2010).
11 Id.
an agent to inspect railroads (and eventually debt issuers) for them. Sensing a unique marketing opportunity, the early rating agencies compiled and interpreted railroad information, which substantially enhanced accessibility for investors.\textsuperscript{13}

1. \textbf{THE BIG THREE: S\&P, MOODY’S, AND FITCH}

In 1860, Henry Varnum Poor published the \textit{History of Railroads and Canals of the United States}, a seminal compilation of financial and operational details of the U.S. railroads.\textsuperscript{14} In 1868, Poor established H.V. and H.W. Poor Co., with his son, Henry William, and published annual updates to his railroad guide.\textsuperscript{15} In 1906, Luther Lee Blake created the Standard Statistics Bureau to provide financial information beyond the railroad industry.\textsuperscript{16} In 1941, Poor’s Publishing and Standard Statistics merged to form Standard & Poor’s Corp. (“S\&P”) and published a guide with 7,000 municipal bond ratings.\textsuperscript{17} In 1966, McGraw-Hill Companies acquired S\&P.\textsuperscript{18}

In 1909, John Moody evaluated the credit quality of 200 railroad companies.\textsuperscript{19} His rating system was the first to assign letter grades in declining order of credit quality.\textsuperscript{20} Born in 1914, Moody’s Investors Services (“Moody’s”) provided ratings for nearly all government bond markets for the next decade and developed into a full-scale rating agency by 1970.\textsuperscript{21}

Similarly, in 1913, John Knowles Fitch marketed statistical and financial analysis to the...
public in the *Fitch Bond Book* and *Fitch Stock and Bond Manual*. In 1924, the Fitch Publishing Company introduced AAA through D ratings. Fitch Ratings Ltd. (“Fitch”) became a full-service rating agency in the late 1990s when it merged with IBCA of London and subsequently acquired Thomson Bank Watch and Duffs and Phelps Rating Agency.

Early rating agencies sold information to interested investors via a “user-pay” revenue model for more than 100 years. In 1975, the SEC designated Nationally Recognized Statistical Rating Organizations (“NRSROs”), and a new “issuer-based” system that charged financial product issuers for credit ratings emerged around the same time.

2. **CURRENT NRSROS**

At the time of this writing, the SEC has qualified only ten NRSROs and denied applications from 130 other rating agencies. Consequently, the “big three” rating agencies, S&P, Moody’s, and Fitch, provide between 95% and 98% of securities ratings. Because credit requirements “depend exclusively on ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs),” the big three CRAs thrive in an oligopolistic market

---

22 *Id.*  
23 *Id.*  
24 *Id.* at 85.  
25 *Id.* at 86.  
26 *Id.* at 87. The “user-pay” model became untenable for two reasons. First, inexpensive copying created a “free rider” problem. Second, intense demand for credible ratings required expensive teams of highly skilled analyst. Subscription revenues alone were insufficient to cover the associated costs of evaluating credit quality on such a scale. “For these reasons, the principal agencies began to charge issuers for their credit ratings, and issuers were willing to pay these rating fees because they benefited from having these ratings.” Carol Ann Frost, *Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies*, 22 J. ACCT. AUDITING & FIN. 469, 478–479 (2007).  
27 Crawford & Wolfson, *supra* note 11, at 87.  
28 *Id.*
structure.  

3. RATING EVALUATIONS

The “big three” rating agencies employ a mix of quantitative models and qualitative analysis to evaluate credit quality, while many of the smaller agencies rely more heavily on quantitative models.  

“The credit rating process at the principal CRAs involves analysis of both business risk (industry characteristics and the company’s competitive position and management quality) and financial risk (financial characteristics, financial policy, capital structure, cash flow protection, and financial flexibility).”

Within each rating agency, a committee votes on a rating for the financial issuer, and the issuer is allowed to provide additional data to the agency before a rating is published.

4. AGENCIES AS GATEKEEPERS

CRAs have the ability to effectively deny issuers’ access to the debt capital markets. The term “gatekeeper” refers to an independent professional in a position “to be able to prevent wrongdoing by withholding necessary cooperation or consent.”

By pledging its reputation capital to the accuracy of its analysis of the entity that it has evaluated, a gatekeeper enables third parties “to rely on the corporation’s own disclosures or assurances where they otherwise might not.”

In an effort to enhance safety and assurance within the financial markets, regulators transformed rating agencies into gatekeepers for companies seeking access to the debt capital

---


30 Frost, supra note 26, at 473.

31 Frost, supra note 26, at 473–74.

32 Id.


34 Id.
markets. U.S. financial regulators and lawmakers rely on credit ratings to establish benchmarks for investment decisions, and institutional investors often design in-house investment rules that set forth rating requirements. Therefore, a substandard rating would effectively deny an issuer’s access to the debt capital markets.

CRAs’ influence extends beyond traditional corporate debt. Indeed, CRAs have facilitated the growth of the securitization market. “With respect to these new instruments, the agencies have become more like ‘gate openers’ than gatekeepers; in particular, their rating methodologies for collateralized debt obligations . . . have created and sustained that multi-trillion dollar market.” Interestingly, a simple letter grade determines the demand for a complex financial instrument.

5. **Reputational Capital**

Many experts consider credit rating quality to be controlled by a “reputational-capital” model that, in their opinion, incentivizes high-quality ratings. “The underlying idea [of the reputational model] is that if investors determine that a rating agency’s ratings are of low quality, they will stop crediting the ratings, and the agency’s business will lose value.”

---

35 Crawford & Wolfson, *supra* note 11, at 87.
36 Frost, *supra* note 26, at 474.
For example, Rule 2a-7 under the Investment Company Act (1940) limits money market funds to investing only in high-quality short-term instruments, where the minimum quality investment standards are based on ratings published by the NRSROs.” *Id.* “As a second example, NRSRO ratings are used to determine eligibility for the issuers’ use of the streamlined SEC registration statements.

*Id.*

37 *Id.*
38 *See* Coffee, *supra* note 33, at 2–3.
39 Partnoy, *supra* note 29, at 60.
41 *Id.*
statistics are typically measured by rating transitions and default rates. However, critics of the reputational model argue that limited competition, conflicts of interest, inadequate disclosure, and financial regulation have undermined its effectiveness. Empirical studies have shown that small CRAs outperformed the three largest CRAs; however, issuers have chosen CRAs based on market reputation and not past performance. During the recent financial crisis, the inadequacies of the reputational model have become more pronounced.


A. DETAILS OF CRASH

The origin of the recent financial crisis can be traced to the burst of the U.S. housing bubble.

Housing peaked in 2005. By early 2006 it was widely recognized the boom was likely over, and by mid-2006 it was beyond question. In June 2006, sales of existing single-family homes were 9% below their year-earlier level, sales of new homes were down 15% and framing lumber prices were down 19%. The Dow Jones Wilshire index of home-building shares had fallen 41% from its July 2005 peak.

As the credit crisis developed, valuations of asset-backed securities held by financial

---

43 See id.
44 Bai, supra note 42, 102–03.
institutions became uncertain. Because liquidity was constrained in secondary markets for asset-backed securities, market valuation techniques became ineffective.

The impact of the crisis was widespread. Global financial institutions were exposed to the U.S. housing market through their investments in collateralized debt obligations ("CDOs"). Insurance companies, such as American International Group, Inc., faced massive losses from their issuance of credit default swaps ("CDSs"). "The market value of U.S. and European financial institutions, especially U.S. mortgage giants Fannie Mae and Freddie Mac, collapsed throughout the summer [of 2008], putting increasing pressure on banking regulators throughout the world." Fannie Mae and Freddie Mac eventually received a government bailout on September 6, 2008; however, their rescue did not calm the markets. "[O]n the following weekend Lehman Brothers and AIG collapsed, and Merrill Lynch was bought at a fire-sale price by Bank of America." Washington Mutual collapsed and was acquired by JP Morgan. Wachovia was purchased by Citigroup and then Wells Fargo.

---

48 The efficient capital markets hypothesis depends on a liquid market for valuation. See, e.g., Freeman v. Laventhal & Horwath, 915 F.2d 193, 199 (6th Cir. 1990) (holding the market for municipal bonds not efficient enough for statements to be reflected in price, so the fraud-on-the-market presumption of reliance is rebutted).
49 Id. at 403.
50 Id. at 403. CDSs are insurance contracts for CDOs. The terms of CDS contracts were triggered during the financial crisis as CDOs defaulted, and the CDS holder was entitled to payment from the insurer.
52 Id. at 425.
53 Id. "The Federal Reserve exercised its emergency powers under Section 13(3) of the Federal Reserve Act to rescue AIG, but the government allowed Lehman Brothers to fail." Id.
54 Id. at 426.
55 Id.
The United States government launched several unprecedented programs to combat the financial crisis. As part of the Troubled Asset Relief Program ("TARP"), Congress approved the Treasury’s request for up to $700 billion to invest in toxic mortgages and troubled assets.\(^{56}\) In an effort to allay deposit fears and prevent massive withdrawals, the Capital Purchase Program (CPP) authorized the Treasury to invest up to $250 billion in preferred stock of insured depository institutions and their holding companies.\(^{57}\) Consequently, other financial institutions rushed to acquire insured depository institutions in order to qualify for CPP money.\(^{58}\) Additionally, "[t]he U.S. Federal Deposit Insurance Corporation (FDIC) temporarily increased deposit insurance coverage to $250,000 per person per institution . . ."\(^{59}\) In November of 2008, "the U.S. government announced an additional $20 billion in capital support and a related $301 billion asset guarantee program for Citigroup . . ."\(^{60}\) In early 2009, the government provided a similar support package to facilitate Bank of America’s acquisition of Merrill Lynch.\(^{61}\)

Banks tightened lending requirements in the aftermath of the crisis, and the lack of available credit restricted the economic growth needed for recovery. "Lenders demand higher credit scores, bigger deposits and more stringent proof of income," while "[p]olicymakers, who had cheered looser lending standards on the way up, are now tightening them further on the way

\(^{56}\) Id. at 425–26.

The House rejected TARP on September 30, 2008, resulting in the largest one-day drop in the Dow Jones Industrial Average of 778 points, or $1.3 trillion in market value. The Senate quickly passed a bill during the first week of October, the House reconsidered its action, and President Bush signed the bill into law on the same day the House approved it.

\(^{57}\) Id. at 426.

\(^{58}\) Id.

\(^{59}\) Id. at 426–27.

\(^{60}\) Id. at 427.

\(^{61}\) Id.
Credit availability was further constrained by historically low interest rates from the Federal Reserve. Financial institutions borrowed from the Federal Reserve at low rates and reinvested those funds in treasuries instead of lending to the private sector. By investing in treasuries, financial institutions effectively lent borrowed funds back to the government at the treasury rate, which was higher than the federal funds lending rate, and profited from the spread.

