Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment

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DEEPLY AND PERSISTENTLY CONFLICTED: CREDIT RATING AGENCIES IN THE CURRENT REGULATORY ENVIRONMENT

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Abstract

Credit rating agencies have a pervasive and potentially devastating influence on the financial well-being of the public. Yet, despite the recent passage of the Credit Rating Agency Reform Act, credit rating agencies enjoy a relative lack of regulatory oversight. One explanation for this lack of oversight has been the appeal of the potentially self-regulating nature of credit rating agencies that claim to rely deeply on their reputational standing within the financial world. There are strong arguments for doubting this reputational concern, including the conflicting self-interest of credit rating agencies whose profits are gained or lost depending on their ability to lure the business of issuers who will always be seeking the highest rating possible.

In recent months, government and press investigations initiated largely in response to the economic turmoil surrounding subprime mortgages have led to additional skepticism about the self-regulating abilities of credit rating agencies’ concerns for reputational integrity. This Article argues that the current underlying theories of credit rating regulation may be prone to fail because they leave in place the fundamental conflicts of interest that have been shown to induce profit-seeking credit rating agencies to over-rate securities, indicating to investors a lower amount of default risk than actually exists. If investors were able to fully discount or adjust for this misinformation, additional governance may not be required. Unfortunately, there is considerable empirical and anecdotal evidence in business as well as behavioral finance literatures that many investors using credit rating agency ratings are simply not able to perform such adjustments.

This Article develops a governance framework that accounts for the rating agencies’ conflicts of interest problem and proposes an independent publicly-funded credit rating agency, arguing that such an institution could provide valuable information to investors, could illuminate the reputational compromises credit rating agencies often make in favor of profit-seeking and thus could mitigate a significant amount of the errant information currently produced by private-sector credit rating agencies.

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INTRODUCTION

The economy is currently in a period of turmoil. Housing prices have fallen significantly. Foreclosures are up. The federal government has rescued Fannie Mae and Freddy Mac, which collectively own or guarantee approximately fifty percent of the country’s mortgages. The federal government bailed out a major Wall Street investment bank. A large commercial bankcollapsed, the largest commercial bank collapse in two decades. Equity values have plummeted. Some have estimated that approximately $1 trillion of wealth will disappear as a result of the drop in value of mortgage-backed securities and related securities. There is a worldwide credit crunch. The U.S. is either in a recession or on the brink of one, and the economic downturn is felt globally. It is not evident that the end is in sight, and the worst may yet come.

Why has the economy entered such a tumultuous period? A partial answer is that too many institutional investors poured too much money into the U.S. housing market during the housing bubble of the 2000s, and when the housing bubble burst, an ensuing wave of foreclosures drove down the value of

1 SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATION OF SELECT CREDIT RATING AGENCIES 12 (2008) (quoting an email written in December 2006 by an analytical manager in the collateral debt obligation (CDO) group of a major credit rating agency to a senior analytical manager within the same group. The full quote states that “[the rating agencies continue to create] an even bigger monster – the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.”).


5 James R. Hagerty et al., U.S. Mulls Future of Fannie, Freddie; Administration Ramps Up Contingency Planning as Mortgage Giants Struggle, WALL ST. J., Jul. 10, 2008, at A1 (reporting that the two mortgage giants collectively own or guarantee approximately $5 trillion in mortgages).


7 Damian Paletta, Crisis Deepens as Big Bank Fails; IndyMac Seized In Largest Bust In Two Decades, WALL ST. J., Jul. 12, 2008, at A1 (reporting the seizure of IndyMac by federal banking authorities).

8 E.S Browning, Market’s Fall Raises Fears on Banks; Fed Mulls Steps to Ease Investment in Lenders; Parallels to the Tech Bust, WALL ST. J., June 27, 2008, at A1 (reporting that the Dow Jones Industrial Average had fallen nearly 20% since October 2007).

9 Michael M. Grynbaum, In Volatile Times, Investors Tune in All and Any Predictions, N.Y. TIMES, Jul. 2008, at C1 (reporting that commercial and investment bank losses to date from mortgage investments have reached $450 billion and that Bill Gross, “a prominent bond fund manager,” predicted that the final loss total would be $1 trillion and that “[s]ome market watchers say the figure could be even higher.”).


11 Lahart, supra note 10.

12 Id.


14 See, e.g., Lauricella, supra note 13; Lahart, supra note 10.

15 See Case-Shiller, supra note 2 (showing dramatic annual increasing in national average housing prices between 1998 and 2006 and a steep decline since); See ROBERT SHILLER, IRRATIONAL EXUBERANCE 14 (2nd ed. 2005) (explaining that the “rocket-taking-off” boom in home prices in the U.S. since 1997 cannot be explained “in terms of building costs, population or interest rates.”). See also Vincent
these investments, forcing some investors into insolvency.\textsuperscript{16} Many institutional investors, in order to meet capital and liquidity requirements, have had to restrict lending\textsuperscript{17} while seeking additional capital.\textsuperscript{18} This has lead to the widespread credit crunch\textsuperscript{19} and a general economic slowdown.\textsuperscript{20} This problem is exacerbated by the fact that many of the security vehicles used to invest in the housing market, mortgage-backed securities ("MBSs") and collateralized debt obligations ("CDOs") based on MBSs, are often complexly structured\textsuperscript{21} and their underlying assets, thousand of individual mortgages, are often legally distant and largely invisible.\textsuperscript{22} This complexity and opacity has resulted in a situation where many security holders do not know the exact nature of the risks they bear,\textsuperscript{23} and the markets cannot easily value these securities.\textsuperscript{24} As a result, liquidity in these products has shrunk considerably,\textsuperscript{25} financial uncertainty is pervasive,\textsuperscript{26} and the credit market has constricted considerably.\textsuperscript{27}

But such an explanation merely raises additional questions. The most immediate question is why did so many ostensibly sophisticated institutional investors invest so heavily into the U.S. housing markets, especially during a housing bubble\textsuperscript{28} and during a time when subprime mortgages constituted such a large percentage of home loans originated in the U.S.\textsuperscript{29}

To begin to answer this question, it is worth investigating the role of the many actors who contributed to the creation of the current turmoil. Some culprits are commonly discussed – unethical home loan originators who preyed on unsophisticated homebuyers whose creditworthiness prevented them from

\textsuperscript{16} See e.g., Damian Palletta, et al., Countrywide Seeks Rescue Deal, \textit{Bank of American Eyes Stricken Home Lender as Crisis Grinds on.}, \textit{WALL ST. J.}, Jan. 11, 2008, at A1; Sidel et al., \textit{The Week, supra note 6; Paletta et al., supra note 7; E.S. Browning, Banks Rally, but Demons Still in Vault; Interbank Lending, House Prices Suggest the Worst Isn’t Over; a Bear Bounce?, \textit{WALL ST. J.}, Jul 28, 2008 at C1 (reporting that moves by the Federal Reserve and other central banks have decreased the fears of widespread bank insolvency).

\textsuperscript{17} See Browning, \textit{supra note 16 (noting that banks must reduce the amount of borrowing and lending they do.)}

\textsuperscript{18} \textit{See, e.g., Lauricella, supra note 13; Jonathan Karp & Michael Corkery, Real-Estate Finance: Middle East Players Arrive; Government Investment Funds, Individuals Fill Need for Cash On Developments Across U.S., \textit{WALL ST. J.}, Mar. 12, 2008, at B9 (reporting that American financial institutions are selling interests to Persian Gulf sovereign wealth funds in order to acquire necessary capital).}

\textsuperscript{19} \textit{Supra note 10.}

\textsuperscript{20} \textit{Lahart, supra note 10; IMF \textit{supra note 13; See also Scott Patterson, How the Credit Mess Affects You, \textit{WALL ST. J} \textit{WALL ST. J., Mar. 2, 2008, at A1 (describing the connection between the housing bubble bursting, subprime mortgages, the credit crunch and the economic slump).}

\textsuperscript{21} \textit{Mortgage-backed securities are debt securities whose payments are based on the total principal and interest payments of a pool of mortgages. The pool may consist of thousands of mortgages. Collateralized debt obligations are securities whose securities are also based on a pool of underlying assets, and MBS-based CDOs are CDOs which are based on a pool of MBSs, often as many as 200 MBS. See \textit{Andrew Davidson et al., Securitization: Structuring and Investment Analysis 24-26 (2003); SEC, supra note 1, at 6-7. The vast majority of MBS and CDOs are purchased and held by institutional investors. IOSCO Subprime Report supra note 10 at 12.}

\textsuperscript{22} \textit{MBS and CDOs based on MBSs are highly structured, meaning, essentially, that the rights to the cash flows from the pool of underlying securities are segmented among different tranches of securities. Different tranches bear different degrees of risk and are priced, in part, relative to their respective levels of risk. This differentiation is obtained by payment subordination, over-collateralization, swaps and other credit enhancements. See \textit{Davidson et al., supra note 21; SEC, supra note 1, at 6-7. The combination of the thousands of underlying assets, the complex structuring and the credit enhancements make the risks of MBS and related securities difficult to thoroughly analyze and understand and makes the securities, therefore, often difficult to price. IOSCO Subprime Report, supra note 10 at 10, 22.}

\textsuperscript{23} \textit{IOSCO Subprime Report, supra note 10.}

\textsuperscript{24} \textit{See Id. at 10, 13, 17-9.}

\textsuperscript{25} \textit{Id. at 5.}

\textsuperscript{26} \textit{Id. at 4-5.}

\textsuperscript{27} \textit{Supra note 10.}

\textsuperscript{28} \textit{Case-Shiller, supra note 2.}

\textsuperscript{29} \textit{John Mills & Paul Kiff, \textit{Money for Nothing and Checks for Free: Recent Developments in the Subprime Mortgage Market 6 (International Monetary Fund, Working Paper No. WP/07/188, July 2007), available at http://www.imf.org/external/pubs/ft/wp/2007/wp07188.pdf (reporting that until 2003, the percentage of all mortgage originations which were not "prime conforming" was very low, but by 2006 approximately half of all mortgage originations were "nonprime" loans (subprime: 21% and Alt-A: 25%). Such nonprime totaled almost $1.5 trillion in 2006).}
taking out traditional home loans;\textsuperscript{30} speculators who took advantage of the inexpensive financing to ride the seemingly endless wave of increasing housing values;\textsuperscript{31} irresponsible homebuyers who took out home loans which they did not understand or could not afford to repay.\textsuperscript{32} Some culprits, however, are less well known. Three additional ones include (i) the investment banks who sponsored the creation of many of MBSs and the CDOs based on them; (ii) the three large American credit rating agencies – Moody’s Investor Service (“Moody’s”), Standard and Poor’s Rating Services (“S&P”), and Fitch Ratings, Ltd. (“Fitch”) – each of which appear to have been rating MBSs and related securities\textsuperscript{33} – recklessly, if not knowingly – as less risky than they actually were and consequently fed investor appetites for MBS and other U.S. real estate financial products; and (iii) the institutional investors themselves, who appear to have been relying too heavily on credit ratings as substitutes for their own internal risk assessments.

This Article addresses the inter-relational dynamics of these last three actors, and in particular focuses on the actions and incentives of the credit rating agencies, the actors positioned immediately between the issuing investment banks and institutional investors. It addresses why the credit rating agencies might issue inaccurately high ratings and why institutional investors might have been encouraged by inaccurately high credit ratings to invest increasingly large sums of money into the U.S. housing market and offers a possible framework for addressing these interrelated problems. Such investment fueled the housing bubble\textsuperscript{34} and created the conditions which would not only result in the current economic turmoil but which would expose both the bad behavior of the credit rating agencies and a certain lack of sophistication on the part of institutional investors.

Part I of this Article briefly describes the credit rating agencies, their operations, and their importance within the capital markets, as well as how the rating agencies’ ratings are used in regulating the investments of certain institutional investors. All large American credit rating agencies earn the vast majority of their revenues from securities issuers who contract with credit rating agencies to have their securities rated.\textsuperscript{35} Part II examines the conflict of interest inherent in this “issuer-pays” revenue model.

The credit rating agencies have acknowledged the existence of the issuer-pays conflict of interest and the more benign risk of error but have typically downplayed their significance, stating that their reputations are far too valuable to the success of their businesses for them to either succumb to the biases inherent in the issuer-pays revenue model or issue inaccurate ratings.\textsuperscript{36} Part III details this “reputation” argument, presents theory-based counterarguments to it, and then presents empirical and anecdotal evidence indicating that a generalized concern for their reputations has not satisfactorily prevented rating agencies from succumbing to those biases for the sake of short-term profits.

Part IV examines the regulatory regime governing the credit rating industry, specifically the Credit Rating Agency Reform Act of 2006 and the rules promulgated by the SEC pursuant to the Act. This Part also discusses the rules currently being proposed by the SEC to address some of the regulatory failures identified during the current subprime episode. Notably, neither the Act, the current SEC rules, nor the proposed SEC rules adequately regulates the fundamental problem of the rating agencies – the issuer-pays conflict of interest. In the current regulatory environment, credit rating agencies are permitted to use the

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\textsuperscript{32} See, e.g., Kimberley E. Strassel, The Bailout Briar Patch, WALL ST. J., Mar. 12, 2008, at A12 (reporting that the presidential administration had distinguished between those homebuyers who have been victims of predatory lending and those who merely “signed up for an unaffordable home”).

\textsuperscript{33} Throughout this Article, any reference to mortgage-backed securities or MBS is meant to include references to all securities based on a pool of mortgages, including collateralized debt obligations based on a pool of MBSs.

\textsuperscript{34} Reinhart, supra note 15 (stating that asset securitization helped “to enable the housing bubble”).

\textsuperscript{35} See infra Part IIA.

issuer-pays model, but if they do, they must publically disclose such fact. Part V details why such a disclosure requirement is unlikely to ensure adequate credibility and accuracy of ratings.

In a world of increasing financial complexity, opacity and interconnectedness, financial crises and economic turmoil could prove to be increasingly profound. These same factors increase the potential for credit rating agencies to engage in public welfare-harming, short-term profit seeking behavior while simultaneously decreasing the ability of investors to adequately monitor, discount and discipline the rating agencies, thus making it more pressing to find ever more reliable governance and regulatory mechanisms to ensure a satisfactory level of financial stability and sustainability. Part VI of the Article proposes a more public-private governance structure which would increase financial stability, promote greater credibility within the private-sector credit rating industry and enable investors to make better informed investment decisions. The heart of that proposal is the establishment of an independent, publically-funded credit rating agency. This Part provides the structural outline of such a public credit rating agency together with other potential benefits of such an agency.

I. CREDIT RATING AGENCIES

A. Credit Rating Agency Fundamentals

In an investment world where information is often difficult to obtain and difficult to adequately process, credit rating agencies play a particularly relevant and important role. The precursors to the modern credit rating agencies were mercantile credit agencies. First formed in the mid-1800’s these agencies assessed the ability of merchants to pay their financial obligations, and sold these assessments to businesses who would then use this information to help them decide whether or not to lend or provide other financing to a particular merchant and, if so, under what terms. In 1909, John Moody formed the first company which assessed the ability of businesses to pay amounts due on the bonds they issued.

Modern credit rating agencies are private, for-profit companies, which assess the creditworthiness of the issuers of debt and debt-like securities. Securities issuers often provide rating agencies with nonpublic

37 See Garry J. Schinasi, Preserving Financial Stability, 36 ECON. ISSUES, International Monetary Fund (Sep. 2005). Complex structured instruments and derivatives of all types are becoming are becoming much more numerous. See Greg Ip & Rebecca Christie, Derivatives Growth has Helped Banks, OEMNews Says, WALL ST. J., Oct. 8, 2002, at A2. Hedge funds, whose investment strategies and portfolios are typically opaque to the public, are also growing, including hedge funds which opaquely keep their investment strategies concealed from their own investors.


39 For a brief description of the historical evolution of the credit rating industry, see, e.g., Cantor & Packer, supra note 38, at 1-5; Richard Sylla, An Historical Primer on the Business of Credit Rating, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM, supra note 38, at 19; SINCLAIR, supra note 38, at 22-7.

40 Cantor & Packer, supra note 38 at 1.

41 Id. at 2.

42 Such securities include long-term corporate bonds, mid-term corporate bonds, short term corporate notes, municipal bonds, asset-backed securities, preferred stocks, privately placed notes and bonds, commercial paper, bank certificates of deposits, mortgage backed securities and other collateralized debt obligations. Some rating agencies rate other payment capabilities such as the claim paying ability of insurance companies and the performance risk of mortgage servicers. Id. at 3.
information about themselves and about their securities. With this information, credit rating agencies make creditworthiness assessments and then make their opinions, or ratings, publically available. Credit rating agencies may rate securities upon their initial issuance and may maintain surveillance over a security afterwards and revise their ratings when and if the creditworthiness of the issuer changes. A credit rating agency is essentially a purveyor of information and of the analysis of that information.

Traditionally, securities are given a single, letter-designated grade, on a linear scale, which is reflective of the credit rating agency’s opinion as to the likelihood of full and timely payment. Credit rating agencies also publically disclose some of the underlying methodology and basic rationale used to conduct their credit analysis.

There are more than one hundred credit rating agencies worldwide. In the United States the credit rating industry is highly concentrated with two firms, Moody’s and S&P, each controlling approximately 40% of the market. It is estimated that Moody’s and S&P each pass judgment on over $30 trillion worth of securities annually.

