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What Makes You So Special?: Ending the Credit Rating Agencies' Special Status and Access to Confidential Information

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Notes

WHAT MAKES YOU SO SPECIAL?: ENDING THE CREDIT RATING AGENCIES' SPECIAL STATUS AND ACCESS TO CONFIDENTIAL INFORMATION

I. INTRODUCTION

*"The story of the credit rating agencies is a story of a colossal failure. . . . The result is that our entire financial system is now at risk"*¹

In the words of a famous presidential advisor, "Never waste a good crisis."² The financial markets crisis that began in the second half of 2007 and surged into a full-blown maelstrom in 2008 is certainly one not to be wasted.³ This crisis can be traced to the 2006 bursting of the housing bubble, which triggered the collapse of the subprime mortgage market.⁴

¹ *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 4 (2008) [hereinafter *CRA Oct. 2008 Hearing*] (statement of Rep. Henry Waxman, Chairman, H. Comm. on Oversight and Gov't Reform) (discussing the role played by the three leading credit rating agencies—Moody's, Standard & Poor's, and Fitch—in creating the financial markets crisis).

² Editorial, *Obamanomics; 'Crisis' is a Cover for Ruining Your Retirement*, WASH. TIMES, Mar. 16, 2009, at A18 (internal quotation marks omitted). This quote is generally attributed to former White House Chief of Staff Rahm Emanuel and "has become the semi-official motto of the Obama administration." *Id.* In an interview, the New York Times quotes Emanuel as saying, "You don't ever want a crisis to go to waste; it's an opportunity to do important things that you would otherwise avoid." Jeff Zeleny & Jackie Calmes, *Obama, Assembling Team, Turns to the Economy*, N.Y. TIMES, Nov. 7, 2008, at A1 (internal quotation marks omitted).

³ See *Written Testimony of Mark Zandi: Hearing Before the Fin. Crisis Inquiry Comm'n*, 111th Cong. 1 (2010) [hereinafter *Zandi*] (statement of Mark Zandi, Chief Economist and Cofounder, Moody's Economy.com) (discussing "The Causes and Current State of the Financial Crisis" (emphasis omitted)). The Dow Jones Industrial Average, a well-known stock market indicator, fell from an all-time high (intraday-theoretical) of 14,279.96 on October 11, 2007 to a subsequent low of 6440.08 (intraday) on March 9, 2009—a 54.9% decline. *DJI Historical Prices*, YAHOO! FIN., <http://finance.yahoo.com/q/hp?s=%5EDJI+Historical+Prices> (last visited Oct. 6, 2011) (based on author's calculations and examination of data); see also NYSE, *A GUIDE TO THE NYSE MARKETPLACE 17* (2d ed. 2006) [hereinafter *A GUIDE TO THE NYSE*], available at http://www.nyse.com/pdfs/nyse_bluebook.pdf (providing definition of the Dow Jones Industrial Average).

⁴ See *Credibility of Credit Ratings, the Investment Decisions Made Based on Those Ratings, and the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Comm'n* 10 (2010) [hereinafter *CRA June 2010 Hearing*] (statement of Phil Angelides, Chairman, Fin. Crisis Inquiry Comm'n) (describing the warning signs of a housing bubble, such as: mortgage fraud, deceptive

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From the peak in mid-2007 to the bottom in early 2009, an estimated \$17.5 trillion—more than twenty-five percent—of U.S. household net worth evaporated.⁵ A combination of “[i]rresponsible risk-taking and debt-fueled speculation—unchecked by sound oversight—led to the near-collapse of [the U.S.] financial system.”⁶

Among the risk taking and incompetence that spawned this crisis, the “big three” credit rating agencies—Standard & Poor’s Ratings Services, Moody’s Investors Service, and Fitch Ratings—stand out among the culpable.⁷ As sophisticated credit risk specialists, credit rating agencies analyze and evaluate the ability of a debt issuer to meet its financial obligations.⁸ Although subprime borrowers represent poor credit risk by definition, the big three credit rating agencies still awarded their highest credit rating—the same rating given to U.S. treasury securities⁹—to *thousands* of bundled packages of subprime mortgages

mortgage practices, and an unprecedented eighty-nine percent increase in housing prices from 2000 to 2006); FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT xvi (2011) [hereinafter 2011 CRISIS REPORT] (calling the collapse of the housing bubble “the spark that ignited a string of events,” and noting the crisis “happened not just in the United States but around the world”).

⁵ Zandi, *supra* note 3, at 8 (quoting Federal Reserve Flow of Funds data). During one twelve-week period alone, five trillion dollars of Americans’ household wealth disappeared when stocks, pensions, and home values plunged, and the capital and credit markets virtually froze. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE U.S. GOVERNMENT: FISCAL YEAR 2011, at 1 (2010) [hereinafter BUDGET].

⁶ BUDGET, *supra* note 5.

⁷ See INT’L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: SOVEREIGNS, FUNDING, AND SYSTEMIC LIQUIDITY 87 (2010) [hereinafter IMF] (internal quotation marks omitted) (referring to the three leading credit rating agencies of Fitch, Moody’s, and Standard & Poor’s as the “big three” (internal quotation marks omitted)); see also *Examining Proposals to Enhance the Regulation of Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 31 (2009) [hereinafter *Senate 2009 Hearing*] (statement of Lawrence J. White, Professor of Economics, New York University) (blaming Moody’s, Standard & Poor’s, and Fitch and their excessively optimistic ratings of subprime residential mortgage-backed securities for playing a central role in the financial debacle); MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 78 (2010) (“Why, for that matter, were Moody’s and Standard & Poor’s willing to bless 80 percent of a pool of dicey mortgage loans with the same triple-A rating they bestowed on the debts of the U.S. Treasury?”). Lewis rhetorically asks why someone did not note that “[t]he rating agencies, the ultimate pricers of all these subprime mortgage loans, clearly do not understand the risk, and their idiocy is creating a recipe for catastrophe[.]” *Id.* (internal quotation marks omitted).

⁸ See STANDARD & POOR’S, GUIDE TO CREDIT RATING ESSENTIALS 3 (2009) (noting that credit rating agencies specialize in evaluating credit risk and the ratings are based on analysis by experienced professionals who evaluate and interpret information received from issuers to form an opinion). Standard & Poor’s has published credit ratings since 1916. *Id.*

⁹ STANDARD & POOR’S, RESEARCH UPDATE: UNITED STATES OF AMERICA LONG-TERM RATING LOWERED TO “AA+” ON POLITICAL RISKS AND RISING DEBT BURDEN; OUTLOOK

representing *billions* of dollars in loans.¹⁰ In contrast, only *eight* publicly traded U.S. corporations merited a triple-A rating from Moody's in March 2005, and only *four* currently garner Moody's triple-A rating.¹¹

NEGATIVE 2 (2011). In a move making front-page headlines, Standard & Poor's cut its long-term sovereign credit rating for the U.S. government from AAA to AA+ on August 5, 2011. *Id.*; Damian Paletta, *U.S. Loses Triple-A Credit Rating*, WALL ST. J., Aug. 6, 2011, at A1. This cut was not the first reduction in the credit rating of the United States; Egan-Jones Ratings Co. cut its rating on July 16, 2011. John Detrixhe, *Egan-Jones Cuts U.S. Rating to AA+ on Spending-Cut Concern*, BLOOMBERG (July 18, 2011, 4:12 PM), <http://www.bloomberg.com/news/2011-07-18/egan-jones-cuts-u-s-rating-to-aa-on-spending-cut-concern-1-.html>.

Before these cuts, others had questioned whether U.S. treasury securities deserved a triple-A rating. Joseph A. Giannone, *Whitehead Sees Slump Worse than Depression*, REUTERS (Nov. 12, 2008), <http://www.reuters.com/article/idUSTRE4AB7HT20081112> (internal quotation marks omitted). John Whitehead, former chairman of Goldman Sachs, noted: "Before I go to sleep at night, I wonder if tomorrow is the day Moody's and S&P will announce a downgrade of U.S. government bonds Eventually U.S. government bonds [will] no longer be the triple-A credit that they've always been." *Id.* In July 2010, a Chinese credit rating agency downgraded the debt of the United States from triple-A status to a double-A rating. Ambrose Evans-Pritchard, *Chinese Rating Agency Strips Western Nations of AAA Status*, THE TELEGRAPH (July 12, 2010, 9:17 PM), <http://www.telegraph.co.uk/finance/china-business/7886077/Chinese-rating-agency-strips-Western-nations-of-AAA-status.html>. This same Chinese credit rating agency subsequently cut its rating for the United States to A+. Matt Phillips, *Chinese Credit Rater Downgrades U.S.*, WALL ST. J. (Nov. 9, 2010, 10:47 AM), <http://blogs.wsj.com/marketbeat/2010/11/09/chinese-credit-rater-downgrades-us/>.

¹⁰ See CRA June 2010 Hearing, *supra* note 4, at 9 (describing Moody's as a "triple-A factory" that slapped its triple-A rating on 9,029 mortgage-backed securities worth \$869 billion in 2006 alone, essentially assigning its triple-A rating to more than thirty mortgage securities each and every working day that year); CRA Oct. 2008 Hearing, *supra* note 1, at 2 (describing the flood of securities backed by risky subprime loans unleashed by Wall Street which generated billions in fees for the credit rating agencies). From 2000 to 2007, Moody's awarded its coveted triple-A rating to 42,625 residential mortgage-backed securities. CRA June 2010 Hearing, *supra* note 4, at 9. Eighty-three percent of those securities were eventually downgraded, causing investors heavy losses. *Id.* at 9-10. The Commission found these downgrades particularly egregious as housing prices had not collapsed but only declined four percent from their peak. *Id.* at 11. *The Big Short* gives an excellent explanation of how the credit rating agencies awarded their highest investment ratings to bundled packages of subprime securities—called CDOs or collateralized debt obligations. LEWIS, *supra* note 7, at 72-73. Lewis describes the CDO market as such:

[T]he CDO [that] had been invented to redistribute the risk of corporate and government bond defaults . . . was now being rejiggered to disguise the risk of subprime mortgage loans. Its logic was exactly that of the original mortgage bonds. In a mortgage bond, you gathered thousands of loans and . . . created a tower of bonds In a CDO you gathered one hundred different *mortgage bonds*—usually, the riskiest, lower floors of the original tower—and used them to erect an entirely new tower of bonds. . . . Having gathered 100 ground floors from 100 different subprime mortgage buildings (100 different triple-B-rated bonds), [investment banks] persuaded the rating agencies that these weren't, as they might appear, all exactly the same things. . . . The rating agencies, who were paid fat fees by . . . Wall

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In the wake of the subprime mortgage crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (“the Dodd-Frank Act”) on July 21, 2010.¹² This legislation offers needed reforms, but stops short of eradicating all the abuses at the root of the problem and suffers from implementation delays.¹³ This Note argues that the big three credit rating agencies should be required to operate by the same rules as other financial market analysts and not receive

Street firms for each deal they rated, pronounced 80 percent of the new tower of debt triple-A. The CDO was, in effect, a credit laundering service . . . that turned lead into gold.

Id. In typical Wall Street gallows-humor style, a biting crude Microsoft Office PowerPoint slide show titled “The Subprime Primer” provides an amusing explanation of the subprime mortgage debacle. *The Subprime Primer*, SLIDESHARE, <http://www.slideshare.net/guesta9d12e/subprime-primer-277484> (last visited Feb. 20, 2012). In one of the slides, a cartoon stick-figure employee at an investment banking firm is shown gesturing toward a fly-laden garbage can and congratulating his stick-figure boss for his genius in “creat[ing] AAA and BBB securities out of a pile of stinky, risky mortgage loans.” *Id.*

¹¹ Matt Krantz, *As Company Priorities Shift, Fewer Get AAA Debt Rating*, USA TODAY (Mar. 15, 2005), http://www.usatoday.com/money/companies/management/2005-03-15-aaa-usat_x.htm (providing statistics). Ironically, one of those eight triple-A firms—American International Group (“AIG”)—was in the process of losing its triple-A status due to its exposure to the subprime mortgage market. *Id.* AIG was later the subject of a \$182 billion government bailout when the firm nearly collapsed under the weight of its exposure to the subprime mortgage securities market. Paul Davidson, *AIG Reaches a Deal to Fully Repay Taxpayer Billions*, USA TODAY (Sept. 30, 2010), www.usatoday.com/money/industries/insurance/2010-09-30-aig-repayment-plan_N.htm. As of August 22, 2011, the only publicly traded U.S. corporations with a triple-A rating from Moody’s were Automatic Data Processing, Exxon Mobil, Johnson & Johnson, and Microsoft. *Research & Ratings*, MOODY’S, <http://v3.moody.com/Pages/default.aspx> (last visited Feb. 20, 2012) (first register with website; then hover on “Research & Ratings” drop-down menu and select “Corporates” from list; next, select “Investment Grade” from “Refine By” menu on left side of page; then, select “Organizations” tab option, and then select “Organization List” hyperlink in center table; sequentially select “Aaa,” “North America,” and “United States & U.S. Territories” from “Refine By” menu; the resulting list shows both private and public firms; using the “Company Search” query form at the SEC website, <http://www.sec.gov/edgar/searchedgar/companysearch.html>, research each company to determine corporate status).

¹² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹³ Daniel A. Cotter, *One Step Forward, Two Steps Back*, in CBA RECORD 18 (2010) (describing a speech given by Michael McRaith, Illinois Department of Insurance Director, in which McRaith stated that Congress’s financial services reform was a good start but did not go far enough to address the causes of the crisis); *see infra* Parts II-III (discussing the shortfalls of the Dodd-Frank Act). According to a report published by Davis Polk & Wardwell LLP, only 13% of the 400 rulemaking requirements of the Dodd-Frank Act have been finalized as of the Act’s one-year anniversary. DAVIS POLK, ONE-YEAR ANNIVERSARY REPORT: DODD-FRANK PROGRESS REPORT 2 (2011), available at http://www.davispolk.com/files/uploads/FIG/072211_Dodd_Frank_Progress_Report.pdf. Davis Polk claims that by its count 130 requirements have already missed their deadlines. *Id.* at 4.

selective access to confidential information.¹⁴ This special treatment has created a “moral hazard” that endangers our entire financial system and must be eliminated.¹⁵

This Note begins in Part II by describing the structure of U.S. financial markets, the credit rating industry, the importance of ratings to the financial markets, problems associated with permitting the rating agencies to access confidential information, and the Dodd-Frank Act.¹⁶ Part III of this Note analyzes how the new Dodd-Frank Act addresses some of the problems that have plagued the credit rating industry and examines the unintended consequences and shortfalls of this legislation.¹⁷ Finally, Part IV of this Note advocates that the playing field should be leveled and the credit rating agencies should be required to operate like other investment analysts by ending their special status and access to confidential information.¹⁸ This change will eliminate the special distinctions accorded this cartel, help erase anti-competitive practices, lead to better credit ratings, and foster stronger financial markets.

II. BACKGROUND

Despite the large role played by the credit rating agencies in the financial markets crisis, “[t]he average American has probably never heard of credit rating agencies.”¹⁹ This Note begins by providing an overview of the U.S. capital markets and the credit rating agencies, describing the power of the credit rating agencies, and noting the growing dependency of government regulators and market participants

¹⁴ See *infra* Part III.C (discussing the implications of the credit rating agencies’ continuing access to confidential information).

¹⁵ IMF, *supra* note 7, at 127 (defining “[m]oral hazard” as “[t]he incentive of individuals or firms to take unreasonable risks when the consequences will not be borne by them. For example, financial institutions have incentives to take excessive risks if they believe that governments will step in and provide support to them in crisis periods”).

¹⁶ See *infra* Part II (providing general background information on the financial markets and credit rating agencies).

¹⁷ See *infra* Part III (discussing some of the provisions of the Dodd-Frank Act).

¹⁸ See *infra* Part IV (proposing amendments to the Dodd-Frank Act and SEC regulations).

¹⁹ *Credit Rating Agencies and the Next Financial Crisis: Hearing Before the H. Comm. on Oversight and Gov’t Reform*, 111th Cong. 1 (2009) (statement of Rep. Edolphus Towns, Chairman, H. Comm. on Oversight and Gov’t Reform) (commenting that the credit rating agencies were at the heart of the last financial collapse and will be at the heart of the next financial collapse even though the average American is unaware of them). Representative Towns also claims “Moody’s business model could be summed up as: leave no fingerprints.” *Id.* at 144.