B. STRUCTURE OF SECURITIZED PRODUCTS

Investors often depend on the CRA’s “letter grade” when evaluating Wall Street’s most opaque financial concoctions and do not supplement their investment decisions with additional research. Frank Partnoy, a highly regarded CRA expert, stated, “Regulators and investors are addicted to credit ratings like heroin.” Undoubtedly, this unquestioning reliance contributed to the financial crisis.

Experts scrutinized the composition of securitized debt products in the aftermath of the financial crisis. Typically, a securitized product utilizes a special purpose vehicle (“SPV”), a distinct legal entity, to pool cash flows from assets such as mortgages and credit card receivables. The SPV issues debt securities which are supported by this diversified portfolio of

---

63 See Cathy McMorris Rodgers, Reverse The Fed's Monetary Practices, FORBES (Sept. 21, 2010, 8:00 PM), http://www.forbes.com/2010/09/21/federal-reserve-spending-barack-obama-opinions-contributors-cathy-mcmorris-rodgers.html. “With the private sector engulfed in so much uncertainty because of the government's spending, borrowing, and bailouts, banks are reducing credit to businesses, while increasing their purchase of government debt.” Id. U.S. treasuries are commonly viewed as having substantially less default risk than private sector lending.
64 Kevin Voigt, Are the ratings agencies credit worthy?, CNN, http://www.cnn.com/2010/BUSINESS/05/04/credit.ratings.agencies/index.html (last visited Oct. 1 2010) (quoting Frank Partnoy). Partnoy went on to say, “The only problem with [credit ratings] is they are false” and “[e]very academic study shows they substantially lag the market.” Id.
cash flows.\textsuperscript{66} The securitized products that collapsed during the recent crisis included pools of various types of contractual debt, including residential mortgages, commercial mortgages, auto loans, and credit card debt obligations.\textsuperscript{67} Many loan pools were comprised of subprime mortgages, which are risky loans with “unfavorable terms to borrowers unable to qualify for conventional loans.”\textsuperscript{68} Michael Lewis recently described the tranche\textsuperscript{69} structure and corresponding interest rates associated with securitized debt products.\textsuperscript{70}

A giant number of individual loans got piled up into a tower. The top floors [i.e. tranches] got their money back first and so got the highest ratings from Moody’s and S&P and the lowest interest rate. The low floors got their money back last, suffered the first losses and got the lowest ratings from Moody’s and S&P. Because they were taking on more risk, the investors in the bottom floors received a higher rate of interest than investors in the top floors.\textsuperscript{71}

Unfortunately, the financial crisis indiscriminately ruined even the highest tranches of securitized debt, regardless of credit rating. After investors surveyed the damage, many wondered how purportedly secure financial products, as indicated by their credit ratings, could have collapsed in such spectacular form.

C. FATALLY FLAWED MODELS

Credit rating models relied heavily on historical real estate trends to assess future housing

\textsuperscript{66} Id.
\textsuperscript{67} Charles Wallace, \textit{Unlocking the ABS Market}, 44 INSTITUTIONAL INVESTOR 50 (2010).
\textsuperscript{68} Katherine Connor Martin, Notes on OED’s June 2008 release of new words, OXFORD ENGLISH DICTIONARY (2008), \textit{available at} http://www.oed.com/news/updates/newwords0806.html
\textsuperscript{69} A tranche is a section of a large pool of cash flows. Cash flows are typically divided by their likelihood of default, and investors have the option of choosing which tranche they want to purchase.
\textsuperscript{70} MICHAEL LEWIS, THE BIG SHORT 26 (2010).
\textsuperscript{71} Id.
prices and mortgage default rates. Therefore, the housing market’s long-established track record of price appreciation contributed to optimistic models. Professor Robert Shiller of Yale University collected the following data:

In the 61 years from 1945 through 2006 the maximum cumulative decline in the average price of homes was 2.84% in 1991. If this low volatility of home prices persisted into the future, a mortgage security composed of a nationally diversified portfolio of loans comprising the first 80% of a home’s value would have never come close to defaulting.⁷²

Home prices appreciated 88.7% from 2000 to 2006, easily outpacing the 17.5% gain in consumer price index and 1% growth in median household income during the same time.⁷³ Home prices had never outpaced consumer prices and incomes to such a degree as the period preceding the financial crisis.⁷⁴

As home prices swelled, “Congress was happy that more Americans could enjoy the ‘American Dream’ of home ownership.”⁷⁵ Lax lending standards enabled increasingly unqualified borrowers to purchase homes that would have been otherwise outside their reach. Fannie Mae and Freddie Mac further contributed to the demand for subprime mortgages.⁷⁶ CRAs relied on a continual ascent of home prices, as opposed to the credit quality of buyers, and concluded that many subprime mortgage bonds were investment grade.⁷⁷ “The credit quality of home buyers was secondary [for rating considerations] because it was thought that underlying collateral—the home—could always cover the principal in the event the homeowner

---

⁷³ Id.
⁷⁴ Id.
⁷⁵ Id.
⁷⁶ Id.
⁷⁷ Id.
defaulted.” This combination of behaviors fueled a housing bubble that was primed for a cataclysmic explosion.

Analysts commonly use statistical data about past experiences to help them predict future events. Therefore, it was not unreasonable for CRAs to review historical default rates for mortgages, credit cards, and other types of debt. However, a persuasive argument can be made that rating models were fatally flawed because they did not consider potential losses that might be encountered during a “Black Swan” event, especially when the construction of many securitized debt products was based on shaky loans distributed during an unprecedented borrowing environment.

D. RESULTANT LITIGATION

As expected, countless lawsuits have emerged from the financial crisis. Most litigation is in its early stages and will likely last for years. California Public Employees’ Retirement System

---

77 Id.
78 Siegel, supra note 72, at A23.
79 The events of the credit crisis, in combination with the burst of the housing bubble, had not occurred in the past and would be considered uncertainty outside of statistical analysis based on prior performance. Professor Frank Knight originally differentiated between risk and uncertainty. See FRANK HYNEMAN KNIGHT, RISK, UNCERTAINTY, AND PROFIT (1921).

Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. . . . The essential fact is that “risk” means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating. . . . It will appear that a measurable uncertainty, or “risk” proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all.

Id. at 19–20.
80 A “Black Swan” event is a significant and rare event that extends beyond historical events, and not subject to statistical analysis based on that uncertainty. See NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPOSSIBLE (2007).
(“CalPERS”), the largest state public pension fund in the United States, recently sued the big three rating agencies for negligent misrepresentation and negligent interference with prospective economic advantage. In summary, CalPERS alleged the following:

The credit ratings on the three [structured investment vehicles] ultimately proved to be wildly inaccurate and unreasonably high. The Rating Agencies’ methods used to rate the [structured investment vehicles] and their underlying assets were seriously flawed in conception and incompetently applied. Moreover, the [structured investment vehicles], which the Rating Agencies represented by their “AAA” credit ratings as most likely able to withstand an economic depression, were structured with Rating Agency participation in a manner that used certain flawed assumptions which ended up ensuring [the structured investment vehicle’s] collapse when a recession actually occurred.

The case was remanded to state court and recently survived a motion to dismiss. Notably, CalPERS presents numerous allegations of specific flaws within the CRAs’ rating methodology. CRA defendants will likely argue that plaintiff’s allegations are based on perfect

---

81 The examples of high leverage became infamous after the crisis. For example, a housekeeper with little, if any, equity would purchase five homes with the intention of flipping them for profit.
86 See, e.g., Complaint, supra note 83, at *30–39. The following statements are specific example of such allegations. “The Rating Agencies created or approved investment parameters that permitted the SIVs’ portfolios to become concentrated in assets that were of the same class, industry, and geographic region.” Id. at 31.
hindsight and that their rating methodology conformed to the same standard of care (i.e. methodology) employed by the entire credit rating industry. As I will illustrate in the following pages, the plaintiffs in this massive lawsuit will have to overcome numerous legal hurdles before they can challenge CRAs’ methodology. According to their distinct legal treatments, I have divided my analysis of CRA liability between private placements and public issuances.

III. CRA LIABILITY IN WIDESPREAD PUBLIC ISSUANCES

As a result of constitutional implications, the scope of an issuance has been dispositive in a number of CRA cases. A public offering is “a sale of an issue of securities to the public” and requires SEC registration. Courts have consistently interpreted the First Amendment to be an impenetrable defense for certain common law claims against CRAs in large public issuances. Additionally, securities laws have been ineffective at establishing liability against CRAs. In the following pages, I explain and criticize these long-standing problems to establish context for my defense of the Dodd-Frank Act in Part VI.

A. CRAS’ FIRST AMPENDMENT PROTECTIONS

Although CRAs are financial analysts and not traditional journalists, both receive similar protections under the First Amendment. Without a contractual relationship, fiduciary duty, or intention to injure, traditional journalists are not liable to the public for negligent

The Rating Agencies also failed to differentiate between a first mortgage and a “piggyback” second mortgage loan. A “piggyback” loan was a second loan taken out, usually from a different lender, to finance the entire purchase of a property. The Rating Agencies failed to recognize that whether or not there was a second “piggyback” loan would (1) render the first lien loan far more risky, as the borrower has a second loan and 0% equity; and (2) render the piggyback loan itself riskier.

Id. at 36.

87 DAVID L. SCOTT, WALL STREET WORDS: AN A TO Z GUIDE TO INVESTMENT TERMS FOR TODAY’S INVESTOR 294 (2003).
misrepresentation. Because CRAs publish credit rating in large public offerings, they are held to the same standard as traditional journalists. Consequently, plaintiffs are generally required to prove that CRA defendants employed “actual malice” when they published their ratings, by proving “that the defendant made the statement with knowledge of its falsity or with reckless disregard of its truth.”

In 1997, in an issue of first impression, the U.S. District Court for the Central District of California considered “whether S&P’s First Amendment privilege requires the [plaintiff] to allege actual malice to state a tort claim arising from the allegedly inaccurate ratings” to pursue a professional negligence claim against a CRA. The Court held that the plaintiff failed “to distinguish between S&P’s activities as an advisor to the County and its constitutionally protected expression” and that “S&P is constitutionally protected from the County’s claim for professional negligence unless there was actual malice.”