B. Revenue Model

Before the mid-1970’s American credit rating agencies made money by selling their credit analysis opinions to members of the investment community. Such purchasers are referred to as subscribers. In the early 1970’s, in part as a result of the 1970 recession and the default of Penn Central on $82 million of debt, the investment environment began to change, and investors began to demand that new security issues

41 SEC 2003 CRA Report, supra note 36, at 21-22, 26. Information considered by credit rating agencies may include, the issuer’s method of cash generation and its use of cash, the nature and amount of its assets and liabilities, debt-to-equity ratios, interest coverage ratio, cash flow predictions, budgets, business projections, amount and nature of fixed charges, advanced notification of major corporate events, nature of its markets, efficiency and nature of its operations, quality of its management, contractual commitments, competitors, current government regulations and its regulatory risk. Id. at 26. Pursuant to SEC Regulation FD, securities issues may not disclose nonpublic information to certain members of the public, such as securities market professionals and others who may use the information for trading purposes, without making that information generally publically available. 17 C.F.R. § 234.100(b)(2)(iii). However, Regulation FD makes an exception for credit rating agencies so that securities issuers can make their non-publically available information available to the credit rating agencies for purpose of credit analysis. The SEC justified the credit rating agency exception because rating agencies would use such information to develop and publically issue a generalized opinion about the creditworthiness of the issuer.

42 See, e.g., Cantor & Packer, supra note 38, at 237 (describing the internal processes used by credit rating agencies to collect and analyze information and decide a rating).


44 For example, Moody’s states, “[A] rating simply helps investor determine the relative likelihood that they might lose money on a given fixed income investment. More technically, [it is an opinion] of the future ability, legal obligation and willingness of a bond issuer or other obligor to make full and timely payments on principal and interest due investors.” Moody’s, http://www.moodys.com (last visited July 15, 2008).

45 For example, Standard & Poor’s rates long-term debt securities on a scale of AAA, AA, A, BBB, BB, CCC, CC, C, and D, with “+” and “-” indicating a rating which is high or low, respectively, within that ratings “notch.” AAA represents a security of the lowest default risk (defined to indicated that “the obligor’s capacity to meet its financial commitment on the obligation is extremely strong”), and D represents a security of the highest default risk (defined to indicate “when payments on an obligation are not made on the date due even if the applicable grace period has not expired, unless Standard & Poor’s believes that such payments will be made during such grace period. The ‘D’ rating also will be used upon the filing of a bankruptcy petition or the taking of a similar action if payments on an obligation are jeopardized.”). Complete S&P rating definitions are available at http://www2.standardandpoors.com/portal/site/sp/en/us/page/article/2,1,9,4,1204834067208.html.


47 Id. at 37. See Lawrence J. White, The Credit Rating Industry: An Industrial Organizational Analysis, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM, supra note 38, at 41, 46 (listing countries with major rating agencies).

48 Hill, supra note 38, at 44. With the passage of the Credit Agency Reform Act of 2006, additional rating agencies may be able to flourish. See infra notes 85-7 and accompanying text.

49 See Serena Ng, Moody’s, S&P Still Hold Advantage; Law to boost Competition in Credit Rating Business Isn’t Likely to Pose Setback, WALL ST. J., Oct. 10, 2006 at C5; see also IOSCO Subprime Report, supra note 10, at 28 (speculating that Moody’s, S&P and Fitch collectively control 85% of the market).

50 Partnoy, Not Like Other Gatekeepers, supra note 38, at 65-6.

have at least one credit rating. As issuers were increasingly required by the marketplace to issue rated securities, the rating agencies realized that they could start to charge issuers, rather than subscribers, for the “service” of rating their securities. Additionally, as communication and document reproduction technology became more advanced and ubiquitous, it became increasingly difficult for credit rating agencies to keep their ratings out of the hands of non-subscribers, and as ratings became increasingly public information, the inclination of subscribers to pay for ratings declined. Furthermore, as securities and the business strategies of issuers become more complex, it became more costly for rating agencies to conduct their analysis, and, consequently, issuing ratings required more resources than could be recovered solely from subscription fees. Together these factors led rating agencies to discover a more viable and a more profitable revenue generation model, and during the mid-1970s the “subscriber-pays” revenue model was gradually replaced by the “issuer-pays” revenue model, a model in which issuers of debt and debt-like securities pay the rating agencies to rate their securities. Today, it is estimated that approximately eighty to ninety percent of the revenues generated by American credit rating agencies are paid by issuers.

Credit rating agencies also occasionally rate the creditworthiness of issuers who have not requested or paid for this service. These ratings are based solely on publically available information and are referred to as “unsolicited” ratings. Credit rating agencies also often also offer ancillary services such as pre-rating security structuring advice.

C. Public Effects of the Credit Rating Agencies

It is widely acknowledged that the credit rating agencies play an important role in the activities of the investment industry, the capital markets, public regulation and private contracting. The globalization of the capital markets and the sheer scope of the investment industry have significantly enhanced their influence.

i. Role in the Capital Markets and Investment Industry

Investors use ratings to help them estimate the default risks associated with rated securities and rated issuers. Rating services are particularly valuable to investors who have relatively limited information gathering and/or analysis capacity, and, therefore, cannot make credit evaluations as effectively or as

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54 Canter & Packer, supra note 38, at 4.
55 Id.; White, supra note 49, at 47.
56 Canter & Packer, supra note 38, at 4; White, supra note 49, at 47.
57 Canter & Packer, supra note 38, at 4; White, supra note 49, at 47.
59 See, e.g., SEC 2003 CRA Report, supra note 36, at 41. Credit rating agencies still have investor subscription services. Subscribers have access to more detailed reports and analysis than what is publically available from the credit rating agencies. SEC 2003 CRA Report, supra note 36, at 22. Moody’s reports that $1,835 million of its total $2,259 million 2007 revenue, or 81%, was revenue from determining and maintaining credit ratings, and most of the remaining revenue was from selling subscription services. Moody’s Corporation, Annual Report (Form 10-K), at 26 (Feb. 29, 2008).
60 Pinto, supra note 38, at 334.
61 Id.
62 See, e.g., SEC 2003 CRA Report, supra note 38, at 19. (“The [SEC] recognized that, in recent years, the importance of credit ratings to investor and other market participants had increased significantly, impacting an issuers access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to make particular investments.”), JOHN BRAITHWAITE & PETER DRACOS, GLOBAL BUSINESS REGULATION 160 (2000) (rating that no market watchdog “has become more powerful than the pre-eminent U.S. rating agencies... [Every] issuer of securities in the world... shudder at the effect on investing publics of even a hint that one of these agencies might qualify their credit rating.”).
63 See also SEC 2003 CRA Report, supra note 36, at 38 (reporting that representatives of non-NRSRO credit rating agencies (see supra Part I.C.ii for a discussion of the NRSRO designation) believe that the NRSRO designation was extremely important, in part because of the pervasiveness of rating-dependent regulation, but also “because the marketplace views the NRSRO designation as the equivalent of the “Good Housekeeping Seal of Approval.”)
efficiently as a rating agency.\textsuperscript{64} Rating agencies also provide an economy of scale.\textsuperscript{65} In theory, rating agencies increase efficiency and lower costs within the investment industry since each investor need not expend the time and energy to conduct similar credit risk analysis.\textsuperscript{66} In the case of less resource-rich investors, it may be prohibitively costly to collect sufficient information about potential investments and thoroughly analyze.\textsuperscript{67} Consequently, the rating services of the rating agencies lower issuers’ costs of capital. In other words, investors are more willing to purchase rated debt securities offering a lower rate of return than they would if (i) they were burdened with having to expend considerable resources to acquire and evaluate all available information themselves, or (ii) they were faced with risking their investment dollars by purchasing securities which they have limited information.\textsuperscript{68}

This is especially true of securities for which information is more difficult to gather, understand or analyze, like sovereign debt\textsuperscript{69} or in the case of particularly complex securities like MBSs, CDOs and other structured finance products, which require considerable resources to comprehensively analyze.\textsuperscript{70} Numerous reports have echoed the fact that investors, because of the complexity and opacity of certain new securities like MBSs, cannot understand them completely and have relied instead on the credit rating agencies.\textsuperscript{71} In the over-the-counter derivatives markets, credit ratings are heavily relied upon to determine the acceptability of counterparties and to determine the level of collateral that might be required for any particular transaction.\textsuperscript{72}

Rating agencies also provide a valuable service to those investors who are not permitted access to nonpublic information or those investors who do not have a direct negotiating relationship with the issuer. Issuers may supply rating agencies with nonpublic information about themselves and the security so that

\textsuperscript{64} Id.
\textsuperscript{66} Id. at 12 (noting, that the costs associated with “each individual investor evaluating his other investment would be excessive” and that “rating agencies improve the efficiency of securities markets by acting as informational intermediaries between issuers and investors in order to increase the transparency of securities and thereby reduce the informational asymmetry” between issuers and investors).
\textsuperscript{67} Id.
\textsuperscript{68} But see Jonathan R. Macey, The Politicization of American Corporate Governance, 1 VA. REV. L. & BUS. REV. 10, 21, 24 (2006) (arguing that although “[i]t is generally accepted that the uninformed investors… clearly rely on… ratings, [the credit rating agencies provide] no information of value to the investing public.”); Partnoy, Like No Other Gatekeepers, supra note 38, 65 [hereinafter Partnoy, The Paradox] (making the same argument and arguing that a rating agency’s only value is that which is contained in the “regulatory licenses” provided to issuers when their securities achieve benchmark ratings required pursuant to rating-dependent regulations).
\textsuperscript{69} See Roman Kraussl, Do Credit Rating Agencies Add to the Dynamics of Emerging Market Crises? 34, 34 (Center for Financial Studies, Working Paper No. 2003/18, August 2003) (reporting that CRAs have substantial influence on the size and volatility on emerging markets lending, where the problem of asymmetric information for even for institutional investors exists).
\textsuperscript{70} See Greg Ip et al., U.S. Mortgage Crisis Rivals S&L Meltdown; Tell of Economic Shocks May Linger for Years; A Global Credit Crunch, Wall Street Journal, Dec. 10, 2007, at A1 (noting that valuing a CDO may entail valuing as many as one hundred separate securities, each of which may contain thousands of individual loans. “This feat, if done on any scale, can require millions of dollars in computing power alone”, and quoting the finance director of King County, Washington, who stated that the county “relied heavily on the ratings agencies” when investing in commercial paper backed by MBS-related special investment vehicles). Cantor & Packer, supra note 38, at 19-20 (stating that that “the need for high ratings [on mortgage backed securities and asset backed securities] appears to arise from… investors’ concerns about the quality of the collateral as well as their unfamiliarity with the complicated structures of the securities”, and later stating expressly, with regard to mortgage backed securities and other asset backed securities, that “in principal, securities with lower credit enhancements can be discounted by the market. However, in practice, the market has trusted agencies to be prudent in the determination of credit support requirements and has not required higher yields from issuers that have switched to agencies with lower enhancement requirements.”). See also David Wessel, From Credit Mess, Lessons About Government, WALL ST. J., Nov. 8, 2007, at A2 (stating that the huge institutional investors who purchased RMBSs and CDOs based on them “now say that they blindly relied on credit-rating agencies….”); Aaron Lucchetti, Rating Game: As Housing Boomed, Moody’s Opened Up, WALL ST. J., Apr. 11, 2008 at A1 (stating that many investors who lost money in the subprime mortgage crisis relied on ratings to signal which securities were safe to buy).
\textsuperscript{72} SEC 2003 CRA Report, supra note 36, at 28.
rating agency can conduct a more informed credit risk analysis. Since the implementation of Regulation FD, the credit rating agencies are the main conduit of nonpublic information to the market.\footnote{Philippe Jorion et al., \textit{Informational Effects of Regulation FD: Evidence from Rating Agencies}, 76 J. FIN. ECON. 309 (2005) (reporting the results of their study which demonstrates that since the implementation of Regulation FD in October 2003, the informational content of credit ratings has increased).}

Institutional investors often use ratings, but the degree and extent that any particular institutional investors uses or relies on the ratings of the credit rating agencies varies.\footnote{David Ellis, \textit{Different Sides of the Same Story: Investors' and Issuers' Views of Rating Agencies}, 7, 4 J. FIXED INCOME FIN. 39 (March 1998) (reporting the results of a survey responded to by 205 institutional fixed income investors in which these institutions report that on a scale of 1-7, with “1” indicating that they rely entirely on their own internal analysis and “7” indicating that they rely primarily on the credit rating agencies ratings, the average score was 4.19, and no respondent reported that they rely entirely on their own analysis. The results of this survey, conducted in 1998, may not represent current reliance).} Many institutional investors, in particular those who are more resource-rich, that is to say, have more informational gathering and analytical capacity, conduct their own creditworthiness analysis of issuers,\footnote{IOSCO Subprime Report, supra note 10, at 9; Ellis, supra note 74, at 35 (noting that as securities become increasingly complex, the need for specialized and sophisticated research is more necessary, but observing, additionally, that with advances in information gathering and analyzing technology and increased sophistication on the part of investors means fewer institutional investors need to wholly rely on the opinions of the credit rating agencies.)} but it is nevertheless typical for the more resource-rich institutional investors to use the ratings issued by the credit rating agencies to inform their own analysis or to include “as one of several valuable ‘inputs’ to their independent credit analysis.”\footnote{SEC 2003 CRA Report, supra note 36, at 21, 28; see also Ellis, supra note 74, at 36; Anusha Shrivastava & Emily Barrett, \textit{Treasuries See Flight to Safety; Subprime Worry Drives Up Prices; It's Buyer Beware}, WALL ST. J., Jul. 11, 2007, at C7 (reporting that an S&P downgrade of almost $400 MBS “served to reignite fears of broad-based selling from anxious investors”, or, in other words, institutional investors are not conducting their own complete analysis; they are relying, at least in part, on the signals given to them by the rating agencies). It is well known that credit rating analysts routinely take calls from and have informal contact from subscribers, typically institutional investors, who are seeking additional insights and further explanations of their credit rating agencies opinions. SEC 2003 CRA Report, supra note 36, at 35. Although some academics believe that there is little or no informational content in rating agencies' ratings, See, e.g., Macey, supra note 68, subscribers seem to disagree. See SEC 2003 CRA Report, supra note 36, at 35, for a discussion of how subscriber services may create improper informational asymmetry in the investor marketplace.} Institutions with fewer resource gathering and information processing capabilities, however, are likely to more heavily rely on the ratings of the credit rating agencies than those institutional investors with significant internal resources.\footnote{Ellis, supra note 74, at 39, (suggesting that the results of a survey of institutional investors indicate that larger, more resource-rich institutions relied less on credit rating agency opinions than do less resource-rich institutions); Shrivastava & Barrett, supra note 76.}

\textit{ii. Public Use of Ratings as Regulatory Benchmarks}

As stated above, issuers’ cost of capital is reduced when a credit rating agency collects and analyzes information for the investment community. Their cost of capital is reduced considerably more when ratings on their securities meet certain regulatory benchmarks. Many institutional investors, pursuant to regulations, are forbidden or discouraged from purchasing certain low rating securities. International organizations and federal and state regulators often adopt the ratings of the credit ratings agencies for determining creditworthiness and credit risk of assets held by, and the capitalization requirements for, certain regulated entities such as commercial banks and insurance companies.\footnote{SEC 2003 CRA Report, supra note 36, at 6.} For example, rating-dependent laws and regulations\footnote{For example, among federal law, the Secondary Mortgage Market Enhancement Act of 1984 (amending the Exchange Act) defined the term “mortgage related security” in such a way that, among other things, required such a security be rated in one of the two highest rating categories by at least one NRSRO. 15 U.S.C. §78c(a)(41) Of particular relevance in the most recent financial crisis, the Federal Deposit Insurance Act states that corporate debt securities are not investment grade unless they are rated in one of the four highest categories by at least one NRSRO. 12 U.S.C. §1831k(3)(H)(A). Among regulations, a rule promulgated by the SEC pursuant to the Investment Company Act of 1940 limits money market funds to investing in only high quality short-term instruments, and NRSRO ratings are used to help determine exactly what those high quality investment instruments are. 17 C.F.R. § 270.3-7. In regulations adopted by state regulatory authorities, the definitions and use of NRSRO ratings are also common.} may restrict firms of certain industries from holding securities below a
certain rating level or may dictate that certain capital charges be imposed on a firm when securities rated below certain levels are held by that firm. Such “ratings-dependent regulations” are becoming more and more widespread and are another indication of the far-reaching public effects of the credit rating agencies.

