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

Timothy E. Lynch

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## ARTICLES

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

*Timothy E. Lynch*<sup>†</sup>

*—Let's hope we are all wealthy and retired by the time this house of cards falters.;o).<sup>1</sup>*

### ABSTRACT

*Credit rating agencies have a pervasive and potentially devastating influence on the financial well-being of the public. Yet,*

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<sup>1</sup> U.S. SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 12 n.8 (2008), *available at* <http://www.sec.gov/news/studies/2008/craexamination070808.pdf> [hereinafter U.S. SEC, SUMMARY REPORT] (quoting an email written in December 2006 by an analytical manager in the Collateral Debt Obligation (CDO) group of a major credit rating agency to a senior analytical manager within the same group). The full quotation from this email states that "the rating agencies continue to create an 'even bigger monster—the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters.;o).'" *Id.*

*despite the recent passage of the Credit Rating Agency Reform Act, credit rating agencies enjoy a relative lack of regulatory oversight. One explanation for this lack of oversight has been the appeal of a self-regulating approach to credit rating agencies that claim to rely deeply on their reputational standing within the financial world. There are strong arguments for doubting this approach, including the conflicting self-interest of credit rating agencies whose profits are gained or lost depending on their ability to lure the business of issuers who will always be seeking the highest rating possible. In recent months, government and press investigations initiated largely in response to the economic turmoil surrounding subprime mortgages have led to additional skepticism about the self-regulating abilities of credit rating agencies' reputational integrity concerns.*

*This Article argues that the current underlying theories of credit rating regulation may be prone to fail because they leave in place the fundamental conflicts of interest that have been shown to induce profit-seeking credit rating agencies to over-rate securities, indicating to investors a lower amount of default risk than actually exists. If investors were able to fully discount or adjust for this misinformation, a goal of the disclosure requirements of the Credit Rating Agency Reform Act, additional governance may not be required. Unfortunately, there is considerable empirical and anecdotal evidence in business as well as behavioral finance literatures that many investors using credit rating agency ratings are simply not able to perform such adjustments.*

*This Article develops a governance framework that accounts for the rating agencies' conflicts of interest problem and makes the proposal that public funding augment the current system of evaluating creditworthiness, either through the establishment of a publicly-funded independent credit rating institution, through the hiring of private rating agencies by the government to rate certain securities, or through the use of the tax system to incentivize private rating agencies to issue more accurate ratings. This Article argues that such mechanisms could provide valuable information to investors, could illuminate the reputational compromises credit rating agencies often make in favor of profit-seeking, and, thus, could mitigate a significant amount of the errant information currently produced by private-sector credit rating agencies.*

INTRODUCTION.....	230
I. CREDIT RATING AGENCIES.....	236
A. <i>Credit Rating Agency Fundamentals</i> .....	236
B. <i>Revenue Model</i> .....	239
C. <i>Public Effects of the Credit Rating Agencies</i> .....	240
1. <i>Role in the Capital Markets and Investment Industry</i> .	240
2. <i>Public Use of Ratings as Regulatory Benchmarks</i> .....	244
3. <i>Contact-based Use of Ratings as Benchmarks</i> .....	246
II. PROBLEMATIC ISSUES PRESENTED BY CREDIT RATING	
AGENCIES.....	246
A. <i>Issuer-Pays Conflict of Interest</i> .....	246
B. <i>Risk of Error Independent of Issuer Bias</i> .....	249
III. CREDIT RATING AGENCY INTEGRITY DEFENSES .....	250
A. <i>The Reputation Defense</i> .....	250
B. <i>Theoretical Responses to the Reputation Defense</i> .....	251
1. <i>Marginal Cost, Marginal Benefit Analysis</i> .....	252
2. <i>Lack of Market Sensitivity</i> .....	253
3. <i>Certain Conflict of Interest Management</i>	
<i>Mechanisms</i> .....	254
C. <i>Empirical and Anecdotal Evidence of the Failure of the</i>	
<i>Reputational Defense</i> .....	256
1. <i>Quantitative Evidence of Capture</i> .....	256
2. <i>Anecdotal Evidence of Capture</i> .....	258
3. <i>Evidence of Error (Independent of Capture)</i> .....	261
a. <i>Lack of Diligence</i> .....	261
b. <i>Poor Modeling</i> .....	264
c. <i>Poor and Inaccurate Disclosure</i> .....	265
d. <i>Issuer-Pays Conflict Exacerbates Laxity</i> .....	266
IV. CREDIT RATING AGENCY REFORM ACT OF 2006 .....	267
V. PROBLEMS WITH THE CURRENT REGULATORY	
ENVIRONMENT .....	273
A. <i>Issuer-Pays Conflict of Interest Persists</i> .....	274
B. <i>Limits to Disclosure</i> .....	274
1. <i>The Disclosing Rating Agency</i> .....	275
2. <i>Limits of Investor Sophistication and Vigilance</i> .....	276
a. <i>Coping with Complexity</i> .....	276
b. <i>Evidence</i> .....	278
c. <i>Behavioral Finance and Bounded Rationality</i> .....	283
3. <i>Other Credit Rating Agencies</i> .....	287
C. <i>Potential Unintended Consequences of Regulation</i> .....	289
VI. PUBLICLY FUNDED CREDIT RATINGS .....	291
A. <i>The Public Agency</i> .....	294

1. Basic Description .....	294
2. Benefits of the Public Agency .....	295
3. Responses to Certain Arguments Against the Establishment of a Public Agency .....	298
B. Government Paying for Private Rating Services .....	300
C. Tax Incentives to the Rating Industry.....	301
CONCLUSION .....	302

## INTRODUCTION

The economy is currently in a period of turmoil. U.S. housing prices have fallen significantly.<sup>2</sup> Foreclosures are up.<sup>3</sup> In order to stabilize the housing market and the economy, the federal government has nationalized Fannie Mae and Freddie Mac.<sup>4</sup> The federal government has taken large ownership interests in several other financial institutions, including one of the world's largest insurance companies.<sup>5</sup> Three of the largest independent Wall Street investment banks have collapsed.<sup>6</sup> Several large commercial banks have

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<sup>2</sup> See Press Release, Standard & Poor's, Home Price Declines Worsen As We Enter the Fourth Quarter of 2008 According to the S&P/Case-Shiller Home Price Indices (Dec 30, 2008), [http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice\\_Release\\_123062.pdf](http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_123062.pdf) (showing that average home prices have fallen nationally since the third quarter of 2006 and have fallen by over 19 percent from 2007 to 2008). See also Anton Troianovski, *Year-End Review of Markets & Finance 2008 – Real Estate Markets Still Plumb for Bottom*, WALL ST. J., Jan. 2, 2009, at R7 (“One in 10 homeowners with a mortgage is either in foreclosure or delinquent on payments . . .”).

<sup>3</sup> See Press Release, Mortgage Bankers Ass'n, Delinquencies Increase, Foreclosure Starts Flat in Latest MBA Delinquency Survey (Dec. 5, 2008) <http://www.mbaa.org/NewsandMedia/PressCenter/66626.htm> (reporting that 2.97 percent of U.S. mortgage loans were in the process of foreclosure in the third quarter of 2008, a record high); see also Troianovski, *supra* note 2.

<sup>4</sup> James R. Hagerty et al., *U.S. Seizes Mortgage Giants; Government Ousts CEOs of Fannie, Freddie; Promises up to \$200 Billion in Capital*, WALL ST. J., Sept. 8, 2008, at A1 (noting that together the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) provide funding for approximately three-quarters of new home mortgages in the U.S.). Together Fannie Mae and Freddie Mac also own or guarantee approximately 50 percent of the country's home mortgages and own approximately \$5 trillion in mortgages. James R. Hagerty et al., *U.S. Mulls Future of Fannie, Freddie; Administration Ramps Up Contingency Planning as Mortgage Giants Struggle*, WALL ST. J., July 10, 2008, at A1.

<sup>5</sup> Matthew Karnitschnig et al., *U.S. Plans Rescue of AIG to Halt Crisis; Central Banks Inject Cash as Credit Dries Up; \$85 Billion Loan for Giant Insurer Aimed at Averting Collapse; Historic Move Would Cap 10 Days that Reshaped U.S. Finance*, WALL ST. J., Sept. 17, 2008, at A1 (reporting the U.S. federal government moving toward an emergency loan to American International Group Inc.).

<sup>6</sup> See Susanne Craig et al., *AIG, Lehman Shock Hits World Markets; Focus Moves to Fate of Giant Insurer After U.S. Allows Investment Bank to Fail; Barclays in Talks to Buy Core Lehman Unit*, WALL ST. J., Sept. 16, 2008, at A1 (reporting bankruptcy filing of Lehman Brothers Holdings Inc.); Carrick Mollenkamp et al., *Crisis on Wall Street as Lehman Totters, Merrill Seeks Buyer, AIG Hunts for Cash; U.S. Opts to Avoid Lehman Rescue, Stirring a Momentous Weekend for American Finance; Traders Brace for a Chaotic Monday*, WALL ST.

collapsed, including the largest to collapse in U.S. history.<sup>7</sup> Equity values have plummeted.<sup>8</sup> There is a worldwide credit crunch.<sup>9</sup> The U.S. economy is in a recession,<sup>10</sup> and the economic downturn is felt globally.<sup>11</sup> In an attempt to halt the economic decline, the federal government has authorized the U.S. Treasury to purchase up to \$700 billion of bad mortgage-related debt securities from private entities.<sup>12</sup>

Why has the economy entered such a tumultuous period? A partial answer is that too many institutional investors poured too much money into the U.S. housing market during the housing bubble of the 2000s,<sup>13</sup> and when the housing bubble burst, an ensuing wave of

J., Sept. 15, 2008, at A1 (reporting the rushed sale of Merrill Lynch & Co. to Bank of America Corp.); Robin Sidel et al., *The Week that Shook Wall Street: Inside the Demise of Bear Stearns*, WALL ST. J., Mar. 18, 2008, at A1 [hereinafter Sidel et al., *The Week*] (reporting the fall of Bear Stearns Company, Inc.); Robin Sidel et al., *J.P. Morgan Buys Bear in Fire Sale, as Fed Widens Credit to Avert Crisis; Ailing Firm Sold for Just \$2 a Share in U.S.-Backed Deal*, WALL ST. J., Mar. 17, 2008, at A1 (describing the bailout of Bear Stearns).

<sup>7</sup> David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi; Deal Avoids Need For Taxpayer Cash; Pandit Vows a Fight*, WALL ST. J., Oct. 4, 2008, at A1 (reporting Wells Fargo's agreement to takeover struggling Wachovia Corp. only days after the government engineered a proposed takeover of Wachovia by Citigroup Inc.); Damian Paletta et al., *Crisis Deepens as Big Bank Fails; IndyMac Seized in Largest Bust in Two Decades*, WALL ST. J., July 12, 2008, at A1 (reporting the seizure of IndyMac Bank by federal banking authorities); Robin Sidel et al., *WaMu Fails, Is Sold off to J.P. Morgan; Biggest Banking Collapse in U.S. History; Government Arranges a Deal to Safeguard Huge Thrift's Deposits, Branches*, WALL ST. J., Sept. 26, 2008, at A1 (reporting the collapse of Washington Mutual Inc. and its purchase by J.P. Morgan Chase and Co.).

<sup>8</sup> *US STOCKS—Wall Street Set for New Year Gain after Bleak 2008*, REUTERS, Jan. 2, 2009, available at <http://www.reuters.com/article/marketsNews/idCAN0227916820090102> ("In 2008 as a whole, the Dow [Jones Industrial Average] fell 33.8 percent, for its bleakest year since 1931; the S&P skidded 38.5 percent; and the Nasdaq posted its worst year ever, with a 40.5 percent drop."). As of December 31, 2008, the Dow Jones Industrial Average dropped almost 40 percent since its all-time high of 14,279.96 on October 11, 2007. See Historical Prices for .DJI (Dow Jones Industrial Average), <http://finance.google.com/finance/historical?q=INDEXDIX:.DJI> (last visited Feb. 22, 2009) (historical data).

<sup>9</sup> TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, REPORT ON THE SUBPRIME CRISIS 1, 3 (May 2008), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf> [hereinafter IOSCO, SUBPRIME REPORT]; see also Justin Lahart et al., *World Economy Shows New Strain; European Output Shrinks; U.S. Inflation Jumps; Fresh Worries in Developing Nations*, WALL ST. J., Aug. 15, 2008, at A1.

<sup>10</sup> Press Release, Business Cycle Dating Comm., Nat'l Bureau of Econ. Research, Determination of the December 2007 Peak in Economic Activity (Dec 11, 2008), available at <http://www.nber.org/cycles/dec2008.pdf> (reporting that the U.S. economy has been in a recession since economic activity peaked in December 2007).