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on the integrity of credit ratings.²⁰ This Note also explains the special Nationally Recognized Statistical Rating Organization (“NRSRO”) designation that was created by the U.S. Securities and Exchange Commission (“SEC”) in 1975 and how that designation created a special government sanctioned cartel.²¹ This Note also describes the lack of government oversight of the credit ratings industry as well as the legal protections that historically protected the credit rating agencies, including their legally sanctioned ability to access confidential information—a practice legally prohibited to other stock and bond analysts.²² In addition, government efforts to rein in the credit rating agencies and specific provisions of the newly enacted Dodd-Frank Act that involve the credit rating agencies are discussed.²³

A. *Structure of the U.S. Capital Markets*

The U.S. stock market, the home of such well-known names as Exxon Mobil, Apple, General Electric, and International Business Machines (aka IBM), is an estimated \$18.2 trillion market—greater than the size of the U.S. gross national product.²⁴ Although the stock market captures the newspaper headlines, the U.S. bond market is much larger in comparison.²⁵ As of the first quarter of 2011, the estimated total value

²⁰ See *infra* Parts II.A–D (discussing the structure of the bond market and the credit ratings industry).

²¹ See *infra* Part II.D (discussing the implications of the NRSRO designation).

²² See *infra* Parts II.E–F (discussing the ability of credit rating agencies to access confidential information and the legal protections and lack of regulatory oversight that have shielded the firms).

²³ See *infra* Part II.G (discussing legislation relative to the credit rating agencies, including the new Dodd-Frank Act).

²⁴ See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS FIRST QUARTER 2011, at 13 (2011) (showing the size of the U.S. gross national product); *id.* at 92 (providing the market value of domestic corporations). Exxon Mobil, Apple, International Business Machines (“IBM”), Chevron, and Microsoft represent the top five companies in the S&P 500 stock index as of August 22, 2011, ranked on market capitalization (number of shares of stock outstanding multiplied by stock price). *S&P 500*, STANDARD & POOR’S (Feb. 17, 2012), <http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usd-f-p-us-l->. The S&P 500 index is a well-known stock market index that tracks the shares of the 500 leading companies in America, representing roughly 75% of the U.S. equities market. *Id.*

²⁵ See *Outstanding U.S. Bond Market Debt*, SIFMA, <http://www.sifma.org/research/statistics.aspx> (last updated Feb. 17, 2012) (click on “US Bond Market Outstanding”) (giving the size of the bond market); see also ANNETTE THAU, THE BOND BOOK: EVERYTHING INVESTORS NEED TO KNOW ABOUT BONDS 8 (2d ed. 2001) (noting that the financial press reports mainly on the stock market). For purposes of this Note, the author generally combines commercial paper, notes, and other short-term debt obligations under the “bonds” label.

of the U.S. bond market was \$35.5 trillion, nearly double the size of the equities market.²⁶ Advertisers may claim that America runs on donuts and coffee, but in reality, the nation runs on leverage.²⁷

Beyond the structural differences of the securities—fractional ownership of a corporation in the case of a stock and an I.O.U. of a corporation in the case of a bond—the markets for stocks and bonds have evolved quite differently.²⁸ Stocks generally trade electronically or on well-recognized securities exchanges such as the New York Stock Exchange.²⁹ Bonds increasingly trade electronically, but a significant percent are still sold in a fragmented, inefficient over-the-counter market dominated by sophisticated institutional investors.³⁰

Perhaps the largest difference between the two securities relates to how they are evaluated by investment professionals. Stocks are typically followed by sell-side, buy-side, and independent securities analysts who analyze the investment prospects of the shares and produce investment reports for use either internally by their employers or externally by customers.³¹ Similar analysts, called credit analysts, operate in the bond

²⁶ *Outstanding U.S. Bond Market Debt*, *supra* note 25.

²⁷ *Dunkin' Donuts Launches New Advertising Campaign "America Runs on Dunkin'"*, DUNKIN' DONUTS (Apr. 10, 2006), http://news.dunkindonuts.com/article_display.cfm?article_id=1185.

²⁸ See THAU, *supra* note 25, at 7–10 (discussing some of the differences between the market for a bond and the market for a stock); A GUIDE TO THE NYSE, *supra* note 3, at 7, 9, 24 (providing definitions of a stock and a bond and detailing how a stock is bought and sold); Paul Conley, *How to Buy a Corporate Bond: Brokers, Over-the-Counter and Exchange-Traded Bonds*, ABOUT.COM, http://bonds.about.com/od/corporatebonds/a/Corporate_bonds.htm (last visited Feb. 20, 2012) (cautioning that investing in bonds is more complex than investing in stocks and is no place for amateurs).

²⁹ See A GUIDE TO THE NYSE, *supra* note 3, at 3–10 (describing the various participants and electronic systems involved in both electronic trading and floor trading). The New York Stock Exchange, a well-known securities exchange, traces its roots to 1792. *New York Stock Exchange*, NYSE EURONEXT, <http://corporate.nyx.com/en/who-we-are/history/new-york> (last visited Feb. 20, 2012).

³⁰ See MICHAEL V. BRANDES, *NAKED GUIDE TO BONDS: WHAT YOU NEED TO KNOW—STRIPPED DOWN TO THE BARE ESSENTIALS* 12 (2003) (noting that, unlike stocks, bonds are more frequently traded in the over-the-counter market and the trading is dominated by institutional investors); Melanie Rodier, *The Massive Growth of Electronic Bond Trading*, WALL STREET & TECH. (Apr. 15, 2008), <http://www.wallstreetandtech.com/showArticle.jhtml?articleID=207200781> (describing how the fixed income market has become increasingly electronic and noting that U.S. corporate bonds are notoriously illiquid); TRACE: *Overview and Implications for an Evolving Credit Market*, CELENT (May 8, 2006), <http://www.celent.com/reports/trace-overview-and-implications-evolving-credit-market> (describing how the U.S. corporate bond market has always been plagued by a severe lack of liquidity where prices have often been inconsistent, varying widely even for trades of similar size executed within minutes of each other).

³¹ *Analyzing Analyst Recommendations*, SEC, <http://www.sec.gov/investor/pubs/analysts.htm> (last modified Aug. 30, 2010) [hereinafter *Analyzing Analysts*]. Sell-side

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market.³² However, the importance of credit analysts in the bond market has historically been secondary.³³ Instead, most fixed-income securities are rated for credit worthiness and repayment risk by a credit rating agency.³⁴

analysts typically work for full-service brokerage firms that also provide investment banking services for corporate clients. *Id.* Because a sell-side analyst may recommend a firm that is also an investment banking client of the analyst's employer, certain conflicts of interest can create pressure on an analyst's independence and objectivity. *Id.* For example, Henry Blodget and Jack Grubman, two prominent Wall Street sell-side analysts, were barred from the securities industry for life and slapped with large fines for fraudulent research reports that represented conflicts of interest. Jake Ulick, *Wall St. Deal is Finalized*, CNNMONEY (Apr. 28, 2003), http://money.cnn.com/2003/04/28/news/wallst_settlement/index.htm. Buy-side analysts typically work for institutional money managers such as mutual funds, hedge funds, or investment advisors that purchase securities for their own or client accounts— hence the name “[b]uy-side.” *Analyzing Analysts, supra.* Independent analysts typically are not associated with brokerage or investment banking firms. *Id.* These analysts typically sell their research reports on a subscription basis to institutional investment companies. *Id.* Many analysts are members of CFA Institute, a professional organization that administers a rigorous graduate-level self-study program and awards a CFA charter that is recognized as the gold standard investment credential. *Organizational Facts and Statistics*, CFA INST., http://www.cfainstitute.org/about/Pages/facts_and_statistics.aspx?intCamp=organizational (last visited Feb. 20, 2012). Ethics, objectivity, and integrity are important components of this program and membership. *Guiding Principles*, CFA INST., <http://www.cfainstitute.org/about/strategy/principles/Pages/index.aspx> (last visited Feb. 20, 2012).

³² See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-782, SECURITIES AND EXCHANGE COMMISSION: ACTION NEEDED TO IMPROVE RATING AGENCY REGISTRATION PROGRAM AND PERFORMANCE-RELATED DISCLOSURES 7 (2010) [hereinafter GAO REPORT] (describing credit analysts).

³³ See Ivy Schmerken, *Demand for Credit Analysts Rises on the Buy Side in Wake of Rating Agency Disasters*, ADVANCED TRADING (Aug. 22, 2008), <http://www.advancedtrading.com/managingthedesk/210200320> (noting that buy-side firms typically rely on Wall Street firms and credit rating agencies to provide them with research, but due in part to the failings of the credit rating agencies, buy-side firms are now increasing their hiring of in-house credit analysts to perform independent analysis). One individual went so far as to proclaim that “the rating agencies are dead and you have to do all original work.” *Id.*

³⁴ See *Senate 2009 Hearing, supra* note 7, at 21 (statement of Sen. Jim Bunning) (questioning whether it was really necessary for the credit rating agencies to rate every security sold to the public); Exhibits, *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. and Governmental Affairs*, 111th Cong. exhibit #30a (2010) (containing the now infamous instant message exchange between two Standard & Poor's employees in which one wrote: “[W]e rate every deal . . . it could be structured by cows and we would rate it”); Alec Klein, *Credit Raters' Power Leads to Abuses, Some Borrowers Say*, WASH. POST, Nov. 24, 2004, at A1 (“They are rating every [bond issue] and charging for each [bond issue] . . .” (alterations in original) (internal quotation marks omitted)).

B. Overview of Credit Rating Agencies

The billion dollar credit rating industry can trace its roots back at least a century.³⁵ Today, more than seventy credit rating agencies operate worldwide, but the industry is dominated by a few giants.³⁶ In the United States, three credit rating agencies, Standard & Poor's, Moody's, and Fitch, account for ninety-seven percent of the U.S. credit ratings market.³⁷

Often confused with credit reporting agencies that analyze a consumer's debt-repayment ability, credit rating agencies analyze the debt-repayment ability of corporations and governments.³⁸ It can be difficult and costly for each potential lender to research the creditworthiness of a specific borrower, particularly when the lender may only purchase a small portion of a bond offering and a printed bond offering document may represent 200 pages.³⁹ In theory, it is much more

³⁵ See CRA Oct. 2008 Hearing, *supra* note 1, at 2, 211 (noting that the big three rating agencies had revenues of over \$6 billion in 2007); *About the Founder of A.M. Best*, A.M. BEST, <http://www.ambest.com/about/bio.html> (last visited Feb. 20, 2012) (noting that A.M. Best began providing reports on insurance companies as early as 1899); *Moody's History: A Century of Market Leadership*, MOODY'S CORP., <http://v3.moodys.com/Pages/atc001.aspx> (last visited Feb. 20, 2012) (noting that John Moody founded his company in 1900 and began publishing letter ratings on railroad securities in 1909).

³⁶ IMF, *supra* note 7, at 86-87, 118-119 (providing a list of seventy-four credit rating agencies but claiming that only the "big three" of Fitch, Moody's, and Standard & Poor's are truly global and broad in product coverage (internal quotation marks omitted)).

³⁷ See SEC, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 5 (2011) (listing the number of credit ratings performed by the ten currently recognized NRSROs and providing data revealing that 97% of the ratings were performed by Standard & Poor's, Moody's, and Fitch, who held 42% percent, 37% percent, and 18% percent market shares, respectively). The calculations given here only include the activities of the ten NRSROs that are legally required to file reports concerning their business operations with the SEC. *Id.* There are other credit rating agencies that are not NRSROs, which operate in the United States, such as Rapid Ratings; however these firms represent a very small segment of the industry. *History*, RAPID RATINGS, <http://www.rapidratings.com/page.php?25> (last visited Feb. 20, 2012).

³⁸ Apartment 604, *Barney Frank, GOP Go After Credit Rating Agency Dominance: Comments*, HUFFINGTON POST (July 16, 2009, 1:35 AM), http://www.huffingtonpost.com/2009/07/15/barney-frank-gop-go-after_n_233989.html ("Some people on here are confusing Wall St. credit rating agencies (Fitch, Moody's, Standard & Poor's) with consumer credit reporting agencies (Experian, Equifax, and TransUnion)."). Out of thirteen comments submitted to the SEC regarding a concept release on credit rating agencies, five letters confused credit rating agencies with credit reporting agencies (letters of Linda B. Gates; Tommy L. Jenkins, III; Kay Leitzen; Robert W. Mabry; and Stephanie L. Rovig). *Credit Rating Agencies Review and Rulemaking: Title IX Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC, <http://www.sec.gov/comments/df-title-ix/credit-rating-agencies/credit-rating-agencies.shtml> (last visited Feb. 20, 2012).

³⁹ See Senate 2009 Hearing, *supra* note 7, at 5-6 (statement of Michael S. Barr, Assistant Sec'y for Fin. Insts., Dep't of the Treasury) (claiming that credit rating agencies provide a

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efficient for a credit rating agency to evaluate the credit risk of a particular borrower on behalf of all lenders, thus avoiding a duplication of research efforts.⁴⁰

Nearly every debt instrument publicly traded in America has been rated by at least one credit rating agency before its issuance.⁴¹ Like the

service based on scale economies, access to information, and accumulated experience that solves a basic market failure particularly for small purchases); Jonathan Barnes, *Solving the Credit Crisis*, CFA MAG., May–June 2009, at 38 (quoting Sean Egan of Egan-Jones Ratings who describes why it is normal for some investors to rely on rating agencies due to information or time constraints and how offering documents may be about 200 pages long); *Do the Credit Rating Agencies Deserve to Exist?*, INT'L ECON., Fall 2008, at 13 (quoting Maurice R. Greenberg, chairman and CEO, C.V. Starr and Company) (noting that market participants need the credit rating agencies because they cannot assess the risk on their own). This is another distinction from the equities market, where investors can gain information about corporate financial information from central depositories such as EDGAR. See *generally Important Information About EDGAR*, SEC, <http://www.sec.gov/edgar/aboutedgar.htm> (last visited Feb 20, 2012) (providing a description).

⁴⁰ See *Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets: Hearing Before the U.S. Sec. and Exch. Comm'n.* (2002) [hereinafter *SEC 2002 Hearing*] (statement of Stephanie B. Petersen, Senior Vice President, Charles Schwab & Co.) (noting that the rating agencies have a prominent role in the fixed-income markets from contributing to market efficiency to setting risk standards); *Senate 2009 Hearing*, *supra* note 7, at 5 (statement of Michael S. Barr) (noting that it would be inefficient for all lenders to get the information they need to evaluate a borrower). Fitch describes the process in this manner:

Rating agencies gather and analyze a variety of financial, industry, market and economic information, synthesize that information and publish independent, credible assessments of the creditworthiness of securities and issuers thereby providing a convenient way for investors to judge the credit quality of various alternative investment options. Rating agencies also publish considerable independent research on credit markets, industry trends and economic issues of general interest to the investing public. By focusing on credit analysis and research, rating agencies provide independent, credible and professional analysis for investors more efficiently than the investors could perform that analysis themselves.

E-mail from Stephen W. Joynt, President & Chief Exec. Officer, Fitch Ratings, to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n (Nov. 12, 2002), available at <http://www.sec.gov/news/extra/credrate/fitchratings1.htm>.