In order to increase the effectiveness of ratings-dependent regulations, it was necessary that the ratings referred to in these regulations be issued by agencies who issued credible and reasonably accurate ratings. Over time, the concept of the “nationally recognized statistical rating organizations” or “NRSRO,” came into existence, and now most ratings-dependent regulations reference the ratings only of the select few credit rating agencies which have been designated by the SEC as an NRSRO. The Credit Rating Agency Reform Act of 2006, discussed more fully below, provides an administrative process for rating agencies to apply for and obtain NRSRO registration.

iii. Private Use of Ratings as Benchmarks

Ratings are often used by private contracting parties. Private contracts often contain “rating triggers” in which a downgrade of a counterparty’s credit rating can trigger, among other things, the acceleration of debt payments, obligations to provide additional collateral, increased interest rates and the activation of previously inactive restrictive covenants. A cascading effect is possible where a debtor’s credit rating drops and such rating-dependent contractual clauses are triggered. For example, if a debtor’s interest rate is increased, additional fixed charges may now be owed and its creditworthiness will be even more impaired. This impairment may trigger other contractual provisions which may in turn trigger further contractual provisions. It is possible for an issuer’s rating to plummet over the course of such a cascade and even send a firm into sudden bankruptcy.

pursuant to the Securities Act, the offerings of certain non-convertible debt, preferred securities and asset-backed securities that are rated investment grade by at least one NRSRO may be registered on Form S-3, the SEC’s short form registration statement, without the issuer satisfying a minimum public float test. Form S-3 (17 CFR §239.13. SEC rules governing the minimum capital requirements of broker-dealers are also based on NRSRO ratings. See SEC 2003 CRA Report, supra note 36, at 6 (discussing how this particular rule coined the term ‘nationally recognized statistical rating organisation’). The U.S. Department of Education uses NRSRO ratings to set standards of financial responsibility for institutions that wish to participate in student financial assistance programs under Title IV of the Higher Education Act of 1965. See 17 C.F.R. 240.15c-3. Among state law, the Code of the State of California states that California incorporated insurance companies may invest excess funds only in debt securities which are, among other things, rated in of the three highest rating categories of at least one NRSRO. (Cal. Ins. Code § 1192.10). The Bank for International Settlements relies on the credit ratings of “external credit assessment institutions” to assign risks to asset classes and thus to determine minimum capitalization requirements for internationally active banks. Basel II International Convergence of Capital Measurement and Capital Standards: a Revised Framework, Part 2, Section II; See also Richard Dale & Stephen. Thomas, The Role of Credit Ratings in the Basel Capital Adequacy Proposals, European Capital Markets Institute, Short Paper No. 2. (2000), available at, http://www.euroncapitalmarkets.org/1pnode/143. For many more examples and a fuller discussion of, and critiques of the use of, ratings-dependent regulations, see, e.g., SEC 2003 CRA Report, supra note 36, at 6-8; Cantor & Packer, supra note 38, at 5-8; Schwarz, supra note 65 (arguing that such rating-dependent regulations grant the credit rating agencies their real value and confers upon issuers who achieve a particular level rating level a “regulatory license,” a “valuable property right associated with compliance with that regulation.”) See also Partnoy, Not Like Other Gatekeepers, supra note 38, at 81-3 (discussing how such rating-dependent regulations make credit rating agencies different from other financial gatekeepers such as auditors and securities analysts). An implicit assumption in ratings-dependent regulations is the ratings spectra of different NRSROs are equivalent to each other and interchangeable and that they are unchanging. Although historically it appears that the markets have viewed Moody’s and S&P rating scales to be roughly equivalent and the other rating agencies appear to have designed their rating scales to harmonize with the Moody’s’ and S&P’s scales. Cantor & Packer, supra note 38, at 13). However, there is no express intention or coordination between the rating agencies and no regulations requiring any particular kind of scale. Id. at 15. Given this market place assumption, an agency seeking to attract additional business might be even more particularly inclined to soften their rating standards relative to other agencies.

80 Such a capital charge requires that firms, when computing applicable net worth for purposes of determining whether or not minimum capital requirements are satisfied, “deduct from their net worth certain percentages of the market value of the proprietary securities position. A primary purpose of these [charges] is to provide a margin of safety against losses that might be incurred by a firm as a result of market fluctuations in the prices of, or lack of liquidity in, their proprietary positions.” SEC 2003 CRA Report, supra note 36, at 6.

81 See Cantor & Packer, supra note 38, at 56; Partnoy, supra note 69, at 68-78.


83 Id. at 29.

84 See, e.g., FRANK PARTNOY, INFECTIOUS GREED 333, 336, 340 (2003) (relating how any mention of a credit ratings downgrade would “create a hush” among a crowd of senior executives and securities analysts and how Enron experienced this type of cascade four days before
II. PROBLEMATIC ISSUES PRESENTED BY CREDIT RATING AGENCIES

A. Issuer-Pays Conflict of Interest

The transformation from a revenue model in which investors paid for credit rating agency services to one in which issuers pay\(^{85}\) created a significant conflict of interest - and should have caused investors to question just how much to rely on their ratings. Ostensibly, the credit rating agencies issue ratings in order to provide information to investors, information which will allow them to make more informed investment decisions. Credit rating agencies, then, ostensibly provide investors with reliable information. However, under the issuer-pays revenue model, credit rating agencies are sensitive to the needs and desires of their paying clients - the issuers. As private, for-profit enterprises, credit rating agencies have a desire - and an obligation to their shareholders - to maximize profits. Unfortunately, the interests of issuers in respect to their ratings often do not align with the needs of investors to receive reliable ratings information.

Issuers want high ratings, not necessarily accurate ratings. The higher their securities are rated, the less concern investors will have about payment default, the greater their liquidity and the lower the issuers’ cost of capital.\(^{86}\) In addition, given the importance of many issuers of tapping large markets, high ratings provide them with access to investors whose investments choices are constrained by ratings-dependent regulations.\(^{87}\) Even after a security has been issued into the primary market, issuers have significant incentive to maintain their ratings both to maintain liquidity and to ensure that no disadvantageous rating-based contractual clauses are triggered.\(^{88}\)

The result is that under the issuer-pays revenue model, the interests of issuers and the interests of the credit rating agencies necessarily coalesce, and the credit rating agencies can make more money by providing their paying customers, issuers, with higher ratings. This conflict occurs at the expense of the investing public and of the beneficiaries of those institutional investors which are subject to ratings-dependent regulations. Simply stated, the credit rating agencies have a strong incentive to issue higher ratings, whether or not the ratings are accurate.\(^{89}\) Consequently, any investor who relies to any extent on ratings may be unknowingly bearing risk for which they are not being compensated.

The current model of the credit rating agencies, therefore, is built upon a fundamental and blatant conflict of interest; the rating agencies are opining as to the creditworthiness of the issuer - ostensibly for the benefit of investors\(^{90}\) – yet the bulk of the revenues generated by the credit rating agencies come from declaring bankruptcy in December 2001). Some lenders have started to shy away from using rating triggers because, though designed to provide lender protection, this cascading effect increases the risk of sudden bankruptcy. SEC 2003 CRA Report, supra note 36, at 30.

85 Of the ten NRSROs recognized as of August 2008, three, Egan-Jones Rating Company, LACE Financial Corp and RealPoint LLC, have repudiated the issuer-pays model and seem to rely instead on the subscriber-pays model for the significant amount of their revenues. (Egan-Jones Rating Company, http://www.egan-jones.com (last visited August 19, 2008); LACE Financial Corp, http://www.lacefinancial.com (last visited August 19, 2008); RealPoint LLC, https://www.realpoint.com (last visited August 19, 2008)) These three agencies, however, are relatively very small companies and two are registered as an NRSRO for only limited classes of securities. (SEC “Commission Orders Granting NRSRO Registration” available at http://www.sec.gov/divisions/marketreg/ratingagency.htm).

86 It should be noted, however, that the market price for a security is not necessarily perfectly correlated its ratings. To the extent the market discounts a rating, the market price may be lower or higher than that which would be determined solely from a rating.

87 See supra Part I.C.ii.

88 See supra Part I.C.iii.

89 See, e.g., John C. Coffee, Jr., Understanding Enron: It’s All about the Gatekeepers, Stupid, 57 BUS. LAW. 1403, at 1408 (remarking on the basic conflict of interested faced by gatekeepers such as credit rating agencies, the “desire to be perceived as credible and objective may often be subordinated to [a] desire to retain and please... clients.”).

90 It could be argued that the rating agencies are also opining ostensibly for the benefit of legislators and regulators who have adopted credit ratings a key determinant in the calculation of institutional risk management and capital requirements, but perhaps it more appropriate to say that the legislators and regulators are merely taking advantage of the fact that credit ratings exist and are therefore using them as a proxy for more direct risk analysis and capital requirement. See, e.g., Partnoy, Not Like Other Gatekeepers, supra note 38 (criticizing regulators for using inherently flawed credit rating agencies ratings for such regulatory purposes).
the issuers, those very debtors being evaluated. As stated earlier, although credit rating agencies generate some revenue from subscribers who purchase more detailed credit analysis and from selling other ancillary services, it is estimated that approximately eighty to ninety percent of the revenues generated by American rating agencies is revenue from issuers requesting a rating on their issued securities. Consequently credit rating agencies may be “captured” by issuers, that is to say, they may succumb to the biases inherent in the issuer-pays conflict of interest.

Prior the enactment of the Credit Rating Agency Reform Act of 2006, the credit rating industry was largely unregulated. The provisions of this Act, certain SEC rules promulgated pursuant to the Act and certain current regulatory proposals, including ones which claim to address the issuer-pays conflict of interest, are presented below in Part V. It is worth noting at this point, however, that under current and proposed regulation, ratings agencies are permitted to continue to base their businesses on the issuer-pays model and the fees charged are not substantively regulated.

B. Risk of Error Independent of Issuer Bias

The Credit Rating Agency Reform Act also does not obligate rating agencies to conduct any due diligence; credit rating agencies are not obligated by any law or regulation to audit the integrity or accuracy of the information given for their analysis, and, consequently, the quality of their analysis is in part a function of the quality of the information they are given by the issuing firms. The SEC has recently proposed rules which would require that rating agencies more fully disclose their due diligence policies, but these proposed rules do not mandate any level of diligence; diligence itself would not be required, but if not conducted, that fact would have to be disclosed.

As suggested in the previous section, inaccurate ratings can result if the credit rating agencies are captured by issuers. However, inaccurate ratings may result independently of any capture by issuers. Inaccurate ratings may result from (i) poor due diligence or a lack of research resources (whether as a result of inadequate research skills or inadequate financial or managerial resources), (ii) a lack of analytical resources (perhaps resulting from inadequate analytical skills or inadequate financial or managerial resources) or (iii) good faith mistakes.

91 The conflict of interest associated with this issuer-pays model has been described relatively extensively in the literature on credit rating. See, e.g., SEC 2003 CRA Report, supra note 36, at 41 (noting that issuing inappropriately high ratings may result from any number of different dynamics. For example, the credit rating agencies could make more liberal assumptions about the issuer and the securities when using their financial model, or the rating agency might not engage in particularly probing due diligence of the issuer, or the issuers might expressly place pressure on the agency to give the ratings the issuer desires. Since the fees charged by the rating agencies typically are a percentage of the size of the issuance, the threat of such pressure may be more likely, and the likelihood of its effectiveness may be greater, when the issuer issues securities of great size and/or issuer securities frequently and earning its continuing business would be particularly lucrative for the credit rating agency); Partnoy, Not Like Other Gatekeepers, supra note 38; Partnoy, Two Thumbs Down, supra note 38, Partnoy, The Paradox, supra note 68; Pinto, supra note 38, at 343-6.

92 supra note 59.


94 SEC 2008 CRA Report, supra note 36, at 31-2; Pinto, supra note 38. In fact, each of the three largest rating agencies, S&P, Moody’s and Fitch, note on their respective websites that “the assignment of a rating is not a guarantee of the accuracy, completeness or timeliness of the information relied on in connection with the rating.” SEC, supra note 1, at 18. The threat of civil liability to the investing public resulting from inaccurate ratings is limited since courts have traditionally deemed their ratings to be mere opinions protected under First Amendment principal. Pinto, supra note 38, at 351-5. (noting that American rating agencies have rarely been sued successfully, and that various theories from tort and from private anti-trust law have been suggested to reach credit rating agencies in the hopes that increased liability would incentivized them to be more diligent and reliable actors, but that none of these theories have gained acceptance in the courts).

95 If a rating agency suspects that the information provided by the issuer is incomplete or inaccurate, a credit rating agency may refuse to rate, withdraw their services, or downgrade a rating previously given.

96 SEC, PROPOSED RULES FOR NATIONALLY RECOGNIZED STATISTICAL RATINGS ORGANIZATIONS, EXCHANGE ACT RELEASE No. 34-57967, p. 61-64, available at http://www.sec.gov/rules/proposed/2008/34-57967.pdf, [hereinafter SEC PROPOSED RULES]. In January 2008, one rating agency reported that it would begin conducting more extensive reviews of subprime mortgage origination practices after sampling forty-five loan files [at the request of the SEC] and finding “the appearance of fraud or misrepresentation in almost every file.” SEC, supra note 1, at 18.
III. CREDIT RATING AGENCY INTEGRITY DEFENSES

The primary defenses against critiques of credit rating agencies has been the claim that credit rating agencies are first and foremost concerned about the marketplace’s perceptions of, and faith in, their ability to issue credible and accurate ratings. This “reputational” argument will be presented below. Following a description of the argument, this section will go onto describe the viable reasons to doubt the strength of the reputational argument.

A. The Reputation Defense

Defenders of the credit rating industry have typically responded to the observation that they may succumb to the biases inherent in the issuer-pays conflict of interest by acknowledging such conflict exists but downplaying its impact. Industry defenders state that the success of a credit rating agency ultimately relies on the agency’s reputation within the investment community for issuing accurate and credible ratings and have claimed that this conflict can be, and has been (at least until the current subprime crisis) effectively managed.\(^{97}\) Their argument proceeds as follows. If the investing public were to come to believe that a credit rating agency was captured too much by issuers and was consequently issuing unreliable, suspect, or less than fully defendable opinions, the credit rating agency’s reputation would be tarnished. The investment community would then discount the value of its ratings, thus reducing market demand for its rating services. Revenues would consequently decrease. In the worse-case scenario, the credit rating agency would go out of business. Only those agencies with good reputations – the collection of which, according to industry defenders, is coterminous with the set of those which issue accurate ratings – would survive and flourish.

Industry defenders have also stated that the rating agencies’ motivation to maintain their good reputation is alone adequate incentive for them to exercise appropriate levels of due diligence; maintain adequate analytical, financial and managerial resources; and conduct careful risk analysis and that this dynamic eliminates the likelihood of issuing persistently inaccurate ratings.\(^{98}\) Again, the argument proceeds similarly to that presented above – any agency which persistently issued inaccurate ratings, for whatever reason even reasons independent of issuer-capture, would likewise tarnish its reputation and not survive in the marketplace.

B. Theoretical Responses to the Reputation Defense

This reputation argument has been compelling to many commentators,\(^{99}\) and the argument may have been one of the reasons the credit rating industry was left largely unregulated until recently. The argument

\(^{97}\) But see Vickie Tillman, Op-Ed., *Don’t Blame the Credit Rating Agencies*, WALL ST. J., Aug. 31, 2007, at A9 (“Reputation and integrity are [S&P’s] most valuable long-term assets, which would make it imprudent for S&P to provide anything other than fair, objective and independent ratings opinions.”); Schwarz, supra note 65, at 13 (“there is little reason to believe that increased regulation will improve the reliability of ratings. Rating agencies have had a remarkable track record of success in their ratings, and recent rating experiences [until 2002] is even more reliable.”); SEC 2003 CRA Report, supra note 36, at 23, 41-42 (paraphrasing industry defenders); But see Fabien Dittrich, The Credit Rating Industry, Competition and Regulation (Jul. 13, 2007) (PhD dissertation at 7, available at http://ssrn.com/abstract=991821 (“Although reputation is widely accepted as the key aspect of credit rating economics, there has been little explicit research on it.”) (emphasis added)).

\(^{98}\) See, e.g., SEC 2003 CRA Report, supra note 36, at 32 (reporting such defenses).

\(^{99}\) In fact, many commentators believe that the incentive to maintain a positive reputation within the investor community is a particularly strong and effective disciplinary mechanism. See, e.g., Cantor & Packer, supra note 38, at 4 (“While the current payment structure may appear to encourage agencies to assign higher ratings to satisfy issuers, the agencies have an overriding incentive to maintain a reputation for high-quality, accurate ratings...” [emphasis added]). See also Schwarz, supra note 97; Dittrich, supra note 97, at 120 (“[T]he reputation mechanism is very robust. A reputable agency will never deviate from the high-quality strategy; outright milking is not an option”, but then noting that if the reputation mechanism were to function improperly and deviations from high quality occurred, an agency would not necessarily be fully punished by the marketplace); Jonathan Macey, *Review: Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation*, F.I.A.S.C.O.: Blood in the Water on Wall Street. Frank Partnoy, 65 U. Chi. L. Rev. 1487, 1500 (1998)
may also have served to entice the investment public into relying more on ratings than they may have otherwise. Proponents of the reputation argument seem to claim that outside observers should never doubt, challenge or regulate ratings agencies. But the reputation argument has some serious flaws.

Reputation is merely a measurement of the perceptions of others and is only indirectly a function of one’s behavior or character, and a concern for one’s reputation, therefore, is only a limited check on one’s behavior. And it may be further limited if competing interests are particularly compelling. Reputational protection might be a motivation but it does not follow that this is a rating agency’s sole motivation or that no other motives (like profit-seeking) will ever compete with reputational protection. If the reputational argument is not as comprehensive as its proponents claim – if, in other words, credit rating agencies are driven by motives that compete with reputational protections – then the potential hazard of allowing it to stand unchallenged is that investors may wrongly believe that reputational protection is a sufficient self-regulatory mechanism to ensure reliable ratings. This would create a false confidence in the integrity of the rating agencies.

i. Marginal Cost, Marginal Benefit Analysis

The reputational argument assumes that being captured by issuers and/or issuing inaccurate ratings will both be readily apparent to the marketplace and result in an appropriate amount of reputational damage. The argument seems to propose, too, that there is nothing to gain by issuing inaccurate ratings. What is actually required is an incremental cost-benefit analysis; any observer should ask just how much incremental benefit a credit agency would receive if it were to progressively succumb to this bias relative to the incremental reputational and revenue costs. It is only when the incremental cost outweigh the incremental benefits that the costs of reputational harm modify behavior.

Reputational capital, once earned, can be abused, taken advantage of, and spent in a quest for short-term profits. Economist Carl Shapiro writes:

The [price] premiums that reputable firms earn also serve a crucial role in inducing such sellers to maintain their reputations. Without premiums for high quality items, sellers would find that a fly-by-night strategy of quality reduction would be profit maximizing. The reason is that, in markets with reputations, sellers can always increase profits in the short-run by reducing the quality of their products. After all, quality reductions will yield immediate cost savings, while the adverse effect on reputation will arise only in the longer run. Since positive profits can be earned via the fly-by-night strategy, it would always dominate unless positive profits could also be earned via the faithful strategy of quality maintenance.