<sup>11</sup> See Mark Landler, *World Bank Expects Pain Worldwide*, N.Y. TIMES, Dec. 10, 2008, at B1; Press Release, World Bank, Global Slump Hits Developing Countries as Credit Squeeze Impedes Growth and Trade; Tensions in Commodity Markets Ease (Dec. 9, 2008), available at <http://go.worldbank.org/F16CTJAHW0>.

<sup>12</sup> David M. Herszenhorn, *Bush Signs Bill*, N.Y. TIMES, Oct. 4, 2008, at A1.

<sup>13</sup> See Press Release, Standard & Poor's, Record Low Annual Declines Recorded in May 2008 for the S&P/Case-Shiller Composite Home Price Indices (July 29, 2008), [http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice\\_Release\\_072943.pdf](http://www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_072943.pdf)

foreclosures drove down the value of these investments, forcing some investors into insolvency.<sup>14</sup> Many institutional investors, in order to meet capital and liquidity requirements, have had to restrict lending<sup>15</sup> while seeking additional capital.<sup>16</sup> This has led to the widespread credit crunch<sup>17</sup> and a general economic slowdown.<sup>18</sup> This problem is exacerbated by the fact that many of the security vehicles used to invest in the housing market—mortgage-backed securities (“MBSs”) and collateralized debt obligations (“CDOs”) based on MBSs—are often complexly structured,<sup>19</sup> and their underlying assets (thousands of individual mortgages) are often legally distant and largely invisible.<sup>20</sup> This complexity and opacity has resulted in a situation

[hereinafter Standard & Poor’s, Case-Shiller] (showing dramatic annual increase in national average housing prices between 1998 and 2006, followed by a steep decline); ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 14 (2d ed. 2005) (explaining that the “rocket-taking-off” boom in home prices in the U.S. since 1997 cannot be explained “in terms of building costs, population, or interest rates”); see also Vincent Reinhart, Op-Ed., *Securitization and the Mortgage Mess*, WALL ST. J., July 18, 2008, at A13 (a former director of the Federal Reserve’s Division of Monetary Affairs referring to the “housing bubble” and the “housing-market collapse”).

<sup>14</sup> See, e.g., E.S. Browning, *Banks Rally, but Demons Still in Vault; Interbank Lending, House Prices Suggest the Worst Isn’t Over; a Bear Bounce?*, WALL ST. J., July 28, 2008, at C1; Damian Paletta et al., *Countrywide Seeks Rescue Deal; Bank of America Eyes Stricken Home Lender as Crisis Grinds on*, WALL ST. J., Jan. 11, 2008, at A1; Paletta et al., *supra* note 7; Sidel et al., *The Week*, *supra* note 6.

<sup>15</sup> See Browning, *supra* note 14 (noting that banks have been forced by recent foreclosure-induced uncertainty and failing confidence in other banks to reduce the amount of their borrowing and lending).

<sup>16</sup> See, e.g., Jonathan Karp & Michael Corkery, *Middle East Players Arrive; Government Investment Funds, Individuals Fill Need for Cash on Developments Across U.S.*, WALL ST. J., Mar. 12, 2008, at B9 (reporting American financial institutions are selling interests to Persian Gulf sovereign-wealth funds in order to acquire necessary capital); Tom Lauricella, *Signs Say Economic Recovery Isn’t Here; Oil, Dollar Offer Hope, but False Starts Pepper Bear Markets with Uncertainty*, WALL ST. J., Aug. 11, 2008, at C1.

<sup>17</sup> See sources cited *supra* note 9.

<sup>18</sup> See Lahart et al., *supra* note 9; Ravi Balakrishnan, *United States Manages First Housing Bust in Four Decades*, IMF SURV. MAG., Aug. 1, 2008, <http://www.imf.org/external/pubs/ft/survey/so/2008/CAR080108A.htm> (“The unusual nature of the ongoing crisis in the financial and housing sectors leaves the [economic] outlook highly uncertain.”); see also Scott Patterson, *How the Credit Mess Squeezes You*, Wall St. J. Online, Mar. 2, 2008, <http://online.wsj.com/article/SB120441177639305685.html> (describing the connection between the housing bubble bursting, subprime mortgages, the credit crunch, and the economic slump).

<sup>19</sup> Mortgage-backed securities are debt securities whose payments are based on the total principal and interest payments of a pool of mortgages. The pool may consist of thousands of mortgages. Collateralized debt obligations are securities whose securities are also based on a pool of underlying assets, and MBS-based CDOs are CDOs which are based on a pool of MBSs, often as many as 200 MBSs. See ANDREW DAVIDSON ET AL., *SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS* 24–26 (2003) (discussing a variety of factors that go into credit rating agencies’ determination of financial strength of securitization); U.S. SEC, *SUMMARY REPORT*, *supra* note 1, at 6–7. The vast majority of MBSs and CDOs are purchased and held by institutional investors. IOSCO, *SUBPRIME REPORT*, *supra* note 9, at 12.

<sup>20</sup> MBSs and CDOs based on MBSs are highly structured, meaning, essentially, that the rights to the cash flows from the pool of underlying securities are segmented among different

where many security holders do not know the exact nature of the risks they bear,<sup>21</sup> and the markets cannot easily value these securities.<sup>22</sup> As a result, liquidity in these products has shrunk considerably,<sup>23</sup> financial uncertainty is pervasive,<sup>24</sup> and the credit market has constricted considerably.<sup>25</sup>

But such an explanation merely raises additional questions. The most immediate question is why did so many ostensibly sophisticated institutional investors invest so heavily in the U.S. housing markets, especially during a housing bubble<sup>26</sup> and during a time when subprime mortgages constituted such a large percentage of home loans originated in the U.S.<sup>27</sup> To begin to answer this question, it is worth investigating the role of the many actors who contributed to the creation of the current turmoil. Some culprits are commonly discussed—unethical home loan originators who preyed on unsophisticated homebuyers whose creditworthiness prevented them from taking out traditional home loans;<sup>28</sup> speculators who took advantage of the inexpensive financing to ride the seemingly endless wave of increasing housing values;<sup>29</sup> and irresponsible homebuyers who took out home loans which they did not understand or could not

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tranches of securities. Different tranches bear different degrees of risk and are priced, in part, relative to their respective levels of risk. This differentiation is obtained by payment subordination, over-collateralization, swaps, and other credit enhancements. See DAVIDSON ET AL., *supra* note 19, at 24–26; U.S. SEC, SUMMARY REPORT, *supra* note 1, at 6–7. The combination of the thousands of underlying assets, the complex structuring, and the credit enhancements make the risks of MBSs and related securities difficult to thoroughly analyze and understand and makes the securities, therefore, often difficult to price. IOSCO, SUBPRIME REPORT, *supra* note 9, at 10, 22.

<sup>21</sup> Cf. IOSCO, SUBPRIME REPORT, *supra* note 9, at 5 (noting that “[t]he uncertainty regarding the quality of [mortgage-related] CDO ratings” created a “liquidity crisis” which had effects in other areas, “particularly in the market for commercial paper”).

<sup>22</sup> See *id.* at 10, 13, 17–19.

<sup>23</sup> *Id.* at 5.

<sup>24</sup> *Id.* at 4–5.

<sup>25</sup> See sources cited *supra* note 9.

<sup>26</sup> Standard & Poor’s, Case-Shiller, *supra* note 13 (showing eight year continued increase in national home price averages followed by steep decline).

<sup>27</sup> John Kiff & Paul Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets* 6 (Int’l Monetary Fund, Working Paper No. WP/07/188, July 2007), available at <http://www.imf.org/external/pubs/ft/wp/2007/wp07188.pdf>. Although until 2003 the percentage of all mortgage originations which were not “prime conforming” was very low, by 2006 approximately half of all mortgage originations were “nonprime” loans (subprime: 21%, and Alt-A: 25%). *Id.* Such nonprime loans totaled almost \$1.5 trillion in 2006. *Id.*

<sup>28</sup> See, e.g., Kai Wright, *The Subprime Swindle*, THE NATION, July 14, 2008, at 11; *Is Wall Street to Blame for the Mortgage Meltdown?* (Fresh Air From WHY NPR radio broadcast July 8, 2008).

<sup>29</sup> See, e.g., George Anders, *Now, Even Borrowers with Good Credit Pose Risks*, WALL ST. J., Dec. 19, 2007, at A2.



afford to repay.<sup>30</sup> Some culprits, however, are less well known. Three additional ones include: (i) the investment banks who sponsored the creation of many MBSs and the CDOs based on them; (ii) the three large American credit rating agencies, Moody's Investor Service ("Moody's"), Standard and Poor's Rating Services ("S&P"), and Fitch Ratings, Ltd. ("Fitch"), each of which appear to have been recklessly, if not knowingly, rating MBSs and related securities<sup>31</sup> as less risky than they actually were and, consequently, to have fed investor appetites for MBSs and other U.S. real estate financial products; and (iii) the institutional investors themselves, who appear to have been relying too heavily on credit ratings as substitutes for—rather than supplements to—their own internal risk assessments.

This Article addresses the inter-relational dynamics of these last three actors, and, in particular, focuses on the actions and incentives of the credit rating agencies—the actors positioned immediately between the issuing investment banks and institutional investors. It addresses why the credit rating agencies might issue inaccurately high ratings, and why institutional investors might have been encouraged by inaccurately high credit ratings to invest increasingly large sums of money into the U.S. housing market, and then offers a possible framework for addressing these interrelated problems. Such investment fueled the housing bubble<sup>32</sup> and created the conditions that would not only result in the current economic turmoil but would expose both the bad behavior of the credit rating agencies and a certain lack of sophistication on the part of institutional investors.

Part I of this Article briefly describes the credit rating agencies, their operations, and their importance within the capital markets, as well as how their ratings are used in regulating the investments of certain institutional investors. All large American credit rating agencies earn the vast majority of their revenues from securities issuers who contract with credit rating agencies to have their securities rated.<sup>33</sup> Part II examines the conflict of interest inherent in this "issuer-pays" revenue model.

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<sup>30</sup> See, e.g., Kimberley E. Strassel, Op-Ed, *The Bailout Briar Patch*, WALL ST. J., Mar. 21, 2008, at A12 (reporting that the presidential administration had distinguished between those homebuyers who have been victims of predatory lending and those who merely "signed up for an unaffordable home").

<sup>31</sup> Throughout this Article, any reference to "mortgage-backed securities," "MBSs," "residential MBSs," "RMBSs," or "mortgage-related securities" is meant to include references to all securities based on a pool of residential mortgages, including collateralized debt obligations based on a pool of MBSs.

<sup>32</sup> Reinhart, *supra* note 13 (stating that asset securitization helped "to enable the housing bubble").

<sup>33</sup> See *infra* Part I.A.

The credit rating agencies have acknowledged the existence of the issuer-pays conflict of interest and the more benign risk of error but have typically downplayed their significance, stating that their reputations are far too valuable to the success of their businesses for them to either succumb to the biases inherent in the issuer-pays revenue model or issue inaccurate ratings.<sup>34</sup> Part III details this “reputation” argument, presents theory-based counterarguments to it, and then presents empirical and anecdotal evidence indicating that a generalized concern for their reputations has not satisfactorily prevented rating agencies from succumbing to those biases for the sake of short-term profits.

Part IV examines the regulatory regime governing the credit rating industry, specifically the Credit Rating Agency Reform Act of 2006 and the rules promulgated by the SEC pursuant to the Act. This Part highlights some of the rules recently announced and some currently being proposed by the SEC to address some of the regulatory failures identified during the current subprime episode. Notably, the Act, the current SEC rules, and the proposed SEC rules do not adequately regulate the fundamental problem of the rating agencies—the issuer-pays conflict of interest. In the current regulatory environment, credit rating agencies are permitted to use the issuer-pays model, but if they do, they must publicly disclose that fact. Part V details why such a disclosure requirement is unlikely to ensure adequate credibility and accuracy of ratings.

In a world of increasing financial complexity, opacity, and interconnectedness,<sup>35</sup> financial crises and economic turmoil could

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<sup>34</sup> U.S. SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 41–42 (2003), available at <http://www.sec.gov/news/studies/credratingreport0103.pdf> [hereinafter U.S. SEC, 2003 CRA REPORT].