⁴¹ See *Roundtable to Examine Oversight of Credit Rating Agencies: Hearing Before the U.S. Sec. & Exch. Comm.* 24 (Apr. 15, 2009) [hereinafter *Roundtable 2009*] (statement of Deven Sharma, President of Standard & Poor's) (noting that Standard & Poor's has rated trillions of dollars of debt). While getting an appraisal from the rating agencies was once automatic, in the aftermath of the credit crisis, more firms are turning to issuing "unrated bonds," because they now view the ratings as unreliable, superfluous, or worthless. *Fitch Worries About Unrated Debt*, RATINGS DEBATE (Nov. 15, 2010), <http://www.theratingsdebate.com/index.php?s=fitch+worries+about+unrated>. While buyers of these securities may be hesitant to invest because of a lack of information concerning the borrower's creditworthiness, issuing unrated bonds has become increasingly attractive to European issuers in part due to the cost savings from not paying for a rating. Aaron Kirchfeld,

letter-grade system used by schools, a rating agency will assign a letter grade to debt securities based on an evaluation of the soundness and debt-repayment ability of the firm issuing the security and the specific debt-repayment terms governing the security.⁴² These letter grades generally range from “AAA” to “D” and communicate the agency’s opinion of the relative level of creditworthiness.⁴³ An “AAA” rating, also known as a triple-A rating, is the highest rating that may be given.⁴⁴

The ratings universe is further broken down into two broad categories: investment grade securities and speculative grade securities.⁴⁵ Investment grade securities are issued by entities that are relatively stable with moderate default risk.⁴⁶ Speculative grade securities, often referred to as “junk bonds” or non-investment grade securities, are issued by firms that have a much higher likelihood of defaulting on their debt obligations.⁴⁷

Unrated Bond Sales Increasing in Germany as Investors Chase Higher Yields, BLOOMBERG (Oct. 7, 2010), <http://www.bloomberg.com/news/2010-10-07/unrated-bond-sales-rise-in-germany-as-investors-chase-yield.html>.

⁴² SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 21, 25 (2003) [hereinafter CRA 2003 ROLE REPORT].

⁴³ *Id.*; see FIN. CRISIS INQUIRY COMM’N, PRELIMINARY STAFF REPORT: CREDIT RATINGS AND THE FINANCIAL CRISIS 5 (2010) [hereinafter PRELIMINARY STAFF REPORT] (listing the ratings for the various agencies); *Ratings Definitions*, MOODY’S, <http://v3.moodys.com/ratings-process/Ratings-Definitions/002002> (last visited Feb. 20, 2012) (describing Moody’s ratings scheme).

⁴⁴ *Credit Ratings Definitions & FAQs*, STANDARD & POOR’S, <http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us> (last visited Feb. 20, 2012).

⁴⁵ ARNAUD DE SERVIGNY & OLIVIER RENAULT, MEASURING AND MANAGING CREDIT RISK 25 (2004). Authors Servigny and Renault write from experience, working as a managing director and an associate director, respectively, at Standard & Poor’s. *Id.* at cover.

⁴⁶ *Id.* at 25.

⁴⁷ *Id.* Junk bonds garnered a fair measure of notoriety when financier Michael Milken of Drexel Burnham Lambert turned these speculative securities from a forgotten sector of Wall Street into a powerful financing engine that dramatically reshaped corporate America in the 1980s before he was indicted on ninety-eight counts of racketeering and fraud relating to his junk bond activities. See CONNIE BRUCK, THE PREDATORS’ BALL: THE INSIDE STORY OF DREXEL BURNHAM AND THE RISE OF THE JUNK BOND RAIDERS 10–11 (1989) (detailing the rise of Milken’s “historic franchise,” which he created for those companies “rated below investment grade by the rating agencies and thus had not been able to raise money by issuing bonds in the public market”); JAMES B. STEWART, DEN OF THIEVES 486 (1992) (describing Milken’s indictment). Milken made \$550 million in salary and bonus in 1986 and eventually agreed to pay a \$600 million fine to the government for his felonies—an amount larger than the yearly budget of the SEC. *Id.* at 20.

Ratings Schemes Used by the Three Leading Credit Rating Agencies⁴⁸

	Standard & Poor's	Moody's	Fitch	Credit Quality
Investment Grade	AAA	Aaa	AAA	Highest Credit Quality
	AA	Aa	AA	High Credit Quality
	A	A	A	Strong Payment Capacity
	BBB	Baa	BBB	Adequate Payment Capacity
Speculative Grade	BB	Ba	BB	Possibility of Credit Risk
	B	B	B	Significant Credit Risk
	CCC	Caa	CCC	High Credit Risk
	CC, C	Ca	CC, C	Default Likely/Imminent
	SD, D	C	D	In Default

C. Importance of Bond Ratings and Power of the Credit Rating Agencies

The difference between an investment grade security and a speculative grade security is more than just semantics.⁴⁹ The interest rate that a bond issuer must pay to attract investors is largely determined by the investment rating assigned to the bond by the credit rating agencies.⁵⁰ A company issuing lower-rated securities can expect to pay a much higher interest rate and make larger interest payments than a company issuing higher-rated securities.⁵¹ Depending on the size of the offering and rating involved, the difference in ratings may cost a debt issuer millions of dollars more in interest.⁵² Thus, a favorable rating is of

⁴⁸ See PRELIMINARY STAFF REPORT, *supra* note 43 (providing a table of the big three credit rating agencies' rating schemes). Although the different agencies measure slightly different credit risk characteristics and have different schemes for different categories of securities, investors and regulators tend to view the ratings as roughly equivalent. *Id.* at 4. Both Fitch and Standard & Poor's subdivide their ratings through the use of "+" and "-" signs after the letter grade. John Cady & Anthony Pellechio, *Sovereign Borrowing Cost and the IMF's Data Standards Initiatives* 20 (Int'l Monetary Fund, Working Paper No. WP/06/78, 2006). Moody's subdivide its ratings through the use of the numbers "1," "2," and "3" after the letter grade. *Id.*

⁴⁹ See TIMOTHY J. SINCLAIR, *THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS* 35 (2005) (noting that the distinction between investment grade and non-investment grade has become a market convention and has defined the demarcation line between bonds that are speculative and those considered acceptable for investment).

⁵⁰ See *id.* at 73 ("Ratings affect the cost of issuing debt.").

⁵¹ See *id.* at 4 ("The higher the rating, the less risk of default on repayment to the lender and, therefore, other things being equal, the lower the cost to the borrower.").

⁵² See SINCLAIR, *supra* note 49, at 73 (citing a 1992 study by Stephen Dafoe of Canadian Bond Rating Service that projected savings of \$0.66 million on a \$200 million bond issue); Frederic M. Biddle, *Wall Street's Bond Busters; The Bay State Feels the Rating Agencies' Wrath*,

immense importance to those issuing debt securities, and in some cases, a favorable rating can make or break a bond deal.⁵³

A high credit rating is also important to bond market investors.⁵⁴ Until the passage of the Dodd-Frank Act in 2010, certain institutional

BOS. GLOBE, July 30, 1989, at 63 (quoting an estimate by Massachusetts' deputy treasurer Patrick Sullivan that recent rating downgrades could cost the state of Massachusetts \$20 million a year in additional interest); see also John Y. Campbell & Glen B. Taksler, *Equity Volatility and Corporate Bond Yields*, 58 J. FIN. 2321, 2327 (2003) (providing a table of average corporate bond yield spreads between corporate bonds of various credit qualities compared to government treasury instruments of similar maturity). Using figures from this table, the difference between the average yield spread on BBB-rated bonds and AA-rated bonds in 1999 (an extreme period) was 90 basis points (175 minus 85). *Id.* Thus, a BBB-rated bond issuer paid an additional \$2.25 million in annual interest compared to an AA-rated issuer on a hypothetical \$250 million bond deal in 1999. *Id.*

⁵³ See INT'L ORG. SEC. COMM'NS, IOSCO STATEMENT OF PRINCIPLES REGARDING THE ACTIVITIES OF CREDIT RATING AGENCIES (2003), available at <http://www.fsa.go.jp/inter/ios/20030930/02.pdf> ("Credit ratings can affect issuers' access to capital, influence the structure of financial transactions, and determine the types of investments fiduciaries and others can make."); *The Make-or-Break Power of Ratings Agencies*, INDEPENDENT (May 10, 2010), <http://www.independent.co.uk/news/business/analysis-and-features/the-make-or-break-power-of-ratings-agencies-1970100.html> (claiming that the credit rating agencies can rattle markets with nothing more than a change of heart). For example, in *King County v. IKB Deutsche Industriebank AG*, the court noted that "the Rated Notes would not sell without the Rating Agencies' highest ratings." 751 F. Supp. 2d 652, 663 (S.D.N.Y. 2010); see also *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, 651 F. Supp. 2d 155, 165 (S.D.N.Y. 2009) ("A credit rating is important to both issuers and investors."). In the words of Representative Henry Waxman, "for Wall Street's investment banks, a triple-A rating became the independent validation that turned a pool of risky home loans into a financial gold mine." *CRA Oct. 2008 Hearing*, *supra* note 1, at 2.

⁵⁴ See *In re Fitch, Inc.*, 330 F.3d 104, 106 (2d Cir. 2003) (noting that, once a security has received a favorable rating, the security is easier to sell to investors and a high rating carries with it a regulatory benefit). A high credit rating assumed such importance that a new line of bond default insurance was created in the 1970s around bond ratings. See *MGIC Forms Municipal Bond Insurance Company*, MILWAUKEE SENTINEL, July 7, 1971, at pt. 2, p. 5 (announcing the formation of American Municipal Bond Assurance Corp. and noting that the concept of insuring the payment of principal and interest on municipal bonds is a new concept in the financial field). In return for a fee, a bond insurer would agree to insure a bond offering against the risk of default and the bond would be assigned the same credit rating as the bond insurer. See CHRISTINE S. RICHARD, CONFIDENCE GAME: HOW A HEDGE FUND MANAGER CALLED WALL STREET'S BLUFF 5 (2010) (explaining the mechanics of this process). The bond would be given the same rating as the bond insurer because the insurance company carried the ultimate payment burden. *Id.* If the bond issuer was unable to make the required payments to investors, the insurance company was then required to make those payments instead. *Id.* Under one sleight of hand arrangement, for example, a hospital with a non-investment grade rating paid an insurance company \$500,000 for bond insurance but saved an estimated \$25 million in interest because of the higher credit rating awarded its bonds. See *id.* at 134 (describing the experience of Allegheny Health, Education, and Research Foundation). Allegheny later filed for bankruptcy. *Id.* at 97. Two things are important to remember when analyzing the conflicts of interests inherent in this feat of financial magic: (1) the credit rating agencies assigned the ratings to all the parties involved—the bond issuer, the insurance company, and the

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investors could *only* invest in “investment grade” securities as rated by a nationally recognized rating agency or those investors would incur regulatory penalties for holding securities that were not investment grade.⁵⁵ Even in the wake of this new legislation, many bank lending documents, mutual fund prospectuses, and private lending contracts dictate that investments only be made in investment grade securities or contain “triggers” that mandate that a firm must maintain a certain credit rating.⁵⁶

Because of the importance of credit ratings to the financial markets, the rating agencies wield tremendous power and are viewed as “essential financial gatekeepers” who function as “unofficial regulators” rather than merely as credit analysts.⁵⁷ Credit ratings by the rating agencies are viewed differently from the “buy,” “sell,” or “hold” recommendations that equity analysts assign to stocks. Instead, an investment grade credit rating is considered a “Good Housekeeping Seal of Approval.”⁵⁸ In keeping with this “gatekeeper” status, credit ratings

actual bond offering; and (2) the credit rating agencies received large fees for this business. *Id.* “Companies like Moody’s make huge fees every time they rate a security backed by [bond insurer] MBIA,” noted hedge fund manager Bill Ackman in June 2003 when he tried to warn the SEC about conflicts of interests between the bond insurers and the credit rating agencies. *Id.* at 94. (internal quotation marks omitted).

⁵⁵ CRA 2003 ROLE REPORT, *supra* note 42, at 6–8; *see infra* Part II.G (describing how the Dodd-Frank Wall Street Reform and Consumer Protection Act mandates the removal of credit ratings from government regulations).

⁵⁶ *See* IMF, *supra* note 7, at 92 (noting the widespread use of credit ratings in numerous private sector contracts); *see e.g.*, Complaint at 6–7, *Water Works Bd. v. Ambac Fin. Grp.*, No. 2:09-cv-02296-WMA, 2010 U.S. Dist. LEXIS 58904 (N.D. Ala. Apr. 1, 2010) (describing the terms of a trust indenture in which “the requirements for the Water Works Board in the event that the rating claims paying ability of the municipal bond insurer who issued the surety bond falls below and [sic] S&P’s rating of ‘AAA’ or a Moody’s rating of ‘Aaa.’”); *see also* COMM. ON GOV’T AFFAIRS, ENRON’S CREDIT RATING: ENRON’S BANKERS’ CONTACTS WITH MOODY’S AND GOVERNMENT OFFICIALS, S. DOC. NO. 107-83, at 2 (2nd Sess. 2003) [hereinafter ENRON] (commenting that the implications of downgrading Enron’s debt from an investment grade rating to junk credit rating were important to Enron given its liquidity problems). Triggers tied to credit ratings in a number of agreements would have constituted a default or forced the firm to post significant amounts of collateral. *Id.*

⁵⁷ *See* CRA Oct. 2008 Hearing, *supra* note 1, at 1, 4 (using the term “essential financial gatekeepers” and noting that “[t]he credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent objective assessments”); RICHARD BITNER, CONFESSIONS OF A SUBPRIME LENDER: AN INSIDER’S TALE OF GREED, FRAUD, AND IGNORANCE 106 (2008) (calling the rating agencies “unofficial regulators”); *see also* Adam J. Levitin & Susan M. Wachter, *Information Failure and the U.S. Mortgage Crisis* 20 (Inst. for Law & Econ., Research Paper No. 10-19, 2010) (“Most investors look[] to rating agencies to serve as information proxies regarding default and loss risk.”).

⁵⁸ *See* CRA June 2010 Hearing, *supra* note 4, at 8 (“Credit rating agencies have played a pivotal role in our financial markets. Their Good Housekeeping Seal of Approval guided decisions by individuals and institutional investors alike”); AMANDA J. BAHENA, WHAT ROLE DID CREDIT RATING AGENCIES PLAY IN THE CREDIT CRISIS? 1 (2010) (“A credit rating is

are provided free of charge to the public on the websites of the credit rating agencies, which is another departure from how analysts in the stock and bond market typically operate.⁵⁹

The three leading credit rating agencies predominately operate under the “issuer-pays” business model, which takes its name from *who* is paying the credit rating agency for its services.⁶⁰ Under the “issuer-pays” business model, the credit rating agency is paid by the debt issuer.⁶¹ In contrast, under the “subscriber-pays” business model used by some of the big three’s competitors, the credit rating agency is paid by the ratings user, similar to a magazine subscription.⁶² The issuer-pays

not a measure of the value or profitability of a financial instrument or of the debtor; it is not the same as a buy, sell, or hold recommendation from an investment analyst.”). The rating agencies themselves are quite eager to reinforce this distinction: “Standard & Poor’s ratings are not indications of investment merit. In other words, the ratings are not buy, sell, or hold recommendations, or a measure of asset value.” STANDARD & POOR’S, *supra* note 8, at 4.

⁵⁹ See GAO REPORT, *supra* note 32, at 9 (noting how such ratings are generally free to the public); *Roundtable 2009*, *supra* note 41, at 46 (statement of Raymond W. McDaniel, Jr., Chairman and CEO of Moody’s) (describing that under the “issuer-pays” business model, “ratings are made available to the investing public free of charge, [which] is, I think, a significant benefit”); Boris Groysberg, Paul Healy, Craig Chapman, Devin Shanthikumar & Yang Gui, *Do Buy-Side Analysts Out-Perform the Sell-Side?* 1, 2, 8–11 (2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=806264 (outlining how buy-side and sell-side analysts operate and are compensated); *Analyzing Analysts*, *supra* note 31 (noting how brokerage firms do not usually directly charge for analyst research reports, but an analyst report can indirectly generate brokerage commissions); see also *supra* note 11 (describing how to access credit ratings on Moody’s website).

⁶⁰ IMF, *supra* note 7 (providing a list of credit rating agencies with their business models); see also GAO REPORT, *supra* note 32, at 60 (describing the “issuer-pay” business model).

⁶¹ IMF, *supra* note 7, at 94 (describing the mechanics of the issuer-pays model and noting that “almost all credit ratings are paid for by the issuer of the instruments”).