A firm engaging in a “fly-by-night” strategy may increase short-term profits by cutting costs, as described by Shapiro, or by expanding the size of its market. As shall be more clearly seen, the major credit rating agencies appear to have engaged in a fly-by-night strategy by issuing overly high ratings for certain securities and consequently expanding the market.
ii. Lack of Market Sensitivity

Additionally, it is not evident that the market is or has been particularly sensitive to any rating agency capture by issuers or to the rating agencies failure to issue accurate ratings. Again, an observer should ask just how inferior a credit rating agency’s performance would have to be before the market reacts in any kind of punishing way. Given the difficulty of assessing whether or not a particular credit rating agency is truly biased or not, the sensitivity of the market may be extremely low. Indeed, through shrewd management, marketing and tacit or explicit cooperation with issuers and other industry players, it may be possible to take advantage of certain cognitive biases and common heuristics and reduce the market’s sensitivity to any failures on the part of the rating agencies. Indeed, it is difficult enough to determine what an “accurate” rating would be, given as it is a prediction of the uncertain future, so there is immediately reason to doubt that investors would be particularly sensitive to any but the grossest inaccuracies.

iii. Certain Conflict of Interest Management Mechanisms

Defenders of the credit rating industry also assert that certain organizational structures and industry realities exist to ensure that the rating agencies would not be captured by issuers. There are reasons to doubt the effectiveness of each. For example, defenders note that rating agencies typically have policies in place which are designed to make analysts’ compensation based on the demonstrated accuracy of their ratings, independent of both the size of the issue being analyzed and any in appropriate interference (from issuers or otherwise) which might make their analysis less than objective. However, a recent SEC report concluded that analysts’ salaries at the three largest NRSROs were generally based on seniority and experience but that bonuses were based on individual performance and the overall success of the firm. A credit rating agency is more successful and more profitable the more business it solicits. All things being equal, the more successful a business, the higher salaries it can pay and the greater the job security its employees have. Therefore, part of the compensation of their analysts has not been, in fact, a direct function of their ability to perform analysis with integrity or the accuracy of the ratings. Furthermore, analysts may own shares of their employer and, in some cases, are awarded stock options as part of the formal compensation package. Again, such compensation, based on the market price of the company’s shares, and thus fundamentally on the future profitability of the agency, conflicts with any claim that analysts’ compensation is free of the biases inherent in the issuer-pays model.

Defenders also note that the fact that no single issuer accounts for a great percentage of an agency’s overall revenues makes any tendency to be captured by any issuer unlikely. S&P has stated that no single issuer or issuer group accounts for more than 2% of its total annual rating revenue. One can quarrel with how small or influential a customer who represents 2% of one’s total revenue actually is, for earning over a 200% increase in RMBS revenue and over a 600% increase in CDO revenue over the same period, and a third reported respective increases of approximately 100% and 180%). The baseline revenues, i.e. the revenues for 2002 were not given. Although S&P, Moody’s and Fitch were the subject of the examination, the report does not ascribe any observation to them specifically and only refers to them as “Firm 1,” “Firm 2,” and “Firm 2.” Id.

103 See infra Part V.B.ii.c (discussing cognitive biases and heuristic devices).
104 See, e.g., SEC 2003 CRA Report, supra note 36, at 23; SEC, supra note 1, at 27. See also Tillman, supra note 97.
105 SEC, supra note 1, at 27.
106 See Lucchetti, supra note 70.
107 The profits and the profit margins and, in the case of the publically traded Moody’s, the appreciation in share price each grew greatly during the early and mid 2000s. Moody’s annual revenues and profits grew by over 20% for each of the five years prior to the recent downturn. Operating margins increased by approximately 50% per year over the same time period. Analysts surmise that margins are similar at S&P and Fitch. The Moody’s Blues, supra note 71. Profits at Moody’s rose 375% in six years. The head of Moody’s structured finance business earned $3.8 million in 2006. Lucchetti, supra note 70. Risk analysts would have been familiar with this growth and would have not only benefited from it but may have, out of economic self-interest, been doing what they could to drive its continued growth. It would have been impossible to fully insulate them from the business aspects of their analysis and eliminate their own conflicts of interest.

109 Id.
an additional 2% of revenue is quite significant, as is losing 2% of revenue. If all issuers were treated with particular diligence or probed too deeply or received opinions which are harsher than they can receive at competitor rating agencies, issuers may take their business to those other agencies, and there need not be too many “small” customer defections before agency revenues are seriously impaired. The issuer-pays conflict of interest can been seen, therefore, as a systemic problem, not merely one which operates on the basis of individual issuer-customers.

Defenders also assert that appropriate and effective organizational firewalls are in place to prevent credit rating analysts, rating committee members, or any other person involved in risk analysis from interacting with issuers in the solicitation of new business and fee negotiations.\(^{110}\) The Credit Rating Agency Reform Act does not currently require that NRSROs maintain such organizational firewalls, but the SEC is currently proposing an additional rule which would expressly require firewalls.\(^{111}\) The mere existence of firewalls should raise doubts about their effectiveness,\(^ {112}\) and the mere need for firewalls should raises doubts about the reliability of any rating.

Additionally, credit rating agencies publically disclose of some of their ratings methodologies and procedures in an effort to counter concerns about the dangers of insufficient diligence and a propensity to issue inaccurate ratings. Disclosure, it was argued, would allow third parties, including investors and other credit rating agencies, to evaluate a firm’s methods and procedures and come to market-wide conclusions about the credibility and accuracy of a rating agency’s ratings. The greater the transparency, the greater is the likelihood that third parties will discover, publish and challenge any errors. However, as will be discussed, there are limits as to how transparent credit agencies can or will be, and there are limits as to how vigilant third parties can or will be.

C. Empirical and Anecdotal Evidence of the Failure of the Reputational Defense

In additional to the theoretical objections just presented, there are empirical and anecdotal reasons to doubt the strength of the reputational argument; there is evidence that rating agencies have succumbed to the pitfalls and biases of the issuer-pays conflict of interest in the past and have issued persistently suspect, if not inaccurate, ratings. Some of this evidence has resulted from quantitative empirical analysis while other evidence has been discovered as part of investigations into the role credit rating agencies played in Enron’s collapse and the current subprime mortgage turmoil.

i. Quantitative Evidence of Capture

In 1994, Richard Cantor and Frank Packer provided empirical evidence calling into question the strength of the reputation defense.\(^ {113}\) Cantor and Packer demonstrated that between 1970 and 1990, the period of time immediately after rating agencies first adopted the issuer-pays model, “the credit rating agencies have been less reliable to absolute credit risks: default probabilities associated with specific letter ratings have drifted over time.”\(^ {114}\) With regard to rating drift, for example, Cantor and Packer show that Moody’s BBB rated bonds defaulted approximately 1% of the time in the early 1970’s but by the end of the 1980’s, BBB rated bonds were defaulting at rates per year of 3% to 4.5%. Moody’s grade B bonds defaulted at a rate of 10-15% per year in the early 1970’s but defaulting at rates of nearly 35% a year by 1989. Similar

\(^{110}\) See, e.g. Id. at 41-2; see also Tillman, supra note 97.

\(^{111}\) SEC Proposed Rules, supra note 96, at 61-4.

\(^{112}\) See, e.g., Partnoy, supra note 84, at 333 (noting that Wall Street investment bankers had defended themselves for years by touting the effectiveness of their “Chinese Walls” between business units which were subject to a conflict of interest, when “[i]n reality, ‘Chinese Walls’ were about eighteen inches high; bankers often compared them to the miniature Stonehenge in the movie, This is Spinal Tap.”).

\(^{113}\) Cantor & Packer, supra note 38. Curiously, as noted above, Cantor and Packer have referred to reputational concerns as providing “an overriding incentive to maintain a reputation for high-quality, accurate ratings.” Id. at 4. An interpretation of their view is presented in this Part III.C.i.

\(^{114}\) Cantor & Packer, supra note 38, at 9. The authors also note that, unsurprisingly, rating agencies do a reasonable job of assessing relative credit risk: lower rated bonds do, in fact, tend to default more frequently than higher rated bonds. Id. at 9-11.
increasing default risk drift has occurred with Moody’s AA, A and B ratings. Relatedly, Cantor and Packer have also shown that in regard to S&P’s rating between the early 1980’s and the early 1990’s, certain indicators of credit risk have drifted too.\textsuperscript{115} For example, the ratio of issuers’ average annual revenues to their average fixed charges (which includes payment obligations due under debt securities) decreased for many ratings. For example, BBB rated firms had on average a ratio of approximately 2.3 in 1982, but by 1992 this ratio had decreased to approximately 1.8. In the same time period this ratio for firms which issued BB rated securities decreased from approximately 2.1 to 1.2. Also, issuers’ debt to asset ratio drifted up, another indication of increasing credit risk. For example, firms who were able to earn a BBB rating in 1992 had on average a debt-to-asset ratio of nearly 50%. By 1992 this figure was 60%. Similar trends existed for other rating categories. Cantor and Packer conclude that “[t]hese data suggest that a relaxation of credit standards may have occurred.”\textsuperscript{116}

Cantor and Packer provide another set of data which appears to be an indictment against the credit rating agencies and their reputational defense. Cantor and Packer examined the 671 bonds which were issued between 1989 and 1993 and which were rated by both Moody’s and S&P and rated below investment grade by at least one of them. Issuers of these bonds were relatively likely to seek a rating from a third rating agency if either (i) the ratings given by Moody’s and S&P were both near (but below) investment grade or (ii) one of the agencies gave an investment grade rating and the other agency did not, i.e., ratings were “mixed.” In fact, forty-six percent of the time when an issuer found itself in the position of having a mixed rating, it sought a third opinion. This, perhaps, is not surprising given the fact that “investment grade” is one of the primary benchmarks in rating-dependent regulations, and without an investment grade rating the available market of investors shrinks significantly for an issuer. What is notable, however, is that of the thirty-four issuers who had a mixed rating and sought a third opinion, twenty-nine – nearly ninety percent – obtained an investment grade rating for the third opinion. Among the issuers which received ratings just slightly below investment-grade from both Moody’s and S&P, approximately a fourth of them sought a third opinion, and of those almost half received an investment grade rating for the third opinion.\textsuperscript{117} It is difficult to know exactly what accounts for such a success rate of those which sought a third opinion. It would seem fair to assume that those issuers with the strongest cases to make would be most likely to seek third opinions, but this self-selection bias may not account for all of the success the third opinion seekers experienced. It is fair to question whether or not the agencies offering third opinion were attracting business by providing liberal and generous analysis and in effect selling investment grade ratings to customers they wished to satisfy.

\textit{ii. Anecdotal Evidence of Capture}

In addition to the theoretical objections and empirical analysis provided above, there is anecdotal evidence belying the strength of the reputational argument. The current subprime mortgage crisis in particular has yielded very strong anecdotal evidence that the major rating agencies, in order to grow their business and increase their revenues, catered to the desires of their issuer-customers at the expense of ratings accuracy.

The Wall Street Journal published a front page article in April 2008 exposing some of the imprudent behavior at Moody’s from the early 2000s until the collapse of subprime mortgage securities in 2007.\textsuperscript{118}

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\item[115] Id. at 12-3. (highlighting the risk of using ratings-dependent regulations, noting that if the risks associate with ratings change over time, the degree of solvency protection anticipated by such regulations will also change over time).
\item[116] Id. at 12. The authors note that the time frame examined controlled for the effects of procyclicality (or the long-term business cycle) but suggest that this drift may be the result of the fact that over the course of the 1970 and 1980’s corporations in general increase their financial leverage. Such a fact, however, though it may contribute to increased credit risk generally, should not translate into changing meanings of the ratings. If corporations are increasingly leveraged on average, there should simply be fewer securities (or a smaller percentage of securities) which receive the higher ratings.
\item[117] Id. at 156.
\item[118] Lucchetti, supra note 70.
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Moody’s analysts were expressly pushed to engage potential client-issuers in order “to find ways to get deals done within their methodologies.” Some analysts who had been recommending lower ratings were fired or reassigned and replaced with analysts who would give higher ratings, and occasionally Moody’s would switch analysts after issuers complained about them. In the same article, a former Moody’s executive is quoted as saying that “the ratings process became a negotiation.”

In July 2008, the U.S. Securities and Exchange Commission released a report entitled “Summary Report of Issues Identified in the Commission Staff’s Examination of Select Credit Rating Agencies” (“SEC Summary Report”) in which members of the SEC’s staff reported the results of their examination of three credit rating agencies, S&P, Moody’s, and Fitch. This examination was conducted “to review their role in the current turmoil in the subprime mortgage-related securities markets.” By rating both subprime residential MBSs and CDOs linked to those MBSs, these three rating agencies had been heavily involved in the creation of a market for such RMBS and CDOs, and accusations that they had been rating MBSs and CDOs too highly in order to satisfy the explicit and implicit demands of issuers had regularly appeared in the financial press over the course of the previous year. Some of the SEC’s staff’s findings lend support to the proposition, that despite the alleged self-regulatory influence of reputational concerns, the credit rating agencies were captured by MBS issuers and bent to the pressures inherent in the issuer-pays business model.

The SEC Summary Report initially notes that from 2002 to 2006 both the volume of RMBS and CDO deals rated by the rating agencies and their revenues from this business greatly increased.

The SEC Summary Report notes that each of the three rating agencies had policies which emphasize the importance of providing accurate ratings with integrity, and, yet, though each had policies which restricted analysts from participating in fee discussions with issuers, at two of the agencies the policies allowed the analysts’ managers to interact with the issuers and to participate in fee discussions. Despite the policies, analysts “appeared to be aware, when rating an issuer, of the ratings agency’s business interest in securing the rating of the deal.” The effectiveness of firewalls which prevent actual analyst-issuer negotiations is questionable if analysts know the business ramifications of their analysis. More generally, an incentive to bend or even break managerial mechanisms, whether they are internal policies or governmental regulations, is created by the issuer-pays conflict of interest, and this is a persistent source of tension.

Many internal agency documents – often emails – are transcribed in the SEC’s 2008 Report, and many are worth re-transcribing here in order to shed light on how this conflict of interest occasionally played out.

• A senior analytical manager in a structured finance group wrote, “I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision [on assigning separate ratings to principal and interest] and if so, how much?...
Essentially, [names of staff] ended up agreeing with your recommendation but the CDO team didn’t agree with you because they believed it would negatively impact business.”

- A business manager at one agency wrote, “We are meeting with your group this week to discuss adjusting criteria for rating CDO’s of real estate assets this week because of the ongoing threat of losing deals.”

- Another business manager wrote, “I had a discussion with the team leaders here and we think that the only way to compete [against another rating agency] is to have a paradigm shift in thinking, especially with the interest rate risk.”

- A senior analytical manager wrote an email stating that ratings methodology would have to change in order to recapture market share.

- At one firm, an internal memorandums were circulated to analytical staff which indicated that market share might decrease if changes were made to its ratings methodologies, a clear breach of their firewall.

- Perhaps most damning (and prophetic) of all is the following December 2006 email quote from an analytical manager in a firm’s CDO group to a senior analytical manager within the same group: The analytical manager writes that the rating agencies continue to create “an even bigger monster – the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.;o).”

The Report concludes that “[r]ating agencies do not appear to take steps to prevent considerations of market share and other business interests from the possibility that they could influence ratings or ratings criteria.” The Report continues, “[w]hile there is no evidence that decisions about rating methodology or models were made based on attracting or losing market share, in most of these instances, it appears that rating agency employees who were responsible for obtaining ratings business would notify other employees, including those responsible for criteria development, about business concerns they had related to the criteria.”

**ii. Evidence of Error (Independent of Capture)**

There is also evidence supporting the claim that, despite the defenders reputational arguments, even the dominant rating agencies do not always engage in high levels of due diligence; do not always ensure they have adequate financial, analytical and managerial resources; do not always use sound risk models; do not always accurately disclose their methods and procedures so that they can be checked; and, in short, do not always take the steps necessary to ensure that they issue credible and accurate ratings (even independent of capture by issuers).

**a. Lack of Diligence**

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129 Id. at 26.
130 Id.
131 Id.
132 Id.
133 Id. at 25.
134 Supra note 1.
135 Id. at 25.
136 Id.
Enron provides an example of a lack of due diligence and of some of the possible consequences of the failure to audit the information provided to them by issuers. The major credit rating agencies had been opining that Enron was a very creditworthy borrower until just four days before it filed for bankruptcy. Enron executives may have provided misleading information and failed to disclose relevant information to the rating agencies, but it is widely believed that in years immediately before Enron’s collapse, the rating agencies failed to invest adequate time and energy into evaluating its creditworthiness.

An SEC report summarizing the conclusions of a 2002 Congressional Staff Report stated:

the credit rating agency analysts seemed to have been less than thorough in their review of Enron’s public filings..... Among other things, the rating analysts appeared to pay insufficient attention to the detail in Enron’s financial statements, failed to probe opaque disclosures, did not review Enron’s proxy statements, and failed to take into account the overall aggressiveness of Enron’s accounting practices. In essence, the Staff Report found that the rating agencies failed to use the necessary rigor to ensure their analysis of a complex company, such as Enron, was sound.

[In the case of Enron, the credit rating agencies failed to use their legally-sanctioned power and access [to Enron’s non-public information] to the public’s benefit, instead displaying a lack of diligence in their coverage and assessment of Enron. The Staff Report found that the credit rating agencies did not ask sufficiently probing questions in formulating their ratings, and in many cases merely accepted at face value what they were told by Enron officials. Further, the rating agencies apparently ignored or glossed over warning signs, and despite their mission to make long-term credit assessments, failed to sufficiently consider factors affecting the long-term health of Enron, particularly accounting irregularities and overly complex financial structures.

[However,] because credit rating agencies are subject to little, if any, formal regulation or oversight, and their liability traditionally has been limited both by regulatory exemptions and First Amendment protections afforded to them by the courts, little exists to hold them accountable for future poor performance.

The current subprime turmoil provides the even more striking examples of a lack of due diligence and rating inaccuracies. The SEC’s 2008 Report states that ratings were issued despite unresolved analysis issues, financial risk models did not appear to do a good job capturing risk, and staffing in at least one agency was inadequate, and that analysts at two of the three rating agencies examined “struggled to adapt to the increase in the volume and complexity of the deals.”