Unlike tort claims, breach of contract claims are not precluded by the First Amendment

---

89 See, e.g., Compuware Corp. v. Moody’s Inv. Servs., Inc., 499 F.3d 520, 529 (6th Cir. 2007) (affirming the dismissal of claims against rating agencies brought on the basis of credit ratings on First Amendment grounds for failing to show actual malice); Jefferson County Sch. Dist. No. R-1 v. Moody’s Invs. Servs., Inc., 175 F.3d 848, 856 (10th Cir. 1999) (same); First Equity Corp. v. Standard & Poor’s Corp., 690 F. Supp. 256, 260 (S.D.N.Y. 1988) (same).
90 See Compuware, 499 F.3d at 525, 529–30.

The Supreme Court established First Amendment protection for publishers in N.Y. Times Co. v. Sullivan. The Court excused publishers from liability for defamation claims absent a showing of “actual malice” and reasoned that protection by means of such a standard for liability was necessary to encourage reporting on matters of public concern.

A. Brooke Murphy, Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies Led to the Subprime Credit Crisis and the Need for Greater Accountability, 62 OKLA. L. REV. 735, 766 (2010).
91 Id. at 526 (citing N.Y. Times Co. v. Sullivan, 376 U.S. 254, 279–80 (1964)) (emphasis added).
93 Id. at 150–51.
and do not require the actual malice standard.⁹⁴ To be successful, however, breach of contract claims must be factually distinct from the CRAs’ publishing activities.⁹⁵ In practice, this distinction can be difficult to make.⁹⁶

Most of the relevant First Amendment case law addresses limitations on speech or mandatory disclosure. Therefore, certain Dodd-Frank provisions may face First Amendment challenges.⁹⁷ In the following pages, I identify problematic issues with the CRA’s First Amendment defense to provide context for the framework that I use to defend the Dodd-Frank Act in Part VI.

1. **First Amendment Objectives**

   When considering the validity of a First Amendment challenge, courts should look to the objectives of the First Amendment. The fear of constrained speech is a central theory behind the actual malice requirement for a misstatement of traditional journalists. The rationale of the standard follows:

   The Court justified this heavy burden on the grounds that “erroneous statement is inevitable in free debate, and . . . must be protected if the freedoms of expression are to have the ‘breathing space’ that they ‘need . . . to survive.’” The Court also grounded its holding in a tradition of American opposition to laws criminalizing seditious libel, i.e., criticism of public officials.⁹⁸

---

⁹⁴ Id. at 147.
⁹⁵ See, e.g., Compuware, 499 F.3d at 531 (holding that the breach of contract claims were subject to the First Amendment actual malice standard because the contract was based on the CRAs publishing activities).
⁹⁶ Id. (citing Hustler Magazine v. Falwell, 485 U.S. 46, 56 (1988)).
⁹⁸ Deats, supra note 102, at 1832 (citing N.Y. Times Co. v. Sullivan, 376 U.S. 254, 279–80 (1964)).
Admittedly, the debt capital markets depend on CRAs to facilitate transactions; however, the fear of constrained speech is less pronounced in this arena than in traditional journalism, and it is substantially outweighed by the need for diligent rating analysis.

The actual malice standard does not hold CRAs accountable if they fail to reasonably investigate the structured debt products that they rate. “The absence of a duty to investigate [ratings that will be published] raises questions about the appropriateness of this standard for rating agencies because even the agencies describe the service they provide in terms similar to investigation.”99 Furthermore, “Unlike in typical actual malice cases, protecting rating agencies has little, if anything, to do with the tradition of American opposition to seditious libel.”100 Unfortunately, the judiciary has ignored this reasoning and the precedent of applying First Amendment protections to CRAs has been well-established.101

2. COMMERCIAL SPEECH APPROACH

Some commentators argue that credit ratings should be characterized as commercial speech,102 which is subject to more stringent government regulation than traditional speech.103

99 Id. at 1833.
100 Id. at 1850.
101 See, e.g., Compuware Corp. v. Moody’s Inv. Servs., Inc., 499 F.3d 520, 529 (6th Cir. 2007) (affirming the dismissal of claims against rating agencies brought on the basis of credit ratings on First Amendment grounds); Jefferson County Sch. Dist. No. R-1 v. Moody’s Invs. Servs., Inc., 175 F.3d 848, 856 (10th Cir. 1999) (same); First Equity Corp. v. Standard & Poor’s Corp., 690 F. Supp. 256, 260 (S.D.N.Y. 1988) (same).
102 See Caleb Deats, Talk That Isn’t Cheap: Does the First Amendment Protect Credit Rating Agencies’ Faulty Methodologies From Regulation?, 110 COLUM. L. REV. 1818, 1850–51 (2010);
“Commercial speakers, the Court has noted, (1) can better assess the truthfulness of their speech than can recipients and (2) are less likely to be chilled by regulation because of the potential for profiting from their speech.” Proponents argue that, “[i]n the context of ratings-driven transactions, ratings are closely analogous to commercial speech because rating agencies work with issuers to ensure that investments receive high ratings, and issuers distribute those high ratings in investments’ informational memoranda.” In terms of liability, the commercial speech framework denies CRA’s First Amendment protection for misleading or deceptive behavior, while retaining protection for negligence.

Although an admirable concept, the commercial speech characterization is also unlikely to be accepted by the judiciary. “The [Supreme Court] has defined commercial speech as speech that does ‘no more than propose a commercial transaction.’” Considering the literal distinction applied by the court in *New Jersey Carpenters Vacation Fund* to differentiate CRAs from underwriters, courts would be extremely unlikely to embrace a commercial speech characterization.

[The commercial speech] approach is appropriate because (1) rating agencies rely on confidential information in formulating their ratings; (2) rating agencies advise issuers on how to obtain top ratings; (3) issuers include the resulting ratings in investments’ informational memoranda and selling documents; and (4) the commercial speech framework prioritizes listeners’ interests in receiving truthful information over speakers’ interests in expressing opinions. None of these factors is a necessary condition for analysis as commercial speech, and several different combinations likely suffice to justify analysis under the commercial speech framework.

---

105 *Id.* at 1854–55.
106 *Id.* at 1836–57 (citing *Cent. Hudson Gas & Electric Corp.*, 447 U.S. at 566 & n.9).
107 Deats, *supra* note 102, at 1854.
characterization for credit ratings. Furthermore, credit ratings do not resemble the advertising at the center of commercial speech cases that offers products and pricing for sale. The Supreme Court has already given strong indications that it would not apply the commercial speech classification beyond advertising:

Noting that the Supreme Court’s commercial speech doctrine was “confined to naked advertising” and arguing that the newsletter went beyond this narrow category by including “expression of fact and opinion implicating . . . ‘substantial individual and societal interests’,” Judge Brieant was of the opinion that the newsletter did “more than ‘propose commercial transaction’” and was entitled to “full First Amendment protection.”

Therefore, despite CRAs’ well-established role in advising product structuring and facilitating transactions in the debt capital markets, most courts would be unlikely to extend the commercial speech standard to CRAs.

3. Commercial Speech Approach

If credit ratings are not characterized as commercial speech and the judiciary insists on applying full First Amendment protections, the constitutionality of CRA regulations will be subject to the strict scrutiny framework. Strict scrutiny analysis is based on a two prong test to

---

109 Compare N.J. Carpenters Vacation Fund, PLC, 720 F. Supp. 2d at 262–64 (citing Consolidated Amended Complaint at 8, 9, 155–56), with Deats, supra note 102, at 1854–56.
112 Federalist Society for Law and Public Policy Studies, supra note 120, at 3.
determine whether: (1) the underlying governmental objective “compelling”\textsuperscript{113} and (2) “the law is a narrowly tailored means of furthering those governmental interests.”\textsuperscript{114} “Narrow tailoring requires that the law capture within its reach no more activity (or less) than is necessary to advance those compelling ends.”\textsuperscript{115}

Contrary to common perception, strict scrutiny is not fatal.\textsuperscript{116} Indeed, when faced with strict scrutiny analysis, congressional laws and federal agencies regulations survive 49% and 45% of challenges, respectively.\textsuperscript{117} Certainly, First Amendment protections appear surmountable for well-considered and limited regulation.\textsuperscript{118} Therefore, I later defend the Dodd-Frank Act in terms of the strict scrutiny framework.\textsuperscript{119}

B. THE SECURITIES LAWS

In the following sections, I lay the foundation for securities laws that have been subsequently modified by the Dodd-Frank Act. As part of the context for its defense, the

\textsuperscript{113} “Because the government is impinging upon someone’s core constitutional rights, only the most pressing circumstances can justify the government action.” Adam Winkler, \textit{Fatal in Theory and Strict in Fact: An Empirical Analysis of Strict Scrutiny in the Federal Courts}, 59 \textit{VAND. L. REV.} 793, 800 (2006) (citing HANS A. LINDE, \textit{WHO MUST KNOW WHAT, WHEN, AND HOW: THE SYSTEMIC INCOHERENCE OF “INTEREST” SCRUTINY, IN PUBLIC VALUES IN CONSTITUTIONAL LAW} 219 (Stephen E. Gottlieb ed., 1993)); \textit{see also} Korematsu v. United States, 323 U.S. 214, 216 (1944) (arguing that constitutional rights are not absolutes and that “pressing public necessity” may warrant interference).

\textsuperscript{114} Winkler, \textit{supra} note 113, at 800.

\textsuperscript{115} \textit{Id.} “An alternative phrasing is that the law must be the ‘least restrictive alternative’ available to pursue those ends.” \textit{Id.} at 800–01.

\textsuperscript{116} “A popular myth in American constitutional law is that the ‘strict scrutiny’ standard of review applied to enforce rights such as free speech and equal protection is ‘strict’ in theory and fatal in fact.” \textit{Id.} at 794.

\textsuperscript{117} \textit{Id.} at 818.

\textsuperscript{118} Even ill-considered legislation has survived strict scrutiny. \textit{See, e.g., Korematsu v. United States}, 323 U.S. 214 (holding that the need to protect against espionage outweighed Fred Korematsu’s individual rights, and the rights of Americans of Japanese descent during World War II).

\textsuperscript{119} \textit{See infra} Parts VI.B–D.
following case law illustrates significant legislative gaps that the Dodd-Frank Act has closed. Generally, SEC regulations have avoided First Amendment scrutiny.\textsuperscript{120}

1. **Sections 11, 12, & 15 of the Securities Act**

In the wake of the financial crisis, many investors brought civil suits against CRAs under the securities laws.\textsuperscript{121} To succeed, a claim under Sections 11 and 15 requires that the plaintiff was a buyer or seller of the debt issuance and does not require a specific contractual relationship between the investor and the CRA.\textsuperscript{122} However, liability under Section 12 requires the defendant

\textsuperscript{120} \textsc{Federalist Society for Law and Public Policy Studies, The First Amendment and Securities Laws} (May 16, 2002), http://www.fed-soc.org/publications/pubID.271/pub_detail.asp. “The one case in which the Supreme Court has addressed the First Amendment in the securities context is Lowe v. SEC, 472 U.S. 181 (1985), where the Court relied on First Amendment concerns to drive a narrow construction of a publishing restriction contained in the Investment Advisers Act, 15 U.S.C. § 80b-1 et seq.” \textit{Id.} at 2. Even though the decision was explicitly decided on statutory construction, the Court’s opinion clearly indicated that applying the act in question to a publisher of non-personal investment newsletters would violate the First Amendment. \textit{Id.} (citing Lowe, 472 U.S. at 204–05, 210 nn. 57 & 58).