⁶² GAO REPORT, *supra* note 32, at 9, 60–61 (describing the “subscriber-pays” business model). Before the late 1960s–early 1970s, the leading credit rating agencies operated under the subscriber-pays business model. E-mail from Stephen W. Joynt, *supra* note 40; STEPHANE ROUSSEAU, CAPITAL MARKETS INSTITUTE, ENHANCING THE ACCOUNTABILITY OF CREDIT RATING AGENCIES: THE CASE FOR A DISCLOSURE-BASED APPROACH 11 (2005). However, the growth of low-cost photocopying technology made it difficult for the credit rating agencies to limit access to their ratings only to paying subscribers, incentivizing them to change to a different model. *Id.* The massive default of Penn Central Transportation Corporation in 1970 frightened investors and gave bond issuers further incentive to pay to have their bond offerings rated by credit rating agencies if they wished to reassure and attract investors. *Id.*; Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 47 (2004). Debt issuers’ willingness to pay for ratings was also increased when the SEC created the NRSRO concept in 1975 and incorporated credit ratings into broker-dealers’ minimum capital requirements based on the quality of the positions held in their portfolios. *Id.* at 53–54; Jonathan S. Sack & Stephen M. Juris, *Rating Agencies: Civil Liability Past and Future*, 238 N.Y. L.J. 88 (2007). The “subscriber-pays” business model is also called the “investor-pay” or “user-pay” model. IMF, *supra* note 7, at 87, 94. Some commentators

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business model has been criticized by many for its inherent conflicts of interest in which a credit rating agency's reputation for reliable credit ratings must struggle against keeping and appeasing a paying credit ratings customer.⁶³ The issuer-pays model introduces the potential for a

argue this model is more timely and efficient than the issuer-pays model. See *Transforming Credit Rating Agencies: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 70 (2009) [hereinafter *Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*] (statement of James H. Gellert, Chairman and CEO of Rapid Ratings International) (testifying that agencies that use only publically available data outperform those that use confidential information); William H. Beaver, Catherine Shakespeare & Mark T. Soliman, *Differential Properties in the Ratings of Certified vs. Non-Certified Bond Rating Agencies*, 42 J. ACCT. & ECON. 303, 332 (2006) (finding that subscriber-pays firms performed better than issuer-pays firms); Martin Mayer, *Credit Rating Agencies in the Crosshairs*, BROOKINGS (Aug. 2010), http://www.brookings.edu/articles/2010/0831_ratings_agencies_mayer.aspx (reporting that William Gross, PIMCO's managing director, says his business would be fine without the rating agencies).

⁶³ See GAO REPORT, *supra* note 32, at 2 (arguing that the rating agencies' dependence on revenues from the firms they rate could induce them to temper their diligence and assign a rating more favorable than circumstances would warrant); IMF, *supra* note 7, at 94 (noting that the issuer-pays model might give an issuer an incentive to "shop around" for the best rating since the issuer is paying for it); see also *King Cnty v. IKB Deutsche Industriebank AG*, 751 F. Supp. 2d 652, 661 (S.D.N.Y. 2010) (noting that investment banking firm Morgan Stanley knew that the rating agencies had bent to its pressure to accept large concentrations of risky subprime securities); *Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 93, 3 (2009) [hereinafter *2009 Hearing Before the H. Comm. on Fin. Servs.*] (statement of Sean Egan) ("[T]hese companies have, for the last 35 years, been in the business of facilitating the issuance of securities for the benefit of issuers and underwriters."); *CRA Oct. 2008 Hearing*, *supra* note 1, at 3 (quoting a portfolio manager from Vanguard, a large mutual fund company, who told Moody's that the rating agencies "allow issuers to get away with murder" (internal quotation marks omitted)). U.S. District Judge Shira A. Scheindlin may best express the inherent problem:

Contrary to past practices where they were paid by investors, the Rating Agencies were compensated by the Cheyne SIV and Morgan Stanley at a fee substantially larger than normally received and a fee that was directly connected to the success of the Cheyne SIV. This structure created a conflict of interest that compromised the objectivity of the ratings. There is no question that companies can conduct business legally, even in the face of conflicts of interest, provided that proper safeguards are in place. The existence of conflicts of interest alone typically is not sufficient to establish that defendants "knowingly" made a false and misleading statement. But where both the Rating Agencies and Morgan Stanley knew that the ratings process was flawed, knew that the portfolio was not a safe, stable investment, and knew that the Rating Agencies could not issue an objective rating because of the effect it would have on their compensation, it may be plausibly inferred that Morgan Stanley and the Rating Agencies knew they were disseminating false and misleading ratings.

Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 178-79 (S.D.N.Y. 2009) (footnotes omitted).

gaming of the system in which decisions by credit rating agencies may be influenced by the companies paying for the rating.⁶⁴

D. Evolution of a Regulatory Scheme and the Market's Increasing Reliance on Ratings

The importance accorded credit ratings by the financial markets today is arguably due to the government's involvement.⁶⁵ In the wake of the October 1929 stock market crash, the Office of the Comptroller of the Currency incorporated ratings from the credit rating agencies into banking guidelines.⁶⁶ This ratings push spread to state and federal insurance and securities regulations and picked up particular momentum when the SEC created a special designation in 1975 for those credit rating agencies that met certain financial and industry reputational hurdles in a vetting process.⁶⁷ The SEC called this newly created subclass of credit rating agencies NRSROs because of their nationally recognized status and highly respected reputation as experts in assigning credit ratings.⁶⁸

In awarding this NRSRO status, the SEC was not seeking to confer an unfair advantage on a select group of firms.⁶⁹ Rather, the NRSRO designation fit into a regulatory scheme that the SEC and other government agencies used for regulating firms under their watch.⁷⁰ It became convenient, for example, for Congress to require that a mortgage related security "be rated in one of the two highest rating categories by

⁶⁴ IMF, *supra* note 7, at 94; Karen Brettell, *Help Needed to Reduce Reliance on Credit Ratings*, REUTERS (July 16, 2009), <http://www.reuters.com/article/idUSTRE56F3TJ20090716?pageNumber=1>.

⁶⁵ See FRANK PARTNOY, COUNCIL INSTITUTIONAL INVESTORS, RETHINKING REGULATION OF CREDIT RATING AGENCIES: AN INSTITUTIONAL INVESTOR PERSPECTIVE 4 (2009) (describing how government regulators have turned to the rating agencies and "rating agencies have shifted from selling information to selling 'regulatory licenses,' keys that unlock the financial markets"); see also CRA 2003 ROLE REPORT, *supra* note 42, at 6–8 (describing the regulatory use of credit ratings).

⁶⁶ See Richard Cantor & Frank Packer, *The Credit Ratings Industry*, FRBNY Q. REV., Summer-Fall 1994, at 6 (detailing the historical development and providing a table of selected rating uses in government regulations); see also PARTNOY, *supra* note 65, at 4 (noting how regulators turned to the credit rating agencies in the wake of the stock market crash).

⁶⁷ CRA 2003 ROLE REPORT, *supra* note 42, at 6–10; Cantor & Packer, *supra* note 66, at 8.

⁶⁸ CRA 2003 ROLE REPORT, *supra* note 42, at 5–9.

⁶⁹ See *id.* at 6 (explaining that "[t]he requirement that [a] credit rating agency be 'nationally recognized' was designed to ensure that its ratings were credible and reasonably relied upon by the marketplace" and the term "NRSRO" was originally adopted solely for making regulatory capital determinations).

⁷⁰ *Id.*

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at least one NRSRO.”⁷¹ A regulatory examiner could then easily reference a bond’s credit rating to determine if the security was suitable for investment.⁷² However, this strategy also required that the credit rating agency issuing the rating itself be credible, thus creating a need for NRSRO accreditation.⁷³ Because of the government’s mandated use of credit ratings and an accreditation process, firms with NRSRO credit ratings were then viewed as a credible authority, and “the creditworthiness judgments of these third-party raters . . . attained the force of law.”⁷⁴

But NRSRO regulations that helped simplify the government’s job had the opposite effect of making the tasks of others harder.⁷⁵ Other credit rating agencies that lacked the NRSRO designation found it hard to compete against the NRSROs, not because they were less capable, but solely because they lacked the NRSRO designation.⁷⁶ Issuers seeking to sell high-quality debt simply had no incentive to hire rating firms lacking the NRSRO designation because that designation was a mandatory investing requirement for certain debt investors.⁷⁷ New credit rating entrants seeking NRSRO status felt disadvantaged by the SEC, who for many years never formalized the NRSRO approval process.⁷⁸ Moreover, a Catch-22 provision for receiving NRSRO status had the effect of

⁷¹ *Id.* at 7–8. The quoted language, which was found at 15 U.S.C. § 78c(41) (2006), has been replaced by “meets standards of credit-worthiness as established by the Commission,” as part of the Dodd-Frank Act. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939(e)(1), (g), 124 Stat. 1376, 1886–87 (2010).

⁷² See LAWRENCE J. WHITE, *THE CREDIT RATING AGENCIES: UNDERSTANDING THEIR CENTRAL ROLE IN THE SUBPRIME DEBACLE OF 2007–2008*, at 4 (2009) (noting that, rather than using their own resources to form judgments about the safety of bonds held by banks, bank regulators delegated or outsourced their safety judgments about suitable bonds to the credit rating agencies).

⁷³ See *id.* at 5 (describing the SEC’s worry that “bogus” rating firms could award high credit ratings to certain companies in return for suitable rewards).

⁷⁴ *Id.* at 3–5 (emphasis omitted).

⁷⁵ See *Senate 2009 Hearing*, *supra* note 7, at 2 (discussing how the NRSRO designation by the SEC represents a barrier to entry into the rating business). By 2009, there were nearly ninety references to NRSROs in U.S. banking and securities statutes, regulations, and guidance documents. BASEL COMM. ON BANKING SUPERVISION, JOINT FORUM, *STOCKTAKING ON THE USE OF CREDIT RATINGS* 87–118 (2009).

⁷⁶ ROUSSEAU, *supra* note 62, at 13–14.

⁷⁷ *Id.*; WHITE, *supra* note 72, at 5; Cantor & Packer, *supra* note 66, at 8.

⁷⁸ See WHITE, *supra* note 72, at 6 (describing that the SEC never established criteria for designating a firm as a NRSRO, never established a formal application and review process, and never explained why it selected some firms for the NRSRO designation and not others); Cantor & Packer, *supra* note 66, at 8 (claiming that the informality of the process and the opaqueness of the acceptance criteria raise serious problems with the NRSRO designation).

keeping new entrants out as well.⁷⁹ To become an NRSRO, a firm needed to be “nationally recognized.”⁸⁰ Yet, without the NRSRO designation, how was a firm to acquire clients and become nationally recognized?⁸¹ In effect, the government’s involvement created a government-sanctioned cartel where “too much power and influence [was] held by too few institutions.”⁸²

E. Credit Rating Agencies’ Access to Confidential Information

Unlike other stock and bond analysts who are barred from selectively receiving confidential information under the securities laws due to insider trading concerns, a credit rating agency hired by a bond issuer is permitted access to material nonpublic information, similar to the access provided an outside accountant or attorney.⁸³ This nonpublic information may range from internal corporate budgets and forecasts to advance notification of major corporate events, such as a merger.⁸⁴ Credit rating agencies use this confidential information to formulate

⁷⁹ See *SEC 2002 Hearing*, *supra* note 40 (statement of Paul Saltzman, Executive Vice President and General Counsel, The Bond Market Association) (asking if a lower level of recognition rather than national recognition can be used instead so that it is not an unreasonable barrier to entry); ROUSSEAU, *supra* note 62, at 14 (noting how the criteria of being “nationally recognized by the predominant users of ratings in the United States as an issuer of credible and reliable ratings” favors existing rating agencies).

⁸⁰ Cantor & Packer, *supra* note 66, at 8.

⁸¹ See Cynthia A. Glassman, Comm’r, SEC, Speech by SEC Commissioner: Statement Regarding the NRSRO Proposal Before the Open Meeting (Mar. 3, 2005), *available at* <http://www.sec.gov/news/speech/spch030305cag.htm> (describing the process of receiving the NRSRO designation as “opaque” or “Kafkaesque,” and noting that “[r]ating agencies cannot be an NRSRO unless their ratings are nationally recognized, yet they cannot achieve national recognition without being recognized by the SEC staff as an NRSRO, a classic ‘chicken and egg’ problem”). This speech also described that applicants may wait years before being told they do not meet the criteria for NRSRO status without being told exactly why they did not meet the criteria. *Id.*

⁸² See Lois R. Lupica, *Credit Rating Agencies, Structured Securities, and the Way Out of the Abyss*, 28 REV. BANKING & FIN. L. 639, 654 (2009) (pointing out the problems with the current NRSRO structure).

⁸³ See Regulation FD, 17 C.F.R. § 243.100(b)(1)–(2) (2010) (noting the exceptions, which permit access by an attorney, investment banker, or accountant and the specific restrictions against access that apply to those affiliated with investment companies, broker-dealers, and investment managers); FITCH RATINGS, WORLDWIDE CONFIDENTIALITY, CONFLICTS OF INTEREST AND SECURITIES TRADING POLICY 6 (2011), *available at* http://www.fitchratings.com/web_content/credit_policy/confidentiality_conflicts_of_int_sec_trad_policy.pdf (explaining that the general public cannot access the commentary and analysis that ratings agencies provide paying issuers); E-mail from Stephen W. Joynt, *supra* note 40 (discussing Fitch’s ability to access nonpublic information and its usefulness in forming a qualitative judgment about a company’s management and prospects).

⁸⁴ See E-mail from Stephen W. Joynt, *supra* note 40 (describing the types of nonpublic information that Fitch might access).

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their initial bond ratings as well as for periodic monitoring and “consulting” or “rating advisory” purposes.⁸⁵ For example, a company in the process of an acquisition, recapitalization, or major asset sale will often contact the credit rating agency to inquire into the impact of the major event on their credit rating.⁸⁶ For a consulting fee, the credit rating agency will provide the company with an estimate of the likely impact on the bond rating from the major event.⁸⁷

Theoretically, this access to nonpublic financial information should not only lead to more accurate credit ratings, but it also represents a hazard, as those “privity to the information beforehand [may be] able to make a profit or avoid a loss at the expense of those kept in the dark.”⁸⁸ Although the leading credit rating agencies generate the bulk of their revenues from fees paid by the bond issuer and provide free ratings on their websites, the big three agencies still have paid subscribers who receive access to additional reports and research unavailable to the general public.⁸⁹ These paid subscribers also routinely have access to employees of the credit rating agency responsible for a particular rating.⁹⁰ Regulators are rightfully concerned whether the employees of credit rating agencies intentionally or inadvertently disclose confidential nonpublic information to paid subscribers.⁹¹

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *See id.* (describing this process and noting that initially Fitch did not charge for this service, but as this accommodation became more demanding on the firm’s time, it started to charge its customers). Fitch also notes that both Standard & Poor’s and Moody’s have been charging their customers for that service for some time. *Id.*

⁸⁸ *Final Rule: Selective Disclosure and Insider Trading*, SEC, <http://www.sec.gov/rules/final/33-7881.htm> (last modified Aug. 21, 2000).

⁸⁹ CRA 2003 ROLE REPORT, *supra* note 42, at 22; GAO REPORT, *supra* note 32, at 9; ROUSSEAU, *supra* note 62, at 18.

⁹⁰ ROUSSEAU, *supra* note 62, at 18.

⁹¹ CRA 2003 ROLE REPORT, *supra* note 42, at 35. In testimony before a SEC investigation, Deborah A. Cunningham, Chief Investment Officer for Federated Investors Money Market Funds, described how her firm evaluates the information provided by the credit rating agencies on a subscription basis to her company, and how she makes a decision whether to subscribe even if the actual letter rating itself is available for free to the public: “The much more important aspect of the rating agency information that we receive is on the actual analysis itself . . . not the actual letter.” *Roundtable 2009*, *supra* note 41, at 138. The SEC even investigated the market sell-off of equity securities that occurred before Standard & Poor’s downgrade of the US credit rating to determine whether Standard & Poor’s leaked information. Mark Gongloff, *SEC Asking About Insider Trading at S&P: Report*, WALL ST. J. BLOG (Aug. 12, 2011, 9:57 AM), <http://blogs.wsj.com/marketbeat/2011/08/12/sec-asking-about-insider-trading-at-sp-report/>.