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138 See, e.g., PARTNOY, supra note 84, at 347, 385.
139 SEC 2003 CRA Report, supra note 36, at 32. (summarizing a report by the staff of the Senate Committee on Governmental Affairs entitled “Financial Oversight of Enron: The SEC and Private-Sector Watchdogs” issued in October 2002).
140 Id. at 17-8.
141 Id. See also PARTNOY, supra note 84, at 296-349, 385(describing Enron’s collapse and the role of the credit rating agencies).
142 SEC, supra note 1, at 12, 21-2 (noting that when monitoring the accuracy of its rating on an ongoing basis after the initial issuance, resources were particularly inadequate, and noting that if rating methodology changed, the agencies would rarely return to previously issued securities and update the ratings based on the updated methodology.)
143 Id. at 12.
Again, the SEC uncovered many internal documents which shed light on the culture and attitude of the credit rating agencies. Here is a sampling:

- One analyst expressed concern that her firm’s model did not capture “half the deal’s risk, but that it could be structured by cows and we would rate it.”

- Another describes an outstanding issue as “poorly addressed – needs to be checked in the next deal” and responds to a question regarding the weighted average recovery rate of a deal by writing “(WARR – don’t ask☺).”

Interestingly, in at least one instance, reputational concerns actually lead to persistent rating errors. At one rating agency, the SEC discovered that a surveillance committee knew that there was an error in a ratings model which was used to rate almost a dozen securities and that as a result of the error, the ratings were higher than they should have been. The committee, however, decided not to downgrade the securities since it feared that acknowledging and reversing the error would result in reputational harm. The committee members were all analysts or analytical managers, people behind the firewall who should have been concerned with only those reputational harms associated with inaccurate ratings.

The obvious question here is whether Enron and the subprime episode are merely isolated incidents of credit rating agency analytical error and lack of due diligence or whether this behavior is more widespread – or even typical – and is it only because Enron collapsed so dramatically and the economy is in such turmoil that a predilection to laxity has been exposed to public view. Given the fact that each of the major rating agencies seemed to have behaved similarly during the subprime episode and given similar evidence from WorldCom and Global Crossing, widespread laxity seems plausible.

b. Poor Modeling

There are reasons to believe, and many claim, that the credit rating agencies often use poor risk assessment models. Professor Partnoy notes that the credit rating agencies have adopted risk assessment models which the Presidents Working Group on the Financial Markets concluded were seriously flawed. He also notes that computer models used to assess CDOs were merely complex ways of justifying higher ratings, that the risk models were created by issuers and that some rating employees did not fully understand them, and that analysts privately admitted that they could “tweak the model” to make a CDO deal appear less risky.

In regards to the current subprime turmoil, the SEC’s 2008 Report stated that financial risk models did not appear to do a good job of capturing risk.
Despite a lack of documentation, the SEC’s Office of Economic Analysis reviewed what they could of the processes and models used by these agencies to rate RMBS and CDO’s which held subprime RMBS securities. The OEA reported that when making assumptions about the future performance of the RMBS’s underlying mortgages, the rating agencies relied upon historical data even though “the performance history of the types of subprime mortgages that dominated many of the RMBS portfolios... has been very short[, and...] the performance history that did exist occurred in very benign economic conditions.”

Furthermore, they note, “the parameters of the models were re-estimated by executing the model with new data very infrequently.”

The Financial Stability Forum, in a report issued in April 2006, simply states that credit rating agencies “assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models.” In short, the risk model’s assumptions were not wholly justifiable.

c. Poor and Inaccurate Disclosure

The public disclosure of ratings methodology and procedures theoretically ferrets out ratings which might be inaccurate and consequently assuage concerns that the rating agencies might chronically issue inaccurate ratings. The SEC noted, however, that significant aspects of the ratings process and the methodologies used to rate RMBSs and CDOs were not always disclosed. Some of the failures to disclose were blatant, including disclosing that they conducted certain analysis when they had made it a practice not to do such analysis and failing to disclose that they at least occasionally overrode the results of their published financial model to make the ratings process more liberal to issuers.

Some of the disclosure failures reflected what may be the difficult reality of disclosing what must be to a certain extent is a subjective process over a complex set of financial issues. The following email from a senior analytical officer in a structured finance surveillance group is particularly illuminating:

[O]ur published criteria as it currently stands is a bit too unwieldy and all over the map in terms of being current or comprehensive. It might be too much of a stretch to say that we’re complying with it because our [structured finance] rating approach is inherently

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156 Id. at 35. (noting that such benign conditions included “consistent economic growth, interest rates at historic lows, very low volatility in interest rates and a period where housing prices increased consistently year over year.”)

157 Id.

158 The Financial Stability Forum is a consortium of senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank first convened at the initiative of G7 finance ministers to promote international financial stability. See www.fsforum.org.

159 FINANCIAL STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE, 32 (2008), available at http://www.fsforum.org/publications/r_0804.pdf. See also IOSCO Subprime Report, supra note 10, at 24-6. (noting that the rating agencies’ ratings methodologies for structured finance securities have “limitations”).

160 SEC supra note 1, at 13-14. The report notes, with a hint of an accusatorial tone, that as part of their NRSRO applications, each of these agencies stated that they do disclose their ratings process. Id.

161 For example, the SEC Report notes that at one agency they had modeling criteria on rating “hybrid” deals, yet did not disclose them publically. Id. In another example, the agency told the staff during the examination that it did make certain analytical adjustments when using the model, yet the SEC staff “discovered instances” where the agency did indeed make such adjustments. Id. at 14.

162 In one example, a rating agency was publically disclosing that it conducted an extensive review of loan origination operations and practices, but the RMBS group was, in fact, long longer conducting formal reviews of origination operations and practices. This would seem particularly misleading since much of the risk associated with subprime RMBS’s were a function of risks acquired during the origination processes, during which originators would often make loans to people who could afford them. Such practices, often abusive or egregious are now widely reported in the popular press. See, e.g., supra note 30.

163 SEC, supra note 1 at 14. The report states that “[o]ne rating agency regularly reduced loss expectations on subprime second lien mortgages from the loss expectation output by its RMBS model, in some cases reducing the expected loss.” [emphasis added] and that though it might have disclosed such reduction to a representative of the issuer, its client, who desired the best rating possible, it did not make such disclosure available to the investing public. Id.
flexible and subjective, while much of our written criteria is detailed and prescriptive. Doing a complete inventory of our criteria and documenting all of the areas where it is out of date or inaccurate would appear to be a huge job – that would require far more man-hours than writing the principles-based articles.\textsuperscript{164}

The SEC noted that the policies and procedures for rating structured finance securities such as RMBSs and CDOs are not satisfactorily documented and that such lack of documentation made it difficult for the SEC staff to determine if the processes actually used were consistent with more general policies of the agencies and noted that this lack of documentation could “impede the effectiveness of internal and external auditor conducted reviews of rating agency activities.”\textsuperscript{165}

d. Issuer-Pays Conflict Exacerbates Laxity

The subprime episode seems to paint a picture in which the rating agencies, captured by the issuers, were more than willing to accept that they lacked the resources to perform credible and accurate analysis. More relevantly, and generally, any inclination to conduct lax diligence, to operate with insufficient resources, to be prone to error and to accept errors, to make relatively opaque disclosures (under the guise of transparency) is exacerbated by the issuer-pays conflict of interest. The desire to generate revenues and explicit or implicit pressure from issuers increases rating inaccuracies.

This dynamic is heightened in a situation where there is a concentration of issuers. Because of the concentration of MBS and MBS-related CDOs issuers, any one could exercise considerable influence over the rating agencies; they could deliver - or withhold – a significant amount of business.\textsuperscript{166}

The result was that short-term competitive pressures and profitability outweighed the need for reputational protection, and the threat of reputational harm did not deter these rating agencies from engaging in a fly-by-night, race-to-the-bottom strategy regarding of MBS credit enhancements. CRAs took full advantage of their reputational standing to engage in activities to derive short-term profits. Now, their reputations have been seriously damaged,\textsuperscript{167} regulations have been imposed\textsuperscript{168} and further regulations are under consideration. However, it must be noted that extensive reputational damage came only after several years of poor behavior and only as a result of a major economic downturn which prompted many investors, journalists and policy makers to examine the conduct of the rating agencies and to expose their poor behavior. In the short to medium term, until an agency’s reputation has been re-acquired, the reputational reasons to maintain integrity and provide accurate and credible ratings may be strong.\textsuperscript{169} However, regardless of the current level the self-regulatory reputational mechanism, as reputational capital is re-acquired and memories of the misconduct fade, the risk increases that the credit rating agencies will risk such reputational capital for additional short-term profit.

IV. CREDIT RATING AGENCY REFORM ACT OF 2006

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  \item \textsuperscript{164} SEC, \textit{supra} note 1, at 13. (quoting an internal agency email) (emphasis added).
  \item \textsuperscript{165} SEC, \textit{supra} note 1, at 16-17. The SEC Report also indicates that these rating agencies lacked sufficient analytical resources and were understaffed and overworked. Id. at 12-17.
  \item \textsuperscript{166} SEC, \textit{supra} note 1, at 32. (reporting the finding of the SEC’s Office of Economic Analysis which noted that the concentration of arrangers with the influence to determine which rating agency to hire “heightened the inherent conflicts of interest that exist in the “issuer-pays” compensation model.”). The OEA referred specifically to “arrangers” instead of issuers, arrangers being the sponsors of the various special purpose issuers. Id.
  \item \textsuperscript{167} See Lucchetti, \textit{supra} note 70.
  \item \textsuperscript{168} See infra Part IV.
  \item \textsuperscript{169} Though the same could have been true in the aftermath of the Enron debacle, but following the outing of the credit rating agencies then, they marched immediately into the subprime debacle.
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On September 29, 2006, Congress passed the Credit Rating Agency Reform Act (the “Act”), and it took effect on June 26, 2007. Prior to enactment of the Act, credit rating agencies in the U.S. were largely unregulated. The Act was enacted in the wake of the collapse of several large and well-rated companies such as Enron and WorldCom and was designed to regulate the credit rating industry in order to prevent similar investment debacles in the future. This section will briefly describe the goals and content of the Act and will then critique it, emphasizing the problematic issue that it permits rating agencies to continue to use the issuer-pays model.

The Act establishes an express process by which a credit rating agency can be deemed to be a “nationally recognized statistical rating organization” (NRSRO) and hence is designed to reduce the barriers to entry into the industry and thus increase competition among rating agencies. With increased competition, it is argued, the performance of the industry will improve, and the ratings attributed to securities and their issuers will be more accurate and credible.

The NRSRO application request must contain information regarding the applicant’s performance measurement statistics, its procedures and methodologies for determining credit ratings, and its conflicts of interest and its policies for managing these conflicts of interest, but there are no substantive requirements that the performance measurement statistics or its procedures nor its methodologies be of a certain quality. In addition, the Act does not prohibit or necessarily dissuade the issuer-pays conflict of interest. However, the application must include written certifications from at least ten institutional investors stating that such investors have used the applicant’s credit ratings for the three preceding years. This written certification requirement would appear to be a proxy for a qualitative review of the performance, procedures, methodologies and management of the conflict of interest of the applicant agency.

Provided the applicant submits the listed documentation, the SEC is obligated to register the applicant as an NRSRO, unless the SEC determines that (i) the applicant does not have “adequate financial and managerial resources to consistently produce credit ratings with integrity” and to “materially comply” with the procedures and methodologies described in their application package and with certain other requirements prescribed by the Act regarding the misuse of nonpublic information, the management of conflicts of interest, the designation of a compliance officer and the prohibition of certain conduct, (each of these requirements is discussed below) or (ii) the applicant has committed certain securities-related crimes or fraudulent acts. The process of registering a credit rating agency as an NRSRO is, then, not a form of regulation as much as it is mere recognition of status.

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170 SEC, supra note 1.
171 SEC, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 1, (June 2008) [hereinafter 2008 NRSRO Report].
172 See Ng, supra note 51. The preamble to the Act states that it is an act “to improve the quality for the protection of investor and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry.” In Section 2 of the Act, Congress notes that the agencies are “of national importance.”
174 See, e.g. Hill, supra note 38, at 85 (“My proposal is gradually to increase the number of NRSRO’s and revisit the issue of eliminating the NRSRO designation in five years, or [when] new firms... establish their reputations.”); but see Partnoy, Like No Other Gatekeeper, supra note 38, at 91 (“[O]pening the market to new NRSROs seems a weak and perhaps counterproductive choice, even if it would be superior to the current approach.”).
Additionally, much of the materials delivered by the agency as a part of its application package are to be made publically available upon its registration as an NRSRO. This publically available material must be kept up to date. This requirement permits market participants to independently evaluate the application materials and determine the degree to which they will rely on this agency’s ratings. An NRSRO is required to update the information contained in its application materials at least once a year and, with certain exceptions, any time the material in its application becomes materially inaccurate.

Immediately prior to the effective date of the Act, there were only a few NRSROs recognized by the SEC as of August 18, 2008, ten had been registered. The SEC is charged with ensuring that when an NRSRO rates securities it uses only those procedures and methodologies that are described either in its application (or its updated application) or in other documentation required by the SEC to be kept and possibly publically disclosed. However, both the SEC and the states are expressly forbidden under the Act from regulating “the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings.” Relatively, the Act also expressly forbids any NRSRO from implying that its registration as an NRSRO conveys upon it any sponsorship, recommendation or approval by the federal government.

The Act and SEC rules promulgated under the Act also require that each NRSRO establish, maintain and enforce policies in order to prevent the misuse of material nonpublic information provided to it by issuers. SEC rules promulgated under the Act also prohibit NRSROs from earning more than 10% of their annual revenues from a single issuer and from rating the securities of issuers who are affiliated with the NRSRO or with a personal associated with the NRSRO. SEC rules also prohibit the NRSRO from issuing or maintaining a rating on an issuer if certain conflicts of interest exist including if (i) the NRSRO owns any securities or has any other direct ownership of the issuer or (ii) a credit analyst that participated in determining the rating or any person responsible for approving a rating directly owns securities of or has any other direct ownership interest in an issuer which is subject to the rating.

SEC rules also prohibit an NRSRO from having the following conflicts of interest unless the NRSRO has publically disclosed the conflict and enforces “written policies and procedures to address and manage” the conflicts: conflicts of interest relating to, among others, (i) any compensation the NRSRO receives

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183 Id.
185 See Ng, supra note 51 (listing S&P, Moody’s, Fitch, Dominion Bond Ratings Service and A.M. Best Co).
189 15 U.S.C. § 78o-7(c)(2). Curiously, the SEC has the authority to suspend the registration of an NRSRO if it fails to “maintain adequate financial and managerial resources to consistently produce credit ratings with integrity,” 15 U.S.C. § 78o-7(d)(3), but without being able to opinie as to the substance of the ratings or the substance of the procedures and methodologies, the SEC may not be able to judge whether or not a rating has integrity or to justify any decision that a rating does not have integrity.
190 15 U.S.C. § 78o-7(0)(1).
191 15 U.S.C. § 78o-7(g); 17 C.F.R. 240.17g-4. Such policies must be reasonably designed to prevent the inappropriate dissemination of nonpublic information, trading on or otherwise benefiting from that information and early dissemination of a pending credit rating action. Id.
193 17 C.F.R. 240.17g-5(c)(1).
194 17 C.F.R. 240.17g-5(c)(2). “Direct” ownership interests do not include indirect ownerships such as through mutual funds or blind trusts.
195 17 C.F.R. 240.17g-5(a).
from issuers,\textsuperscript{196} e.g., those conflicts of interest included in the issuer-pays conflict; (ii) any ancillary services provided to issuers,\textsuperscript{197} (iii) any business, ownership, financial or personal relationships between persons within an NRSRO and any issuer,\textsuperscript{198} and (iv) any affiliation of the NRSRO with any underwriters of any securities that are the subject of a credit rating.\textsuperscript{199}

In June 2008, in order to address some of the abuses discovered during examinations of Moody’s, S&P and Fitch\textsuperscript{200} and to increase NRSRO transparency, the SEC proposed a number of additional rules with respect to NRSRO’s. Among the proposed rules is one which would prohibit NRSRO’s from issuing a rating on a structured security (including MBSs and CDOS) without disclosing information about the underlying assets.\textsuperscript{201} This serves two purposes. Other rating agencies would have an opportunity to issue unsolicited ratings on the security and expose any of the hired agency’s inaccuracies, and investors would be able to better conduct their own risk analysis and discipline any agency who issues inaccurate ratings.\textsuperscript{202}

The SEC is also currently proposing rules which would require NRSROs to disclose any material deviation from a quantitative risk model’s output\textsuperscript{203} and to disclose all third party complaints about analysts.\textsuperscript{204} This latter proposal is designed to inhibit NRSROs from removing conservative or cautious analysts from projects after complaints by issuers.\textsuperscript{205}

Prior to the passage of the Act, there had been accusations that the largest rating agencies occasionally take advantage of their dominant position to engage in overly aggressive or anti-competitive practices.\textsuperscript{206} Among the accusations were that the dominant rating agencies would (i) refuse to rate an issuer’s security (accurately or at all) unless that issuer purchased ancillary services,\textsuperscript{207} (ii) threaten to lower a rating unless the issuer purchase ancillary services,\textsuperscript{208} and (iii) would refuse to rate an issuer’s security based on a pool of assets (accurately or at all) unless the rating agency was awarded the business of rating a substantial portion of the assets within such pool.\textsuperscript{209} SEC rules promulgated pursuant to the Rating Agency Reform

\textsuperscript{196} See 15 U.S.C. § 78o-7(b)(2)(A); 17 C.F.R. 240.17g-5(b)(1); 17 C.F.R. 240.17g(b)(2) and 17 C.F.R. 240.17g-5(b)(5). Rules 17g-5(b)(1) and 17g(b)(2) relate to payments by issuers and obligors, whereas Rule 17g-5(b)(5) relates to payments from subscribers and addresses situations where the subscriber hopes that a security attains a certain (high or low) rating which would thus benefit the subscriber. Additionally, the SEC is currently proposing an additional rule which would expressly require that NRSROs manage and disclose any conflicts of interest which arise as a result of repeatedly being paid by issuers and other sponsors of structured financial products. SEC PROPOSED RULES, supra note 96, at 2941.