<sup>35</sup> See Garry J. Schinasi, *Preserving Financial Stability*, in ECONOMIC ISSUES (Int’l Monetary Fund, Econ. Issues Series No. 36, Sept. 2005), available at <http://www.imf.org/external/pubs/ft/issues/issues36/ei36.pdf>. Complex structured instruments and derivatives of all types are becoming much more numerous. See Greg Ip & Rebecca Christie, *Derivatives Growth Has Helped Banks*, *Greenspan Says*, WALL ST. J., Oct. 8, 2002, at A2. Hedge funds, whose investment strategies and portfolios are normally opaque to the public, are also growing. U.S. SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION vii (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> [hereinafter U.S. SEC, 2003 HEDGE FUND REPORT] (“The hedge fund industry recently [through 2003] has experienced significant growth in both the number of hedge funds and the amount of assets under management. Based on current estimates, 6,000 to 7,000 hedge funds operate in the United States managing approximately \$600 to \$650 billion in assets. In the next five to ten years, hedge fund assets have been predicted to exceed \$1 trillion.”); ALEXANDER INEICHEN & KURT SILBERSTEIN, AIMA’S ROADMAP TO HEDGE FUNDS 18 (2008), available at [http://www.aima.org/en/knowledge\\_centre/education/aimas-roadmap-to-hedge-funds.cfm](http://www.aima.org/en/knowledge_centre/education/aimas-roadmap-to-hedge-funds.cfm) (“The overall annual growth rate for the whole [hedge fund] industry from 1990 to 2007 was around 23.5% in terms of assets under management.”). More relevantly for our purposes, many hedge funds keep the details of

prove to be increasingly profound. These same factors increase the potential for credit rating agencies to engage in public welfare harming, short-term profit seeking behavior while simultaneously decreasing the ability of investors to adequately monitor, discount, and discipline the rating agencies, thus making it more pressing to find ever more reliable governance and regulatory mechanisms to ensure a satisfactory level of financial stability and sustainability. Part VI of the Article proposes a governance structure with more public participation, which would increase financial stability, promote greater credibility within the private-sector credit rating industry and enable investors to make better informed investment decisions. Three possibilities are discussed under this proposal: (i) the establishment of an independent, publicly-funded credit rating agency, (ii) the use of public funds to hire rating agencies which do not use the issuer-pays revenue model to conduct credit analysis on selected securities, and (iii) the use of the tax system to incentivize rating agencies to issue more accurate credit ratings. In a spirit of prompting future discussion, Part VI briefly provides the structural outline of each proposal, describes some of their potential benefits, and identifies some implementation obstacles.

## I. CREDIT RATING AGENCIES

### A. Credit Rating Agency Fundamentals

In an investment world where information is often difficult to obtain and adequately process, credit rating agencies play a particularly relevant and important role.<sup>36</sup> The precursors to the

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their investment strategies concealed from their own investors. U.S. SEC, 2003 HEDGE FUND REPORT, *supra*, at 46–47 (“Hedge fund advisers typically provide information to investors during an investor’s initial due diligence review of the fund, although some, more proprietary, information may not be provided until after the investor has made a capital commitment to the fund, if at all. . . . In practice, even very large and sophisticated investors often have little leverage in setting terms of their investment and accessing information about hedge funds and their advisers.”).

<sup>36</sup> For comprehensive descriptions of credit rating agencies, see generally, RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM (Richard M. Levich et al. eds., 2002); TIMOTHY J. SINCLAIR, THE NEW MASTERS OF CAPITAL: AMERICAN BOND RATING AGENCIES AND THE POLITICS OF CREDITWORTHINESS (2005); Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED. RES. BANK N.Y. Q. REV., Summer-Fall 1994, at 1, 1; Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 47 (2004); Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59 (Yasuyuki Fuchita & Robert E. Litan eds., 2006) [hereinafter Partnoy, *Not Like Other Gatekeepers*]; Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 622 (1999) [hereinafter Partnoy, *Two Thumbs Down*]; Arthur R. Pinto, *Control and Responsibility of*

modern credit rating agencies were mercantile credit agencies. First formed in the mid-1800s, these agencies assessed the ability of merchants to pay their financial obligations<sup>37</sup> and sold these assessments to businesses who would then use this information to help them decide whether or not to lend or provide other financing to a particular merchant and, if so, under what terms.<sup>38</sup> In 1909, John Moody formed the first company focused specifically on assessing the ability of businesses to pay amounts due on the bonds they issued.<sup>39</sup>

Modern credit rating agencies are private, for-profit companies that assess the creditworthiness of the issuers of debt and debt-like securities.<sup>40</sup> Securities issuers often provide rating agencies with nonpublic information about themselves and about their securities.<sup>41</sup> With this information, credit rating agencies make creditworthiness assessments, and, then, most rating agencies, including the very largest, make their opinions, or ratings, publicly available.<sup>42</sup> Credit

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*Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. SUPP. 341 (2006); see also U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 5.

<sup>37</sup> For a brief description of the historical evolution of the credit rating industry, see generally, SINCLAIR, *supra* note 36, 22–27; Cantor & Packer, *supra* note 36, at 1–5; Partnoy, *Two Thumbs Down*, *supra* note 36, at 636–54; Richard Sylla, *An Historical Primer on the Business of Credit Rating*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM, *supra* note 36, at 19, 21–22.

<sup>38</sup> Cantor & Packer, *supra* note 36, at 1.

<sup>39</sup> *Id.* at 2.

<sup>40</sup> Such securities include long-term corporate bonds, mid-term corporate bonds, short-term corporate notes, municipal bonds, asset-backed securities, preferred stocks, privately placed notes and bonds, commercial paper, bank certificates of deposits, mortgage backed securities, and other collateralized debt obligations. Some rating agencies rate other payment capabilities, such as the claim paying ability of insurance companies and the performance risk of mortgage servicers. *Id.* at 3.

<sup>41</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 21–22, 26. Information considered by credit rating agencies may include the issuer's method of cash generation and its use of cash, the nature and amount of its assets and liabilities, debt-to-equity ratios, interest coverage ratios, cash flow predictions, budgets, business projections, amount and nature of fixed charges, advanced notification of major corporate events, nature of its markets, efficiency and nature of its operations, quality of its management, contractual commitments, competitors, current government regulations, and its regulatory risks. *Id.* at 26. Pursuant to SEC Regulation FD, securities issuers may not disclose nonpublic information to certain members of the public, such as securities market professionals and others who may use the information for trading purposes, without making that information generally publicly available. 17 C.F.R. § 243.100(b)(2)(iii) (2008). However, Regulation FD makes an exception for credit rating agencies so that securities issuers can make their non-publicly available information available to the credit rating agencies for purposes of credit analysis. The SEC justified the credit rating agency exception because rating agencies use such information to develop and *publicly* issue a generalized opinion about the creditworthiness of the issuer. 17 C.F.R. § 243.100(b); Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,719–20 (August 24, 2000).

<sup>42</sup> See, e.g., U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 21–22 (describing the internal processes used by credit rating agencies to collect and analyze information and decide a rating).

rating agencies may rate a security upon its initial issuance and may maintain surveillance over a security afterwards, revising the rating when and if the creditworthiness of the issuer changes.<sup>43</sup> A credit rating agency is, therefore, essentially a purveyor of information and of the analysis of that information.<sup>44</sup>

Traditionally, securities are given a single, letter-designated grade on a linear scale, which is reflective of the credit rating agency's opinion as to the likelihood of full and timely payment.<sup>45</sup> Credit rating agencies also publicly disclose some of the underlying methodology and basic rationale used to conduct their credit analysis.<sup>46</sup>

There are more than one hundred credit rating agencies worldwide.<sup>47</sup> In the United States, the credit rating industry is highly concentrated,<sup>48</sup> with two firms, Moody's and S&P, each controlling approximately 40 percent of the market.<sup>49</sup> It was estimated that as of 2005 Moody's and S&P each had credit rating opinions outstanding on approximately \$30 trillion worth of securities.<sup>50</sup>

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<sup>43</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 26.

<sup>44</sup> MOODY'S INVESTORS SERVICE, MOODY'S RATING SYMBOLS & DEFINITIONS 1-2, 6-7 (2008), available at <http://v2.moodys.com/moodys/cust/research/MDCdocs/29/2006600000424852.pdf?frameOfRef=corporate>.

<sup>45</sup> See Standard & Poor's, Standard & Poor's Ratings Definitions, <http://www.standardandpoors.com> (follow "Ratings" hyperlink; then follow "Criteria, Policies, Definitions, & Requests for Comment" hyperlink; then follow "Definitions" hyperlink; then follow "Standard & Poor's Ratings Definitions" hyperlink) (last visited Dec. 18, 2008). Standard and Poor's long-term issue credit ratings are based on a scale of AAA, AA, A, BBB, BB, CCC, CC, C, and D, with "+" and "-" indicating a rating which is high or low, respectively, within that ratings "notch." AAA represents a security of the lowest default risk (defined to indicate that "[t]he obligor's capacity to meet its financial commitment on the obligation is extremely strong"), while D represents a security of the highest default risk ("The 'D' rating category is used when payments on an obligation are not made on the date due even if the applicable grace period has not expired, unless Standard & Poor's believes that such payments will be made during such grace period. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of a similar action if payments on an obligation are jeopardized."). *Id.* Complete Standard & Poor's rating definitions are available at Standard & Poor's website. *Id.*

<sup>46</sup> See U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 21-22.

<sup>47</sup> See *id.* at 36-37; see also Lawrence J. White, *The Credit Rating Industry: An Industrial Organizational Analysis*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM, *supra* note 36, at 41, 46 (listing countries with major rating agencies).

<sup>48</sup> See Hill, *supra* note 36, at 44. With the passage of the Credit Agency Reform Act of 2006, additional rating agencies may be able to flourish. See *infra* notes 57, 84-86 and accompanying text.

<sup>49</sup> Serena Ng, *Moody's, S&P Still Hold Advantage; Law to Boost Competition in Credit-Rating Business Isn't Likely to Pose Setback*, WALL ST. J., Oct. 10, 2006 at C5; see also IOSCO, SUBPRIME REPORT, *supra* note 9, at 28 (noting that "some data indicates" that Moody's, Standard & Poor's, and Fitch collectively control approximately 85 percent of the credit-rating market).

<sup>50</sup> Partnoy, *Not Like Other Gatekeepers*, *supra* note 36, at 65-66.

### B. Revenue Model

Before the mid-1970s, American credit rating agencies made money by selling their credit analysis opinions to members of the investment community.<sup>51</sup> Such purchasers are referred to as subscribers. In the early 1970s, in part as a result of the 1970 recession and the default of Penn Central (a major railroad company) on \$82 million of debt, the investment environment began to change, and investors began to demand that new security issues have at least one credit rating.<sup>52</sup> As issuers were increasingly required by the marketplace to issue rated securities, the rating agencies realized that they could start to charge issuers, rather than subscribers, for the “service” of rating their securities.<sup>53</sup> Additionally, as communication and document reproduction technology became more advanced and ubiquitous, it became increasingly difficult for credit rating agencies to keep their ratings out of the hands of non-subscribers, and as ratings became increasingly public information, the inclination of subscribers to pay for ratings declined.<sup>54</sup> Furthermore, as securities and the business strategies of issuers became more complex, it became more costly for rating agencies to conduct their analysis, and, consequently, issuing ratings required more resources than could be recovered solely from subscription fees.<sup>55</sup>

Together these factors led rating agencies to create a more viable and profitable revenue generation model, and, during the mid-1970s, the “subscriber-pays” revenue model was gradually replaced by the “issuer-pays” revenue model—a model in which issuers of debt and debt-like securities pay the rating agencies to rate their securities.<sup>56</sup> Although credit rating agencies still have investor subscription services,<sup>57</sup> it is estimated that today approximately 80 to 90 percent of

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<sup>51</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 41; *see also* Cantor & Packer, *supra* note 36, at 4; Sylla, *supra* note 37, at 35.

<sup>52</sup> Cantor & Packer, *supra* note 36, at 4.

<sup>53</sup> *Id.*; White, *supra* note 47, at 47.

<sup>54</sup> Cantor & Packer, *supra* note 36, at 4; White, *supra* note 47, at 47.

<sup>55</sup> *See* U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 41.

<sup>56</sup> *Id.*; Cantor & Packer, *supra* note 36, at 4; Sylla, *supra* note 37, at 35.

<sup>57</sup> Subscribers have access to more detailed reports and analysis than what is publicly available from the credit rating agencies. U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 22. Of the ten NRSROs recognized as of August 2008, three, Egan-Jones Rating Company, LACE Financial Corp, and RealPoint LLC, have repudiated the issuer-pays model and seem to rely instead on the subscriber-pays model for the significant amount of their revenues. Egan-Jones Rating Co., <http://www.egan-jones.com> (last visited Aug. 19, 2008) (reporting that it does not have any conflicts of interest because it does not receive compensation from issuers); LACE Financial Corp., <http://www.lacefinancial.com> (last visited Aug. 19, 2008) (reporting that it is unbiased because it does not receive compensation for its ratings); RealPoint LLC, <https://www.realpoint.com/PublicDocs%5CNRSRO%20Designation.pdf> (last visited Feb. 2, 2009) (discussing how RealPoint LLC is the only SEC-recognized NRSRO specializing in the

the revenues generated by American credit rating agencies are paid by issuers.<sup>58</sup>

Credit rating agencies also occasionally rate the creditworthiness of issuers who have not requested or paid for this service.<sup>59</sup> These ratings, referred to as “unsolicited ratings” are done at the rating agency’s own expense and are based solely on publicly available information. Credit rating agencies also typically offer ancillary services such as pre-rating security structuring advice.<sup>60</sup>

### *C. Public Effects of the Credit Rating Agencies*

It is widely acknowledged that the credit rating agencies play an important role in the activities of the investment industry, the capital markets, public regulation, and private contracting.<sup>61</sup> The globalization of the capital markets and the sheer scope of the investment industry have significantly enhanced their influence.