\textsuperscript{121} “[E]ach of the major rating agencies currently faces a securities fraud class action arising from the subprime crisis.” John Patrick Hunt, \textit{Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement}, 2009 \textsc{Columbia Bus. L. Rev.} 109, 190 (2009).

Shareholder lawsuits based on securities fraud theories were filed against (1) Moody’s, Consolidated Amended Complaint, \textit{In re Moody’s Corp. Secs. Litig.}, No. 1:07-cv-8375-SWK (S.D.N.Y. June 27, 2008) . . . (2) McGraw-Hill, Lead Plaintiff’s Amended Consolidated Class Action Complaint for Securities Fraud, Reese v. The McGraw-Hill Cos, No. 1:08-cv-07202-SHS (S.D.N.Y. Dec. 3, 2008) . . . and (3) Fitch, Fitch Class Action Complaint for Violations of the Federal Securities Laws, Indiana Laborers Pension Fund v. Fimalac, S.A., No. 1:08-cv-05994-SAS (S.D.N.Y. July 1, 2008) (voluntarily dismissed, Oct. 3, 2008). The theory of these suits is that the rating agencies failed to disclose to their investors that their ratings for RMBS and RMBS-backed CDOs suffered from reliance on models they knew to be of poor quality as well as from abandonment of the agency’s own rating procedures and poor frequency and quality of ratings surveillance, and that the agencies deliberately overstated the extent of their monitoring. The plaintiffs allege that these failures to disclose rendered the agencies’ optimistic claims about their business false and misleading.

\textit{Id.} at n.\textsuperscript{264}.

to have offered or sold the security.\textsuperscript{123}

Section 11 of the Securities Act of 1933 ("Securities Act") establishes liability for "every underwriter with respect to such security" included in a misleading registration statement.\textsuperscript{124} In addition, "every accountant, engineer, or appraiser, or other person" who \textit{consents or certifies} part of the registration statement is also held accountable under Section 11.\textsuperscript{125} Section 12 of the Securities Act provides for liability for untruths and omissions in connection with prospectuses and other sales communications.\textsuperscript{126} Finally, Section 15 of the Securities Act creates liability for persons "controlling" those held liable for Section 11 or 12 violations.\textsuperscript{127}

In 2010, the New Jersey Carpenters Vacation Fund and Boilermaker Blacksmith National Pension Trust claimed that the ratings agencies, among others, violated Sections 11, 12, and 15 of the Securities Act, by "alleged omissions and misstatements in registration statements and prospectuses filed with SEC."\textsuperscript{128} The court dismissed those claims at the pleading stage because the rating agencies "cannot be held liable under this set of facts as 'underwriters.'"\textsuperscript{129} "Having a

\begin{flushleft}
\textsuperscript{123} The Securities Act of 1933, 73 Pub. L. No. 22, §12, 48 Stat. 74, 84 (1933) (current version at 15 U.S.C.S. § 77l (2010)).
\textsuperscript{126} The Securities Act of 1933, 73 Pub. L. No. 22, §12, 48 Stat. 74, 84 (1933) (current version at 15 U.S.C.S. § 77l (2010)).
\textsuperscript{127} Id.
\textsuperscript{129} Id.
\end{flushleft}
relationship with an issuer or an underwriter . . . does not transform one into an underwriter."\textsuperscript{130}

The court stated that the rating agency defendants participated at the “back end” of the securitization process, and plaintiffs did not allege that the rating agencies “held themselves out in any respect as to the public offering” or “suggest that the [defendants] bore any risk with respect to that transaction.”\textsuperscript{131} Although the court acknowledged that “the Rating Agency Defendants’ activities were not necessarily innocent,” it determined that the rating agencies did not partake in “the core functions of an underwriter, i.e. the marketing, distribution, and sale of offerings to investors.”\textsuperscript{132} Because the Section 15 claims were dependent upon the outcome of the Section 11 claims, they were also dismissed.\textsuperscript{133}

The standards to sustain a claim are well established. A complaint will be dismissed under Rule 12(b)(6) if there is a “failure to state a claim upon which relief can be granted.”\textsuperscript{134} “To survive a motion to dismiss under Rule 12(b)(6), a plaintiff must ‘plead enough facts to state a claim to relief that is plausible on its face.’”\textsuperscript{135} The court must “assume [the] veracity [of the allegations] and determine whether they ‘plausibly give rise to an entitlement to relief.’”\textsuperscript{136} Of course, conclusory allegations are insufficient.\textsuperscript{137} In \textit{New Jersey Carpenters Vacation Fund v.}

\textsuperscript{130} \textit{Id.} at 263 (quoting \textit{In re} Worldcom, Inc. Sec. Litig., 308 F. Supp. 2d 338, 344 (S.D.N.Y. 2004); \textit{see also In re} Refco, Inc. Secs. Litig., No. 05 Civ. 8626 (GEL), 2008 U.S. Dist. LEXIS 62543, at *3 (S.D.N.Y. Aug. 14, 2008) (Plaintiffs cite no case where a party “that participated in the drafting of a registration statement, but who was not identified to the public as endorsing the truth of representations contained therein, has been held liable under § 11 as an underwriter.”)).


\textsuperscript{132} \textit{Id.}

\textsuperscript{133} \textit{Id.}

\textsuperscript{134} \textit{Id.} (quoting Fed. R. Civ. P. 12).

\textsuperscript{135} \textit{Id.} (citing Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007)).

\textsuperscript{136} \textit{Id.} (citing Ashcroft v. Iqbal, 129 S.Ct. 1937, 1950 (2009)).

"Royal Bank of Scotland," the plaintiffs make a compelling argument in their attempt to satisfy those requirements.

In their complaint, the plaintiffs alleged that the ratings agencies advised the issuer to select certain loans at loan auctions and suggested bid prices.\textsuperscript{138} The CRA defendants issued preliminary ratings during the underwriting process.\textsuperscript{139} Effectively, “[T]he Rating Agencies assisted in determining which of the purchased loans were to be included in the mortgage pools underlying the Certificates and thereafter the structure of the Certificates themselves.”\textsuperscript{140} In its decision, the court cites several broad definitions of “underwriters” from prior cases which suggest that “the definition revolves around the sale and distribution of securities.”\textsuperscript{141} However, the court applied a limited interpretation and refused to acknowledge allegations that the CRAs’ role was inextricably intertwined with the buying and selling function.\textsuperscript{142}

Fundamentally, credit ratings facilitate transactions in the debt capital markets. By issuing ratings, CRAs participate in the marketing, distribution, and sale of offerings to investors. Therefore, it seems shortsighted for the court to apply such a limited definition of an underwriter. Admittedly, CRAs do not directly purchase securities from an issuer or sell as an agent. However, direct participation is not required by statute. Section 2(11) of the Securities Act includes in its definition of underwriter any person who “participates or has a direct or indirect participation” in the sale of a security.\textsuperscript{143} The definitions of “sale” and “offer” are also broad.\textsuperscript{144}

\textsuperscript{138} Id. (citing Consolidated Amended Complaint at 50, 54).
\textsuperscript{139} Id. (citing Consolidated Amended Complaint at 58–61).
\textsuperscript{140} Id. (quoting Consolidated Amended Complaint at 7).
\textsuperscript{141} Id. at 263.
\textsuperscript{142} The court stated, “Plaintiffs make no factual allegation that the Rating Agency Defendants directly participated in the sale or distribution of the Harborview Trusts by, for instance, marketing the securities to the public, assisting in investor “road shows,” or purchasing the securities themselves for re-sale.” Id.
In *Pinter v. Dahl*, the Supreme Court acknowledged that “the range of persons potentially liable under § 12(1) is not limited to persons who pass title” and extends beyond the actual owner of the security.\textsuperscript{145} In *New Jersey Carpenters Vacation Fund*, the court ignored the Supreme Court’s reasoning from *Pinter*.

Appraisers should not face underwriter liability; however, a business advisor or consultant, especially in an area of upmost public importance, should face underwriter liability if they become substantially entangled in the underwriting process.\textsuperscript{146} Perhaps, the issue should be categorized as a factual question to be decided by a jury. Alternatively, courts could view CRAs and issuers as an underwriting partnership. Issuers provide funding, while CRAs contribute their structuring expertise. In terms of promotion, credit ratings are responsible for significant demand. Moreover, issuers and CRAs are often compensated by the success of the offering.\textsuperscript{147} For these reasons, I later argue that the Section 939G of the Dodd-Frank Act is essential to correct this gaping loophole and must be upheld to prevent future injustice.\textsuperscript{148}

2. **RULE 10(b)-5 AND SECTION 10(b) OF THE EXCHANGE ACT**

\textsuperscript{144} The Supreme Court highlighted certain sections of the definitions as follows:

Section 2(3) defines “sale” or “sell” to include “every contract of sale or disposition of a security or interest in a security, for value,” and the terms “offer to sell,” “offer for sale,” or “offer” to include “every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.”


\textsuperscript{145} *Id.*

\textsuperscript{146} As I previously noted, the Court has opened the possibility for such liability in *Dahl*. See *id.* Conversely, aiding and abetting 10(b)-5 liability, as I will discuss in the following section, was limited by statutory text. See, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157–158 (U.S. 2008).

\textsuperscript{147} Compensation includes actual currency and reputational capital.