F. Regulation and Oversight of the Credit Ratings Industry

Despite the government's growing reliance on credit ratings, the powerful credit rating agencies themselves have operated with scant government oversight for much of their 100-plus year history.⁹² Instead, judicial decisions and government regulations largely shielded them from legal liability for faulty ratings.⁹³ Unlike auditors, accountants, and investment bankers, the credit rating agencies were not liable as experts for the investment ratings that they assigned to the debt securities they rated, and the First Amendment gave them protection for their credit "opinions."⁹⁴

A complaint filed against Moody's by Jefferson County School District over a 1993 bond offering illustrates how this First Amendment protection may lead to abuse.⁹⁵ Despite employing Moody's in the past, Jefferson County declined to hire the firm for a new bond offering, using

⁹² See CRA 2003 ROLE REPORT, *supra* note 42, at 18 ("[B]ecause 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 them by the courts, little exists to hold them accountable for future poor performance."); see also *In re Enron Corp. Sec.*, 535 F.3d 325, 331 (5th Cir. 2008) (citing the Securities Litigation Uniform Standards Act to dismiss a class action claim); *Compuware Corp. v. Moody's Investors Servs.*, 499 F.3d 520, 522 (6th Cir. 2007) (denying defamation and breach of contract claims involving a credit rating report); *Quinn v. McGraw-Hill Cos.*, 168 F.3d 331, 333 (7th Cir. 1999) (denying claims for negligent misrepresentation and breach of contract concerning a credit rating awarded a collateralized mortgage obligation); *First Equity Corp. v. Standard & Poor's Corp.*, 869 F.2d 175, 180 (2d Cir. 1989) (refusing to hold a credit rating agency liable for an inaccurate publication); *N.J. Carpenters Vacation Fund v. Royal Bank of Scot. Grp., PLC*, 720 F. Supp. 2d 254, 262-64 (S.D.N.Y. 2010) (dismissing claims against the rating agencies for Section 11 violations and "control person liability"); *Cantor & Packer*, *supra* note 66, at 4 (noting the threat of legal liability for inaccurate ratings by a ratings agency has not yet materialized and how certain cases against the firms have been dropped); Larry P. Ellsworth & Keith V. Porapaiboon, *Credit Rating Agencies in the Spotlight: A New Casualty of the Mortgage Meltdown*, 18 BUS. L. TODAY 35 (2009), available at <http://www.abanet.org/buslaw/blt/2009-03-04/ellsworth.shtml> (noting that even though the credit rating agencies face the threat of mounting litigation, they possess a number of substantial legal defenses due to their unique treatment under the U.S. Constitution and regulatory system); *Sack & Juris*, *supra* note 62 (noting that the NRSROs have largely been insulated from liability).

⁹³ See *Senate 2009 Hearing*, *supra* note 7, at 30 (stating that credit rating agencies do not face any meaningful risk of liability); *CRA June 2010 Hearing*, *supra* note 4, at 441-47 ("[T]he difference between Moody's and an accounting firm or a law firm is that at least there is some theoretical risk that the accounting firm and the law firm might be found liable.").

⁹⁴ *PARTNOY*, *supra* note 65, at 2, 15-16; *ROUSSEAU*, *supra* note 62, at 35-36; *Ellsworth & Porapaiboon*, *supra* note 92; *Sack & Juris*, *supra* note 62.

⁹⁵ *Jefferson Cnty. Sch. Dist. No. R-1 v. Moody's Investor's Servs., Inc.*, 175 F.3d 848 (10th Cir. 1999).

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two other credit rating agencies instead.⁹⁶ When Jefferson's bonds were brought to market, the school received subscriptions from investors for the purchase of substantially all the bonds.⁹⁷ However, less than two hours after the sale began, Moody's electronically published an article about Jefferson that it sent to subscribers and news services.⁹⁸ Even though Moody's had not been paid to rate Jefferson's bond deal and any information that Jefferson had sent to Moody's was more than a year old, Moody's determined *at that particular time* that its "outlook on the district's general obligation debt is negative" and noted the school's ongoing financial pressures and legal uncertainties.⁹⁹ Within minutes, another electronic news service repeated Moody's comments, purchase orders for Jefferson's bonds ceased, and several buyers canceled earlier orders.¹⁰⁰ The school was ultimately forced to reprice the bonds at a higher interest rate to complete the deal at a cost of \$769,000.¹⁰¹

Jefferson sued Moody's claiming that Moody's published the article to retaliate against it for refusing to use Moody's to evaluate its bonds.¹⁰² The school asserted claims under state "law for intentional interference with contractual relations, intentional interference with prospective contractual relations, and publication of an injurious falsehood."¹⁰³ Jefferson's suit was dismissed based on First Amendment grounds protecting the expression of opinions.¹⁰⁴ Moody's negative comments about Jefferson which hurt the profitability of the school's bond offering were deemed to be constitutionally protected expressions of Moody's opinion.¹⁰⁵

G. Market Reform Measures Relating to the Credit Rating Agencies

To prevent threats to market integrity through the selective disclosure of material nonpublic information and insider trading, the

⁹⁶ *Id.* at 850. The bond offering was actually a refinancing deal in which the school wanted to take advantage of lower interest rates. *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.* In the article, Moody's noted that even though it had not been asked to rate the bonds, it intended to assign a rating to the issue after the sale. *Id.*

⁹⁹ *Id.* at 850-51. In its complaint, the school alleged that Moody's statement was materially false in that it conveyed the impression that Moody's assessment of the school's financial condition was based on current information. *Id.* at 850.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 851.

¹⁰² *Id.*

¹⁰³ *Id.* Later, the school unsuccessfully attempted to add antitrust claims against Moody's for monopolization and attempted monopolization under the Sherman Act. *Id.*

¹⁰⁴ *Id.* at 860-61.

¹⁰⁵ *Id.*

SEC adopted a new rule, Regulation FD, in 2000.¹⁰⁶ Regulation FD clarified the disclosure requirements that applied to stock and bond analysts as well as other securities market professionals, but it specifically exempted credit rating agencies from these requirements:

(a) Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person [who is a broker or dealer, investment adviser, institutional investment manager, investment company, or person associated with those entities or a holder of the issuer's securities] . . . , the issuer shall make public disclosure of that information . . . :

(1) Simultaneously, in the case of an intentional disclosure; and

(2) Promptly, in the case of a non-intentional disclosure.

....

(b)(2) Paragraph (a) of this section shall not apply to a disclosure made:

(i) To a person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant);

(ii) To a person who expressly agrees to maintain the disclosed information in confidence;

(iii) To an entity whose primary business is the issuance of credit ratings, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available; or

(iv) In connection with a securities offering registered under the Securities Act.¹⁰⁷

The credit rating agencies were specifically exempted and permitted access to nonpublic information because their ratings were viewed as a

¹⁰⁶ Regulation FD, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (codified at 17 C.F.R. § 243); see Philippe Jorion, Zhu Liu & Charles Shi, *Informational Effects of Regulation FD: Evidence from Rating Agencies*, 76 J. FIN. ECON. 309, 310-11 (2004) (describing Regulation FD's prohibition of selective disclosure of nonpublic information).

¹⁰⁷ Regulation FD, 65 Fed. Reg. at 51,738. This special exemption for the credit rating agencies was removed by the Dodd-Frank Act. *Id.*; see *infra* Part III.C (detailing the change to Regulation FD).

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valuable “public good.”¹⁰⁸ Government regulators did not believe this same argument held true for other Wall Street analysts and felt permitting them access to confidential information would “defy the principles of integrity and fairness.”¹⁰⁹ In crafting this regulation, the SEC noted that: “selective disclosure bears a close resemblance . . . to ordinary ‘tipping’ and insider trading. In both cases, a privileged few gain an informational edge—and the ability to use that edge to profit—from their superior access to corporate insiders, rather than from their skill, acumen, or diligence.”¹¹⁰

Had the 2001 Enron bankruptcy debacle never occurred, the special treatment given credit rating agencies and the NRSRO oligopoly involving Standard & Poor’s, Moody’s, and Fitch may have continued indefinitely.¹¹¹ However, the big three agencies only downgraded Enron’s debt securities a mere four days before Enron filed for bankruptcy.¹¹² The massive size of this bankruptcy and the late timing of the ratings downgrade sparked a large public outcry against the rating agencies who were supposed to be respected credit analysis experts—particularly since this was not the first large bankruptcy filing tied to inaccurate credit ratings.¹¹³

¹⁰⁸ See IMF, *supra* note 7, at xiii (describing the “public good” characteristic of ratings in aggregating and how it is difficult to obtain private information).

¹⁰⁹ SEC News Supplement: *Opening Statement of Chairman Arthur Levitt, Open Meeting on Regulation Fair Disclosure*, SEC (Aug. 10, 2000), <http://www.sec.gov/news/extra/seldisal.htm>.

¹¹⁰ Regulation FD, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (codified at 17 C.F.R. § 243). For an example of the SEC’s use of Reg. FD see *SEC Charges Office Depot and Company Executives with Improper Disclosures to Analysts*, SEC (Oct. 21, 2010), <http://www.sec.gov/news/press/2010/2010-202.htm>.

¹¹¹ See GAO REPORT, *supra* note 32, at 1-2 (noting the highly publicized alleged failures by credit rating agencies to warn investors in a timely manner about the impending bankruptcies of Enron and others, and explaining how this has raised concerns in Congress about the role and performance of the NRSROs and the SEC’s supervision of the industry).

¹¹² CRA 2003 ROLE REPORT, *supra* note 42, at 3; GAO REPORT, *supra* note 32, at 2; see ENRON, *supra* note 56, at 13 (noting that government committee staff believed that the credit ratings agencies should have downgraded Enron to below investment grade much earlier than they did).

¹¹³ See ENRON, *supra* note 56, at 1 (describing how Enron’s collapse was particularly shocking and problematic because of its size and the appearance that its sudden downturn could be traced to widespread fraud); see also *The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs.*, 110th Cong. 1 (2007) (statement of Rep. Paul E. Kanjorski) (discussing the failure of the credit raters Moody’s, Standard & Poor’s, and Fitch to warn investors about the severe financial problems of WorldCom, New York City, Washington Public Power Supply System, and Orange County); PARTNOY, *supra* note 65, at 5 (describing both Enron and the Orange County default as prominent examples of when issuers continue to receive high credit ratings until just before they file for bankruptcy protection).

In the wake of Enron's bankruptcy, congressional hearings were held to determine whether efforts by Enron's bankers and government officials convinced Moody's not to downgrade Enron's debt despite financial liquidity problems.¹¹⁴ These hearings uncovered that had Moody's lowered Enron's debt to below investment grade status, Enron would have been unable to enter into trading agreements with counterparties and one of the firm's most profitable divisions would have been unable to operate.¹¹⁵ Contractual "triggers" tied to credit ratings in a number of Enron's business agreements would have either pushed the firm into default or required the firm to post significant amounts of cash collateral had its rating been downgraded.¹¹⁶ Such a downgrade would have effectively terminated a proposed merger between Enron and another company due to a material adverse change clause in the merger agreement.¹¹⁷

In response to the poor performance by the big three relating to Enron's bankruptcy and the subsequent 2002 WorldCom default, the U.S. Government enacted the Credit Rating Agency Reform Act of 2006.¹¹⁸ This legislation gave the SEC new regulatory powers over the rating agencies and encouraged the SEC to award NRSRO status to additional credit rating companies to lessen the oligopolistic grip the big three had on the franchise.¹¹⁹ While this legislation increased the number of NRSRO firms to ten, it did little to alter the dominant position of the big three agencies, as evidenced by their current ninety-seven percent market share.¹²⁰ The Credit Rating Agency Reform Act of 2006

¹¹⁴ ENRON, *supra* note 56, at 1.

¹¹⁵ *Id.* at 2.

¹¹⁶ *See id.* (providing a detailed history of the events surrounding Enron); *see also* IMF, *supra* note 7, at 92 (noting the widespread use of "ratings triggers" in financial contracts that terminate credit availability or accelerate credit obligations in the event of specified downgrades).

¹¹⁷ ENRON, *supra* note 56, at 3.

¹¹⁸ Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006); *see* GARY SHORTER & MICHAEL V. SEITZINGER, CONG. RESEARCH SERV., R40613, CREDIT RATING AGENCIES AND THEIR REGULATION (2009) (noting the "spectacular failures" of the credit rating agencies in relation to Enron and WorldCom who retained their high credit ratings until a few days before they filed for bankruptcy).

¹¹⁹ Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006); PARTNOY, *supra* note 65, at 67; *see* GAO REPORT, *supra* note 32, at 2-3 (describing provisions of Credit Rating Agency Reform Act).

¹²⁰ GAO REPORT, *supra* note 32, at 56-57; *Credit Rating Agencies – NRSROs*, SEC, <http://www.sec.gov/answers/nrsro.htm> (last modified May 12, 2011). The ten NRSROs are: A.M. Best Company, Inc. (added Sept. 24, 2007); DBRS Ltd. (added Sept. 24, 2007); Egan-Jones Rating Company (added Dec. 4, 2008); Fitch, Inc. (added Sept. 24, 2007); Japan Credit Rating Agency, Ltd. (added Sept. 24, 2007); LACE Financial Corp. (added Feb. 11, 2008); Moody's Investors Service, Inc. (added Sept. 24, 2007); Rating and Investment Information, Inc. (added Sept. 24, 2007); Realpoint LLC (added June 23, 2008); and

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also did not address all the conflicts of interest that exist in the credit rating industry, such as rate shopping, and actually *barred* private rights of action against the credit rating agencies.¹²¹ The recent subprime mortgage debacle merely brought these issues back into the spotlight.

The subprime mortgage crisis was not a new phenomenon, but simply déjà vu all over again with investors once again left holding the bag.¹²² Like most market meltdowns, the subprime mortgage debacle was fueled by excessive leverage, in this case, of risky subprime

Standard & Poor's Ratings Services (added Sept. 24, 2007). See Letter from Nancy M. Morris, Sec'y, SEC, to A.M. Best Co., Inc. Corp. (Sept. 24, 2007), available at <http://www.sec.gov/rules/other/2007/34-56507.pdf>; Letter from Nancy M. Morris, Sec'y, SEC, to DBRS Ltd. (Sept. 24, 2007), available at <http://www.sec.gov/rules/other/2007/34-56508.pdf>; Letter from Florence E. Harmon, Acting Sec'y, SEC, to Egan-Jones Rating Co. (Dec. 4, 2008), available at <http://www.sec.gov/rules/other/2008/34-59056.pdf>; Letter from Nancy M. Morris, Sec'y, SEC, to Fitch, Inc. (Sept. 24, 2007), available at <http://www.sec.gov/rules/other/2007/34-56509.pdf>; Letter from Nancy M. Morris, Sec'y, SEC, to Japan Credit Rating Agency, Ltd. (Sept. 24, 2007), available at <http://www.sec.gov/rules/other/2007/34-56510.pdf>; Letter from Nancy M. Morris, Sec'y, SEC, to LACE Fin. Corp. (Feb. 11, 2008), available at <http://www.sec.gov/rules/other/2008/34-57300.pdf>; Letter from Nancy M. Morris, Sec'y, SEC, to Moody's Investors Serv., Inc. (Sept. 24, 2007), available at <http://www.sec.gov/rules/other/2007/34-56511.pdf>; Letter from Nancy M. Morris, Sec'y, SEC, to Rating and Inv. Info., Inc. (Sept. 24, 2007), available at <http://www.sec.gov/rules/other/2007/34-56512.pdf>; Letter from Florence E. Harmon, Acting Sec'y, SEC, to Realpoint LLC (June 23, 2008), available at <http://www.sec.gov/rules/other/2008/34-58000.pdf>; Letter from Nancy M. Morris, Sec'y, SEC, to Standard & Poor's Ratings Servs. (Sept. 24, 2007), available at <http://www.sec.gov/rules/other/2007/34-56513.pdf>); *Credit Rating Agencies-NRSROs, supra*; *Seven Credit Rating Agencies Register with SEC as Nationally Recognized Statistical Rating Organizations*, SEC (Sept. 24, 2007), <http://www.sec.gov/news/press/2007/2007-199.htm>; see also *No Action Letters*, SEC, <http://www.sec.gov/answers/noaction.htm> (last modified Mar. 5, 2005) ("An individual or entity who is not certain whether a particular product, service, or action would constitute a violation of the federal securities law may request a 'no-action' letter from the SEC staff."); *supra* note 37 (providing details of 97% market share calculation).

¹²¹ Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 15E(m)(2), 120 Stat. 1327, 1336 (2006); see *Senate 2009 Hearing, supra* note 7, at 23 ("[I]ssuers went shopping for ratings like they were shopping for used cars."). "Rate shopping" is the practice whereby an issuer unhappy with a credit rating from one rating agency simply moves to another rating agency in search of a more favorable rating. *Senate 2009 Hearing, supra* note 7, at 23.