#### *1. Role in the Capital Markets and Investment Industry*

Investors use ratings to help them estimate the default risks associated with rated securities and rated issuers.<sup>62</sup> Rating services are

structured finance sector that “uses a subscription-based investor model as opposed to the traditional issuer-paid model,” which, according to its president and CEO, “gives investors truly independent, unbiased analysis and greater transparency of the process”). These three agencies, however, are relatively small companies, and two are registered as NRSROs for only limited classes of securities. See U.S. SEC, Nationally Recognized Statistical Rating Organizations (“NRSROs”), <http://www.sec.gov/divisions/marketreg/ratingagency.htm> (under the heading “Commission Orders Granting NRSRO Registration,” follow “Release No. 34-58000,” “Release No. 34-57300,” and “Release No. 34-57031” hyperlinks) (last visited Dec. 19, 2008).

<sup>58</sup> See, e.g., U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 41 n.110. Credit rating agencies still have investor subscription services. Moody’s reports that \$1.835 billion of its total \$2.259 billion 2007 revenue, or 81 percent, was revenue from determining and maintaining credit ratings, and most of the remaining revenue was from selling subscription services. MOODY’S CORP., FORM 10-K (ANNUAL REPORT), at 28 (2008); Partnoy, *Two Thumbs Down*, *supra* note 36, at 652 (“Ninety-five percent of the agencies’ annual revenue is from issuer fees, typically two to three basis points of a bond’s face amount.” (footnotes omitted)).

<sup>59</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 27 n.67; Pinto, *supra* note 36, at 344.

<sup>60</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 42–43; Pinto, *supra* note 36, at 344.

<sup>61</sup> See, e.g., JOHN BRAITHWAITE & PETER DRAHOS, GLOBAL BUSINESS REGULATION 160 (2000) (“[No market watchdog] has become more powerful than the pre-eminent US rating agencies . . . . [Every] issuer of securities in the world . . . . shudder[s] at the effect on investing publics of even a hint that one of these agencies might qualify their credit rating.”); U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 19 (“The [SEC] recognized that, in recent years, the importance of credit ratings to investors and other market participants had increased significantly, impacting an issuer’s access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to make particular investments.”).

<sup>62</sup> See U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 38 (reporting that representatives of non-NRSRO credit rating agencies believe that the NRSRO designation was extremely important, in part because of the pervasiveness of rating-dependent regulation, but also “because

particularly valuable to investors who have relatively limited information gathering and/or analysis capacity, and, therefore, cannot make credit evaluations as effectively or efficiently as a rating agency.<sup>63</sup> Rating agencies also provide an economy of scale.<sup>64</sup> In theory, rating agencies increase efficiency and lower costs within the investment industry since each investor need not expend the time and energy to conduct similar credit risk analyses.<sup>65</sup> In the case of less resource-rich investors, it may be prohibitively expensive to collect sufficient information about potential investments and thoroughly analyze that information.<sup>66</sup> Consequently, the rating services of the rating agencies lower issuers' costs of capital. In other words, investors are more willing to purchase a rated debt securities offering, despite a lower rate of return, than they would be if (i) they were burdened with having to expend considerable resources to acquire and evaluate all available information themselves, or (ii) they were faced with risking their investment dollars by purchasing securities on which they have limited information.<sup>67</sup>

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the marketplace views the NRSRO designation as the equivalent of the 'Good Housekeeping Seal of Approval'" (quoting *The Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets: Hearings Before the U.S. Securities and Exchange Commission* (Nov. 21, 2002) (testimony of Larry G. Mayewski, Executive Vice President and Chief Ratings Officer, Ratings Division, The A.M. Best Company), available at [http://www.sec.gov/spotlight/rating\\_agency.htm](http://www.sec.gov/spotlight/rating_agency.htm)). See Part I.C.2 for a discussion of the NRSRO designation.

<sup>63</sup> See David M. Ellis, *Different Sides of the Same Story: Investors' and Issuers' Views of Rating Agencies*, J. FIXED INCOME, Vol. 7(4), March 1998, at 35. Based on the results of his survey, Ellis notes that there is a large group of institutional investors that rely on their own analysis considerably more than that of the rating agencies and, additionally, another large group of institutional investors that rely more on the rating agencies. Ellis suggests that this indicates that the former group consists of "sophisticated investors who can produce their own credit analysis." *Id.* at 39; see also U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 28 ("Most of the large buy-side firms active in the fixed income markets are substantial users of information from credit rating agencies, even though they typically conduct their own credit analysis," which suggests that smaller buy-side firms active in the fixed income markets are less able to conduct their own internal analysis.).

<sup>64</sup> Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 21-22.

<sup>65</sup> *Id.* at 12, 22 (noting that the costs associated with "each investor individually evaluating his or her investment would be excessive" and that "rating agencies improve the efficiency of securities markets by acting as informational intermediaries between issuers and investors in order to increase the transparency of securities and thereby reduce the information asymmetry").

<sup>66</sup> See *id.*

<sup>67</sup> But see Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10, 21, 24 (2006) (arguing that although "[i]t is generally accepted that the uninformed investors . . . clearly rely on . . . ratings, . . . [the credit rating agencies provide] no information of value to the investing public"); Partnoy, *Not Like Other Gatekeepers*, *supra* note 36, at 61 (stating that ratings possess "little" informational value); Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM, *supra* note 36, at 65 [hereinafter Partnoy, *The Paradox*] (making the same argument and arguing that a



This is especially true of securities for which information is more difficult to gather, understand, or analyze, like sovereign debt<sup>68</sup> or particularly complex securities like MBSs, CDOs, and other structured finance products that require considerable resources to comprehensively analyze.<sup>69</sup> Numerous reports have echoed the fact that investors, because of the complexity and opacity of certain new securities like MBSs, cannot understand these securities completely and have relied instead on the credit rating agencies.<sup>70</sup> In the over-the-counter derivatives markets, credit ratings are also heavily relied upon to determine the acceptability of counterparties and to determine the level of collateral that might be required for any particular transaction.<sup>71</sup>

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

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rating agency's only value is that which is contained in the "regulatory licenses" provided to issuers when their securities achieve benchmark ratings required pursuant to rating-dependent regulations).

<sup>68</sup> See Roman Kräussl, *Do Credit Rating Agencies Add to the Dynamics of Emerging Market Crises?* 3-4, 34 (Ctr. for Fin. Studies, Working Paper No. 2003/18, Aug. 2003) (reporting that CRAs have "substantial influence on the size and volatility of emerging markets lending," where the problem of asymmetric information, even for institutional investors, exists).

<sup>69</sup> See Cantor & Packer, *supra* note 36, at 19-20 ("The need for high ratings [on mortgage backed securities and asset backed securities] appears to arise from . . . investors' concerns about the quality of the collateral as well as their unfamiliarity with the complicated structures of the securities. . . . In principle, securities with lower credit enhancements can be discounted by the market. However, in practice, *the market has trusted agencies* to be prudent in the determination of credit support requirements and has not required higher yields from issuers that have switched to agencies with lower enhancement requirements." (emphasis added) (citation omitted)); Greg Ip et al., *U.S. Mortgage Crisis Rivals S&L Meltdown; Toll of Economic Shocks May Linger for Years; A Global Credit Crunch*, WALL ST. J., Dec. 10, 2007, at A1 (noting that valuing a CDO may entail valuing as many as one hundred separate securities, each of which may contain thousands of individual loans ("a feat that, if done on any scale, can require millions of dollars in computing power alone"), and quoting the finance director of King County, Washington, who stated that the county "relied heavily on the ratings agencies" when investing in commercial paper backed by MBS-related special investment vehicles); see also Aaron Lucchetti, *Rating Game: As Housing Boomed, Moody's Opened Up*, WALL ST. J., Apr. 11, 2008, at A1 (stating that many investors who lost money in the subprime mortgage crisis relied on ratings to signal which securities were safe to buy); David Wessel, *From Credit Mess, Lessons About Government*, WALL ST. J., Nov. 8, 2007, at A2 (stating that the huge institutional investors who purchased RMBSs, and CDOs based on them, "now say they blindly relied on credit-rating agencies").

<sup>70</sup> See, e.g., TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, *THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS* (2008), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf>; Cantor & Packer, *supra* note 36; Editorial, *The Moody's Blues*, WALL ST. J., Feb. 15, 2008, at A14.

<sup>71</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 28.

more informed credit risk analysis. Since the implementation of Regulation FD,<sup>72</sup> the credit rating agencies are the main conduit of nonpublic information to the market.<sup>73</sup>

Institutional investors often use ratings, but the degree and extent to which any particular institutional investor uses or relies on the ratings of the credit rating agencies varies.<sup>74</sup> Many institutional investors—in particular those who are more resource-rich and have greater information gathering and analytical capacities—conduct their own creditworthiness analysis of issuers.<sup>75</sup> But it is nevertheless typical for these more resource-rich institutional investors to refer to credit ratings to inform their own analysis or to include a rating “as one of several valuable ‘inputs’ to their independent credit analysis.”<sup>76</sup> Institutions with fewer resource gathering and information processing capabilities, however, are likely to rely more heavily on the ratings of these agencies than those institutional investors with significant internal resources.<sup>77</sup>

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<sup>72</sup> See *supra* note 41.

<sup>73</sup> Philippe Jorion et al., *Informational Effects of Regulation FD: Evidence from Rating Agencies*, 76 J. FIN. ECON. 309 (2005) (reporting the results of their study which demonstrates that since the implementation of Regulation FD in October 2003, the informational content of credit ratings has increased).

<sup>74</sup> See Ellis, *supra* note 63, at 37–40 (reporting the results of a survey of 205 institutional fixed income investors, in which these institutions report that on a scale of 1–7, with “1” indicating that they rely entirely on their own internal analysis and “7” indicating that they rely primarily on the credit rating agencies ratings, the average score was 4.19, and no respondent reported that they rely entirely on their own analysis (the results of this survey, conducted in 1998, may not represent current reliance)); see also Abby Schultz, *S&P Faces Criticism in Mortgage Area*, WALL ST. J., Jan. 4, 1994, at A7A. *But see* Macey, *supra* note 67, 21–24 (arguing that sophisticated or institutional investors should not use the information contained credit ratings and that that ratings do not even contain any useful information).

<sup>75</sup> See IOSCO, SUBPRIME REPORT, *supra* note 9, at 9; Ellis, *supra* note 63, at 39 (noting that as securities become increasingly complex, the need for specialized and sophisticated research is more necessary, but observing, additionally, that advances in information gathering and analyzing technology, and increased sophistication on the part of investors, fewer institutional investors need to rely wholly on the opinions of the credit rating agencies).

<sup>76</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 21, 28; see also Ellis, *supra* note 63, at 36; Anusha Shrivastava & Emily Barrett, *Treasurys See Flight to Safety: Subprime Worry Drives Up Prices; ‘It’s Buyer Beware,’* WALL ST. J., July 11, 2007, at C7 (reporting that an S&P downgrade of almost 400 MBSs “served to reignite fears of broad-based selling from anxious investors”—in other words, institutional investors are not conducting their own complete analysis but instead are relying, at least in part, on the signals given to them by the rating agencies). It is well known that credit rating analysts routinely take calls from and have informal contact from subscribers, typically institutional investors, who are seeking additional insights and further explanations of their credit rating agencies opinions. U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 35. Although some academics believe that there is little or no informational content in rating agencies’ ratings, see, e.g., Macey, *supra* note 67, subscribers seem to disagree. See U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 35, for a discussion of how subscriber services may create improper informational asymmetry in the investor marketplace.

<sup>77</sup> Ellis, *supra* note 63, at 39 (suggesting that the results of a survey of institutional investors indicate that larger, more resource-rich institutions relied less on credit rating agency

## 2. Public Use of Ratings as Regulatory Benchmarks

As stated above, issuers' cost of capital is reduced when a credit rating agency collects and analyzes information for the investment community. Their cost of capital is reduced considerably more when ratings on their securities meet certain regulatory benchmarks. Many institutional investors, pursuant to regulations, are forbidden or discouraged from purchasing certain low rating securities. Federal and state regulators, as well as international organizations, often adopt the credit rating agencies' ratings in order to determine the creditworthiness and credit risk of assets held by certain regulated entities, such as commercial banks and insurance companies, and the minimum capitalization requirements for these entities.<sup>78</sup> For example, rating-dependent laws and regulations<sup>79</sup> may

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opinions than did less resource-rich institutions); Shrivastava & Barrett, *supra* note 76.