\textsuperscript{148} See Part VI.D.
Section 10(b)\(^{149}\) of the Securities Exchange Act of 1934 (“Exchange Act”) and SEC Rule 10b-5\(^{150}\) combat fraud in the secondary market. “To state a claim under Section 10(b) and Rule 10b-5(b), plaintiffs must allege, in connection with the purchase or sale of securities: ‘(1) a misstatement or omission, (2) of a material fact, (3) made with scienter, (4) justifiably relied on by plaintiffs, and (5) proximately causing them injury.’”\(^{151}\) Although most of those components can be proven by hindsight, the subjective nature of ratings and the lack of concrete guidelines for rating methodology makes scienter difficult to establish.\(^{152}\) Generally, “a plaintiff must prove that the defendant acted with scienter, ‘a mental state embracing intent to deceive, manipulate, or defraud.’”\(^{153}\) The Sixth Circuit accepted reckless behavior as sufficient to establish liability under Section 10(b).\(^{154}\) Regardless of the standard applied, courts have held that other explanations for errant ratings were plausible and could have been responsible for high ratings.\(^{155}\)

Current case law is devoid of any successful suits against rating agencies for aiding and

\(^{150}\) 17 C.F.R. 240.10b-5 (2010).
\(^{154}\) Id. (citing Robert N. Clemens Trust v. Morgan Stanley DW, Inc., 485 F.3d 840, 847 (6th Cir. 2007). “Recklessness is a mental state falling ‘somewhere between intent and negligence’ and is characterized by ‘highly unreasonable conduct which is an extreme departure from the standards of ordinary care.’” Id. (quoting Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1025 (6th Cir. 1979)). CRAs may challenge the recklessness standard based on their First Amendment protections that require actual malice.
abetting a violation of the antifraud provisions of the securities laws. In *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court held that a private civil liability under Section 10(b) of the Exchange Act does not extend to those who aid and abet the violation without engaging in the manipulative or deceptive practice.\(^\text{156}\) In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the Court declined to extend a private right of action under Section 10(b) of the Exchange Act and Rule 10b-5 to customers and suppliers who had agreed to arrangements that allowed a company to mislead its auditor and issue misleading financial statements, which ultimately influenced the company’s stock price.\(^\text{157}\) The Dodd-Frank Act does not amend the existing case law for aiding and abetting a securities violation.\(^\text{158}\)

IV. **CRA LIABILITY IN PRIVATE PLACEMENTS**

Plaintiffs have had better, if mixed, results against CRAs in private placement cases that do not invoke First Amendment protections or the securities laws.\(^\text{159}\) A private placement is the

\(^\text{155}\) *In re Nat’l Century Fin. Enters.*, 580 F. Supp. 2d at 644. “Given the omissions in the complaint, these nonculpable explanations are more compelling than the contention that Moody’s acted with scienter.” *Id.* Earlier in the case, the court held that the select class of institutional investors does not create a matter of public concern entitled to First Amendment protections. *Id.* at 640.

\(^\text{156}\) 511 U.S. 164, 178, 185 (1994).


\(^\text{158}\) However, the Dodd-Frank Act does address the prosecution, penalties, and standard of knowledge for aiding and abetting violations in Section 929M, 929N, and 929O, respectively.


It is well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an “actual malice” exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern. However, where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection. Here, plaintiffs have plainly alleged that the Cheyne SIV’s ratings were never widely disseminated, but were provided instead in connection with a private placement to a select group of investors. Thus, the Rating Agencies’ First Amendment argument is rejected. *Id.* at 175–176.
Typically, an investment banker arranges a private placement sale from an issuer to an institutional investor without SEC registration. In the following pages, I describe several lawsuits against CRAs in private placements to survey the legal landscape once plaintiffs surmount CRA’s First Amendment protections.

A. NEGLIGENT MISREPRESENTATION

There has been little consistency in the judiciary’s evaluation of negligent misrepresentation claims against CRAs in private placements. The Second Restatement of Torts provides for liability against professionals who “suppl[y] false information for the guidance of others in their business transactions . . . if [they] fail[] to exercise reasonable care or competence in obtaining or communicating the information . . .” if such information is distributed to “a limited group of persons for whose benefit and guidance he intends to supply the information.”161 Specifically, for a negligent misrepresentation claim to succeed, plaintiffs must prove the following components:

(1) a false statement of material fact, (2) carelessness or negligence in ascertaining the truth of the statement by defendant, (3) an intention to induce the other party to act, (4) action by the other party in reliance on the truth of the statements, (5) damage to the other party resulting from such reliance, and (6) a duty owed by defendant to plaintiff to communicate accurate information.162

I evaluate these components in cases involving a limited number of investors in private debt issuances.

160 SCOTT, supra note 87, at 287.
In 1991, Maurice Quinn invested in collateralized mortgage obligations that had received an “A” rating by S&P. Quinn purchased the entire $1,290,000 issuance through his controlling interest in two banks. About two and a half years after Quinn’s purchase, S&P dropped their rating from “A” to “CCC.” Subsequently, the bonds defaulted, and Quinn sued S&P for negligent misrepresentation. In light of the disclaimers issued by S&P, the court determined that the plaintiff’s reliance on S&P’s credit ratings was unreasonable and dismissed the entire claim without addressing the remaining components.

In 2008, the Southern District of Ohio arrived at an entirely different conclusion about a similar negligent misrepresentation claim. Multiple plaintiffs sued Moody’s and Fitch alleging that the CRAs induced them to invest millions of dollars in notes issued by National Century Financial Enterprises, Inc. The court allowed the negligent misrepresentation claims to proceed. Because the issuance was “part of a limited class whose reliance on Moody’s ratings of the [] notes was foreseeable,” the plaintiffs were part of a limited class to which the defendants owed a duty. Furthermore, “Under the liberal pleading standard of Rule 8(a), Lloyds has sufficiently alleged that Moody’s did not exercise reasonable care in obtaining and supplying financial information to [plaintiffs] for its guidance in deciding whether to invest in [the] notes.” The court determined that the issue of justifiable reliance was a factual question.
not to be decided on a motion to dismiss.\textsuperscript{172} However, subsequent cases have held that reliance is reasonable, even for sophisticated investors.\textsuperscript{173} To better understand the application of liability for negligent representation claim against CRAs, I consider the treatment of audit opinions in the following pages. Furthermore, I argue why liability for inaccurate fairness opinions, which are issued from a similar industry, is not sufficiently comparable for my theory.

1. \textbf{Audit Opinions}

Auditors issue opinions on whether an entity’s financial statements fairly present the financial position of the company and the results of its operations and cash flows.\textsuperscript{174} Depending on the jurisdiction, auditors may be held liable to third parties for negligent misrepresentation under one of the following four approaches.\textsuperscript{175} I analyze each approach in order of the scope of liability against auditors, from least liability to most liability. The first approach, established by Justice Cardozo in \textit{Ultramares Corp. v. Touche}, limited liability to those with which the auditor had privity.\textsuperscript{176} \textit{Ultramares} became an almost impenetrable defense that was successfully used by auditors against third-party plaintiffs seeking to recover for damages caused by an auditor’s

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{172} \textit{Id.}
\item \textsuperscript{174} Auditor’s Opinion, \textit{INVESTOPEDIA}, http://www.investopedia.com/terms/a/auditors-opinion.asp (last visited Feb. 4, 2011).
\item \textsuperscript{175} See Ellis v. Grant Thornton LLP, 530 F.3d 280, 287–88 (4th Cir. 2008).
\item \textsuperscript{176} 174 N.E. 441, 444 (N.Y. 1931).
\end{itemize}
\end{footnotesize}
The second approach was created in 1985, when the New York Court of Appeals relaxed the strict *Ultramares* doctrine to require a relationship “sufficiently approaching privity” in certain circumstances. In the third approach, the Second Restatement of Torts “provides the general rule that one who negligently supplies false information for the use of another person in his business is liable for losses caused to such person as a result of that person’s reliance on the information.” Currently, the Restatement has been adopted by twenty-two jurisdictions. Most notably, it creates liability against an “auditor [who] can foresee as parties who will (and do) rely upon financial statements . . .” The fourth and final

---

178 *Ellis*, 530 F.3d at 287–88.
179 The “near-privity” approach applies to the following:
- (1) the accountant must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountant linking him to that party or parties, which evinces the accountant’s understanding of that party or parties’ reliance.
180 Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110, 118 (N.Y. 1985) Acevedo, *supra* note 177, at 41–42. However, even the Restatement approach is limited. The [California Supreme Court] held that “an auditor’s liability for general negligence in the conduct of an audit of its client financial statements is confined to the client, i.e., the person who contracts for or engages the audit services.” The California Supreme Court reasoned that “under the Restatement rule, an auditor retained to conduct an annual audit and to furnish an opinion for no particular purpose generally undertakes no duty to third parties. Such an auditor is not informed ‘of any intended use of the financial statements . . .’” This reasoning echoes the Restatement’s requirement that an auditor be placed on notice before he can be found liable to a third-party.
181 *Id.* at 42–44. See, e.g., *Ellis*, 530 F.3d 280 (auditors may be held liable per negligence standard if they know that the audit is being prepared for the use of a third party, such as a lender). “(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information . . . .” RESTATEMENT (SECOND) OF TORTS § 552 (1977).
182 *Id.*
approach significantly expands liability against auditors by “permit[ing] all parties who are reasonably foreseeable recipients of financial statements for business purposes to recover as long as they rely on the statements for those business purposes.”  

2. **FAIRNESS OPINIONS**

Although some may argue that a CRA’s rating should be held to the same negligent misrepresentation standard as an investment bank’s fairness opinion, I disagree and argue that fairness opinions are too dissimilar for such application. Investment bankers issue fairness opinions to opine on the fairness of an acquisition price. Professor William Carney noted that “accountants are today on notice that shareholders, prospective investors, and creditors would rely on [the accountant’s certificate].” In an argument against liability for fairness opinions, Professor Carney distinguishes audit opinions from fairness opinions by stating that “investment bankers do not deliver fairness opinions for the benefit of public shareholders” nor should investors “attach too much to it.” Because credit ratings facilitate investor’s participation in the debt capital markets and the public attaches substantial significance to those ratings, credit ratings are more analogous to audit opinions than fairness opinions. Therefore, one of the audit liability approaches would be more appropriate to apply to the credit rating industry for negligence representation.

B. **COMMON LAW FRAUD**

---

183 *Id.* at 288 (emphasis added).