¹²² See Francis A. Bottini, *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 SAN DIEGO L. REV. 579, 584-600 (1993) (detailing a lengthy history of rating failures and serious industry problems). Bottini adds additional companies to the lengthy list already presented by the Author. *Id.* at 606; see also Randy Myers, *Ratings Disaster*, CFO MAG. (June 1, 2010), www.cfo.com/article.cfm/14499520 (comparing Moody's and Standard & Poor's to operators of nuclear reactors and asking whether they would still be in business given their record as architects of one ratings failure after another over the past decade). Baseball player Yogi Berra is famous for the expression "déjà vu all over again." ALLEN BARRA, *YOGI BERRA: ETERNAL YANKEE* xxxiv (2009).

mortgage loans extended to borrowers with bad credit histories based on little or no loan documentation or loan down payment.¹²³ These subprime mortgages bore scant resemblance to traditional mortgages; instead, they resembled an “assembly-line affair” of repackaging and reselling in which even a \$14,000-a-year strawberry picker could receive a mortgage for a \$720,000 home.¹²⁴ The complex securities created by the securitization of these subprime loans and the movement away from relationship-based lending grounded in trust created a systematic failure.¹²⁵

When the subprime market imploded, the crash was literally felt around the world.¹²⁶ Trillions of dollars of subprime mortgage securities had been sold to investors.¹²⁷ Due to the widespread use of subprime securities, their inherent complexity, and the high degree of leverage involved, the subprime mortgage crisis led to: government bailouts, bankruptcy filings, large scale investment write-downs, and a raft of lawsuits.¹²⁸

In response, the United States enacted the Dodd-Frank Act to rein in the abuses.¹²⁹ Noting both the systemic importance of credit ratings and the reliance placed on those ratings by individuals, institutions, and regulators, Congress believed that credit ratings were of national public

¹²³ See GILLIAN TETT, *FOOL'S GOLD* 95 (2009) (describing subprime loans as high risk and noting these loans were increasingly extended to borrowers with bad credit histories on whatever terms the players wished).

¹²⁴ See *id.* (claiming the subprime lending market developed into a free-for-all with little government oversight). According to Tett, sales of subprime mortgage bonds totaled \$800 billion in 2005, meaning that almost half of all mortgage-linked bonds in America that year were based on subprime loans. *Id.*

¹²⁵ See Lupica, *supra* note 82, at 644–45, 653, 659 (blaming the credit rating agencies for failing to adapt their quantitative models to reflect the lower underwriting standards used by lenders in awarding loans); see also SERVIGNY & RENAULT, *supra* note 45, at 15, 366–67 (explaining the mechanics and growth of securitization and how it represents a major shift in the role of commercial banks in financial markets).

¹²⁶ See Jenny Anderson & Heather Timmons, *Why a U.S. Subprime Mortgage Crisis is Felt Around the World*, N.Y. TIMES, Aug. 31, 2007, <http://www.nytimes.com/2007/08/31/business/worldbusiness/31derivatives.html?pagewanted=all> (commenting that investors in some foreign countries were surprised to find that the problems with U.S. subprime mortgage securities could be felt so keenly in their home markets).

¹²⁷ *Id.*; see CRA June 2010 Hearing, *supra* note 4, at 8; see also Levitin & Wachter, *supra* note 57, at 18 (noting that historically low rates on Treasuries left investors hungry for yield and eager for more attractive alternatives).

¹²⁸ 2011 CRISIS REPORT, *supra* note 4, at 22–23; Zandi, *supra* note 3, at 1–3; Anderson & Timmons, *supra* note 126.

¹²⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

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interest and central to capital formation, investor confidence, and the efficient performance of the economy.¹³⁰ Congress found:

Credit rating agencies, including nationally recognized statistical rating organizations, play a critical “gatekeeper” role in the debt market that is functionally similar to that of securities analysts, who evaluate the quality of securities in the equity market, and auditors, who review the financial statements of firms. Such role justifies a similar level of public oversight and accountability.¹³¹

Because of the value Congress placed on the credit rating agencies, this sweeping legislation provides for a new Office of Credit Ratings, requires new internal controls to help credit rating agencies monitor conflicts of interest, calls for enhanced regulation and transparency of NRSROs, and mandates various SEC and General Accountability Office studies.¹³² In addition, Section 933 of the Dodd-Frank Act eliminates the ability of NRSROs to use statutory safe-harbor protections for forward-looking statements, loosens the pleading standards in private rights of action, and treats statements made by a credit rating agency in the same manner as statements made by a public accounting firm or securities analyst under the securities laws.¹³³ Significantly, the Dodd-Frank Act removes the protection that NRSROs enjoyed from “expert” liability under Section 11 by repealing Rule 436(g), eliminates the exemption pertaining to credit rating agencies in Regulation FD, and directs that each federal agency:

remove any reference to or requirement of reliance on credit ratings [in its regulations] and . . . substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate In making such determination, such

¹³⁰ *Id.* § 931(1).

¹³¹ *Id.* § 931(2).

¹³² *Id.* § 932-939H. Among the findings in this massive Act, Congress found: Because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial “gatekeepers” do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers.

Id. § 931(3).

¹³³ *Id.* § 933.

agencies shall . . . tak[e] into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.¹³⁴

Like its less sweeping predecessor the Credit Rating Agency Reform Act of 2006, the Dodd-Frank Act targets a number of credit rating abuses.¹³⁵ Sadly, like its predecessor, the Dodd-Frank Act also permits certain industry abuses to continue and is not without its unintended consequences and shortfalls.¹³⁶ This legislation—if it is ever fully implemented—should only be viewed as a first step in addressing some of the problems that have plagued the securities markets, as additional measures are needed.¹³⁷ Part III of this Note addresses some of these considerations.

III. ANALYSIS

Called by some the most sweeping change to financial regulation since the Great Depression, the Dodd-Frank Act ushers in a sea of change in the way the capital markets operate.¹³⁸ Its provisions call for the creation of new regulatory offices, the tightening of numerous regulations, and the expansion of regulation to additional segments of the financial markets.¹³⁹ Unfortunately, more than a year later, many of its reform measures have still not been implemented; some reform measures of the Dodd-Frank Act do not take effect until a future date, and in some cases, a perceived abuse is only subject to government study rather than actual change.¹⁴⁰ Part III of this Note offers an analysis of some of the provisions of the Dodd-Frank Act that impact the credit

¹³⁴ *Id.* §§ 939A(b)(a), 939B, 939G; *see supra* text accompanying note 107 (giving the original language of Regulation FD).

¹³⁵ *See supra* Part II.G (discussing the Credit Rating Agency Reform Act of 2006).

¹³⁶ *See infra* Part III (detailing some of the abuses that may continue under the Dodd-Frank Act).

¹³⁷ *See* JOHN C. PARTIGAN, PRACTICAL TIPS FOR MEETING WITH CREDIT RATING AGENCIES AFTER DODD-FRANK (2011), available at http://www.nixonpeabody.com/linked_media/publications/http://www.nixonpeabody.com/linked_media/publications/Securities_Law_Alert_05_23_2011.pdf (noting that the agencies can still access material nonpublic information under the Dodd-Frank Act); *infra* Part IV (offering a suggested improvement to the Dodd-Frank Act).

¹³⁸ Cotter, *supra* note 13.

¹³⁹ *See supra* Part II.G (describing some of the provisions of the Dodd-Frank Act, which relate to the credit rating agencies).

¹⁴⁰ Cotter, *supra* note 13; *see supra* note 13 (documenting that only 13% of the regulations required by Dodd-Frank have been finalized).

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rating agencies, evaluating both the strengths and shortcomings of those provisions.¹⁴¹

A. *Implications of Removing References to Credit Ratings from Government Regulations*

“Power tends to corrupt and absolute power corrupts absolutely.”¹⁴² As noted previously, the U.S. credit ratings industry is dominated by three giants who control ninety-seven percent of the market and wield tremendous power.¹⁴³ One of the Dodd-Frank Act’s biggest strengths is its acknowledgement of the need for repair and legislative changes in the credit rating industry.¹⁴⁴ By removing any references to credit ratings in government statutes or regulations, the Dodd-Frank Act is making a bold move toward reining in the tremendous power of the NRSROs.¹⁴⁵ This move is not without risk and the potential for unintended consequences. However, given the inability of the reform measures passed in the Credit Rating Agency Reform Act of 2006 to either address or prevent the problems behind the subprime mortgage debacle, it is clear that additional reforms are necessary.¹⁴⁶

For over seventy years—either by choice or mandate—investors, regulators, issuers, and other market participants have used credit ratings in making investment decisions and structuring their business operations.¹⁴⁷ As noted previously, certain institutional investors could only invest in investment grade securities and were required to sell those holdings if the bond rating dropped to non-investment grade.¹⁴⁸ Regulatory reliance on credit ratings has been faulted by many as

¹⁴¹ See *infra* Part III (outlining how the new Dodd-Frank Act will impact the perceived shortcomings of the credit ratings industry).

¹⁴² THE OXFORD DICTIONARY OF QUOTATIONS 1 (Elizabeth Knowles ed., 5th ed. 2001) (quoting Lord Acton).

¹⁴³ SEC, ANNUAL REPORT, *supra* note 37; see *supra* Part II.C–D (discussing the importance of bond ratings, the power of the credit rating agencies, and the market’s reliance on credit ratings).

¹⁴⁴ See *supra* Part II.G (describing some of the provisions of the Dodd-Frank Act).

¹⁴⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939A, 124 Stat. 1376, 1887 (2010); see *supra* text accompanying note 134 (providing the language from the Dodd-Frank Act, which discusses the removal of credit ratings from agency regulations); *supra* Part II.C–D (discussing the power of the credit rating agencies and the government’s reliance on NRSROs).

¹⁴⁶ See *supra* Part II.G (noting the continued dominance of the big three agencies despite the passage of the Credit Rating Agency Reform Act of 2006 and abusive practices).

¹⁴⁷ See GAO REPORT, *supra* note 32, at 7–8 (describing some of the uses of credit ratings by financial markets participants); *supra* Part II.D (tracing the history of this reliance on credit ratings since the 1930s).

¹⁴⁸ See *supra* Part II.C (noting that both regulatory and contractual provisions often demanded that certain institutional investors only own investment grade securities).

perpetuating the hold that the NRSRO cartel has over the rating industry by creating barriers to entry, fostering excessive investor trust in the value of credit ratings, and artificially creating a demand for ratings.¹⁴⁹ Eliminating government reliance on ratings would eliminate this source of power over borrowers, and market forces would be free to work.¹⁵⁰ Under this approach, regulated institutional investors and financial institutions will bear the burden of justifying the safety of their bond portfolios to regulators.¹⁵¹ This strategy is expected to improve ratings quality and create a healthier rating industry by fostering competition and forcing institutions to play a more decisive role.¹⁵²

¹⁴⁹ *Senate 2009 Hearing, supra* note 7, at 32 (statement of Lawrence J. White, Professor of Economics, New York University). Professor White also argues that detailed regulation of the NRSROs would not be necessary if market forces were permitted to work, particularly given the institutional nature of the bond market where sophisticated investors are better positioned to monitor the process and not a retail securities market where retail customers need more guidance and help in investing. *Id.* “Critical market participants relied too much on NRSRO ratings and the NRSRO designation should not equate to a government good housekeeping seal of approval That has had lots of unintended consequences.” *See Roundtable 2009, supra* note 41, at 186 (statement of Christopher L. Gootkind, Vice President and Fixed Income Portfolio Manager, Wellington Management) (commenting from his experience as a credit analyst, research director, and fixed income portfolio manager on the problems with the credit ratings industry and the issuer-pays business model); *see also* Lupica, *supra* note 82, at 654–55 (pointing out the problems with the current NRSRO structure, and commenting that the internal policies of the credit rating agencies have in effect adjusted the “ground rules” of international capital markets and shaped the internal organization and behavior of those institutions seeking funds).

¹⁵⁰ *See Senate 2009 Hearing, supra* note 7, at 32 (urging government officials to “[e]liminate [the credit rating agencies’] force of law, and bring market forces to bear”); *see also* GAO REPORT, *supra* note 32, at 47–48 (describing some of the mechanics of removing those references from regulations).

¹⁵¹ *Senate 2009 Hearing, supra* note 7, at 32–33. In the words of Professor White:
 [T]he burden should be placed directly on the regulated institutions to demonstrate and justify to their regulators that their bond portfolios are safe and appropriate, either by doing the research themselves or by relying on third-party advisors who might be the incumbent rating agencies, or might be new firms that none of us have discovered yet, but could come forth in this more open environment. Since financial institutions could then call upon a wider array of sources of advice on the safety of their bond portfolios, the bond information market would be opened to innovation and entry and new ideas in ways that have not been possible since the 1930s.

Id. William Gross, managing director of PIMCO, one of the nation’s largest institutional bond investment firms, is quoted as saying that credit ratings should be abolished given the rating industry’s poor track record; his business would get along fine without them. Mayer, *supra* note 62. Gross noted: “Their quantitative models appeared to have a Mensa-like IQ of at least 160, but their common sense rating was closer to 60, resembling an idiot savant with a full command of the mathematics, but no idea of how to apply them.” *Id.*

¹⁵² *See Senate 2009 Hearing, supra* note 7, at 32–33 (discussing the benefits of competition and institutional markets in ratings).

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This change should also reduce the ability of the credit rating agencies to coerce issuers into using their rating services or to retaliate against them.¹⁵³ It is a power that the agencies have been willing to exploit, and many corporations, municipalities, and foreign governments are wary of the credit rating agencies because of their abusive strong-armed tactics and high fees.¹⁵⁴ As one chief financial officer expressed it, “[T]hey can pretty much charge the fees they want to You have no choice but to pay it.”¹⁵⁵ Observers have also charged that the credit rating agencies continually find new circumstances to extract fees.¹⁵⁶ In the wake of the Dodd-Frank Act, if a bond issuer is no longer “required” to have its bonds rated by a credit rating agency, the issuer now has the opportunity to stop paying a rating fee.¹⁵⁷ Indeed, this is already

¹⁵³ See *supra* Part II.C (outlining the power of the credit rating agencies); *supra* Part II.F (describing the problems encountered by Jefferson County School District when it declined to use Moody’s services for its bond offering and Jefferson’s claim of retaliation against Moody’s).

¹⁵⁴ See Klein, *supra* note 34 (describing the credit rating agencies’ strong-armed tactics and threats). In his Washington Post article, Alec Klein paints a frightening picture of coercion in the credit ratings industry. *Id.* Klein describes the travails of Hannover Re, who received a letter from Moody’s informing the firm that it intended to rate its financial health “at no charge.” *Id.* However, the letter suggested that “Moody’s looked forward to the day Hannover would be willing to pay.” *Id.* Because Hannover “was already writing six-figure checks annually” for ratings from two of Moody’s competitors, the firm did not see the need to pay for another rating from Moody’s. *Id.* Over the successive years, Moody’s continued to rate Hannover even though the firm did not pay, giving it progressively weaker ratings and telling Hannover that, if it paid for the rating, it “could have a positive impact” on the grade. *Id.* (internal quotation marks omitted). Eventually, Moody’s cut Hannover’s debt rating to junk status at the same time that other credit rating firms were giving Hannover a clean bill of health. *Id.* Hannover’s stock immediately dropped, lowering Hannover’s market value roughly \$175 million within hours. *Id.* Klein’s article also sheds light on the fee structure of the credit rating agencies. *Id.* According to Moody’s, in 2004 a credit rating cost between \$50,000 and \$300,000 for a corporate borrower. *Id.*

¹⁵⁵ *Id.* (internal quotation marks omitted). Life has been very good to the credit rating agencies:

The leading credit rating agencies grew rich rating mortgage-backed securities and CDOs. . . . [T]otal revenues for the three firms[] double[d] from \$3 billion in 2002 to over \$6 billion in 2007. At Moody’s, profits quadrupled between 2000 and 2007. In fact, Moody’s had the highest profit margin of any company in the S&P 500 for [five] years in a row.

CRA Oct. 2008 Hearing, supra note 1, at 2.

¹⁵⁶ See Klein, *supra* note 34 (quoting a former Wall Street banker who claims that the credit rating agencies charge clients for many different securities, even if the ratings are all the same); see also E-mail from Stephen W. Joynt, *supra* note 40 (noting that initially Fitch did not charge its clients for rating advisory services, but later started charging its customers for this accommodation).