<sup>78</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 6–8.

<sup>79</sup> For example, among federal law, the Secondary Mortgage Market Enhancement Act of 1984 (amending the Securities Exchange Act of 1934) defined the term “mortgage related security” in such a way that, among other things, required such a security be rated in one of the two highest rating categories by at least one NRSRO. *See* 15 U.S.C. § 78c(a)(41) (2006). Of particular relevance in the most recent financial crisis, the Federal Deposit Insurance Act states that corporate debt securities are not investment grade unless they are rated in one of the four highest categories by at least one NRSRO. 12 U.S.C. § 1831e(d)(4)(A) (2006). Among regulations, a rule promulgated by the SEC pursuant to the Investment Company Act of 1940 limits money market funds to investing in only high quality short-term instruments, and NRSRO ratings are used to help determine exactly what those high quality investment instruments are. 17 C.F.R. § 270.3a-7 (2008). In regulations adopted pursuant to the Securities Act, the offerings of certain non-convertible debt, preferred securities, and asset-backed securities that are rated investment grade by at least one NRSRO may be registered on Form S-3, the SEC’s short form registration statement, without the issuer satisfying a minimum public float test. 17 C.F.R. § 239.13 (2008). SEC rules governing the minimum capital requirements of broker-dealers are also based on NRSRO ratings. *See* U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 6 (discussing how the SEC originally coined the term “nationally recognized statistical rating organization,” yet many others use it today). The U.S. Department of Education uses NRSRO ratings “to set standards of financial responsibility for institutions that wish to participate in student financial assistance programs under Title IV of the Higher Education Act of 1965.” *Id.* at 8. Among state law, the Code of the State of California states that California incorporated insurance companies may invest excess funds only in debt securities which are, among other things, rated in one of the three highest rating categories of at least one NRSRO. CAL. INS. CODE § 1192.10 (West 2005). The Bank for International Settlements relies on the credit ratings of “external credit assessment institutions” to assign risks to asset classes and thus to determine minimum capitalization requirements for internationally active banks. BASEL COMM. ON BANKING SUPERVISIONS, BANK FOR INT’L SETTLEMENTS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK 19–50 (2006), available at <http://www.bis.org/publ/bcbs128.pdf?noframes=1>; *see also* RAWI ABDELAL, CAPITAL RULES: THE CONSTRUCTION OF GLOBAL FINANCE 192–95 (2007); Michael R. King & Timothy J. Sinclair, *Private Actors and Public Policy: A Requiem for the New Basel Capital Accord*, 24 INT’L POL. SCI. REV. 345 (2003) (criticizing Basel II’s proposal to use (now, practice of using) ratings to help determine bank capital requirements). For many more examples and a fuller discussion of, and critiques of the use of, ratings-dependent regulations, *see*, for example, U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 6–8; Cantor & Packer, *supra* note 36, at 5–8;

restrict firms in certain industries from holding securities below a certain rating level, or may dictate that certain capital charges be imposed on a firm when securities rated below certain levels are held by that firm.<sup>80</sup> Such “ratings-dependent regulations” are becoming more and more widespread<sup>81</sup> and are another indication of the far-reaching public effects of the credit rating agencies.

In order to increase the effectiveness of ratings-dependent regulations, it became necessary for the ratings referred to in these regulations to be established by agencies that issued credible and reasonably accurate ratings. Over time, the concept of the “nationally recognized statistical rating organization,” or “NRSRO,” came into existence, and now most ratings-dependent regulations reference the ratings only of the select few credit rating agencies that have been designated by the SEC as an NRSRO.<sup>82</sup> The Credit Rating Agency Reform Act of 2006, discussed more fully in Part IV, provides an administrative process for rating agencies to apply for and obtain NRSRO registration.

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Partnoy, *Two Thumbs Down*, *supra* note 36, at 681–703, 682 (arguing that such rating-dependent regulations grant the credit rating agencies their real value and confer upon issuers who achieve a particular level rating level a “regulatory license,” a “valuable property right[] associated with compliance with that regulation”); *see also* Partnoy, *Not Like Other Gatekeepers*, *supra* note 36, at 81–83 (discussing how such rating-dependent regulations make credit rating agencies different from other financial gatekeepers such as auditors and securities analysts). Implicit assumptions in ratings-dependent regulations are that the ratings spectra of different NRSROs are equivalent to each other and interchangeable, and that they are unchanging. Historically it appears that the markets have viewed Moody’s and S&P rating scales as roughly equivalent, and the other rating agencies appear to have designed their rating scales to harmonize with the Moody’s and S&P scales. Cantor & Packer, *supra* note 36, at 13. However, there is no express intention of coordination between the rating agencies and no regulations requiring any particular kind of scale. *Id.* at 15. Given this market place assumption, an agency seeking to attract additional business might be even more particularly inclined to soften their rating standards relative to other agencies.

<sup>80</sup> Such a capital charge requires that firms, when computing applicable net worth for purposes of determining whether or not minimum capital requirements are satisfied, “deduct from their net worth certain percentages of the market value of their proprietary securities positions. A primary purpose of these [charges] is to provide a margin of safety against losses that might be incurred . . . as a result of market fluctuations in the prices of, or lack of liquidity in, their proprietary positions.” U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 6.

<sup>81</sup> *See* Cantor & Packer, *supra* note 36, at 5–6; Partnoy, *The Paradox*, *supra* note 67, at 68–78; Partnoy, *Two Thumbs Down*, *supra* note 36, at 704–09 (arguing that, because of the lack of informational value in credit ratings and the potential for abuse, the use of rating dependent regulations should be abandoned, but could be replaced with risk control regulations that instead reference credit spreads, i.e., the difference in yield between U.S. federal government-issued debt securities and the subject private debt security).

<sup>82</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 6.

### 3. *Contact-based Use of Ratings as Benchmarks*

Ratings are often used by private contracting parties. Private contracts often contain “rating triggers” in which a downgrade of a counterparty’s credit rating can trigger, among other things, the acceleration of debt payments, obligations to provide additional collateral, increased interest rates, and the activation of previously inactive restrictive covenants.<sup>83</sup> A cascading effect is possible where a debtor’s credit rating drops and such rating-dependent contractual clauses are triggered. For example, if a debtor’s interest rate is increased, additional fixed charges may now be owed, and the debtor’s creditworthiness will be even more impaired. This impairment may trigger other contractual provisions, which may in turn trigger further contractual provisions. It is possible for an issuer’s rating to plummet over the course of such a cascade and even send a firm into sudden bankruptcy.<sup>84</sup>

## II. PROBLEMATIC ISSUES PRESENTED BY CREDIT RATING AGENCIES

### *A. Issuer-Pays Conflict of Interest*

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

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<sup>83</sup> *Id.* at 29.

<sup>84</sup> *See, e.g.*, FRANK PARTNOY, *INFECTIOUS GREED* 333, 336, 340 (2003) (relating how any mention of a credit ratings downgrade “created a hush” among a crowd of senior executives and securities analysts and how Enron experienced this type of cascade four days before declaring bankruptcy in December 2001). Some lenders have started to shy away from using rating triggers because, though designed to provide lender protection, this cascading effect increases the risk of sudden bankruptcy. U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 30.

<sup>85</sup> For a list of NRSRO’s which do not use the issuer-pays revenue model, see *infra* note 57 and accompanying text.

Issuers want high ratings, not necessarily accurate ratings. The higher the securities rating, the less concern investors will have about payment default, the greater the liquidity, and the lower the issuers' cost of capital.<sup>86</sup> In addition, given the importance many issuers place on the ability to tap large markets, higher ratings provide them with access to investors whose investment choices are constrained by ratings-dependent regulations.<sup>87</sup> Even after a security has been issued into the primary market, issuers have significant incentive to maintain their ratings both to maintain liquidity and to ensure that no disadvantageous rating-based contractual clauses are triggered.<sup>88</sup>

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

The current model of the credit rating agencies, therefore, is built upon a fundamental and blatant conflict of interest; the rating agencies are opining as to the creditworthiness of the issuer—ostensibly for the benefit of investors<sup>90</sup>—yet the bulk of the revenues generated by the credit rating agencies come from the issuers, those very debtors being evaluated.<sup>91</sup> As stated earlier,

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

<sup>87</sup> See *supra* Part I.C.2.

<sup>88</sup> See *supra* Part I.C.3.

<sup>89</sup> See, e.g., John C. Coffee, Jr., *Understanding Enron: "It's All About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1408 (2002) (remarking on the basic conflict of interest faced by gatekeepers such as credit rating agencies, "whose desire to be perceived as credible and objective may often be subordinated to [a] desire to retain and please . . . clients").

<sup>90</sup> It could be argued that the rating agencies are also opining ostensibly for the benefit of legislators and regulators who have adopted credit ratings, a key determinant in the calculation of institutional risk management and capital requirements. But perhaps it is more appropriate to say that the legislators and regulators are merely taking advantage of the fact that credit ratings exist and are therefore using them as a proxy for more direct risk analysis and capital requirement. See, e.g., Partnoy, *Not Like Other Gatekeepers*, *supra* note 36 (criticizing regulators for using inherently flawed credit rating agencies' ratings for such regulatory purposes).

<sup>91</sup> The conflict of interest associated with this issuer-pays model has been described relatively extensively in the literature on credit rating. See, e.g., U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 41–42 (noting that issuing inappropriately high ratings may result from any

although credit rating agencies generate some revenue from subscribers, who purchase more detailed credit analysis, and from selling other ancillary services, it is estimated that approximately 80 to 90 percent of the revenue generated by American rating agencies is revenue from issuers requesting a rating on their issued securities.<sup>92</sup> Consequently, credit rating agencies may be “captured” by issuers—that is to say, they may succumb to the biases inherent in the issuer-pays conflict of interest. This conflict of interest is similar to the conflict of interest securities analysts experience when employed by broker-dealers that do a substantial amount of investment banking business with the same companies about which these analysts publicly opine—a conflict of interest that earlier this decade generated extensive federal, state, and industry investigations and resulted in criminal charges against several Wall Street investment firms.<sup>93</sup>

Prior to the enactment of the Credit Rating Agency Reform Act of 2006, the credit rating industry was largely unregulated. The provisions of this Act and certain SEC rules promulgated pursuant to the Act, including ones that claim to address the issuer-pays conflict of interest, are presented below in Part IV. It is worth noting at this point, however, that under current and proposed regulation, ratings agencies are permitted to continue to base their businesses on the issuer-pays model, and the fees charged are not substantively regulated.<sup>94</sup>

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number of different dynamics). For example, the credit rating agency could make more liberal assumptions about the issuer and the securities when using its financial model, or the rating agency might not engage in particularly probing due diligence of the issuer, or the issuers might expressly place pressure on the agency to give the ratings the issuer desires. Since the fees charged by the rating agencies typically are a percentage of the size of the issuance, the threat of such pressure may be more likely, and the likelihood of its effectiveness may be greater, when the issuer issues securities of great size and/or issues securities frequently and when earning its continuing business would be particularly lucrative for the credit rating agency. *See id.* at 40–43; *see also* Partnoy, *Not Like Other Gatekeepers*, *supra* note 36; Partnoy, *The Paradox*, *supra* note 67; Pinto, *supra* note 36, at 343–46.

<sup>92</sup> *See supra* note 58 and accompanying text.

<sup>93</sup> Such securities analysts have been charged with overly touting the equity securities of public companies in order to raise the market value of the shares of these companies and thus attract lucrative investment banking contracts for their firms and raise the value of shares held in their firm’s own accounts. For a more detailed discussion of the conflicts of interest experienced by equity securities analysts, *see*, for example, Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035 (2003); Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39 (2007).

<sup>94</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 41.

### B. Risk of Error Independent of Issuer Bias

The Credit Rating Agency Reform Act also does not obligate rating agencies to conduct any due diligence. Credit rating agencies are not obligated by any law or regulation to audit the integrity or accuracy of the information given for their analysis, and, consequently, the quality of their analysis is, in part, a function of the quality of the information they are provided by the issuing firms.<sup>95</sup> The SEC, however, has recently enacted a rule that would require rating agencies to more fully disclose their due diligence policies, but this rule does not mandate any level of diligence; diligence itself would not be required, but, if not conducted, that fact would have to be disclosed.<sup>96</sup>

As suggested in the previous section, inaccurate ratings can result if the credit rating agencies are captured by issuers. However, inaccurate ratings may result independently of any capture. Inaccurate ratings may result from (i) poor due diligence or a lack of research resources (as a result of inadequate research skills or inadequate financial or managerial resources), (ii) a lack of analytical resources (perhaps resulting from inadequate analytical skills and/or inadequate financial or managerial resources), or (iii) good faith mistakes.<sup>97</sup>

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<sup>95</sup> See *id.* at 31–32; Pinto, *supra* note 36. In fact, each of the three largest rating agencies, S&P, Moody's, and Fitch, note on their respective websites that "the assignment of a rating is not a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating." U.S. SEC, SUMMARY REPORT, *supra* note 1, at 18.