185 SCOTT, *supra* note 87, at 141.


187 *Id.* at 3. Professor Carney goes on to state that “the nature of the fairness opinion is such that neither courts nor investors should attach too much weight to it nor impose liability because of it, except in instances of fraud.” *Id.*
Between 2004 and 2007, two institutional investors, King County, Washington and Abu Dhabi Commercial Bank, suffered losses on their investments in a structured investment vehicle.\(^{188}\) In 2009, those investors alleged common law fraud in a class action lawsuit against eight defendants, including Moody’s and S&P.\(^{189}\) Predictably, the defendants moved to dismiss for lack of subject matter jurisdiction and for failure to state a claim upon which relief can be granted.\(^{190}\) The court disagreed and held that the plaintiffs adequately pled a common law fraud claim.\(^{191}\)

> [T]o state a claim for fraud a plaintiff must demonstrate: (1) a misrepresentation or omission of material fact; (2) which the defendant knew to be false; (3) which the defendant made with the intention of inducing reliance; (4) upon which the plaintiff reasonably relied; and (5) which caused injury to the plaintiff.\(^{192}\)

The court determined that “the Rating Agencies’ ratings were not mere opinions but rather actionable misrepresentations,”\(^ {193}\) and that the plaintiffs sufficiently pled that the CRAs “did not genuinely or reasonably believe that the ratings they assigned to the Rated Notes were accurate and had a basis in fact.”\(^ {194}\) To address the intention to induce reliance, the court noted the CRAs’ desire to gain additional business from the issuer and fee structures that were dependant


\(^{189}\) Id. at 163. The plaintiffs brought “thirty-two claims of common law fraud, negligent misrepresentation, negligence, breach of fiduciary duty, breach of contract and related contract claims, unjust enrichment, and aiding and abetting against defendants.” Id. The remaining claims, besides common law fraud, were dismissed for a variety of reasons. Id. at 188. Specifically, the breach of contract claims were inadequately plead. Id. at 184.

\(^{190}\) Id. at 163–64.

\(^{191}\) Id. at 175–83.

\(^{192}\) Id. at 171 (citing Wynn v. AC Rochester, 273 F.3d 153, 155 (2d Cir. 2001)).

\(^{193}\) Abu Dhabi Commer. Bank, 651 F. Supp. 2d at 175–76.

\(^{194}\) Id. at 176.
on the success of the offering. Finally, the court held that the plaintiffs’ reliance on credit ratings was reasonable because CRAs have “access to non-public information that even sophisticated investors cannot obtain.”

Plaintiffs can also succeed with a claim of aiding and abetting an issuer’s common law fraud. To pursue such a claim, first, the “plaintiff must adequately plead the existence of a primary tort.” Then, “[t]he elements of an aiding and abetting claim are: ‘(1) knowledge that the primary party’s conduct is a breach of duty and (2) substantial assistance or encouragement to the primary party in carrying out the tortious act.’”

The court in *In re National Century Financial Enterprises, Inc.* held that the plaintiff’s sufficiently pled a claim of aiding and abetting fraud. First, the plaintiffs established a primary tort claim of fraud by the issuer. Next, as evidence showing the defendant’s awareness of the fraud, the plaintiffs presented letters that whistleblowers had sent to the CRAs alleging fraud. Finally, the plaintiffs satisfied the substantial assistance component by claiming that the CRAs issued AAA rating on the fraudulent notes.

**C. BREACH OF CONTRACT CLAIMS**

Generally, investors do not engage in an explicit contractual relationship with CRAs. However, several investors have alleged breach of contract claims against CRAs for failing to

---

195 *Id.* at 179.
196 *Id.* at 181. The court did not specifically address injury to the plaintiff.
197 *Abu Dhabi Commer. Bank*, 651 F. Supp. 2d at 186 (holding that the plaintiffs failed to establish a primary tort).
199 *Id.* at 654.
200 *Id.* at 654.
201 *Id.* at 655–56.
202 Typically, a CRA contracts with the financial issuer to issue ratings.
adequately rate the issuance described within the contract between CRAs and issuers. To successfully plead a breach of contract claim, the “[p]laintiff must provide specific allegations as to the agreement between the parties, the terms of that agreement, and what provisions of the agreement were breached as a result of the acts at issue.” If that claim does not succeed, investors may alternatively claim that they are third-party beneficiaries to contracts between issuers and CRAs. The criteria to establish a plaintiff as a third-party beneficiary follows:

Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and . . . the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.

However, unless an explicit contract exists, courts have generally interpreted such third-party beneficiary claims to be conclusory, and plaintiffs have failed to establish that the parties to the contract intended to benefit third-party investors. Courts have rationalized that by recognizing

---

203 See, e.g., Compuware Corp. v. Moody’s Invs. Servs., 499 F.3d 520, 532 (6th Cir. 2007).
205 These claims often fail. See, e.g., id.

Plaintiffs’ pleadings lack any contractual term from which it could be plausibly inferred that the defendants intended plaintiffs to be third-party beneficiaries of their contracts. Plaintiffs further fail to identify any meetings, correspondence, or any other indication of intent on the part of any of the defendants to benefit plaintiffs. Without more, plaintiffs’ claims based on their third-party beneficiary status are dismissed.

Id. (holding that the breach of contract allegations did not meet Illinois’ high standard of “either express language identifying purchasers like Quinn by name or its functional equivalent.”).
investors as third-party beneficiaries, they would be undervaluing the benefits conferred to the issuers by the CRAs. 208

Courts are underestimating the value conferred to investors from the credit rating contract by not recognizing investors as third-party beneficiaries. Investors often base their entire investment decision on a letter grade assigned to incredibly complex debt instruments. Furthermore, investors would be unlikely to invest in an issuance that has not been rated. Therefore, investors are certainly foreseeable beneficiaries of the credit rating contract and their receipt of credit ratings are necessary to effectuate a successful debt issuance. I later explain how the Dodd-Frank Act correctly applies CRA liability through the securities laws, without having to establish a contractual relationship for investors.

V. SARBANES-OXLEY ACT MISSED OPPORTUNITIES

Eight years ago, legislators failed to apply basic reforms from the Sarbanes-Oxley Act to the credit rating industry. For that reason, Congress missed a chance to avert the recent financial crisis. Although some academics argue that the credit rating process is distinct from an external audit, 209 there are substantial similarities, and comparable regulations are appropriate. 210

SOX established the Public Company Accounting Oversight Board (“PCAOB”), 211 set

208 Id. at 186.
209 See Carol Ann Frost, Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies, 22 J. ACCT. AUDITING & FIN. 469, 474 (2007) (“Certainly, the relationship between an issuer and the credit analyst is nothing like the relationship the issuer has with the engagement partner of its external audit firm or with the partner in charge of its account at its main outside law firm. The credit analyst only has infrequent personal meetings with company management, is responsible for rating dozens of issuers, and is not paid based on any relationship with any issuer.”).
210 Although both industries are gatekeepers, it should be noted that CRAs generally rely on financial statements that have been evaluated by auditors.
quality control and independence standards for auditors, and established corporate responsibility policies for management. The Sarbanes-Oxley Act even ordered a study of the rating agencies, presciently considering “any conflicts of interest in the operation of [CRAs] and measures to prevent such conflicts or ameliorate the consequences of such conflicts.” The consequent report was issued in January 2003. Many of the concerns raised in that report are eerily similar to those at the forefront of the current financial crisis. In regard to the issuer pay model, the study determined that “participants did not believe that reliance by rating agencies on issuer fees leads to significant conflicts of interest” and that any potential conflicts were being effectively managed. The report also raised concerns about conflicts of interest from CRAs providing both advisory services and ratings to the same client. Furthermore, the report considered improving transparency of the ratings process, mandating qualifications for CRA analysts, and reducing barriers to entry for new CRAs.

In 2003, the SEC issued a “Concept Release” to showcase recommendations for CRA

---

212 Id. § 7213.
213 Id. § 7214.
216 Id. at 23 (emphasis added).
217 See id.
218 Id. at 32. “A related concern arises as a result of the recent implementation by the Commission of Regulation FD which, in very broad terms, prohibits selective disclosure of nonpublic issuer information, but provides a conditional exception for rating agencies.” Id. As previously noted, this exception was repealed by the Dodd-Frank Act, over seven years after this report.
219 Id. at 31. The reported noted “rating agencies failed to use the necessary rigor to ensure their analysis of a complex company, such as Enron, was sound.” Id. However, “[t]he rating agencies tend to have a more limited view of their role in verifying information reviewed in the credit rating process. In general, the rating agencies state that they rely on issuers and other sources to provide them with accurate and complete information.” Id.
220 Id. at 36.
reforms including, among other reforms, streamlining the NRSRO certification process to enhance competition, implementing measures to address conflicts of interest, improving transparency of the ratings process, and additional oversight.\textsuperscript{221} As the recent credit crisis and resulting litigation suggest, many of the problems in the CRA industry were not cured after the 2003 SEC report.\textsuperscript{222} In the next section, I argue that the Dodd-Frank attempts to correct some of these long-standing issues; however, more concrete reforms are needed.

VI. \textbf{THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT}

A. \textbf{INTRODUCTION}

In the wake of the financial crisis, the need for reform was apparent. In hindsight, at least, credit ratings severely understated the default risk of complex financial products. Inaccurate credit ratings contributed to risk mismanagement by financial institutions and individual investors. In July 2010, Congress responded to the financial crisis by passing the Dodd-Frank Act.\textsuperscript{223} Among its many financial reform provisions, the Dodd-Frank Act lays the foundation for systemic change and accountability in the credit rating industry. Inside the Dodd-Frank Act, many CRA reforms target structural and procedural issues,\textsuperscript{224} while others enhance CRA accountability.\textsuperscript{225}

Any new cause of action derived from the Dodd-Frank Act will likely face constitutional scrutiny. Again, to survive a “strict scrutiny” challenge, the new law must be narrowly tailored

\begin{footnotesize}
\textsuperscript{222} The Credit Rating Agency Reform Act of 2006 was designed to enhance competition between the CRAs by new registration standards with the SEC. 109 Pub. L. 291, 120 Stat. 1327 (2006).
\textsuperscript{223} Dodd-Frank Wall Street Reform and Consumer Protection Act § 931, 15 U.S.C.A. § 78o-7 (West 2010).
\textsuperscript{224} See infra Part VI.B.
\textsuperscript{225} See infra Parts VI.C–D.
\end{footnotesize}
and serve a compelling state interest.\textsuperscript{226} At the time of this writing, the Supreme Court has not addressed the issue of whether credit ratings are expressions of protected speech under the First Amendment.\textsuperscript{227} I argue why each of the following sections should withstand such scrutiny. Furthermore, I propose outcomes for each of the Dodd-Frank Act’s proposed studies.