¹⁵⁷ See Klein, *supra* note 34 (chronicling the experience of an investment banker who suggested that a cash-strapped school district drop one of its two credit ratings to save

happening to a small degree, particularly in Europe where “unrated” bonds are being sold.¹⁵⁸ Less demand for credit ratings should translate into less power for the credit rating agencies to wield and less potential for abuses to occur.

Yet the complexity of this task is not to be underestimated, and the potential for negative consequences is real.¹⁵⁹ According to a 2009 survey of its member authorities by The Joint Forum, there were eighty-one references to NRSRO ratings in U.S. federal banking and securities statutes, legislation, regulations, and guidance.¹⁶⁰ In July 2008, the SEC proposed amendments to remove references to NRSRO ratings from several SEC rules.¹⁶¹ Although the SEC subsequently removed references to NRSROs from six rules and two forms, it retained the use of ratings or delayed further action on two rules over concerns that the proposed new credit standards might instead permit *riskier* securities to qualify for investment than those securities permitted for investment under the existing rule.¹⁶² In the United States Government Accountability Office’s opinion, without a plan for ensuring that the new standards of creditworthiness required by the Dodd-Frank Act accomplish what they are designed to do, and that examiners have the requisite skills to apply the new standards, the risk is that any new standards of creditworthiness used in place of the NRSRO ratings may not be effective.¹⁶³ Noting the level of difficulty associated with removing credit ratings from government regulations, a senior associate director of the Federal Reserve commented: “To protect the safety and soundness of individual banking firms and of financial stability more broadly, we are striving to develop alternative standards of creditworthiness . . . that possess the virtues of credit ratings but not the vices.”¹⁶⁴

Other potential negative consequences remain. As the power of the credit rating agencies diminishes, their willingness to maintain the integrity of their credit ratings in the face of customer retaliations and

money, but reversed that advice after Standard & Poor’s threatened to pull all the school’s ratings).

¹⁵⁸ See *supra* note 41 (discussing the increasing use of unrated bonds).

¹⁵⁹ See GAO REPORT, *supra* note 32, at 47–53 (describing the SEC’s previous experience with proposals to remove credit rating references from its regulations and its hesitation to implement those proposals fully).

¹⁶⁰ BASEL COMM. ON BANKING SUPERVISION, *supra* note 75, at 87–118 (2009); GAO REPORT, *supra* note 32, at 48.

¹⁶¹ GAO REPORT, *supra* note 32, at 47.

¹⁶² *Id.*

¹⁶³ *Id.* at 96, 100.

¹⁶⁴ *Hearing Before the H. Subcomm. on Oversight & Investigations of the H. Comm. on Fin. Serv.*, 112th Cong. 3 (2011) (statement of Mark E. Van Der Weide).

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defections will come under attack.¹⁶⁵ For example, in the wake of Standard & Poor's well-publicized downgrade of the United States in August 2011, the Senate Banking committee began gathering information about the downgrade, the SEC launched an inquiry into the situation, and some market observers questioned whether a concurrent Department of Justice investigation of the firm was the government's way of retaliating for the downgrade.¹⁶⁶ Following that lead, several municipalities fired Standard & Poor's over their debt downgrades.¹⁶⁷ In light of the tremendous power of the U.S. government, it is perhaps not surprising that neither Fitch nor Moody's supported Standard & Poor's U.S. downgrade decision and perhaps not a coincidence that Devin Sharma, Standard & Poor's president, agreed to step down not long after the downgrade was announced.¹⁶⁸ It is a valid worry that the credit rating agencies will knuckle under the pressure from debt issuers for higher than deserved credit ratings.

Market inefficiency and higher costs are other potential problems. As noted previously, it is much more efficient for one firm to analyze a particular bond on behalf of all potential lenders than have separate lenders duplicate that analysis.¹⁶⁹ In congressional testimony, the

¹⁶⁵ See *supra* Part II.C (discussing problems with the issuer-pays business model and how credit rating agencies struggle against keeping and appeasing a paying credit rating customer).

¹⁶⁶ See Jean Eaglesham & Jeannette Neumann, *SEC Checks S&P's Downgrade Math*, WALL ST. J., Aug. 13, 2011, <http://online.wsj.com/article/SB10001424053111904823804576504631278044492.html> (reporting that "the [SEC] will scrutinize the model used by credit-rating firm Standard & Poor's to downgrade" the United States); Susanna Kim, *Standard and Poor's: Downgrade Backlash?*, ABC NEWS (Aug. 18, 2011), <http://abcnews.go.com/Business/standard-poors-justice-department-reportedly-investigates-credit-rating/story?id=14332010> (discussing whether a Department of Justice investigation of Standard & Poor's is coincidence or political payback for Standard & Poor's downgrade of the United States); Rachele Younglai & Richard Cowan, *Senate Panel Reviewing S&P Downgrade*, REUTERS (Aug. 8, 2011, 7:11 PM), <http://www.reuters.com/article/2011/08/08/us-usa-debt-congress-idUSTRE7775UO20110808> (noting that a Senate panel was gathering information about Standard & Poor's).

¹⁶⁷ See Kate Linthicum, *Los Angeles to Quit Hiring Standard & Poor's to Rate Its Investments*, L.A. TIMES, Aug. 18, 2011, <http://articles.latimes.com/2011/aug/18/local/la-me-0817-sp-city-20110818> (discussing the decision of Los Angeles and two other municipalities to quit using Standard & Poor's after the agency downgraded the municipalities' bonds).

¹⁶⁸ See Claes Bell, *Fitch Joins Moody's with AAA for US*, BANKRATE.COM (Aug. 16, 2011, 11:00 AM), <http://www.bankrate.com/financing/banking/fitch-joins-moodys-with-aaa-for-us/> (discussing Fitch's and Moody's decisions not to downgrade the United States after Standard & Poor's did); *S&P President Sharma to Leave, Replaced by Citi's Peterson*, FOX BUS. (Aug. 22, 2011), <http://www.foxbusiness.com/technology/2011/08/22/sp-upgrades-google-stock-days-after-sell-view/> (announcing the departure of Standard & Poor's president).

¹⁶⁹ See *supra* Part II.B (providing an overview of the credit rating agencies and their value). "Done properly, [credit rating agencies'] evaluations of credit risk are essential to

Federal Reserve specifically noted the particular burden placed on smaller banks lacking the credit assessment resources of larger banks.¹⁷⁰ In the Dodd-Frank Act, Congress itself noted the value of the gatekeeper role that the NRSROs play.¹⁷¹ Without question, a bright-line creditworthiness standard such as a credit rating holds great intuitive appeal and is much simpler and less expensive than performing credit analysis on an investment portfolio of securities.

Timing is another issue. As mentioned previously, deadlines for 130 of the 400 regulations mandated by the Dodd-Frank Act have already been missed.¹⁷² Federal Deposit Insurance Corp. Chairwoman Shelia Bair has publicly commented about the difficulty of finding an alternative to credit ratings in the time frame that the legislation mandates.¹⁷³ Warren Buffett, Chairman of Berkshire Hathaway, and indirectly, Moody's biggest shareholder, perhaps sums the situation up best: "As problematic as ratings were in this crisis and the central role they played, finding an alternative is going to be very, very difficult."¹⁷⁴

B. *Implications of Tackling the Issuer-Pays Problem*

For years, critics have called for the end of the issuer-pays business model in the credit ratings industry, and the cautious approach taken by the Dodd-Frank Act in respect to that issue is disappointing, but not surprising.¹⁷⁵ As discussed previously, borrowers pay the credit agencies directly for their ratings under the issuer-pays model, which

many market participants who lack the resources or skill to make an independent evaluation." *Do the Credit Rating Agencies Deserve to Exist?*, *supra* note 39, at 13 (quoting Maurice R. Greenberg, chairman and CEO, C.V. Starr and Company).

¹⁷⁰ See *supra* text to note 165 (noting that the Federal Reserve Board is particularly sensitive to the difficulties faced by smaller banks).

¹⁷¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931, 124 Stat. 1376, 1872 (2010); see *supra* note 132 (listing congressional findings in the Dodd-Frank Act).

¹⁷² See *supra* note 13 (citing Davis Polk Dodd-Frank Progress Report).

¹⁷³ FDIC *Unsure How to Comply with Rating Agency Provisions*, RATINGS DEBATE (Jan. 4, 2011), <http://www.theratingsdebate.com/fdic-unsure-how-to-comply-with-rating-agency-provisions/>.

¹⁷⁴ *Id.* (internal quotation marks omitted).

¹⁷⁵ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939D, 124 Stat. 1376, 1888 (2010) (mandating that the Comptroller General of the United States study the compensation issue); GAO REPORT, *supra* note 32, at 2 (quoting an SEC report that this compensation model could induce the credit rating agencies to rate issuers more liberally and temper their diligence in probing for negative information); *Roundtable 2009*, *supra* note 41, at 84 (calling the business model of the credit rating agencies and the issuer-pays model broken); Myers, *supra* note 122 (noting that some critics believe that "[credit] rating agencies watered down their standards" to win business under the issuer-pays model).

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can create multiple conflicts of interest.¹⁷⁶ For example, credit agencies are permitted to advise the firms whose securities they rate, which may lead to a gaming of the system to achieve the desired credit rating.¹⁷⁷ In addition, critics charge that the rating agencies are often slow to lower a rating due to the potential implications of a downgrade.¹⁷⁸

Under Section 939D of the Dodd-Frank Act, the Government Accountability Office is merely required to conduct a study of alternative compensation means for NRSROs and submit that report and any recommendations to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.¹⁷⁹ The purpose of this study is to evaluate alternative means for compensating NRSROs to create incentives for the NRSROs to provide more accurate credit ratings, and a number of alternate compensation strategies have been offered by various market observers.¹⁸⁰ According to Sean Egan, President of Egan-Jones Rating Company, the problem with various rating industry reform proposals is:

[T]hey proceed from the erroneous premise that the major rating agencies are in the business of providing timely and accurate ratings for the benefit of investors . . . when, in fact, these companies have, for the last 35 years, been in the business of facilitating the

¹⁷⁶ See Myers, *supra* note 122 (discussing the “issuer-pays” business model).

[A]ll [the credit rating agencies] were doing is being paid by the very people they were rating. Never bothered to do due diligence at all to determine whether or not these products were as creditworthy as they were claiming to be. And yet still to this day [the credit rating agencies are] suggesting somehow that they are independent, conducting risk evaluation at all. Quite the opposite.

Senate 2009 Hearing, supra note 7, at 2 (statement of Sen. Christopher J. Dodd).

¹⁷⁷ See *supra* Part II.C (describing this process).

¹⁷⁸ Brettell, *supra* note 64; see *supra* note 56 (discussing the implications of downgrading Enron’s debt and whether the credit rating agencies should have acted sooner).

¹⁷⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939D, 124 Stat. 1376, 1888 (2010)

¹⁸⁰ *Id.*; GAO REPORT, *supra* note 32, at 79–93. During an April 2009 roundtable held by the SEC to examine the oversight of the credit rating agencies, participants were asked their opinions of the issuer-pays business model and whether one business model represented a better approach to managing conflicts of interest than another. *Roundtable 2009, supra* note 41, at 4. The goal was to better align the credit raters’ interest with those who rely on the credit ratings. *Id.* Based on that meeting and other congressional hearings, the Government Accountability Office identified five alternative business models in various stages of development that have been proposed to replace the issuer-pays model. GAO REPORT, *supra* note 32, at 79–84. Some of these included: a random selection model, an investor-owned credit rating agency model, a stand-alone model, a designation model, and a user-pay model. *Id.*

issuance of securities for the benefit of issuers and underwriters.¹⁸¹

Empirical evidence by Stanford University researchers would appear to support Mr. Egan's contentions.¹⁸² In a study comparing Egan-Jones, a "subscriber-pays" firm, to Moody's, an "issuer-pays" firm, researchers noted that Egan-Jones' ratings were more timely, and the firm made nearly twice as many rating changes over the period studied.¹⁸³ The Stanford researchers hypothesized that either Moody's was more conservative in its ratings approach than Egan-Jones or lacked the incentive to be competitive and responsive to its constituents.¹⁸⁴ Their conclusions concerning Moody's were particularly damning:

[T]he results of this paper are also consistent with Moody's market power. The certified agencies within the credit rating industry have an effective oligopoly due to various regulations that have developed over time. It is nearly impossible for firms to have a successful bond issue without a certified agency rating. Therefore, Moody's has little incentive from competitive pressures to be responsive to the needs of investors.¹⁸⁵

It is worth noting, despite the massive attention focused on Standard & Poor's downgrading of the United States' credit rating on August 5, 2011, Egan-Jones Ratings in fact downgraded the United States in July 2011 – beating Standard & Poor's to the punch.¹⁸⁶

C. Implications of Continuing Access to Confidential Information

The Dodd-Frank Act's handling of confidential information relative to the credit rating agencies is another weakness of the new legislation. Section 939B states: "Not later than 90 days after the date of enactment of this subtitle, the SEC shall revise Regulation FD (17 C.F.R. 243.100) to remove from such regulation the exemption for entities whose primary

¹⁸¹ 2009 *Hearing Before the H. Comm. on Fin. Servs.*, *supra* note 63, at 3.

¹⁸² See generally Beaver, Shakespeare & Soliman, *supra* note 62, at 332 (comparing the performance of ratings from Egan-Jones, a "subscriber-pays" firm, with the performance of ratings from Moody's, an "issuer-pays" firm; finding that Egan-Jones' ratings were timelier, performed better for investors, and were more closely aligned with their interests).

¹⁸³ *Id.* at 305.

¹⁸⁴ *Id.* at 306.

¹⁸⁵ *Id.* at 332–33.

¹⁸⁶ See *supra* note 9 (describing the Egan-Jones downgrade as well as two earlier downgrades of the United States by a Chinese rating agency).

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business is the issuance of credit ratings (17 C.F.R. 243.100(b)(2)(iii)).¹⁸⁷ The problem with this change is that the Dodd-Frank Act is not eliminating the rating agencies' ability to access material nonpublic information.¹⁸⁸ Rather, the elimination of the exemption means only that a credit rating agency now owes a duty of trust or confidence to a debt issuer if it wishes to continue to access confidential information—the Dodd-Frank Act does not even require that the credit rating agency sign a formal confidentiality agreement.¹⁸⁹ Thus, a shortfall of the Dodd-Frank Act is that it continues to permit this potentially abusive practice.

Laws banning the use of insider information, such as Regulation FD, prohibit a corporation from selectively releasing sensitive confidential information to others, such as stock analysts, for their use.¹⁹⁰ However, a double standard exists in relation to the rating agencies that operate under the issuer-pays model, as they have successfully convinced debt issuers and regulators that access to such confidential information is necessary for accurate ratings.¹⁹¹

¹⁸⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939B, 124 Stat. 1376, 1887–88 (2010).

¹⁸⁸ *Id.*; PARTIGAN, *supra* note 137; see CRA 2003 ROLE REPORT, *supra* note 42, at 22 (claiming that the larger credit rating agencies typically maintain confidentiality agreements with the issuers that they rate).

¹⁸⁹ Partigan, *supra* note 137. Regulation FD provides that:

Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person [who is a broker, dealer, investment adviser, institutional investment manager, investment company, person associated with those entities or a holder of the issuer's securities], the issuer shall make public disclosure of that information . . . [s]imultaneously, in the case of an intentional disclosure; and [p]romptly, in the case of a non-intentional disclosure.

Regulation FD, 17 C.F.R. § 243.100 (2010). Regulation FD also specifically protects or excludes disclosures made to persons who owe a duty of trust or confidence to the issuer and those who have expressly agreed to maintain the disclosed information in confidence. *Id.* § 243.100(b)(2). A good example of this policy in operation is the enforcement action that the SEC announced against Office Depot, Inc. and two of its officers. *SEC Charges Office Depot*, *supra* note 110. The SEC charged Office Depot with selectively disclosing material nonpublic information to its largest investors and Wall Street analysts regarding the fact that Office Depot would not meet Wall Street's earnings estimates. *Id.* These private discussions violated Regulation FD, which requires that a firm make a simultaneous disclosure of nonpublic material information. *Id.* Office Depot agreed to settle with the SEC and paid a one million dollar fine. *Id.* Office Depot's chief executive officer and chief financial officer also paid fines of fifty thousand dollars each. *Id.*

¹⁹⁰ Regulation FD, 17 C.F.R. § 243.100 (2010); Jorion, Liu & Shi, *supra* note 106, at 310–11.