\textsuperscript{197} 15 U.S.C. § 78o-7(h)(2)(b); 17 C.F.R. 240.17g(b)(6); 17 C.F.R. 240.17g(b)(7). The SEC is currently proposing an additional rule which would expressly prohibit an NRSRO from issuing a rating on a security if that NRSRO or any of its analysts has made recommendations to the issuer or other parties responsible for structuring the security about the corporate or legal structures, assets, liabilities or activities of the issuer. SEC PROPOSED RULES, supra note 96, at 58-61. The SEC is also currently proposing an additional rule which would expressly prohibit an NRSRO analyst or anyone else involved with approving a rating from accepting gifts from issuers. Id. at 64-67.

\textsuperscript{198} 15 U.S.C. § 78o-7(h)(2)(C).

\textsuperscript{199} 15 U.S.C. § 78o-7(h)(2)(D); 17 C.F.R. 240.17g-5(b)(8). The Act also grants the SEC authority to require that registered NRSROs make certain reports and keep certain records and authority to conduct examinations on NRSRO’s. It was pursuant to this authority that the SEC conducted its examination of Moody’s, S&P and Fitch and their contribution to the subprime crisis.

\textsuperscript{200} This examination was conducted in order to determine the role of the credit rating agencies in the economic turmoil surrounding the subprime crisis. SEC, supra note 1, at 1.

\textsuperscript{201} SEC PROPOSED RULES, supra note 96.

\textsuperscript{202} Id., at 27 (discussing the intention of the proposed rule).

\textsuperscript{203} SEC PROPOSED RULES, supra note 96, at 74-78.

\textsuperscript{204} Id. at 78.

\textsuperscript{205} Id. The SEC is also currently proposing an additional rule which would require NRSROs to make a detailed record of any rating actions (e.g. initial issuance, change in grade, placement on a watch list) and the information used to take such action and to make this information publically available within six months of such action. Id. at 67-74.

\textsuperscript{206} SEC 2003 CRA Report, supra note 36.

\textsuperscript{207} Id. at 23; Pinto, supra note 38, at 344.


\textsuperscript{209} The practice of refusing to rate a security based on a pool of assets unless the rating agency was awarded the business of rating the assets within the pool is referred to as “notching.” SEC 2003 CRA Report, supra note 36, at 24.
Act prohibit NRSROs from engaging in certain unfair, coercive and abusive acts including those described in this paragraph.\footnote{15 U.S.C. § 78o-7(i)(1); 17 C.F.R. 240.17g-6(a).}  

The Act has several other provisions, including the requirement that each NRSRO (i) designate a compliance officer responsible for administering the policies and procedures designed to manage nonpublic information and conflicts of interest and for ensuring compliance with all securities laws and regulations and (ii) regularly furnish financial statements to the SEC. The discussion above noted that credit rating agencies are largely not civilly liable for the inaccuracies of their ratings.\footnote{See supra note 94.} Nothing in the Credit Rating Agency Reform Act creates any private rights of action,\footnote{15 U.S.C. § 78o-7(m).} leaving NRSROs relatively insulated from litigation.

\section*{V. PROBLEMS WITH THE CURRENT REGULATORY ENVIRONMENT}

The Credit Rating Agency Reform Act did not become effective until June 2007. Most of the credit rating agency abuses – and investor reliance – associated with the above discussions occurred prior to this effective date. The Act and the SEC rules promulgated pursuant to the Act may contribute to the reduction of these abuses and the ability of investors to appropriately discount the opinions of the rating agencies. The success of this regulatory regime, however, depends on both a satisfactory level of disclosure and a satisfactory level of marketplace vigilance and rationality. It is not evident, however, that a satisfactory and effective level of disclosure is possible nor that satisfactory levels of marketplace vigilance and rationality exist. Additionally, the current regulations may lead to certain undesirable negative consequences.

\subsection*{A. Issue-Pays Conflict of Interest Persists}

The fundamental problem with this regulatory regime is that it permits the credit rating industry to continue to be founded on a revenue model in which issuers are the paying customers; the issuer-pays conflict of interest persists – disclosure of such conflicts notwithstanding. It is illuminating to point out that many of the recently reported abuses by credit rating agencies stem from this very issuer-pays conflict. And, indeed, given the limitations of the subscriber-pays model and the profitability of the issuer-pays model, the issuer-pays model and the resulting conflict of interest may necessarily dominate the industry. Despite the requirements to disclose the conflicts of interest associated with the issuer-pays model, if the benefits of falling prey to and engaging in the “fly-by-night” strategy – whether sporadically or on a pervasive, widespread scale – there are plenty of opportunities to conduct favored, sloppy or inadequate credit analysis. From a public service perspective, there is still cause for concern.

\subsection*{B. Limits to Disclosure}

The Credit Rating Agency Reform Act and SEC rules issued pursuant to the Act require that each NRSRO publically disclose (either through its website or otherwise) select materials contained in its most current NRSRO application.\footnote{15 U.S.C. § 78o-7(a)(1)(B).} These materials include, among other things, (i) its credit rating performance measurement statistics over short-term, medium term and long-term periods; (ii) the procedures and methodologies it uses to determine ratings; (iii) its organizational structure; (iv) whether or not it has a code of ethics, and if not, the reasons it does not; and (v) any conflicts of interest relating to the issuance of ratings.\footnote{See 15 U.S.C. § 78o-7(a)(1)(B).} Additionally, the SEC is currently proposing a rule prohibiting an NRSRO from
rating a structured security unless it also discloses all the information the NRSRO used to determine the rating. Making such information available would better enable other rating agencies, investors and other analysts to evaluate the rating agencies’ performance or conduct unsolicited ratings on the securities.

The rationale of the disclosure paradigm generally as a method for securities regulation is the faith that “sophisticated investors... will bring market prices in line with disclosures.” In the case of credit rating agencies, disclosure of methodologies, procedures, permitted conflicts of interests and policies to manage them appear to be designed to allow investors to appropriately figuratively “price” or discount the informational value of ratings, and consequently better price debt and debt-like securities, and, it is argued, to expose the NRSRO to greater scrutiny and inflict market discipline on them when appropriate.

However, there is a large literature critiquing the disclosure paradigm and criticizing its ability to bring market prices in line with fundamental values. Building on this literature, the following discussion of the limits to disclosure addresses (i) the obligation and the inevitability of the disclosing rating agencies to limit disclosure and (ii) the limits of the investment community to fully analyze disclosed material.

i. The Disclosing Rating Agency

There are limits to how transparent a NRSRO can be. In order to most fully conduct a detailed evaluation of the creditworthiness of an issuer, credit rating agencies must obtain information about the issuer and the security. Often some of this information is provided confidentially directly from the issuer to the credit rating agency and is not publicly available. It can be argued that their access to this nonpublic information and their synthesis of both public and nonpublic information into a generalized rating is the primary source of value to the investing world. However, credit rating agencies cannot make the nonpublic information public; it must remain confidential. The investment public never knows, therefore, what specific information the credit rating agency uses to determine its ratings.

Additionally, it is simply impossible to collect and disclose all details of an analysis, every explicit and implicit analytical assumption; every step of a model financial; and every assumption and bias of every analyst and every ratings committee member. To the extent that there is nonpublic information, proprietary methodologies and opacity internal to a rating agency, this difficulty and the inability to disclose completely transparently is compounded. This impossibility is true for all transactions; for more complex transactions – those very transactions for which investors may more rely on rating agency ratings – disclosure is even more limited.

Furthermore, the credit rating agencies evaluate information with the use of financial models, methodologies and procedures and more than a handful of assumptions about the securities, the issuers, the industry, the economy, etc. The ability to generate financial models and make sophisticated and appropriate assumptions is the skill marketed by the credit rating agencies and it is to be expected that they will keep the details of certain proprietary methodologies and procedures. Additionally, because of their conflicts of interest, rating agencies may opaquely disclose — or may obfuscate — their actual methods and

215 Id.
216 Id. at 29-32.
218 See, e.g., Schwarcz, Rethinking, supra note 217, at 1 (arguing that when a transaction is so complex so as to be “disclosure impaired” that supplemental measures which would buttress disclosure and provide “cost effective... protections that minimize [informational] asymmetry or mitigate its consequences” ought to be required, specifically, if there are any conflicts of interest in the transaction, that the transaction be prohibited.)
219 SEC Regulation FD permits credit rating agencies to receive nonpublic information from issuers without any obligation to disclose such information publicly. Supra note 43.
220 SEC’s 2003 CRA Report, supra note 36, at 33-4 (noting in that whenever there is a ratings change, there appears to be excess volatility in the market price of the issuer’s securities since the investor marketplace must make a guess as to whether or not, and to what extent, the change was a function of non-public information).
ii. Limits of Investor Sophistication and Vigilance

a. Coping with Complexity

The disclosure of complex transactions, structures and analytical methods “may well be either too detailed for most investors... to understand and assimilate, or too superficial to allow investors to fully assess the [structure or] transaction and its ramifications.” In regards to particularly complex products and transactions, such as the structure of MBSs, CDOs and other structured securities, not to mention the myriad of internal analysis dynamics and conflicts of interests and attempts (both sincere and otherwise) to manage such conflicts within a particular credit rating agency, disclosure is particularly problematic and may be particularly insufficient to remedy informational asymmetry.

Even otherwise sophisticated institutional investors struggle with understanding complex disclosures or satisfactorily reading between the lines of overly simplistic disclosures. Even professional securities analysts have limited ability to fully understand the modern complexities of companies they follow. Indeed, the anecdotal evidence presented earlier seems to indicate that even a credit rating agency, an organization staffed by many hundreds of professionally-trained risk analysts, struggled to understand the risks inherent in the more complex structured products. If these large agencies find themselves without the resources to properly conduct risk analysis, why is it reasonable to expect any but the most resource-rich and sophisticated investors will be capable of doing so? Investors may find it too difficult or too costly to determine what a rating would have been absent factors such as conflicts of interest; scarcity of financial, managerial or analytical resources; or an inability to access information.

Furthermore, however, if it is the case that only the most sophisticated and resource-rich institutional investors will be capable of successfully scrubbing rating agency disclosures (provided they are sufficiently detailed and evaluating their performance and conveying their findings to the marketplace, there is reason to doubt that they will actually do so. These are likely to be the same investors who do not rely on ratings

221 “Conflicts of interest can undermine the reliability of disclosure.” Schwarcz, Rethinking, supra note 217, at 11, 23. Loose disclosure requirements would exacerbate the ability of rating agencies to engage in such non-illuminating disclosure.

222 Id. at 5 (noting, additionally, for example, that Enron’s structured transactions were “so complex that disclosure either would have had to oversimplify the transactions or else provide detail and sophistication beyond the level of both ordinary and otherwise savvy institutional investors in Enron securities.”) Id. at 6.

223 See Id. at 6 (stating that in a world of complexity, disclosure can be insufficient to remedy the “informational asymmetry”). It is not the intent of this article to challenge this lack of transparency. Issuers have non-public information which must remain non-public, and credit rating agencies in order to ensure continued access to such information must be required to keep this information confidential. Furthermore, credit rating agencies must be able to keep some details of their proprietary financial analysis tools confidential. And one cannot require a level of transparency which is either impossible or too costly to achieve.

224 See, e.g., Id. at 8 (noting that even sophisticated institutional investors can lack the ability to understand derivative transactions”); PARTNOY, supra note 84, at 302-5, 331 (arguing that Enron often disclosed its off balance sheet transactions, even going as far as to note that they were not completely arms length transactions, but that the underlying reality of the transactions were so complex even the chair of the audit committee of Enron’s board of directors, Robert K. Jaedicke, an emeritus professor of accounting at Stanford Business School, “did not grasp” them).

225 PARTNOY, supra note 84, at 268 (noting that even for professional securities analysts, who may intensely follow fifteen public companies, it would take a full day to fully carefully analyze a mere annual report).

226 See supra Part III.C.iii.

227 Cognitive limitations and people’s tendency to engage in herding behavior when facing ambiguous choices may also hamper the ability of third parties to evaluate complex disclosures. See Schwarcz, Rethinking, supra note 217, at 15 (stating that “[c]omplexity heightens ambiguity, which in turn... allows people to see what they are already inclined to believe. Thus, the inclination to follow the crowd is not surprising. Moreover, even for market professionals, it would be difficult to change this behavior.”).

228 Schwarcz, supra note 65 at 11 (expressing skepticism about the ability of additional CRA disclosure requirements to benefit investors).
and are the least vulnerable to rating agency inaccuracies. Perversely, then, the most sophisticated and resource-rich who are best equipped to close the disclosure loop and encourage the disciplining of rating agencies are also those who are least incented to review rating agency performance. Indeed, the most sophisticated among them may be able to take advantage of market inefficiencies created by inaccurate ratings, and, therefore, may prefer the existence of inaccurate ratings and take no steps to evaluate the rating agencies.

Finally, it is not efficient for each investor to conduct its own analysis of debt. To the extent they provide an economy of scale for creditworthiness research and evaluation, the rating agencies provide a valuable service to the investment industry. A full analysis of credit rating agency ratings would require essentially duplicating the efforts of each credit rating agency, obviating the purpose or supposed value of the rating agencies altogether.

b. Evidence

One of the justifications for permitting the issuer-pays model to exist seems to be that through disclosure of policies and efforts to manage such conflict, investors will be able to appropriately monitor the behavior of the rating agencies and appropriately discount their ratings when their behavior is biased or sloppy. Given the conflicts of interest associated with the credit rating agencies, the opportunities to exercise poor judgment when conducting credit analysis, their relative lack of transparency and history of engaging in anti-competitive practices, it seems reasonable to ask whether or not investors have been appropriately discounting the opinions of the credit rating agencies in the past as a way to give us insight into whether or not we can expect them to do so in the future.

The following anecdotes, which address only institutional investors (presumably those investors which possess superior financial sophistication and analytical resources) should make one wonder if adequate investor sophistication exists. There is strong anecdotal evidence that the investing community, including ostensibly sophisticated institutional investors, is not, on average, sufficiently sophisticated to conduct such monitoring and discounting.

Much has been written about the Enron debacle and that company’s bankruptcy filing in December 2001. Though their bankruptcy was a sudden surprise to the vast majority of the investment community, Frank Partnoy has argued that Enron often disclosed its off balance sheet transaction, even going as far as to note that they were not completely arms-length transactions, and that “there enough key details about [certain special purpose entities created to provide off-balance sheet transactions] in the footnotes to Enron’s financial statements to warn off any investor who read them.” Enron’s disclosures also identified certain significant conflicts of interest of key employees. Yet, Alliance Capital Management, a large mutual fund and “one of the best-run mutual funds,” gobbled up shares to become Enron’s largest shareholder by 2001 with 43 million shares. It lost billions. Top managers at Alliance admitted after

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229 Perhaps by issuing securities which are rated too high (and therefore, perhaps, priced too high), or buying credit default swaps on securities which are rated too high, or by purchasing securities which are rated too low (and therefore, perhaps, priced too low), or selling credit default swaps on securities which are rated too low. For a description of credit default swaps, see, e.g., Frank Partnoy & David A. Skeel, Jr., Debt as a Lever of Control: The Promise and Perils of Credit Derivatives, 75 U. CIN. L. REV. 1019 (2007).

230 The vast majority of subprime MBS and nearly all CDOs are bought and sold by institutional investors. IOSCO Subprime Report, supra note 10, at 12.

231 For a detailed description of the growth and decline of Enron, see, e.g., PARTNOY, supra note 84.

232 Id. at 302-3.

233 Id. at 312.

234 Id. at 331.

235 Id. at 441.
Enron’s bankruptcy that “the fund’s managers did not dig into Enron’s footnotes, and did not uncover key
details or even ask key questions.”

While the credit rating agencies’ apparent failures with regard to rating subprime mortgage-backed
securities have come as a surprise to many, this surprise is itself evidence of an inability to appropriately
discount ratings and a lack of full investing sophistication. There were signals along the way that these
ratings should have been viewed with suspicion. As early as 1994 academic and media commentators were
publishing observations which would indicate that something might go awry, that the credit rating agencies
were succumbing to behaviors incented by their interest in pleasing their issuer-customers and conducting
increasingly generous analysis, and that the ratings assigned to MBSs were not accurate or reliable. Did
ostensibly sophisticated investors take these developments into account when deciding how credible or
accurate or defensible the MBS ratings were? Given the evidence of broad and deep investor reliance on
rating agencies in relation to subprime securities and the extent of the subprime losses, it seems that they
did not.

Published accounts of the credit rating agencies and mortgage backed securities since the mid-1990s
noted that issuers typically consulted and worked directly with the credit rating analysts to find out how
their MBSs and other asset backed securities could be structured to obtain the highest rating for the largest
pieces of the asset pool, or, in other words, how to achieve the largest tranche sizes with the very high
ratings. Published accounts since the mid-1990’s reported that rating agencies competed on rating criteria
in a veritable race-to-the-bottom, each touting their more liberal criteria and their reduced credit
enhancement requirements in order to attract more business, and therefore “potentially undermining the
reliability of the rating.” Published accounts reported that agencies which adopted such strategies did
indeed gain market share. It was well known that the rating agencies were enjoying tremendous revenue
growth almost entirely as a result of the growth in these transactions and that there was not only strong
incentive to capture as much of this growth as possible but to contribute to its continued growth. In other
words, there was reason to believe that the credit rating agencies were creating the demand for the products
that facilitated the subprime mortgage crisis. By 2003 it was widely reported in the popular financial press
that a greater and greater proportion of the mortgages originating in the U.S. were subprime mortgages and
that default rates were rising. Was it not evident that the expansion of the subprime market was fueled

236 Id. (noting, too, that despite the investment loss having “decimated the investors in Alliances mutual funds,” the portfolio manager
nevertheless earned over $4 million in personal compensation in 2000 and $2 million in 2001).