B. \textbf{SECTIONS 932, 936, AND 939B: STRUCTURAL AND REGULATORY CHANGES}

The Dodd-Frank Act enhances internal control and attestation requirements under the supervision of the SEC.\textsuperscript{228} Between January through July 2011, Section 932 of the Dodd-Frank Act orders the SEC to propose rules for: (1) mandating CRA reports about internal controls over the ratings process; (2) preventing sales and marketing activities from influencing credit ratings; (3) reporting to the SEC when an entity subject to a rating employs a former CRA employee; (4) issuing technical amendments to CRA rules; (5) enhancing the transparency of CRA performance; (6) modifying ratings procedures and methodologies; (7) enhancing disclosures that accompany ratings; (8) requiring third parties conducting due diligence to certify certain information for the CRAs; and (9) setting fines and penalties for violations.\textsuperscript{229} In an unprecedented step, Section 932 specifically allows the SEC to “prescribe rules, for the protection of investors and in the public interest, with respect to the \textit{procedures and methodologies}, including qualitative and quantitative data and models.”\textsuperscript{230} Additionally, at some

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{226} Deats, \textit{supra} note 102, at 1837–38.
\item \textsuperscript{228} Dodd-Frank Wall Street Reform and Consumer Protection Act § 932, 15 U.S.C.A. § 78o-7 (West 2010).
\item \textsuperscript{230} Dodd-Frank Wall Street Reform and Consumer Protection Act § 932 (emphasis added).
\end{itemize}
\end{footnotesize}
point after January 2012, the SEC will create an Office of Credit Ratings.\footnote{Id.}

Section 932 has the potential to improve the reputational capital model by improving performance disclosure. Currently, comparing CRA performance is an arduous task that has had little influence on issuer’s choice of CRA.\footnote{See supra text accompanying notes 42–44.} The SEC should propose a central credit rating repository, with standardized and comparable data, would allow issuers to select a CRA without laborious research.\footnote{Bai, supra note 42, 102–03. This service would be similar to Morningstar’s service, which monitors and ranks mutual funds. \textit{Id.}} Effectively, a service would rate CRAs based on performance.

By regulating CRA methodology and conduct, Section 932 implicitly enhances CRA liability. Before Section 932 rulemaking, plaintiffs lacked objective benchmarks with which to compare the rating process. Credit rating regulation lagged behind the audit industry. Since 1973, non-governmental accounting standards have been set by the FASB.\footnote{\textit{Facts about FASB}, FIN. ACCOUNTING STANDARDS BD., http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495 (last visited Dec. 30, 2010).} FASB board members and staff have knowledge and experience in “investing, accounting, finance, business, accounting education, and research.”\footnote{\textit{Id.}} In 2002, SOX created the PCAOB to “oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports.” As evidenced by the recent financial crisis, standards were desperately needed to ensure the objectivity and accuracy of the credit rating industry. Once Section 932 is implemented, plaintiffs will be able to objectively assess CRA performance.

The Dodd-Frank Act also addresses CRA analyst competency. Between January and
March 2011, Section 936 of the Dodd-Frank Act orders the SEC to “[p]ropose rules establishing training, experience and competence standards and a testing program for NRSRO analysts.” Currently, no such standards are in place for CRA analysts; however, the American Institute of Certified Public Accountants (“AICPA”) sets professional standards for accountants and administers the Uniform Certified Public Accountant Examination. Considering the public’s dependence on credit ratings, such prophylactic measures should have been applied to the credit rating industry long ago.

Section 939B of the Dodd-Frank Act removes the rating agency exemption from Regulation Full Disclosure. However, many observers believe that the new regulation will have little practical impact for two reasons. First, rating agencies will enter into a confidentiality agreement with issuers, which permits selective disclosure under Regulation FD and bypasses Section 939B of the Dodd-Frank Act. Second, Regulation FD only applies to disclosures to certain persons, and CRAs “are often outside this category of enumerated entities.” Interestingly, accountants remain exempt from Regulation FD.

CRAs may challenge Sections 932, 936, and 939B under the First Amendment for constraining speech and mandating disclosure. The regulations in those sections should survive

240 Id.
241 Id.
242 See 17 C.F.R. § 243.100.
a challenge under the two components of the strict scrutiny framework. First, there is certainly a compelling government interest. During the financial crisis, scores of investors suffered devastating losses from investments in structured debt products that had previously received high credit ratings. Even those without direct exposure to the debt capital markets felt the ripple effect of the crisis. Global financial markets became paralyzed, and the economy has been mired in a “great recession” for years. Experts identified instances of inadequate transparency, substandard internal controls, conflicts of interests, and a general lack of oversight throughout the credit rating industry. Sections 932, 936, and 939B attempt to address many of those pervasive problems. Second, the new legislation is narrowly tailored; it fills substantial legislative gaps that have undermined the credibility of the credit rating industry and harmed the public. Additionally, the regulations mirror safeguards that have been successfully applied to the audit industry. The restrictions and disclosure requirements are limited in purpose: enhance the dissemination of accurate credit ratings.

C. SECTION 933: STATE OF MIND IN PRIVATE ACTIONS

For a private securities action under Section 15E of the Securities Act, Section 933 of the Dodd-Frank Act holds CRAs accountable “in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst.

---

243 See infra text accompanying notes 112–115. I am assuming that a court would utilize the strict scrutiny test instead of the more lenient commercial speech framework. See infra text accompanying notes 102–115. I will proceed under this assumption for the remaining analysis in this article. Regardless, a speech restriction (or required speech) will pass the commercial speech framework if it passes the strict scrutiny test. My assumption tackles the worst case scenario.

244 Notably, the Supreme Court upheld the constitutionality of state securities laws that required security dealers to be licensed. Hall v. Geiger-Jones Co., 242 U.S. 539 (U.S. 1917). However, that decision was based on due process and commerce clause challenges First Amendment challenges have not yet been addressed by the Supreme Court.
under the securities laws . . .”245 Plaintiffs will have to plead with particularity that the CRAs “knowingly or recklessly failed—(i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) to obtain reasonable verification of such factual elements. . . .”246 In addition, CRA statements will no longer be considered forward-looking for purposes of the safe harbor provision in Section 21E of the Exchange Act.247 By utilizing the securities laws, the Dodd-Frank Act surpasses obstacles that have been present in private placement actions, such as establishing a contractual relationship.

CRA defendants will almost certainly claim that they should be subjected to an actual malice standard (knowledge or reckless disregard for the truth)248 and challenge the constitutionality of the Dodd-Frank Act’s “reasonable investigation” threshold. However, Section 933 should survive a First Amendment challenge under the strict scrutiny framework. First, the imposition of a recklessness standard serves a compelling state interest. Credit ratings directly influence the debt capital markets, and investors that suffer losses as a result of CRA recklessness should be entitled to recourse. Furthermore, Section 933 strengthens Sections 932, 936, and 939B of the Dodd-Frank Act. CRAs will carefully follow those provisions to avoid liability under Section 933. As I have previously described, legitimate plaintiffs’ lawsuits have been denied because of the First Amendment’s onerous actual malice standard. Second, Section 933 should survive constitutional scrutiny because it is narrowly tailored. A “reasonable

246 Id. (internal quotations omitted) (emphasis added).
248 See supra notes 88–90 and accompanying text. This is also the standard used under SEC Rule 10(b)-5.
investigation” standard targets correctable behavior without subjecting CRAs to devastating liability that a negligence standard might imply. By targeting careless behavior, the legislation does not subject CRAs to liability based on perfect hindsight or “honest” mistakes.

D. SECTION 939G: REPEAL OF RULE 436(G) OF THE SECURITIES ACT OF 1933

Section 436(a) of the Securities Act provides that “[i]f any portion of the report or opinion of an expert or counsel is quoted or summarized as such in the registration statement or in a prospectus, the written consent of the expert or counsel shall be filed as an exhibit to the registration statement and shall expressly state that the expert or counsel consents to such quotation or summarization.” However, Section 436(g) of the Securities Act provided an exception for CRAs that they “shall not be considered a part of a registration statement.” Section 939G of the Dodd-Frank Act repeals Rule 436(g) of the Securities Act.\(^\text{249}\) The repeal of Rule 436(g) mandates issuers to include a consent from a NRSRO as an exhibit to their registration statement,\(^\text{250}\) and, consequently, subjects CRAs to Section 11 liability\(^\text{251}\) for material misstatements or omissions. In *New Jersey Carpenters*,\(^\text{252}\) the CRA defendants escaped liability under Section 11 because the court refused to hold them accountable as underwriters. Section 939G closes that loophole.

CRAs have already protested the Section 939G. Indeed, the four largest NRSROs “indicated they would not allow their organizations to be named as experts in [asset-back


\(^{250}\) *Id.*

\(^{251}\) *Id.*

securities ("ABS") registration documents filed with the SEC.” Without their consent, “disclosures were impossible, and new registered offerings of ABS could not proceed.” In response to a frozen ABS market, the SEC delayed enforcement of the new provision.

CRA defendants will likely challenge the constitutionality of Section 939G because it subjects CRAs to liability for material misstatements and omissions without requiring proof of actual malice. Section 939G should survive a First Amendment challenge under the strict scrutiny framework. First, a compelling governmental interest exists. When deciding whether or not to purchase a newly issued security, investors depend on registration statements to guide their decisions. Material errors can cause investors to assume risks that they otherwise would have avoided. As I argued in Part III.B.1, Section 11 allegations of egregious CRA misconduct should not be dismissed because CRAs were inextricably intertwined with the underwriting process. Because of their integral role in the construction and issuance of debt securities, CRAs should face liability for their contribution to misleading registration statements. Second, Section 939G should survive the strict scrutiny framework because it is narrowly tailored to achieve the

---

254 Id. In the day after the legislation was signed, Ford Motor Company’s financing arm, Ford Motor Credit Company LLC, attempted to issue $1.082 billion in ABS. Id. “The Ford deal stalled because the company was unable to use credit ratings in its offering documents.” Id.
255 The particular sequence of events follows:

That day, July 22, 2010, Ford wrote to the SEC’s Division of Corporation Finance asking the Division not to recommend enforcement action if Ford did not include ratings in a prospectus relating to an offering completed during a “specified, temporary period of time.” The SEC responded immediately, issuing a no-action letter indicating that, given the rating agencies’ refusal to be named experts, the Division of Corporation Finance would not recommend enforcement action if an issuer omits the ratings disclosure required [the new provisions] during a six-month grace period. The SEC’s no-action position was set to expire with respect to any registered offerings of asset-backed securities with initial bona fide offers on or after January 24, 2011, but was recently extended indefinitely.
government’s interest. The legislation is designed to correct a loophole that allows CRAs to escape liability for their material misstatements or omissions in registration statements. Furthermore, it subjects CRAs to the same standard of liability that auditors and other experts faced since 1933.256

E. UPCOMING STUDIES AND PROPOSED SOLUTIONS

Many SOX reforms were implemented with an incomplete understanding of the externalities associated with compliance.257 By ordering studies before implementing major reforms, the legislature’s circumspect approach in the Dodd-Frank Act will limit unintended consequences of rushed legislation. Moreover, it establishes a timetable to determine the most practical avenues of change. By granting the Comptroller General of the United States and the SEC the power to investigate and implement meaningful reform, Congress defers to those most capable of designing and implementing meaningful change.