¹⁹¹ See *Final Rule*, *supra* note 88 (claiming that because credit rating agencies publicly disclose their ratings, it is appropriate to permit them access to nonpublic information); see also Jorion, Liu & Shi, *supra* note 106, at 2 (noting that selectively disclosing confidential information to equity analysts was widely perceived as market abuse).

Not all agree that such access is necessary. For example, Jerome Fons and Sylvain Raynes, two former employees of Moody's who now operate their own firms, argue that ratings models should be more objective and have a stronger emphasis on fundamental data to minimize the influence of human judgment.¹⁹² Ratings based on statistical fundamentals and limited human interpretation can ensure a more objective view of risk in their opinion.¹⁹³ In Fons's view, the industry needs to get away from the large credit rating agencies having all the power, and reforms and proposals for the industry must be careful not to further entrench the large firms.¹⁹⁴

Surprisingly, comments from Moody's president Raymond W. McDaniel support the views of Fons and Raynes as well: "The ratings process is produced by human beings, and human beings have views and emotions about certain things We do not deny there are latent or inherent conflicts of interest in our business."¹⁹⁵ Human grudges can be ugly, and at least one unfortunate firm, whose combative executives alienated some of Moody's analysts, ended up with a lower credit rating than its financials would suggest, costing it potentially millions in extra interest payments.¹⁹⁶

Finally, empirical evidence also argues against a continuation of this practice. As noted previously, the ratings assigned to debt issuers by Egan-Jones, a firm not privy to issuers' confidential information, outperformed the ratings assigned to debt issuers by Moody's, a firm with access to issuers' confidential information.¹⁹⁷ Likewise, James H. Gellert, Chairman and CEO of Rapid Ratings International, a firm which only uses publicly available statistical data in formulating its ratings, claims that his firm's ratings performance "far [exceeds] the traditional [issuer-pays] rating agencies in innumerable cases and also typically outperform[s] the prevalent market-based default probability models."¹⁹⁸

This access to confidential information creates an unfair competitive advantage relative to other market analysts.¹⁹⁹ A bond analyst *employed by a Wall Street firm* is not permitted access to confidential information.²⁰⁰

¹⁹² Brettell, *supra* note 64.

¹⁹³ *Id.*

¹⁹⁴ *Id.*

¹⁹⁵ Klein, *supra* note 34, at A1 (internal quotation marks omitted).

¹⁹⁶ *See id.* (quoting a former Moody's analyst who claimed that this firm's rating was reduced by approximately a full notch due to personality issues with Moody's employees).

¹⁹⁷ *See supra* Part III.B (describing this performance).

¹⁹⁸ *Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs., supra* note 62, at 70 (2009) (statement of James H. Gellert, Chairman and CEO of Rapid Ratings International).

¹⁹⁹ Jorion, Liu & Shi, *supra* note 106, at 1-4.

²⁰⁰ *Id.*

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Yet, that same confidential information *is* available to a bond analyst employed by a credit rating agency merely because of the rating agency's perceived gatekeeper function in the market.²⁰¹ A large problem, as discussed previously, is that the credit rating agencies have the potential to tip that information either intentionally or unintentionally to their paid subscribers or others.²⁰² The general public receives the ratings for free from the credit rating agencies, but they are not privy to the commentary and analysis that paid subscribers receive, which may be quite valuable in communicating nuances in a rating.²⁰³ According to University of California researchers Jorion, Liu, and Shi, this access confers a strategic advantage to the credit rating agencies.²⁰⁴

While acknowledging the special treatment that subscribers to the credit rating agencies' services receive, Stephanie Petersen from Charles Schwab also brings up a valid point in her SEC testimony regarding the value that the credit rating agencies provide in disseminating information.²⁰⁵ According to Petersen, some municipal bond issuers are better than others at releasing financial information to the public, as they are not required to follow the rules for dissemination that publicly traded companies must follow.²⁰⁶ Central depositories of municipal information do not exist, as they do for corporate financial information, such as the SEC's EDGAR system.²⁰⁷ According to Petersen, the clout wielded by the credit rating agencies often can be brought to bear upon the reluctant municipal bond issuers who have been remiss in supplying timely financial information to bond holders.²⁰⁸ This testimony suggests that reducing the power of the credit rating agencies by eliminating their access to confidential information could lead to less debtor financial

²⁰¹ *Id.*

²⁰² See Gongloff, *supra* note 19 (describing the SEC's investigation of the major market sell-off of equity securities and heavy trading volume that occurred before Standard & Poor's decision to downgrade the United States and whether that information was leaked); see also *supra* note 91 and accompanying text (discussing how regulators are concerned with the disclosure of confidential information and whether it is being disclosed intentionally or inadvertently).

²⁰³ See FITCH RATINGS, *supra* note 83, at 6 (describing how analysts at Fitch "may discuss the analysis supporting the rating of any Rated Entity or any Securities on investor calls" in the company's confidentiality policy); see also Roundtable 2009, *supra* note 41, at 138 (providing comments of Deborah Cunningham that support the value to institutional investors of receiving this paid information from the credit rating agencies).

²⁰⁴ Jorion, Liu & Shi, *supra* note 106, at 1, 22.

²⁰⁵ SEC 2002 Hearing, *supra* note 40 (statement of Stephanie B. Petersen, Senior Vice President, Charles Schwab & Co.).

²⁰⁶ *Id.*

²⁰⁷ *Id.* See generally Important Information About EDGAR, *supra* note 39 (providing a description of this central depository).

²⁰⁸ SEC 2002 Hearing, *supra* note 40.

information available for analysis. Restricting the credit rating agencies' ability to access confidential information could also lead to less accurate credit ratings. Ask yourself intuitively whose ratings you would trust most: the firm with access to confidential information about the debtor or the firm without access to confidential information about the debtor?

The Dodd-Frank Act makes a number of valuable changes to the laws affecting credit rating agencies that should reduce future abuses. In addition, it has valuable proposals in place for future rulemaking that have the potential for stopping further abuses. However, "studying" is not the same as "stopping." The Dodd-Frank Act needs to level the playing field and require the credit rating agencies to operate like any other investment analyst. It must be amended to address the credit ratings industry problems.

IV. CONTRIBUTION

The Dodd-Frank Act offers the potential for needed improvements, but a stronger legislative reach is necessary to make sure that the problems are corrected. This Note advocates that the time for change is now, and the approach is intuitively simple. Rather than creating elaborate government-imposed business models and complex and lengthy regulations, simply by removing the special preferences that have protected the credit rating agencies and requiring them to operate like other market participants, this Note argues that the forces of the free market will level the playing field and clean up the abuses of the industry.

The Dodd-Frank Act falls short of mandating all the necessary reforms that may prevent other financial market meltdowns from occurring. The underlying problem that has historically permeated the credit ratings industry is the special treatment the NRSRO firms have enjoyed relative to other market participants. The newly enacted Dodd-Frank Act eliminates much of this special treatment. Gone is the regulatory reliance on credit ratings, which gave the NRSROs a guaranteed market for their ratings.²⁰⁹ Also whittled back are the legal protections shielding the NRSROs from liability for faulty credit ratings.²¹⁰ Congress left the NRSRO designation intact, but placed additional monitoring restrictions on those firms.²¹¹ Further, because of the removal of NRSRO references in government regulations, that

²⁰⁹ See *supra* Part II.G (describing the Dodd-Frank Act); *supra* Part III.A (discussing the implications of removing credit ratings from government regulations).

²¹⁰ See *supra* Part II.G (describing the changes in the Dodd-Frank Act).

²¹¹ See *supra* Part II.G (noting the imposition of new internal controls to monitor conflicts of interest).

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franchise is less valuable. What will happen in the issuer-pays area is undecided and being studied, but is unlikely to be adequately fixed by current proposals.²¹² What can fix all these issues in a deceptively simple manner is to simply eliminate the NRSRO's access to confidential information.

This Note proposes several additions to the Dodd-Frank Act that are much broader than the existing legislation and are more definitive. Regulation FD—which regulates access to confidential information—should be amended to prohibit the use of confidential information by the credit rating agencies for credit rating purposes. Under this Note's suggestion, those credit rating agencies who wish to provide consulting services to particular clients will still be free to do so. However, because consulting entails access to confidential information, this Note advocates that the credit rating agencies should not be permitted to offer both consulting and rating services to the same clients simultaneously.

A. Prohibiting the Use of Confidential Information and Ability to Provide Consulting and Ratings Services to the Same Clients

To correct the deficiencies in the Dodd-Frank Act, both the Public Law itself and the relevant SEC federal regulation need to be changed as follows:

**Public Law 111-203 [H.R. 4173]
DODD-FRANK WALL STREET REFORM AND
CONSUMER PROTECTION ACT**

An Act

To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

²¹² See *supra* Part III.B (discussing the study required to be performed by the GAO).

SEC. 939B. ELIMINATION OF EXEMPTION FROM FAIR DISCLOSURE RULE AND PROHIBITION AGAINST ACCESS.

Not later than 90 days after the date of enactment of this subtitle, the Securities *and* Exchange Commission shall revise Regulation FD (17 C.F.R. 243.100) to remove from such regulation the exemption for entities whose primary business is the issuance of credit ratings (17 C.F.R. 243.100(b)(2)(iii)) *and prohibit their access to material nonpublic information for ratings purposes. Credit rating agencies may still access material nonpublic information for consulting purposes but may not then provide rating services to a consulting services client or consulting services to a rating services client within one year of providing such services.*

B. Commentary

Modifying Section 939B of the Dodd-Frank Act in the above manner does two things. First, it clarifies that credit rating agencies are no longer exempt from the provisions of Regulation FD, as originally enacted in the Dodd-Frank Act. In addition, the proposed change helps close the loophole currently existing in Regulation FD that permits a person who owes a duty of trust or confidence to the issuer, such as an attorney, investment banker, or accountant, and who expressly agrees to maintain the disclosed information in confidence to continue to access such information and use it in publishing credit ratings. The suggested change still permits credit rating agencies to offer consulting services if they wish, but forbids them from simultaneously offering consulting and rating services to the same client. Modifying Section 243.100 addresses the second half of the needed change:

Part 243 – Regulation FD

§ 243.100 General rule regarding selective disclosure.

(a) Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information as provided in § 243.101(e):

(1) Simultaneously, in the case of an intentional disclosure; and

(2) Promptly, in the case of a non-intentional disclosure.

(b)(1) Except as provided in paragraph (b)(2) of this section, paragraph (a) of this section shall apply to a disclosure made to any person outside the issuer:

(i) Who is a broker or dealer, or a person associated with a broker or dealer, as those terms are defined in Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a));

(ii) Who is an investment adviser, as that term is defined in Section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)); an institutional investment manager, as that term is defined in Section 13(f)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(f)(5)), that filed a report on Form 13F (17 CFR 249.325) with the Commission for the most recent quarter ended prior to the date of the disclosure; or a person associated with either of the foregoing. For purposes of this paragraph, a "person associated with an investment adviser or institutional investment manager" has the meaning set forth in Section 202(a)(17) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(17)), assuming for these purposes that an institutional investment manager is an investment adviser;

(iii) Who is an investment company, as defined in Section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), or who would be an investment company but for Section 3(c)(1) (15 U.S.C. 80a-3(c)(1)) or Section 3(c)(7) (15 U.S.C. 80a-3(c)(7)) thereof, or an affiliated person of either of the foregoing. For purposes of this paragraph, "affiliated person" means only those persons described in Section 2(a)(3)(C), (D), (E), and (F) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(3)(C), (D), (E), and (F)), assuming for these purposes that a person who would be an investment company but

for Section 3(c)(1) (15 U.S.C. 80a-3(c)(1)) or Section 3(c)(7) (15 U.S.C. 80a-3(c)(7)) of the Investment Company Act of 1940 is an investment company; or

(iv) Who is a credit rating agency, as that term is defined in Section 3(a)(60) of the Securities Exchange Act (15 U.S.C. 78c(a)(60)), and the information is intended for any use in developing, maintaining, or changing a published credit rating concerning the issuer's securities; or

(v) Who is a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information.

(2) Paragraph (a) of this section shall not apply to a disclosure made:

(i) To a person who owes a duty of trust or confidence to the issuer (such as an attorney, investment banker, or accountant);

(ii) To a person who expressly agrees to maintain the disclosed information in confidence;

(iii) In connection with a securities offering registered under the Securities Act, other than an offering of the type described in any of Rule 415(a)(1)(i) through (vi) under the Securities Act (§ 230.415(a)(1)(i) through (vi) of this chapter) (except an offering of the type described in Rule 415(a)(1)(i) under the Securities Act (§ 230.415(a)(1)(i) of this chapter) also involving a registered offering, whether or not underwritten, for capital formation purposes for the account of the issuer (unless the issuer's offering is being registered for the purpose of evading the requirements of this section)), if the disclosure is by any of the following means:

(A) A registration statement filed under the Securities Act, including a prospectus contained therein;

(B) A free writing prospectus used after filing of the registration statement for the offering or a

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communication falling within the exception to the definition of prospectus contained in clause (a) of section 2(a)(10) of the Securities Act;

(C) Any other Section 10(b) prospectus;

(D) A notice permitted by Rule 135 under the Securities Act (§ 230.135 of this chapter);

(E) A communication permitted by Rule 134 under the Securities Act (§ 230.134 of this chapter); or

(F) An oral communication made in connection with the registered securities offering after filing of the registration statement for the offering under the Securities Act.

C. Commentary

Modifying Section 243.100 in the above manner accomplishes two goals. First, it prohibits a credit rating agency from accessing material nonpublic information intended for any use in developing, maintaining, or changing a published credit rating concerning the issuer's securities. Second, it still leaves a credit rating agency the option to access nonpublic, confidential information should it wish to work with the issuer on consulting projects as long as the rating agency does not also provide published credit ratings. The suggested change balances the need to eliminate abuses in the credit rating industry without unduly restricting the business opportunities available to the credit rating agencies.

V. CONCLUSION

As famous presidential advisor Rahm Emanuel urged, the subprime mortgage debacle is not a crisis to be wasted. For over seventy years, the credit rating agencies have painted themselves as quasi-regulators, and their credit rating systems were incorporated into U.S. and international laws. They were given or permitted to have tremendous power. Yet, they broke the special and unusual trust that had been placed in them despite the massive investment losses inflicted on others. Wishing to be prudent, legislators were careful in the Dodd-Frank Act to move

relatively slowly.²¹³ In a number of cases, the Dodd-Frank Act only mandates that either the affected agency or the Government Accountability Office study the matter and report later with its recommendations and findings.²¹⁴ Particularly in light of the large size of this legislation and the sweeping changes that it proposes, this cautionary approach should help mitigate negative consequences from any implemented changes. However, this cautionary approach suffers from two significant problems: (1) the risk that the abuses of the current system will continue to occur during the study period, and (2) that the momentum for change runs out of steam during the study period, and the opportunity to end shortcomings of the current system is lost in the face of opposition. Given that many of the mandated changes required by the Dodd-Frank Act have already missed their congressionally imposed deadlines, this latter risk appears very real.

Certainly, there is no sense in replacing a broken system with an even more disastrous one. However, the abuses plaguing the credit ratings industry and bond market have gone on too long. Definitive changes need to be made to end the credit rating agencies' tremendous power over the financial markets. This Note does not ask for a major regulatory rewrite with all its accompanying unintended consequences, but only that the credit rating agencies' access to confidential information be eliminated and free market forces be left to work. This change does not create a new system, but only requires that the credit rating agencies play by the same rules as other investment analysts who operate in the financial markets.²¹⁵ This change is an easy one with far-reaching impacts that may eliminate many problems in the credit rating industry with one stone.

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²¹³ See *supra* Part III (analyzing the Dodd-Frank Act).

²¹⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). For example, Section 939C provides for a three-year deadline for submission of a study concerning strengthening credit rating agency independence, including recommendations for improving the integrity of credit ratings issued by NRSROs. *Id.* § 939C(c).

²¹⁵ This approach would essentially mirror the system that is already used in the equity market.

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