237 See, e.g., Schultz, supra note 74 (noting that S&P, Moody’s and Fitch have all drawn criticism that they have soften their criteria for
mortgage-backed securities in order to win clients).

238 See, e.g., Cantor & Packer, supra note 38, at 19. As discussed above, the amount of credit support (e.g. letters of credit, bond
insurance, subordinated interests, cash collateral, reinvestment of any excess cash generated by the pools) each tranche has plays a large role
in determining how risky that tranche is and therefore just how high a rating it could receive.

239 See e.g., Cantor & Packer, supra note 38, at 19; Schultz, supra note 74 (reporting that S&P had recently adjusted its ratings criteria
allowing several securities to maintain their rating even though the new criteria required on average 30% less credit support).

240 See, e.g., Cantor & Packer, supra note 38, at 19-21 (noting that until the mid 1980’s, S&P was the undisputed leader in the MBS
and asset backed securities sector and was the only agency rating mortgage backed securities not backed by a government or quasi-
government agency such as the Federal National Mortgage Association (Fanny Mae), but in that in 1986, Moody’s entered the market with
lower credit enhancement requirements – and thus offering a less expensive, and therefore more attractive, path to high ratings for the
issuer – than S&P for certain mortgage backed securities such that by 1989 Moody’s share of the MBS business exceeded that of S&P; and
further noting that in 1990 Fitch entered the market with even more liberal credit enhancement requirements, such that by 1994 Fitch was
the MBS market share leader; and further noting that Duff and Phelps entered the market in 1992 also offering low credit enhancement
requirements; and further noting that by 1993, S&P had only 55% of the market share, in a sector where most issuers normally hire two
rating agencies, but that S&P responded that year with reduced requirements for credit enhancements, such that within months, S&P
regained 15% of the market share, largely at Moody’s expense.) Analysts and the ratings agencies claimed that the on-going decline in credit
enhancement levels were due, in part, to their own learning curves about the performance of MBSs. Id. at 21.

241 E.g., Patrick Barta, The Economy: Mortgage Data Give Mixed Message on Market – Delinquent Loans Decline, But Foreclosures Gain; Stress in
Subprime Sector, WALL ST. J., Jan. 8, 2003 at A2 (quoting a credit analyst saying that the subprime market is the “next shoe to drop” in
by investor enthusiasm for the U.S. housing market, specifically for highly rated MBS and MBS-related CDOs?

Yet, instead of being punished, the credit rating agencies were rewarded by the marketplace; the institutional investor appetite for mortgage backed securities and CDO’s based on them increased voraciously until 2007, and the major credit rating agencies profited handsomely as a result. Why? The institutional investors were generally unable to fully understand the details of the complex structures of these securities or all the risks associated with them. Nonetheless, it appears that for many institutional investors, instead of choosing to avoid these securities, they relied on the ratings and considered them safe, at least safe relative to the returns being offered.

The Wall Street Journal has recently referred to institutional investor purchases of RMBS as “myopic” and has stated that

investors who relied on the rating agencies – particularly supposedly sophisticated pension funds and other institutions – are at fault, too. Rating firms became a crutch for investors who simply didn’t want to spend the time and money required to be prudent investors at a time when low interest rates had everyone reaching for higher returns without contemplating the higher risks.

And, in the same article, “Lenders need someone to prevent them from competing their way to the bottom” Arthur Levitt, Jr., the former Chairman of the SEC wrote in a Wall Street Journal editorial:

[W]e need investors to accept more responsibility for evaluating structured financial products. Credit rating agencies play a critical role in the capital markets, but their judgments are guides, not stamps of approval. Too often, institutional investors have been investing in sophisticated credit products on the basis solely of the credit rating and without fully understanding the inherent risks they are undertaking.

More generally, the Wall Street Journal, prompted by the institutional investors who invested in MBS, stated, “A big title at a big-name company is no guarantee of smart, savvy management.” These institutions seemed to be enticed by a bubble – and restricted by their own analytic limitations. As a result they were unable to appropriately discount the opinions of a perceived authority, the credit rating industry.


243 See, e.g., Cantor & Packer, supra note 38, at 19; Schultz, supra note 74; IOSCO Subprime Report, supra note 10, at 13 (“[S]ome institutional investors when purchasing the more complex CDOs appear to have had little understanding of the instruments or the underlying cash flow and security upon which the instruments derived their value.”)


245 Id.

246 Id.


248 Wessel, supra note 70 (further suggesting that at least some senior executives at prestigious financial institutions may be “incompetent, imprudent [and] shortsighted”).

249 The question for our purposes is to ask whether or not the investor community took these observations into account and appropriately discounted the opinions of the rating agencies. When asking this questions, it is necessary to be particularly wary of hindsight bias and to acknowledge that even rational, sophisticated and fully formed investment decision-making can yield undesired results, since nearly all investments entail some degree of risk and what may seem to be a bad investment decision in hindsight may have been an eminently rational one at the time it was made. However, considering the foregoing discussion, anecdotal evidence and the fact that institutional investors, by at least one estimate, invested approximately $7.5 trillion into these subprime-based mortgage backed securities, which in retrospect certainly seem like somewhat risky investments, and will costs investors, according to some estimate, approximately $1 trillion (Grynbaum, supra note 9), one just might suspect that they in fact unsophistically over-relied on the opinions of
c. Behavioral Finance and Irrationality

Behavioral finance may shed light on this inability of investors, in particular the collection of ostensibly sophisticated investors, both to reduce their exposure to subprime MBSs and related products and to realize that rating agencies might have been misleading them by engaging in a fly-by-night strategy.

Behavioral finance is the branch of economics which devotes attention to the irrational behavior of investors and other finance industry agents and is based in part on the findings of cognitive psychologists. For example, through experimentation, psychologists have discovered that people have a tendency to anchor to initial values or judgments from which they may make insufficient adjustments when provided later with reliable information which they could use to adjust their judgment. Such a bias may have contributed to a belief in the sustainability of increasing U.S. housing prices over the course of the early and mid 2000s or the belief that such prices would not fall. Relatedly, people generally exhibit an availability bias; they tend to use memories, recollections and information which are the most available, recallable or salient - not necessarily the most relevant - in order to form judgments, valuations and estimates. In the mid 2000's, the then-current housing prices and the housing boom were more salient pieces of information than the prices and the price volatilities of earlier times. This cognitive trait, combined with the tendency to engage in anchoring, may have exacerbated the belief in the security and the profitability of investing in housing.

It is also well known that people often engage in herding behavior and often, consequently, economic bubbles - and crashes - result. Psychologists have described the significant power of social influence on individual judgment. Such influence can be transmitted by society at large or by authority figures. Often there is no problem with this dynamic of having faith in authority figures since those in

the rating agencies, did not appropriately discount the AAA and AA ratings that typically were attached to the highest tranches of these securities, and made poor investment decisions.


251 Barberis & Thaler, supra note 250, at 1068. Anchoring may be a particular influential cognitive process in making judgments about the value of a financial security and the direction of its future market price. Likely anchors in this regard may include the security’s current price, its most recent prices, and the prices of other seemingly related securities, whether or not the relationship between the securities is relevant, whether or not the relationship is one which points to a relationship in fundamental valuation and changes in values. Shiller, supra note 15, at 149. See also Eldar Shafir & Amos Tversky, Thinking through Uncertainty: Nonconsequential Reasoning and Choice, 24 COGNITIVE PSYCHOL. 449 (1992).

252 Despite such anchoring in the market, markets do make dramatic shifts, most dramatically in the form of stock market crashes. Anchoring, when it slips, has the ability to slip dramatically Shiller, supra note 15, at 155.

253 Barberis & Thaler, supra note 250, at 1068; See also Sunstein, supra note 250, at 5.

254 History is ripe with fascinating examples of extreme market bubbles. See, e.g., CHARLES MACKAY, MEMOIRS OF EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (Prometheus Books 2001) (1852) (describing “Tulipmania” and the Great Railway Bubble); Shiller, supra note 15 (describing the 1929 Crash, the October 1987 crash and the “Millennium Crash”).

255 Shiller defines a bubble as “a situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person in the prices amplifying stories that might justify the price increases and bringing in a larger and larger class of investors, who, despite doubts about the real value of an investment, are drawn to it partly through envy of others’ successes and partly through a gambler’s excitement.” Shiller, supra note 15, at 2.

256 E.g., SOLOMON ASCH, SOCIAL PSYCHOLOGY (1952); STANLEY MILGRAM, OBEDIENCE TO AUTHORITY (1974).

257 See, e.g. Milgram, supra note 256, at 13-54. Morton Deutsch & Harold B. Gerard, A Study of Normative and Informational Social Influences upon Individual Judgment, 51 J. ABNORMAL & SOCIAL PSYCHOLOGY 629-36 (1955). Discussed in Shiller, supra note 15, at 157-9. In Deutsch and Gerard’s experiment, test subjects were asked a question, the answer to which was not difficult to determine and usually answered correctly by individuals from a control group. The test subjects were told, however, that all others who were being asked the same question were responding with a different answer, a wrong answer. When then requested to answer the question themselves, a third of the time the test subjects, often displaying signs of anxiety, gave the identical wrong answer. Herding may be the result of using social proxies in situations where one personally lacks adequate direct information to form an individualized judgment. To disagree with consensus opinion puts one in the risk of being thought of as foolish, ignorant or callous. Sunstein, supra note 250, at 9. This is an informational proxy, and is not an unreasonable position to take, especially in matters of complexity or when one does not or cannot process all the relevant
such positions often are correct in their opinions, and people have learned to have some degree of faith in the reliability of their opinions.\footnote{Shiller, supra note 15, at 159 (also stating that “people are respectful of authorities in formulating he opinions about which they will alter be so overconfident, transferring their confidence tin authorities to their own judgments based upon them.”)} The more interesting aspect of these psychology experiments are, however, that people, as they do in environments where there is a group opinion, have a tendency to have faith in the reliability of the opinion of authority figures even when they contradict how an independent observer would certainly conclude.\footnote{Id. (“[Milgram’s experiment] demonstrates that people are ready to believe… authorities even when they plainly contradict matter-of-fact judgment.”).} Rating agencies position themselves as authorities on credit risk. Their opinions, both accurate and inaccurate, may, therefore, be overweighted by investors, especially in situations of complexity or ambiguity – as when estimating the risk and values of complex structured securities.\footnote{Id. (“[Milgram’s experiment] demonstrates that people are ready to believe… authorities even when they plainly contradict matter-of-fact judgment.”).}

One of the necessary characteristics of a powerful herd producing “infection” is the existence of a salient and tellable story to support the infection.\footnote{No less of an authority than Alan Greenspan, the then-Federal Reserve Board Chairman, stated in 2004 that there can be no housing bubble since the high cost of moving [ones household] “are significant impediments to speculative trading and development of price bubbles.” Ip et al., supra note 70 (quoting Greenspan).} In the case of the subprime debacle, the salient story may have been that housing prices generally do not go down nationwide. Observing that the credit rating agencies were issuing ratings consistent with their beliefs about the housing market and the riskiness (or relative lack thereof) of MBSs and CDOs, investors may have been less inclined to doubt the credibility of the rating agencies or to perceive, let alone criticize, the rating agencies’ inability to manage the issuer-pays conflict of interest. Ironically, then the housing bubble was created in part by the volume of credit poured into the U.S. housing market by MBS and CDO investors and may have also contributed to investors’ belief in the risklessness and safety of MBS and CDOs. Investing in the housing market, then, contributed to their faith in the housing market, because such investing bolstered that market. This circular dynamic was unsustainable.\footnote{Id. (“[Milgram’s experiment] demonstrates that people are ready to believe… authorities even when they plainly contradict matter-of-fact judgment.”).}

It should be noted that not every institutional investor relied on the opinions of the credit rating agencies with regard to the subprime based MBS’s. Given the thousands of institutional and wealthy individual investors, analysts and financial managers, some, if not many, will be particularly rational, skillful and sophisticated, and, indeed some appear in retrospect to have been appropriately wary of credit rating agencies’ opinions regarding MBSs.\footnote{Because of their size and human, technological and economic resources, large institutions with greater amounts of information gathering and analytical capabilities are likely to exhibit superior sophistication and investing skill. See e.g., Schultz, supra note 74. (quoting and then paraphrasing Edward Toy, a portfolio manager at Teachers Insurance and Annuity Association-College Retirement Equities Fund, in regards to mortgage backed securities. At the time, TIAA-CREF was the world’s largest pension fund with $125 billion in assets. “As much as we do our own underwriting, we still rely on the rating agencies to provide good, solid information and an objective viewpoint as to where things are going.’ To the extent they themselves are competing for business, they lose credibility.’ Mr Toy stated.... If new criteria put out by [the rating agencies] don’t meet his fund’s standards, the pension fund may stipulate its own credit levels and put the agency ratings on the shelf.... To the extent this results in a lower creditenhancement level, Teachers Insurance will probably start demanding [lower prices] on the securities it purchases, Mr. Toy says. ‘If it means we start passing on some deals, so be it,’ he adds.” The article continues stating that “smaller investors can’t be so dismissive. Most don’t have extensive research staffs maintained by larger investment firms and rely on [credit] agency analysis.”).} Furthermore, some not only concluded that MBSs were overrated by
the credit rating agencies and by the market place but made money betting against the U.S. housing market.\textsuperscript{264}

C. Potential Unintended Consequences of Regulation

In the years prior to the passage of the Credit Rating Agency Reform Act, many commentators proposed that one of the solutions to the problems posed by the credit rating agencies was to recognize additional NRSROs and increase competition between them.\textsuperscript{265} The Act establishes a relatively transparent administrative process for registering NRSROs, and since the Act’s effective date in 2007, ten NRSROs have been registered, five more than were recognized immediately prior to the effective date.\textsuperscript{266} As competition intensifies, observers will be able to better assess whether or not such increased competition has satisfactorily addressed the problems associated with the credit rating agencies.

However, in an environment where there may be greater numbers of NRSROs, it can be expected that, as a result of natural variation, that some agencies will tend to rate higher than other agencies. This would be true even if all agencies were free of issuer capture. The more competitors there are, the more likely it is that some agencies will rate particularly highly, both relative to the other NRSROs and relative to an accurate rating. The current and proposed regulations will not prevent issuers from shopping for ratings, and issuers will gravitate to those agencies which typically offer the most favorable ratings at the lowest cost (which costs include not merely the fees charged by the rating agency but any costs incurred by investors discounting the rating). The existence of rating-dependent regulations intensifies issuers’ demand for satisfactory ratings.\textsuperscript{267}

Furthermore, agencies will be induced to grant more liberal ratings since doing so will benefit their bottom lines, at least until any reputational harm becomes incrementally more costly than the benefits of doing so. Given the evidence contained herein, there is strong reason to believe that when a larger number of NRSROs compete more intensely for business, the likelihood of racing to the bottom increases and the bottom may be pushed lower.

Thus, in an environment where issuers demand generous ratings and choose which rating agencies to hire and numerous NRSROs more intensely compete for business, it seems inevitable that securities will, on average, be overvalued. In other words, despite these regulations and the effectiveness of any firewalls to manage the issuer-pays conflict of interest, there is still a race-to-a-bottom, and valuations industry-wide are likely to be skewed high.\textsuperscript{268} And in this particularly competitive business environment, we have already seen that the bottom may be quite low. In order to compensate for this persistent level of ratings inaccuracy, investors must always discount appropriately.\textsuperscript{269}

\begin{footnotesize}
\begin{enumerate}
\item See, e.g., Gregory Zuckerman, \textit{Trader Made Billions on Subprime; John Paulson Bet Big on Drop in Housing Values; Greenspan Gets a New Gig, Soros Dues Lunch}, WALL ST. J., Jan. 15, 2008, at A1 (reporting that John Paulson’s earned $15 billion in 2007 for his hedge funds by betting on the fall of the housing market); Jed Horowitz & Kate Kelly, \textit{How Long Can Goldman Dance?; Wall Street Firm Sides Steps Subprime, Up to a Point; Average $662,000 Payday}, WALL ST. J., Dec. 19, 2007 at C3.
\item See supra note 174 and accompanying text.
\item Supra notes 184-186 and accompanying text.
\item See, e.g., Partnoy, \textit{Not Like Other Gatekeepers}, supra note 38, at 90 (“there is an argument that opening the [NRSRO] market to competition could make regulatory licenses more important, by creating incentives for rate shopping among issuers.”); Rating-dependent regulations pose several problems and have been criticized by a number of commentators. See, e.g., Id. at 89 (suggesting that the regulatory use of ratings as benchmarks be abandoned).
\item By way of contract, a credit rating industry which follows a subscriber-pays revenue model would not experience such a race-to-the-bottom, but rather a race-to-the-top.
\item On the other hand, it may be possible that newly registered NRSROs will somewhat unwilling to issue ratings substantially different from the ratings of the large, established NRSROs. If a new NRSRO believes that its ratings, though different from those issue by other NRSROs, are in fact more accurate, to publish such different ratings carries the risk of being perceived by the marketplace as less accurate if the market’s benchmarks are effectively the ratings of those large NRSROs with long histories and established reputations. To some extent, therefore, it may be possible, that until a newly registered NRSRO achieves a strong and widespread reputation within the marketplace that it will engage in herding behavior and will follow the lead of the established NRSROs. In such a situation the immediate added value of the new NRSRO is nil, if not negative.
\end{enumerate}
\end{footnotesize}
Another possible unintended consequence of the current regulatory regime concerns the legitimization that the NRSRO designation and regulatory oversight conveys. Some have argued that the source of an NRSRO’s positive reputation may not be based so much on its ratings performance but on the fact that it has been recognized by the SEC as a NRSRO.\footnote{E.g. Partnoy, \textit{Like No Other Gatekeeper}, supra note 38 (arguing that the only value provided by an NRSRO is the regulatory license it can offer issuers).} When evaluating the credibility of an NRSRO subject to a regulatory regime, many investors may now rely not merely on an agency’s recognition as an NRSRO, but also on the supposed strength of the regulations and the assumed vigilance of others to adequately discipline the NRSRO. The incentive for each member of the marketplace to conduct independent evaluations is thus reduced, and an exercise in widespread free-ridership may result. Since NRSROs are regulated and subject to evaluation by the marketplace, the freerider concludes, NRSROs must be reputable and their ratings accurate. An overabundance of such free ridership may enable NRSROs to “slip by” or fly-by-night without damaging their reputations at all.\footnote{Or, the marketplace may conduct intendment analysis of NRSRO performance, deem them to be performing at a certain level of reliability and stop devoting their energy to such independent evaluation.} Such a dynamic would, therefore, demand an \textit{even greater} willpower or commitment on the part of the investor community to adequately process NRSROs’ disclosures and independently evaluate the accuracy and credibility of their ratings, but perversely that commitment may be undermined by the mere existence of the regulatory environment.