<sup>96</sup> Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6,456, 6,459–60 (Feb. 9, 2009) (to be codified at 17 C.F.R. pts. 240 & 249b) [hereinafter Amendments to Rules] (discussing the final amendments to Credit Rating Agency Reform Act instructions to Exhibits 2 of Form NRSRO, to be effective on April 10, 2009); see also U.S. SEC, FACT SHEET: FINAL RULES AND PROPOSED RULES RELATING TO THE NATIONALLY RECOGNIZED STATISTICAL RATINGS ORGANIZATIONS AND CREDIT RATINGS, Dec. 3, 2008, available at <http://www.sec.gov/news/press/2008/nrsrofactsheet-120308.htm> [hereinafter U.S. SEC, FACT SHEET] (discussing the final amendments to instructions to Exhibits 1 and 2 and to Form NRSRO); Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212, 36,233–34 (June 25, 2008) [hereinafter Proposed Rules] (discussing disclosure changes to the Credit Rating Agency Reform Act). In January 2008, one rating agency reported that it would begin conducting more extensive reviews of subprime mortgage origination practices after sampling forty-five loan files and finding "the appearance of fraud or misrepresentation in almost every file." U.S. SEC, SUMMARY REPORT, *supra* note 1, at 18 n.23. If a rating agency suspects that the information provided by the issuer is incomplete or inaccurate, a credit rating agency may refuse to rate, withdraw their services, or downgrade a rating previously given.

<sup>97</sup> The threat of civil liability to the investing public resulting from inaccurate ratings is limited since courts have traditionally deemed their ratings to be mere opinions protected under First Amendment principles. Pinto, *supra* note 36, at 351–55 (noting that American rating agencies have rarely been sued successfully—and that various theories from tort and from private anti-trust law have been suggested to reach credit rating agencies in the hopes that increased liability would incentivize them to be more diligent and reliable actors—but that none of these theories have gained acceptance in the courts).



### III. CREDIT RATING AGENCY INTEGRITY DEFENSES

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

#### *A. The Reputation Defense*

Defenders of the credit rating industry have typically responded to the observation that they may succumb to the biases inherent in the issuer-pays conflict of interest by acknowledging such a conflict exists, but downplaying its impact.<sup>98</sup> Industry defenders state that a credit rating agency's success ultimately relies on the agency's reputation within the investment community for issuing accurate and credible ratings, and they claim that this conflict can be, and has been (at least until the current subprime crisis), effectively managed.<sup>99</sup> Their argument proceeds as follows. If the investing public were to come to believe that a credit rating agency was captured too much by issuers and was consequently issuing unreliable, suspect, or less than fully defensible opinions, the credit rating agency's reputation would be tarnished. The investment community would then discount the value of its ratings, thus reducing market demand for its rating services. Revenues would consequently decrease. In the worst-case scenario, the credit rating agency would go out of business. Only those agencies with good reputations—the collection of which, according to industry defenders, is coterminous with the set of those that issue accurate ratings—would survive and flourish.

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<sup>98</sup> See, e.g., Partnoy, *Two Thumbs Down*, *supra* note 36, at 628–36 (presenting a comprehensive explanation, and critique, of how industry defenders claim that credit rating agencies acquire and depend on reputational capital).

<sup>99</sup> See U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 23, 41–42 (paraphrasing industry defenders); Schwarcz, *supra* note 64, at 13 (“[T]here is little reason to believe that increased regulation will improve the reliability of ratings. Rating agencies have had a remarkable track record of success in their ratings, and recent rating experience [until 2002] is even more reliable.” (footnote omitted)); Vickie Tillman, Op-Ed., *Don't Blame the Rating Agencies*, WALL ST. J., Aug. 31, 2007, at A9 (“Reputation and integrity are [S&P’s] most valuable long-term assets, which would make it imprudent for S&P to provide anything other than fair, objective and independent ratings opinions.”). *But see* Fabien Dittrich, *The Credit Rating Industry: Competition and Regulation 7* (July 13, 2007) (unpublished Ph.D dissertation, University of Cologne), available at <http://ssrn.com/abstract=991821> (“Although reputation is widely accepted as the key aspect of credit rating economics, *there has been little explicit research on it.*” (emphasis added)).

Industry defenders have also stated that the rating agencies' motivation to maintain their good reputation is, alone, adequate incentive for them to exercise appropriate levels of due diligence; maintain adequate analytical, financial, and managerial resources; and conduct careful risk analysis—and that this dynamic eliminates the likelihood of persistently issuing inaccurate ratings.<sup>100</sup> Again, the argument proceeds similarly to that presented above—any agency which persistently issued inaccurate ratings, for whatever reason, even reasons independent of issuer-capture, would tarnish its reputation and not survive in the marketplace.

### *B. Theoretical Responses to the Reputation Defense*

Many commentators have found the reputation argument compelling,<sup>101</sup> and the argument may have been one of the reasons the credit rating industry was left largely unregulated until recently. The argument may also have served to entice the investment public into relying more on ratings than they may have otherwise. Proponents of the reputation argument seem to claim that outside observers should never doubt, challenge, or regulate ratings agencies. But the reputation argument has some serious flaws.

Reputation is merely a measurement of the perceptions of others and is only indirectly a function of one's behavior or character. A concern for one's reputation, therefore, is only a limited check on one's behavior. And it may be further limited if competing interests are particularly compelling. Reputational protection might be a

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<sup>100</sup> See, e.g., U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 32 (paraphrasing the responses of rating agencies to concerns about the accuracy and completeness of the ratings process).

<sup>101</sup> See Partnoy, *Two Thumbs Down*, *supra* note 36, at 633 (explaining the "reputational capital" view of credit rating agencies). In fact, many commentators believe that the incentive to maintain a positive reputation within the investor community is a particularly strong and effective disciplinary mechanism. See, e.g., Cantor & Packer, *supra* note 36, at 4 ("While the current payment structure may appear to encourage agencies to assign higher ratings to satisfy issuers, the agencies have an *overriding* incentive to maintain a reputation for high-quality, accurate ratings." (emphasis added)); see also SINCLAIR, *supra* note 36, at 29 ("The real constraint [preventing capture by issuers] is that any hint of corruption in ratings would diminish the reputation of the major agencies—and reputation is the very basis of the rating franchise."); Schwarcz, *supra* note 64, at 14; Jonathan R. Macey, *Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation*, 65 U. CHI. L. REV. 1487, 1500 (1998) (reviewing FRANK PARTNOY, F.I.A.S.C.O.: BLOOD IN THE WATER ON WALL STREET (1997)) ("Rating agencies . . . do not charge higher fees for better ratings. Indeed, the only reason that rating agencies are able to charge fees at all is because the public has enough confidence in the integrity of these ratings to find them of value in evaluating the riskiness of investments."); Dittrich, *supra* note 99, at 120 ("[T]he reputation mechanism is very robust. A reputable agency will never deviate from the high quality strategy; outright milking is not an option. What, however, if the reputation mechanism does not function properly? Then an agency will not be (fully) punished [by the marketplace] for a quality drop.").

motivation, but it does not follow that it is a rating agency's *sole* motivation or that no other motives (like profit-seeking) will ever compete with reputational protection. If the reputational argument is not as comprehensive as its proponents claim—if, in other words, credit rating agencies are driven by motives that compete with reputational protections—then the potential hazard of allowing it to stand unchallenged is that investors may wrongly believe that reputational protection is a sufficient self-regulatory mechanism to ensure reliable ratings. This would create a false confidence in the integrity of the rating agencies.

### *1. Marginal Cost, Marginal Benefit Analysis*

The reputational argument assumes that being captured by issuers and/or issuing inaccurate ratings will both be readily apparent to the marketplace and result in an appropriate amount of reputational damage. The argument seems to presuppose, too, that there is nothing to gain by issuing inaccurate ratings. What is actually required is an incremental cost-benefit analysis; any observer should ask just how much incremental benefit a credit agency would receive if it were to progressively succumb to this bias relative to the incremental reputational and revenue costs.<sup>102</sup> It is only when the incremental cost outweighs the incremental benefit that the cost of reputational harm modifies behavior.

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

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

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<sup>102</sup> See Partnoy, *The Paradox*, *supra* note 67, at 73 (“Just as rating agencies will sell information until the marginal cost of acquiring and transferring information exceeds the marginal benefit from issuer fees, rating agencies will sell regulatory licenses until the marginal cost of acquiring and transferring regulatory licenses exceeds the marginal benefit from issuer fees.”).

could also be earned via the *faithful strategy* of quality maintenance.<sup>103</sup>

A firm engaging in a “fly-by-night” strategy may increase short-term profits by cutting costs, as described by Shapiro, or by expanding the size of its market. As shall be more clearly seen, the major credit rating agencies appear to have engaged in a fly-by-night strategy by issuing overly-high ratings for certain mortgage-related securities and consequently expanding their market.<sup>104</sup>

## 2. Lack of Market Sensitivity

Additionally, it is not evident that the market is or has been particularly sensitive to any rating agency capture by issuers or to the rating agencies’ failure to issue accurate ratings. Again, an observer should ask just how inferior a credit rating agency’s performance would have to be before the market reacts in any kind of punishing way. Given the difficulty of assessing whether or not a particular credit rating agency is truly biased or not, the sensitivity of the market may be extremely low. Indeed, through shrewd management, marketing, and tacit or explicit cooperation with issuers and other industry players, it may be possible to take advantage of certain cognitive biases and common heuristics<sup>105</sup> to reduce the market’s sensitivity to any failures on the part of the rating agencies. Indeed, it is difficult enough to determine what an “accurate” rating would be, given the fact that it is a prediction of the uncertain future. So there is immediately reason to doubt that investors would be particularly sensitive to any but the grossest inaccuracies.<sup>106</sup>

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<sup>103</sup> Carl Shapiro, *Premiums for High Quality Products as Returns to Reputations*, 98 Q.J. ECON. 659, 660 (1983).

<sup>104</sup> See IOSCO, SUBPRIME REPORT, *supra* note 9, at 27; U.S. SEC, SUMMARY REPORT, *supra* note 1, at 10–11 figs. The SEC reported that of the three largest U.S. rating agencies, one reported nearly a 250 percent increase in RMBS revenue and a 900 percent increase in CDO revenue between 2002 and 2006, another reported over a 200 percent increase in RMBS revenue and over a 600 percent increase in CDO revenue over the same period, and a third reported respective increases of approximately 100 percent and 180 percent. *Id.* The baseline revenues, i.e., the revenues for 2002, were not given. Although S&P, Moody’s, and Fitch were the subject of the examination, the report does not ascribe any observation to them specifically and only refers to them as “Firm 1,” “Firm 2,” and “Firm 3.” *Id.*

<sup>105</sup> See *infra* Part V.B.2.c (discussing cognitive biases and heuristic devices).

<sup>106</sup> See Partnoy, *Two Thumbs Down*, *supra* note 36, at 705 (suggesting that market-based credit spreads are far more sensitive and responsive than credit ratings to real time changes in the risk of debt securities).

### 3. Certain Conflict of Interest Management Mechanisms

Defenders of the credit rating industry also assert that certain organizational structures and industry realities exist to ensure that the rating agencies would not be captured by issuers. There are reasons to doubt the effectiveness of each. For example, defenders note that rating agencies typically have policies in place that are designed to ensure analysts' compensation is based on the demonstrated accuracy of their ratings, independent of both the size of the issue being analyzed and any inappropriate interference (from issuers or otherwise) that might make their analysis less than objective.<sup>107</sup> However, a recent SEC report concluded that although analysts' salaries at the three largest NRSROs were generally based on seniority and experience, bonuses were based on individual performance *and* the overall success of the firm.<sup>108</sup> The more business a credit rating agency solicits, the more successful and profitable it becomes. All things being equal, the more successful a business, the higher salaries it can pay and the greater the job security its employees have. Therefore, part of the compensation of their analysts has *not* been, in fact, a direct function of their ability to perform analyses with integrity or of the accuracy of their ratings. Furthermore, analysts may own shares of their employer and, in some cases, are awarded stock options as part of their formal compensation package.<sup>109</sup> Such compensation—based on the market price of the company's shares, and thus fundamentally on the future profitability of the agency—conflicts with any claim that analysts' compensation is free of the biases inherent in the issuer-pays model.<sup>110</sup>

Defenders also argue that an agency is unlikely to be captured by any particular issuer because of the fact that no single issuer accounts for a great percentage of an agency's overall revenues.<sup>111</sup> S&P has

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<sup>107</sup> See, e.g., U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 23; U.S. SEC, SUMMARY REPORT, *supra* note 1, at 27; see also Tillman, *supra* note 99.