1. INDEPENDENCE

Section 939C of the Dodd-Frank Act orders the SEC to evaluate the impact of CRAs independence on credit ratings.258 In particular, the SEC must review potential conflicts arising from risk management advisory services, ancillary assistance, and consulting services.259 The

Id. (internal citations omitted).
256 I allude to the Securities Act of 1933.
257 See Ginger Carroll, Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes-Oxley Act, 58 ALA. L. REV. 443, 444 (2006); see Tosha Huffman, Section 404 of the Sarbanes-Oxley Act: Where the Knee Jerk Bruises Shareholders and Lifts the External Auditor, 43 BRANDEIS L.J. 239 (2005); see also Robert Prentice, Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404, 29 CARDOZO L. REV. 703, 725–763 (2007) (discussing the many consequences of the SOX legislation and Section 404 which governs internal control requirements for publicly traded companies).
259 Id.
study will consider the potential impact of prohibiting such services.\textsuperscript{260} The results of the study and recommendations shall be due to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services within three years of the bill’s passage.\textsuperscript{261}

Conflicts of interest within the credit rating industry have been subject to intense criticism for their role in the financial crisis.\textsuperscript{262} In particular, consulting arrangements present unique problems for an industry that professes its objectivity.

Due to regulatory requirements, virtually all [debt] securities must be rated by an NRSRO. Presently, however, not only do the NRSRO’s rate the securities, the agencies also assist the issuers in creating them. This means that the agencies are paid to assist in structuring a security that they will be paid to rate. Both the structuring and the rating of securities are lucrative. Consequently, there are strong incentives for the rating agencies to please the issuers.\textsuperscript{263}

In 2002, SOX expressly prohibited accounting firms from providing consulting and related services to their audit clients.\textsuperscript{264} The SOX reforms include: (1) auditors must receive

\footnotesize{\begin{itemize}
\item[(i)] bookkeeping or accounting services;
\item[(ii)] financial information systems design;
\item[(iii)] appraisal or valuation services, including fairness opinions;
\item[(iv)] actuarial services;
\item[(v)] internal audit outsourcing services;
\item[(vi)] management functions or human resources;
\item[(vii)] broker or dealer, investment adviser, or investment banking services;
\item[(viii)] legal services and expert services not related to the audit;
\item or (ix) any other service that PCAOB determines, by regulation, to be impermissible.
\end{itemize}}

\textsuperscript{260} \textit{Id.}
\textsuperscript{261} \textit{Id.}

\begin{itemize}
\item[(i)] bookkeeping or accounting services;
\item[(ii)] financial information systems design;
\item[(iii)] appraisal or valuation services, including fairness opinions;
\item[(iv)] actuarial services;
\item[(v)] internal audit outsourcing services;
\item[(vi)] management functions or human resources;
\item[(vii)] broker or dealer, investment adviser, or investment banking services;
\item[(viii)] legal services and expert services not related to the audit;
\item or (ix) any other service that PCAOB determines, by regulation, to be impermissible.
\end{itemize}

approval by the client’s audit committee before providing any audit or non-audit services (2) audit partners must rotate off the audit engagement every five years (3) auditors must prepare and submit reports directly to the client’s audit committee; and (4) an auditor may not perform an audit for a public client where any C-level executive or controller of the client was an employee of the auditor prior to the audit engagement and participated in an audit of that client during the preceding year. However, those independence requirements were never applied to the credit rating industry. Ultimately, the recommendations should mirror the SOX requirements to segregate consulting and audit functions.

CRA liability requires a balancing of two public interests. First, by rating complex debt products, credit ratings facilitate transactions within the debt capital markets. Second, CRAs must be held accountable for inaccurate ratings. Therefore, rating and consulting services should be immediately defined and segregated. CRAs should be forced to decide whether they will offer advisory services to issuers or rate the ultimate securities, but not both. CRAs would not have to spin-off or segregate consulting or rating divisions, but they would have to be allowed to serve only one role to each client. Furthermore, a blackout period between switching roles for a particular clients would prevent CRAs from bypassing the rule.

Internal documents and statements from CRA management underscore the need for independence. In October 2007, the CEO of Moody’s acknowledged CRAs’ desire to increase margins and market share poses a “‘risk’ to the quality of the ratings process.” Internal documents are even more illustrative. “At S&P, one employee wrote in an instant-message

---

265 See O’Connor, supra n. 264.
exchange: ‘btw-that deal is ridiculous.’ A colleague replied: ‘it could be structured by cows and
we would rate it.’”267

2. ALTERNATE PAY MODELS AND ASSIGNMENT

Several sections of the Dodd-Frank Act establish studies to re-evaluate the current issuer-
pay model. Section 939D of the Dodd-Frank Act orders the Comptroller General of the United
States to study alternate compensation structures for rating agencies and issue results and
recommendations within 18 months of the bill’s passage.268 Section 939F orders the SEC to
carries a study of “the credit ratings process for structured finance products and conflicts of
interest associated with the issuer-pay and the subscriber-pay models.” 269 Additionally, Section
939F orders the SEC to consider the feasibility of a “public or private utility or self-regulatory
organization” assigning CRAs to issuers.270 The study also considers mechanisms for
determining CRA fees, the potential for moral hazard, constitutional issues, and alternative
compensation structures to incentivize more accurate ratings.271 This study will be completed by
July 2012,272 and the Dodd-Frank Act endows the SEC with the power to enact its
recommendations.273

Credit rating objectivity may be compromised by a practice known as “ratings shopping.”
Generally, CRAs review the structure of a proposed financial product and advise the issuer on
“how much of the securitization could be given a top credit rating, and help decide what credit

267 Id.
(West 2010).
269 Id.
270 Id.
271 Id.
272 Id.
273 Id.
enhancements were needed to maximize high ratings.” After the assessment process, issuers often negotiate the security’s rating with other rating agencies. Consequently, ratings shopping allowed issuers “to pressure rating agencies to provide high ratings and minimum credit enhancements in order to receive the profitable rating business.”

John C. Coffee Jr., a highly regarded CRA expert, recently considered potential reforms to the issuer-pay model. Coffee considered the advantages and pitfalls of three alternatives—the government as a hiring agent, encouraging a “subscriber pays” model, and a government created rating agency.

[T]he more feasible response to the conflict of interest inherent in the “issuer pays” model may to permit the issuer to pay for the rating, but not to select the rater. This strategy would also respond to the independent problem of “rating shopping,” under which issuers seek preliminary ratings and then choose the agency giving it the highest preliminary rating to issue the final rating.

Although, pitfalls seem to hamper each alternative. The government as a hiring agent “potentially provides politicians with an enormous patronage system,” while a random rotational system will create little incentive for CRAs to compete, and a merit-based allocation would be

---

274 See New Jersey Carpenters Vacation Fund v. Royal Bank of Scotland Grp., PLC, 720 F. Supp. 2d 254, 259 (S.D.N.Y. 2010) (citing Consolidated Amended Complaint at 59). “For example, ‘S&P would advise Greenwich Capital . . . that 94.25% of the Certificates would be rated AAA as long as 5.75% of the total collateral balance supporting those Certificates were subordinate [i.e. given a lower credit rating and subordinating their payment to the higher-rated certificates].’” Id.

275 Id.

276 Id.

277 Coffee, supra note 227, at 31–32.

278 Id. at 31–32.

279 Id. at 29–40.
difficult to implement. While a “subscriber-pay” model would encourage competition beyond
the largest CRAs and potentially more comprehensive ratings, investors are likely to resist
paying fees for ratings. Additionally, ratings could be easily communicated to non-
subscribers. The third option, a governmental rating agency, is certainly the most flawed.

First, governmental agencies cannot pay the same salaries or incentive
compensation to analysts as firms in the private sector, with the consequence that
a “public” rating agency might have to rely on inferior personnel. Second and
more importantly, serious doubt exists that a “public” rating agency could give a
negative (or “junk”) rating to an important or politically-favored local firm.

Based on the logistical and bureaucratic issues, the governmental approach should not be
implemented.

Considering the significant problems with each alternative approach, the issuer-pay
model is the most appropriate and should remain. A similar issuer-pay system has survived in
the audit industry; however, the accounting industry has independence safeguards that were not
present in the credit rating industry. As I have described in the previous sections, the Dodd-
Frank Act improves accountability and mitigates conflicts of interest. In light of those
improvements to the credit rating industry and the lack of viable alternatives, the issuer-pay
model should remain.

3. CREATION OF AN INDEPENDENT PROFESSIONAL ANALYST ORGANIZATION

The Comptroller General shall research the “feasibility and merits of creating an

---

280 Id. at 34.  
281 Id. at 35–36.  
282 Id. at 38.  
283 See, e.g., supra Part V.  
284 See supra Part VI.B,C, D, and E.1.
A professional organization for ratings analysts should establish governing standards, an ethical code, and improve oversight.

Rating agency analysts serve a crucial role in our economy and certainly deserve a standard-setting organization. Therefore, a professional organization for CRA analysts seems long overdue. In addition to setting audit standards, the AICPA serves as the professional organization of the accounting profession. It develops and administers the Uniform Certified Public Accountant Examination and sets ethical standards. The AICPA should serve as a model for a similar CRA organization. The new CRA professional organization should be funded by fees from current NRSROs and have the statutory authority to regulate CRA analysts. A professional certification examination, similar to the Uniform Certified Public Accountant Examination, would ensure that CRA analysts are sufficiently competent to evaluate securities. An independent analyst organization would protect the public from incompetence and unethical behavior.

CONCLUSION

In the years leading up to the financial crisis, issuers profited from securitized products filled with shaky loans, while CRAs issued high ratings as a stamp of approval. In hindsight, this behavior contributed to a real estate bubble that eventually collapsed in spectacular form. Unfortunately, financial innovation consistently outpaces legislation. Although the Dodd-Frank Act will offer little comfort to investors that have already been harmed, it establishes concrete

286 Id.
287 About the AICPA, AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, http://www.aicpa.org/About/Pages/About.aspx (last visited Nov. 11, 2010).
reforms will benefit the debt capital markets in the long term.

Instead of hiding behind the First Amendment, CRAs should prove that their work is objective, comprehensive, and transparent. By utilizing the securities laws, the Dodd-Frank Act takes the appropriate steps to place CRAs in that position. However, the judiciary’s interpretation of the CRA’s First Amendment claims will determine whether or not the Dodd-Frank Act succeeds. Ultimately, the Supreme Court should conclude that the Dodd-Frank Act is appropriately designed in the best interest of the public and passes constitutional muster. Furthermore, regulators should segregate CRAs’ rating and consulting functions, maintain the issuer-pay model, and create an independent analyst organization to complete the Dodd-Frank Act’s reforms.

288 Id.