\section*{VI. THE PUBLIC CREDIT RATING AGENCY}

This article has highlighted both the significance of the credit rating industry in modern capital markets and some of the problems inherent in the credit rating industry under the current regulatory regime, and, in particular, problems associated with the issuer-pays conflict of interest. One of the ways to address many of these problems is for the rating agency industry to abandon the issuer-pays revenue model. This seems unlikely.\footnote{See supra Part I.B.} As described previously, the issuer-pays model solves the problem of procuring adequate analytical resources and eliminates the need to keep ratings confidential from non-subscribers. It also is a very profitable model. The issuer-pays model could be prohibited, but such a step would seem drastic at this stage. Another ameliorative possibility would be to create a rating agency which provides publically available substantive risk analysis and which would be funded by the tax-paying public.

\subsection*{A. Envisioning the Public Agency}

A current topic of discussion within a number of academic literatures is the private ordering of public functions.\footnote{See, e.g., \textit{John Braithwaite, Regulatory Capitalism: How it Works, Ideas For Making it Work Better} (2008); \textit{John Braithwaite & Peter Drahos}, supra note 62; Saskia Sassen, \textit{Regulating Immigration in a Global Age: A New Policy Landscape}, 570 The Annals Am. Acad. Pol. & Soc. Sci. 65, at 72 (2000); and by a number of the contributors to a symposium volume titled \textit{Democracy and the Transnational Private Sector} 15 IND. J. GLOBAL LEGAL STUD. (2008, forthcoming).} The private-sector credit rating agencies often are used as examples of such private ordering.\footnote{See, e.g., Braithwaite, supra note 273, at 23, 25; Sassen, supra note 273, at 72.} The credit rating agencies provide a service to the investing public. They also provide a service to the general public, since the economic well-being of general is in large part a function of the well-being of the economy generally. The raison d’être of private sector, for-profit credit agencies, however, is not, in fact, public service. Given that credit rating agencies perform a public function effectively for the benefit of the investing public and the economy generally, it is eminently reasonable for the services provided by a credit rating agency be paid by its public beneficiaries.\footnote{The tax discussed here is a general tax on the general population. However, it may be more politically expedient, especially considering the fact that the most direct beneficiaries of such a public agency are investors, that a tax could be levied on certain securities trading transactions and that the proceeds of this tax be earmarked for the public rating agency. It should be noted that it is not the}
Over the course of the 2000s, however, the major American private credit rating agencies have negligently executed their public function; they have taken advantage of their authority, have preferred their pecuniary interests over the public interest and have been identified as a primary contributor to the subprime meltdown, disappearing wealth and the worldwide credit crisis. This being the case, it is worthwhile to consider whether these private sector entities require a public sector competitor or complements if they are to adequately execute their public function.

This vital public function may be best executed within a plural governance structure, one in which both private and public entities participate. Private, for-profit credit rating agencies have a role to play but their performance can be augmented and improved by the participation of an independent, publically funded credit rating agency charged with conducting substantive risk analysis for the public good. While it is beyond the scope of this Article to provide the level of detail that would be necessary in designing the organization and operation of such an agency, it will provide its fundamental characteristics.

i. Mission

The public agency could be given the authority to determine for itself which securities and which issuers to evaluate. This body could be permitted to conduct substantive, merit-based credit evaluations and other analysis on any security and any issuer, or on any class of security generally, but could be expected to primarily use their resources to rate those securities and those issuers which might most adversely affect the general public. Such securities are most likely those which were the most complex and opaque, those for which the investing public might appear to have an “irrational exuberance” and those with the most potential to have an adverse affect on the well being of public beneficiaries and the financial market as a whole. Often this will consist of large issuances, large security categories and new security categories.

ii. Independence and Transparency

In order to minimize political biases, it would be imperative that this public agency be independent and shielded as much as possible from political pressure. This agency would also have to operate with a great deal of transparency. It should make its analytical tools and its financial models, methodologies, procedures and assumptions publicly available and subject to public comment. There would be no proprietary models to protect; the public would be entitled to access all of its information, except non-public information received from issuers. To the extent that it will not be captured by issuers, the agency would not be inclined to make opaque or obfuscated disclosures about its methods and procedures. The agency would have no subscribers and, subject to the requirements of confidentiality, would make all of its reports and evaluations, detailed and otherwise, readily publically available.

iii. Powers, Protections and Funding

In order to make the most informed evaluations, this agency ought to have the power to request non-public information from issuers. An issuer could choose whether or not to participate in the process, and all non-public information made available must be kept confidential and used in accordance with applicable

intention of this Article to imply that all services which seem uniquely “public” should be provided by public, tax-funded entities. Indeed, public services can be and are often provided solely by private entities. However, some public services may be more effectively provided by public entities or by a collection of both public and private entities.

276 The Wall Street Journal may have, inadvertently or not, have hinted at such an idea when it stated in an Op-Ed., “Hopefully [the Credit Rating Agency Reform Act] will prove to be effective in mitigating the central problems with ratings agencies – their conflict of interest. If not, then we should consider more direct methods to change who pays for rating fees.” Levitt, supra note 247.

277 Detailed planning of the structure and operation of this agency would of course be required but will demand significantly more resources.

278 It may be politically necessary to restrict such a public agency from opining on the credit risk of political jurisdictions, including U.S. states and foreign governments.

279 The Federal Reserve or the Supreme Courts may provide an example of political independence.
securities regulations. Certain protections may be warranted in order to encourage issuers to cooperate and to better ensure the efficacy of this body’s work. Such protections might include making all non-publicly available information unavailable for any regulatory, tax or criminal enforcement action. Issuers must have incentives to participate in the process. Refusal to participate may be prompted by a strong desire to keep trade secrets, to keep adverse information away from the rating analysts or to hide criminality or because of some generalized suspension of the government’s intentions and processes. In cases where issuers refuse to participate in the process and refuse to make its non-public information available, the public agency could announce publically that the issuer chose not to participate. Such lack of cooperation would then itself be public information which could be used by the investing public to inform its investing decisions. It would be worth considering whether or not this public agency, in particular circumstances, could have subpoena power to gain access to non-public information of the issuer.

This agency must also be provided with enough funding to enable it to have the information collection and analytical capacity to make credible and accurate ratings, such funding must include adequate amounts to compensate its analysts and managers to attract the most highly skilled, public service oriented people from private practice in order to assure the quality and credibility of the agency’s ratings.

B. Benefits of the Public Agency

This agency would provide a number of benefits. The most obvious benefits result from the fact that this agency would not be faced with the conflicts, biases and costs created when issuers pay for rating services. Such a result is desirable since given the evidence presented regarding (i) the results of the issuer-pays conflict and (ii) the inability of the investment community to evaluate the performance of the rating agencies and appropriately discount their opinions.

It would not be surprising, given the fact that this agency will operate from the influential platform of a government agency with a voice of presumed authority and the fact that its methodologies and procedures will be readily publically available, that its methodologies and procedures will be regularly and rigorously examined and commented on by leading academics in the field and that a dialogue between the public agency and private experts will be created which will increase the accuracy of their opinions. Over time, methodological approaches to ratings may also benefit from this interaction. These exchanges, together with equal access to information and analytical resources, provide reason to anticipate that the ratings and other opinions of this public agency will be, on average, more accurate that those of the private rating agencies. Given the unbiased (or differently biased) position of the agency’s analysis, the rating opinions issued by this body would provide informational value different from that embedded in ratings issued by the private-sector agencies. Individual members of the investment public, then, when making investment decisions would be in a position to take into consideration – in addition to their own independent analysis and the opinions of the private credit rating agencies – the ratings and information provided by this independent public agency. As part of this suggestion to establish a public rating organization, no recommendation is being made to change the current credit rating agency regulatory scheme or to change

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280 The U.S. federal tax code provides for similar protection to encourage illegal immigrants to pay personal income taxes.

281 Including technological resources and human skills.

282 It is not this Article’s claim that this public agency would always necessarily issue more reliable ratings than the private credit rating agencies. (See Schwarcz , supra note 65, at 26-7 (noting that “[t]here is little current literature on government certification of securities quality because until recently disclosure was seen as the complete answer.”) The individuals staffing this body would cope with limited institutional, analytical and informational resources, competing pressures, uncertainty, professional biases and cognitive limitations. This agency would not be able to be completely transparent, in part because of the difficulty of revealing all analytical processes and the limits to self knowledge but also because non-public information must be kept confidential. Analysts’ personal conflicts of interest must still be managed. However, this agency would be immune from the perverse agency conflicts of the issuer-pays conflict. It would not face competitive pressure and would not be faced with the conflicts of interest associated with ancillary services. It may also be able to analyze more carefully, thoroughly without the time pressure of producing product for its clients.
or eliminate the private rating agencies. The private rating agencies would function as they will, in parallel with the public agency, and investors could decide how to use, how to interpret, and to what extent to rely on each of their respective opinions. In essence, the public agency would only be providing additional information – risk opinions not tainted by biases in favor of issuers – and investors would be free, as they are now, to make their own investment decisions.

A public credit rating agency would also give legislators and regulators another option to choose from and use in establishing ratings-dependent regulations. When crafting investment restricting regulations, regulators would be able to choose the ratings of the public agency as regulatory risk benchmarks or may chose a set of options, one of which may be the public agency’s ratings. When discussing rating-dependent regulations and the NRSRO designation, Professor Richard Sylla hinted at the value of a public-sector rating process when he wrote rhetorically:

 Should representative governments be in the business of passing out [NRSRO] designations if the designees are thereby allowed to profit from selling regulatory licenses? Or, if ratings are to be incorporated in financial regulations, is it possible that regulatory authorities have a responsibility to come up with, and apply, their own ratings?

In an environment of increasingly global interconnectedness, this governance issue is particularly important. Aaron Untermann’s argument encouraging the establishment of an “international capital organization” not only highlights the importance of this issue, it also strongly hints that the issuance of credit ratings should not be left solely to private-sector credit rating agencies, and states explicitly that such a public credit regulatory body “should also monitor and report on macroeconomic developments and trends of concern to the capital market.”

C. Responses to Arguments against the Establishment of a Public Agency

Some may be opposed on free market principles to the suggestion that the government conduct merit-based evaluations of private enterprise securities issuers, but such activity by government authorities and quasi-government organizations is not unprecedented. State securities regulators often conduct merit-based evaluations of securities in order to determine whether or not certain securities can be marketed within the state. The Securities Valuation Office of the National Association of Insurance Commissioners (NAIC) conducts substantive risk analysis to determine how they will evaluate the riskiness of certain securities held by insurance companies in cases where there is a split rating or a disagreement between two or more private credit rating agencies.

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283 It is beyond the scope of this Article to opine as the desirability of rating-dependent regulations. But see Partnoy, Not Like Other Gatekeepers, supra note 271 (arguing for the discontinuation of ratings-dependent regulations).

284 Sylla, supra note 39, at 38.


286 Id. at 131 (“The role of credit ratings at the international capital market is paramount and should not be entrusted to private firms.”).

287 Id.


289 See Cantor & Packer, supra note 38, at 6. (noting that there is a cost to this process, the costs of establishing in-house analytical capacity). The SVO only can only issue their own rating if it is lower than that implied by the public rating or ratings. Id. Given limited resources, the NAIC’s SVO devotes most of its energies evaluation unrated private placement securities and resolving difference of opinions between the credit rating agencies.
Some may argue that an independent tax-payer funded rating agency would be unable to attract skillful analysts and would likely do a worse job at evaluation risk than private agencies. It appears true that analysts compensation must be appropriately high in order to establish and maintain a satisfactory level of institutional risk analysis skill. However, working in such a public interest oriented agency may particularly appealing to skillful, intelligent, public interest minded financial analysts and economists, and the compensation need not necessarily be equal to that offer in private practice. Such a public agency, especially if it becomes highly reputable, may be a place for experienced analysts to cap a honorable career or a place for young, ambitious, highly skilled analyst to begin one.

Others may argue that the establishment of a public agency may undermine the market for private credit rating analysts, thereby eliminating any reduced information asymmetry resulting from the private analysts. However, according to this proposal the public agency would only provide information to investors, and the marketplace of investors would decide which agencies’ opinion it will value. Increasing competition between NRSROs has been advocated as a way to improve the accuracy of the agencies and eliminate those agencies whose opinions were not valued, a public agency would merely participate in that competition. The loss of any private jobs would merely be the result of the consensus of the marketplace that the information provided by the public agency so seriously undermined the reliability of a private-sector rating agency that it could no longer charge the fees it had been charging or could longer survive.

Perhaps the strongest argument against the immediate establishment of an independent, publically-funded credit rating agency is that the reforms contained in and directed by the Credit Rating Agency Reform Act have only recently been implemented. Though this Article argues that there are substantial reasons to doubt the effectiveness of these reforms and that these reforms have not adequately addressed the problem of the issuer-pays conflict of interest, much of the current regulatory regime exists to try to enable the marketplace to try to manage this very problem. Perhaps going forward investors will come to adequately discount the opinions of the rating agencies; perhaps rating agencies will find that there is rarely an occasion when short-term profit incentives outweigh any threat to their reputations; perhaps rating agencies which shun the issuer-pays model will displace the traditional rating agencies. Perhaps. Time will tell to what extent these reforms are effective, if indeed, they are effective at all. Unfortunately, it would appear to be a difficult task to determine the actual effectiveness of these reforms – and may even require another economic downturn or securities debacle to reveal persistent rating agency misbehavior. Nevertheless, a very healthy skepticism of these reforms’ effectiveness is eminently warranted, especially in light of the empirical and anecdotal evidence presented here. This Article has provided a route forward for skeptics of the Act’s effectiveness.

CONCLUSION

Mortgage-backed securities and the collateralized debt obligations based on them are complex securities, and as a result, many investors appear to have relied on ratings as informational, analytical, and risk assessment proxies for their own due diligence. In the case of subprime mortgage-backed securities and related products, such reliance may have been misplaced and seems to have cost investors dearly. But

291 See JOHN BRAITHWAITE, MARKETS IN VICE, MARKETS IN VIRTUE, 202 (2005) (discussing the integration of private and public markets and how the public markets might be able to attract the best professionals).
293 See supra note 174 and accompanying text.
294 Of course, given that this agency will have the platform of a federal government agency, the authority of its voice may be overvalued, but at least its voice will be untainted by the pervasive conflict faced by the private agencies, one which has created havoc in entire economies and threatens to do so again.
mortgage-backed securities are only one of several complex and opaque securities instruments available today to the investment community.\(^{295}\) Financial innovation is likely to produce more and increasingly complex and/or opaque investment products. Furthermore, capital markets are increasingly more interrelated, interdependent and global, which contributes to the potential to create increasingly complex securities.\(^{296}\)

In a world of increasing complexity and opacity, investors will find it increasingly difficult to engage in their own risk assessments, and even if they could do so, for all of them to do so would be increasingly inefficient. Investors will continue to rely on rating agencies, financial analysts and other informational proxies to provide reliable information about the risks and values of securities as well as on and on the most resource-rich and skillful institutional investors to bring market prices in line with fundamental values and discipline analyst and rating agency misbehavior. Those truly sophisticated and resource-rich industry players, however, may take advantage of the increasing informational asymmetry and their investment capabilities, by innovating, creating and selling complex financial products and pocketing fees along the way or creating trades in hard-to-value (and therefore often misvalued) securities designed for the purpose of receiving abnormal returns.\(^{297}\) Furthermore, some undeserving participants within the industry are likely to be positioned, like subprime mortgage originators, to divert a portion of the generous flow of funds from investors into their own personal coffers.

The financial system may come to look increasingly like a wealth re-distribution system from the masses of individual investors, less sophisticated institutional investors and mom-and-pop beneficiaries to the exceptionally well-skilled and resource-rich and the luckily well-positioned. If this is an undesirable function of capital markets, or if it is a function that should be constrained, then regulatory innovation, often based on public-private governance structures such as the publically funded rating agency described herein, will be necessary to facilitate transparency and a broader and deeper understanding of entities that currently have profound public impact but which currently benefit from opacity, complexity and imprecise or poorly designed regulation.

\(^{295}\) Others include collateralized debt obligations generally, credit default swaps, other derivative instruments, and hybrid and/or synthetic versions of each. Some hedge funds do even not reveal their investment strategies to their own investors, but rely on past return to convince potential investors of the quality of their investment strategy.

\(^{296}\) See IOSCO Subprime Report, supra note 10, at 7.

\(^{297}\) It is not this Article’s intention to discourage financial innovation. Financial innovation is often beneficial. For example, innovation may disperse risk and lead to increased overall financial stability and often allows otherwise restricted investors to participate in desirable investments.