<sup>108</sup> U.S. SEC, SUMMARY REPORT, *supra* note 1, at 27.

<sup>109</sup> See Lucchetti, *supra* note 69.

<sup>110</sup> The profits, profit margins, and—in the case of the publicly traded Moody's—appreciation in share price each grew greatly during the early and mid 2000s. Moody's annual revenues and profits grew by over 20 percent for each of the five years prior to the recent downturn. Operating margins increased by approximately 50 percent per year over the same time period. Analysts surmise that those margins are similar at S&P and Fitch. Editorial, *supra* note 70. Profits at Moody's rose 375 percent in six years. The head of Moody's structured finance business earned \$3.8 million in 2006. Lucchetti, *supra* note 69. Risk analysts would have been familiar with this growth, and would have not only benefitted from it but may have, out of economic self-interest, been doing what they could to drive its continued growth. It would have been impossible to fully insulate them from the business aspects of their analysis and eliminate their own conflicts of interest.

<sup>111</sup> See, e.g., U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 41.

stated that no single issuer or issuer group accounts for more than 2 percent of its total annual rating revenue.<sup>112</sup> One can quarrel with how small or influential a customer who represents 2 percent of one's total revenue actually is, for earning or losing an additional 2 percent of revenue is quite significant. Yet if issuers are treated with particular diligence or probed too deeply, or receive opinions which are harsher than they could receive at competitor rating agencies, issuers may take their business to other agencies—and there need not be too many “small” customer defections before an agency's overall revenues are seriously impaired. The issuer-pays conflict of interest can be seen, therefore, as a systemic problem, not merely one that operates on the basis of individual issuer-customers.

Defenders also assert that appropriate and effective organizational firewalls are in place to prevent credit rating analysts, rating committee members, or any other person involved in risk analysis from interacting with issuers in the solicitation of new business and fee negotiations.<sup>113</sup> The Credit Rating Agency Reform Act itself does not require that NRSROs maintain such organizational firewalls, but the SEC has recently announced a rule that would expressly require firewalls.<sup>114</sup> However, the mere existence of firewalls should raise doubts about their effectiveness,<sup>115</sup> and the mere need for firewalls should raise doubts about the reliability of any rating.

Additionally, credit rating agencies publicly disclose some of their ratings methodologies and procedures in an effort to counter concerns about the dangers of insufficient diligence and a propensity to issue inaccurate ratings. Disclosure, it was argued, would allow third parties, including investors and other credit rating agencies, to evaluate a firm's methods and procedures and come to market-wide conclusions about the credibility and accuracy of a rating agency's

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<sup>112</sup> *Id.* at 41 n.113.

<sup>113</sup> *See, e.g., id.* at 41–42; *see also* Tillman, *supra* note 99.

<sup>114</sup> Amendments to Rules, *supra* note 96, at 6,467 (announcing the final version of new rule, 17 C.F.R. § 240.17g-5(c)(6), to be effective on April 10, 2009, that will prohibit an NRSRO from “issuing or maintaining a credit rating where the fee paid for the rating was negotiated, discussed, or arranged by a person within the NRSRO who has responsibility for participating in determining or approving credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models.”); *see also* Proposed Rules, *supra* note 96, at 36, 227 (discussing the rule when originally proposed, which prohibited conflicts of interest relating to the participation of certain personnel in fee discussions).

<sup>115</sup> *See, e.g.,* PARTNOY, *supra* note 84, at 333 (noting that Wall Street investment bankers had defended themselves for years by touting the effectiveness of their “Chinese Walls” between business units which were subject to a conflict of interest, when “[i]n reality, ‘Chinese Walls’ were about eighteen inches high; bankers often compared them to the miniature Stonehenge in the movie *This is Spinal Tap*.”).

ratings.<sup>116</sup> The greater the transparency, the greater the likelihood that third parties will discover, publish, and challenge any errors. However, as will be discussed, there are limits as to how transparent credit agencies can or will be and as to how vigilant third parties can or will be.

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

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

#### *1. Quantitative Evidence of Capture*

In 1994, Richard Cantor and Frank Packer provided empirical evidence calling into question the strength of the reputation defense.<sup>117</sup> Cantor and Packer demonstrated that between 1970 and 1990—the period of time immediately after rating agencies first adopted the issuer-pays model—“[a]gency ratings ha[d] been a less reliable guide . . . to absolute credit risks: default probabilities associated with specific letter ratings have drifted [up] over time.”<sup>118</sup> With regard to rating drift, for example, Cantor and Packer show that Moody's BBB rated bonds defaulted approximately 1 percent of the time in the early 1970s, but, by the end of the 1980s, BBB rated bonds were defaulting at rates of 3–4.5 percent per year. Moody's grade B bonds defaulted at a rate of 10–15 percent per year in the early 1970s, but were defaulting at rates of nearly 35 percent a year by 1989. Similar increasing default risk drift has occurred with

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<sup>116</sup> See, e.g., Tillman, *supra* note 99 (“We strive to make sure issuers and investors are fully aware of how we determine creditworthiness and believe that all parties are better served when the process is open and transparent.”).

<sup>117</sup> See Cantor & Packer, *supra* note 36. Curiously, as noted above, Cantor and Packer have referred to reputational concerns as providing “an overriding incentive to maintain a reputation for high-quality, accurate ratings.” *Id.* at 4.

<sup>118</sup> *Id.* at 9. The authors also note that, unsurprisingly, rating agencies do a reasonable job of assessing relative credit risk: lower rated bonds do, in fact, tend to default more frequently than higher rated bonds. *Id.* at 9–11.

Moody's AA, A, and B ratings. Relatedly, Cantor and Packer have also shown that, in regard to S&P's rating between the early 1980s and early 1990s, certain indicators of credit risk have drifted, too.<sup>119</sup> For example, the ratio of issuers' average annual revenues to their average fixed charges (which includes payment obligations due under debt securities) decreased for many ratings. For example, BBB rated firms had, on average, a ratio of approximately 2.3 in 1982, but by 1992 this ratio had decreased to approximately 1.8. In the same time period, the ratio for firms that issued BB rated securities also decreased—from approximately 2.1 to 1.2. In addition, issuers' debt to asset ratio drifted up, another indication of increasing credit risk. For example, firms who were able to earn a BBB rating in 1992 had, on average, a debt-to-asset ratio of nearly 50 percent. By 1992 this figure was 60 percent. Similar trends existed for other rating categories. Cantor and Packer conclude that "[t]hese data suggest that a relaxation of credit standards may have occurred."<sup>120</sup>

Cantor and Packer provide another set of data that appears to be an indictment against the credit rating agencies and their reputational defense. Cantor and Packer examined the 671 bonds that were issued between 1989 and 1993, rated by both Moody's and S&P, and rated below investment grade by at least one of them. Issuers of these bonds were relatively likely to seek a rating from a third rating agency if either (i) the ratings given by Moody's and S&P were both near, but below, investment grade, or (ii) one of the agencies gave an investment grade rating and the other agency did not (thus, the ratings were "mixed"). In fact, 46 percent of the times when an issuer found itself in the position of having a mixed rating, it sought a third opinion. This, perhaps, is not surprising given the fact that "investment grade" is one of the primary benchmarks found in rating-dependent regulations, and, without an investment grade rating, the available market of investors shrinks significantly. What is notable, however, is that of the thirty-four issuers who had a mixed rating and sought a third opinion, twenty-nine—nearly 90 percent—obtained an investment grade rating for the third opinion.

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<sup>119</sup> *Id.* at 12–13 (highlighting the risk of using ratings-dependent regulations, and noting that if the risks associated with ratings change over time, the degree of solvency protection anticipated by such regulations will also change over time).

<sup>120</sup> *Id.* at 12. The authors note that the time frame examined controlled for the effects of procyclicality (or the long-term business cycle) but suggest that this drift may be the result of the fact that, over the course of the 1970s and 1980s, corporations in general increased their financial leverage. *Id.* at 11, 12. Such a fact, however, though it may contribute to increased credit risk generally, should not translate into changing meanings of the ratings. If corporations are increasingly leveraged on average, there should simply be fewer securities (or a smaller percentage of securities) that receive the higher ratings.



Among the issuers receiving ratings just slightly below investment grade from both Moody's and S&P, approximately one-fourth of them sought a third opinion, and, of those, almost half received an investment grade rating with the third opinion.<sup>121</sup> It is difficult to know exactly what accounts for such a success rate of those that sought a third opinion. It would seem fair to assume that those issuers with the strongest cases to make would be most likely to seek third opinions, but this self-selection bias may not account for all the success the third opinion seekers experienced. It is fair to question whether or not the agencies offering third opinions were attracting business by providing liberal and generous analysis—in effect selling investment grade ratings to customers they wished to satisfy.

## 2. Anecdotal Evidence of Capture

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

The *Wall Street Journal* published a front-page article in April 2008 exposing some of the imprudent behavior at Moody's from the early 2000s until the collapse of subprime mortgage securities in 2007.<sup>122</sup> Moody's analysts were expressly pushed to engage potential client-issuers in order “to find ways deals could get done within Moody's methodologies.”<sup>123</sup> Some analysts who had been recommending lower ratings were fired or reassigned and replaced with analysts who would give higher ratings;<sup>124</sup> and, occasionally, Moody's would switch analysts after issuers complained about them.<sup>125</sup> In the same article, a former Moody's executive is quoted as saying that ““the rating process became a negotiation.””<sup>126</sup>

In July 2008, the U.S. Securities and Exchange Commission released a report, entitled *Summary Report of Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies* (“SEC Summary Report”), in which members of the SEC's staff reported the results of their examination of three credit rating

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<sup>121</sup> *Id.* at 16.

<sup>122</sup> See Lucchetti, *supra* note 69.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.* (quoting Paul Stevenson, former Moody's executive).

agencies: S&P, Moody's, and Fitch. This examination was conducted "to review their role in the recent turmoil in the subprime mortgage-related securities markets."<sup>127</sup> By rating both subprime residential MBSs ("RMBS") and CDOs linked to those RMBSs, these three rating agencies had been heavily involved in the creation of a market for such RMBSs and CDOs, and suggestions that they may have been rating MBSs and CDOs too highly in order to satisfy the explicit and implicit demands of issuers had regularly appeared in the financial press over the course of the previous year.<sup>128</sup> Some of the SEC staff's findings lend support to the proposition that, despite the alleged self-regulatory influence of reputational concerns, the credit rating agencies were captured by MBS issuers and bent to the pressures inherent in the issuer-pays business model.

The SEC Summary Report initially notes that from 2002 to 2006 both the volume of RMBS and CDO deals rated by the rating agencies and their revenues from this business greatly increased.<sup>129</sup> Each of the three rating agencies had policies which emphasized the importance of providing accurate ratings with integrity,<sup>130</sup> and, yet—though each had policies which restricted analysts from participating in fee discussions with issuers—at two of the agencies, the policies allowed the analysts' managers to interact with the issuers and participate in fee discussions.<sup>131</sup> Despite the policies, "[a]nalysts appeared to be aware, when rating an issuer, of the rating agency's business interest in securing the rating of the deal."<sup>132</sup>

The effectiveness of firewalls that prevent actual analyst-issuer negotiations is questionable if analysts know the business ramifications of their analysis. More generally, an incentive to bend or even break managerial mechanisms, whether they are internal policies or governmental regulations, is created by the issuer-pays conflict of interest, and this is a persistent source of tension. Many internal agency documents—often emails—are transcribed in the SEC Summary Report, and many are worth re-transcribing here in order to shed light on how this conflict of interest occasionally played out.

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<sup>127</sup> U.S. SEC, SUMMARY REPORT, *supra* note 1, at 1.

<sup>128</sup> See, e.g., Lucchetti, *supra* note 69; *Taming the Beast*, THE ECONOMIST, Oct. 11, 2008, at 6 ("[The] credit-rating agencies . . . encouraged the creation of mortgage securities by publishing misleading assessments of their quality. . . . [C]redit-rating agencies are paid by the issuers of securities and so have an inbuilt incentive to tailor their ratings to their clients' needs."); Paul J. Davies et al., *Reputations to Restore; Rating Agencies Come under Ever Closer Scrutiny*, FINANCIAL TIMES (London), July 22, 2008, at 11.

<sup>129</sup> See *supra* note 104.

<sup>130</sup> U.S. SEC, SUMMARY REPORT, *supra* note 1, at 23.

<sup>131</sup> *Id.* at 24. Both of these agencies subsequently amended their policies to restrict all analytical staff from engaging in fee discussions with issuers. *Id.*

<sup>132</sup> *Id.*

- A senior analytical manager in a structured finance group wrote, “I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision [on assigning separate ratings to principal and interest] and if so, how much?” ‘Essentially, [names of staff] ended up agreeing with your recommendations but the CDO team didn’t agree with you because they believed it would negatively impact business.’”<sup>133</sup>
- A business manager at one agency wrote, “[w]e are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals.””<sup>134</sup>
- Another business manager wrote, “I had a discussion with the team leaders here and we think that the only way to compete [against another rating agency] is to have a paradigm shift in thinking, especially with the interest rate risk.””<sup>135</sup>
- A senior analytical manager wrote an email stating that ratings methodology would have to change in order to recapture market share.<sup>136</sup>
- At one firm, internal memorandums were circulated to analytical staff that indicated market share might decrease if changes were made to its ratings methodologies<sup>137</sup>—a clear breach of the firm’s firewall.
- Perhaps most damning—and prophetic!—of all is the following December 2006 email quote from an analytical manager in a firm’s CDO group to a senior analytical manager within the same group: the analytical manager writes that the rating agencies continue to create “an ‘even bigger monster—the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.;o).’”<sup>138</sup>

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<sup>133</sup> *Id.* at 26 (alterations in original).

<sup>134</sup> *Id.* (alteration in original).

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> *Id.* at 25.

<sup>138</sup> *Id.* at 12 n.8.

The Summary Report concludes that “[r]ating agencies do not appear to take steps to prevent considerations of market share and other business interests from the possibility that they could influence ratings or ratings criteria.”<sup>139</sup> The Report continues,

While there is no evidence that decisions about rating methodology or models were made based on attracting or losing market share, in most of these instances, it appears that rating agency employees who were responsible for obtaining ratings business (i.e., marketing personnel) would notify other employees, including those responsible for criteria development, about business concerns they had related to the criteria.<sup>140</sup>

### *3. Evidence of Error (Independent of Capture)*

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

#### *a. Lack of Diligence*

Enron provides an example of a lack of due diligence and of some of the possible consequences of a failure to audit the information provided by issuers. The major credit rating agencies had been opining that Enron was a very creditworthy borrower until just four days before it filed for bankruptcy.<sup>141</sup> Enron executives may have provided misleading information and failed to disclose relevant information to the rating agencies, but it is widely believed that, in the years immediately before Enron’s collapse, the rating agencies failed to invest adequate time and energy into evaluating the corporation’s creditworthiness.<sup>142</sup>

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

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<sup>139</sup> *Id.* at 25.

<sup>140</sup> *Id.*

<sup>141</sup> See U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 3.

<sup>142</sup> See, e.g., PARTNOY, *supra* note 84, at 347, 385.

the credit rating agency analysts seemed to have been less than thorough in their review of Enron's public filings . . . . Among other things, the rating analysts appeared to pay insufficient attention to the detail in Enron's financial statements, failed to probe opaque disclosures, did not review Enron's proxy statements, and failed to take into account the overall aggressiveness of Enron's accounting practices. In essence, the Staff Report found that the rating agencies failed to use the necessary rigor to ensure their analysis of a complex company, such as Enron, was sound.<sup>143</sup>

Specifically, the SEC report noted:

[I]n the case of Enron, the credit rating agencies failed to use their legally-sanctioned power and access [to Enron's non-public information] to the public's benefit, instead displaying a lack of diligence in their coverage and assessment of Enron. The Staff Report found that the credit rating agencies did not ask sufficiently probing questions in formulating their ratings, and in many cases merely accepted at face value what they were told by Enron officials. Further, the rating agencies apparently ignored or glossed over warning signs, and despite their mission to make long-term credit assessments, failed to sufficiently consider factors affecting the long-term health of Enron, particularly accounting irregularities and overly complex financing structures. . . . [However,] because credit rating agencies are subject to little, if any, formal regulation or oversight, and their liability traditionally has been limited both by regulatory exemptions and First Amendment protections afforded them by the courts, little exists to hold them accountable for future poor performance.<sup>144</sup>

The current subprime turmoil provides even more striking examples of a lack of due diligence and rating inaccuracies. The SEC Summary Report states ratings were issued despite the fact that unresolved analysis issues existed, that financial risk models did not appear to do a good job capturing risk, that staffing in at least one

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<sup>143</sup>U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 32 (summarizing a Senate staff report, STAFF OF SENATE COMM. ON GOVERNMENTAL AFFAIRS, FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS (2002)).

<sup>144</sup>*Id.* at 18 (footnote omitted); *see also* PARTNOY, *supra* note 84, at 296-349, 385 (describing Enron's collapse and the role of the credit rating agencies).

agency was inadequate,<sup>145</sup> and that analysts at two of the three rating agencies examined “struggle[d] to adapt to the increase in the volume and complexity of the deals.”<sup>146</sup> The SEC again uncovered many internal documents that shed light on the culture and attitude of the credit rating agencies. For example:

- One analyst expressed concern that her firm’s model did not capture “‘half’ of the deal’s risk, but that ‘it could be structured by cows and we would rate it.’”<sup>147</sup>
- Another “describes an outstanding issue as ‘poorly addressed—needs to be checked in the next deal’” and responds to a question regarding the weighted average recovery rate of a deal “by writing ‘(WARR—don’t ask ☺).’”<sup>148</sup>

Interestingly, in at least one instance, reputational concerns actually led to persistent rating errors. At one rating agency, the SEC discovered that a surveillance committee knew that there was an error in a ratings model that was used to rate almost a dozen securities and, as a result of the error, the ratings were higher than they should have been. The committee, however, decided not to downgrade the securities since it feared that acknowledging and reversing the error would result in reputational harm.<sup>149</sup> The committee members were all analysts or analytical managers,<sup>150</sup> people behind the firewall who should have been concerned with only those reputational harms associated with inaccurate ratings.

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

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<sup>145</sup> U.S. SEC, SUMMARY REPORT, *supra* note 1, at 12, 21–22 (noting that when monitoring the accuracy of rating on an ongoing basis after the initial issuance, resources were particularly inadequate, and noting that if rating methodology changed, the agencies would rarely return to previously issued securities and update the ratings based on the updated methodology).

<sup>146</sup> *Id.* at 12.

<sup>147</sup> *Id.* (quoting an internal agency email).

<sup>148</sup> *Id.* at 12 n.8 (quoting an internal agency document).

<sup>149</sup> *Id.* at 26.

<sup>150</sup> *Id.*

from WorldCom<sup>151</sup> and Global Crossing,<sup>152</sup> widespread laxity seems plausible.

*b. Poor Modeling*

There are reasons to believe, and many claim, that the credit rating agencies often use poor risk assessment models. In his book exploring greed in the credit ratings market, Professor Partnoy notes that the credit rating agencies have adopted risk assessment models that the President's Working Group on the Financial Markets<sup>153</sup> concluded were seriously flawed.<sup>154</sup> He explains that computer models used to assess CDOs were merely complex ways of justifying higher ratings,<sup>155</sup> that the risk models were created by issuers, and that some rating employees did not fully understand them.<sup>156</sup> In addition, he states that analysts privately admitted that they could "tweak the model" to make a CDO deal appear less risky.<sup>157</sup>

Turning to the current subprime turmoil, the SEC Summary Report found that financial risk models did not appear to do a good job of capturing risk.<sup>158</sup> Despite a lack of documentation, the SEC's Office of Economic Analysis ("OEA") reviewed what they could of the processes and models used by these agencies to rate MBSs and CDOs holding subprime MBS securities. The OEA reported that, when making assumptions about the future performance of the MBSs' underlying mortgages, the rating agencies relied upon historical data even though "the performance history of the types of subprime mortgages that dominated many of the RMBS portfolios . . . has been very short[, and] the performance history that did exist occurred under very benign economic conditions."<sup>159</sup> Furthermore, "the parameters of the models were re-estimated by executing the model with new data infrequently."<sup>160</sup>

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<sup>151</sup> See PARTNOY, *supra* note 84, at 368.

<sup>152</sup> *Id.* at 385.

<sup>153</sup> The President's Working Group on Financial Markets is comprised of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve Bank, the Chairman of the SEC, and the Chairman of the Commodities Futures Trading Commission. Exec. Order No. 12,631, 3 C.F.R. 559 (1989), *reprinted in* 15 U.S.C. § 78b (2006).

<sup>154</sup> See PARTNOY, *supra* note 84, at 264.

<sup>155</sup> *Id.* at 386.

<sup>156</sup> *Id.*

<sup>157</sup> *Id.*

<sup>158</sup> U.S. SEC, SUMMARY REPORT, *supra* note 1, at 12, 21–22.

<sup>159</sup> *Id.* at 35 (noting that such benign conditions included "consistent high economic growth, interest rates at historic lows, very low volatility in interest rates and a period where housing prices increased consistently year over year").

<sup>160</sup> *Id.*

The Financial Stability Forum,<sup>161</sup> a consortium of industry leaders established to promote international finance stability, issued a report in April 2006 simply stating that credit rating agencies “assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models.”<sup>162</sup> In short, the risk model’s assumptions were not wholly justifiable.

*c. Poor and Inaccurate Disclosure*

The public disclosure of ratings methodology and procedures theoretically ferrets out ratings that might be inaccurate, and consequently assuages concerns that the rating agencies might chronically issue inaccurate ratings. In its Summary Report the SEC noted, however, that significant aspects of the ratings process and the methodologies used to rate MBSs and CDOs were not always disclosed.<sup>163</sup> Some of the failures to disclose were blatant,<sup>164</sup> including disclosing that they conducted a certain analysis when they had made it a practice not to do such analysis<sup>165</sup> and failing to disclose that they at least occasionally overrode the results of their published financial model to make the ratings process more liberal to issuers.<sup>166</sup>

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<sup>161</sup> The Financial Stability Forum is a consortium of senior representatives of national financial authorities (e.g., central banks, supervisory authorities, and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts, and the European Central Bank. It first convened at the initiative of G7 finance ministers to promote international finance stability. See Fin. Stability Forum, Overview, <http://www.fsforum.org/about/overview.htm> (last visited Oct. 18, 2008).

<sup>162</sup> FIN. STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 32 (2008), available at [http://www.fsforum.org/publications/r\\_0804.pdf](http://www.fsforum.org/publications/r_0804.pdf); see also IOSCO, SUBPRIME REPORT, *supra* note 9, at 24–26 (noting that the rating agencies’ ratings methodologies for structured finance securities have “limitations”).

<sup>163</sup> U.S. SEC, SUMMARY REPORT, *supra* note 1, at 13–14. The SEC Summary Report notes, with a hint of an accusatorial tone, that as part of their NRSRO applications, each of these agencies stated that they do disclose their ratings process. See *id.*

<sup>164</sup> For example, the SEC Summary Report notes that at one agency they had modeling criteria on rating “hybrid” deals, yet did not disclose them publicly. *Id.* In another example, the agency told the staff during the examination that it did not make certain analytical adjustments when using the model, yet the SEC staff “observed instances” where the agency did indeed make such adjustments. *Id.* at 14.

<sup>165</sup> In one example, a rating agency publicly disclosed that it conducted an extensive review of loan origination operations and practices, but the RMBS group was, in fact, no longer conducting formal reviews of origination operations and practices. U.S. SEC, SUMMARY REPORT, *supra* note 1, at 14. This would seem particularly misleading since much of the risk associated with subprime RMBSs was a function of risks acquired during the origination processes, during which originators would often make loans to people who could afford them. Such practices, often abusive or egregious, are now widely reported in the popular press. See, e.g., sources cited *supra* note 27.

<sup>166</sup> U.S. SEC, SUMMARY REPORT, *supra* note 1, at 14. The SEC Summary Report states that “[o]ne rating agency regularly reduced loss expectations on subprime second lien mortgages from the loss expectations output by its RMBS model, in some cases reducing the



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

“[O]ur published criteria as it currently stands is a bit too unwieldy and all over the map in terms of being current or comprehensive. It might be too much of a stretch to say that we’re complying with it because *our SF* [structured finance] *rating approach is inherently flexible and subjective*, while much of our written criteria is detailed and prescriptive. Doing a complete inventory of our criteria and documenting all of the areas where it is out of date or inaccurate would appear to be a huge job—that would require far more man-hours than writing the principles-based articles.”<sup>167</sup>

The SEC noted that the policies and procedures for rating structured finance securities such as RMBSs and CDOs are not satisfactorily documented, and that such lack of documentation made it difficult for the SEC staff to determine if the processes actually used were consistent with more general policies of the agencies. It also noted that this lack of documentation could “impede the effectiveness of internal and external auditors conducting reviews of rating agency activities.”<sup>168</sup>

#### *d. Issuer-Pays Conflict Exacerbates Laxity*

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

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expected loss.” *Id.* (emphasis added). Though the rating agency might have disclosed such reduction to a representative of the issuer, its client, who desired the best rating possible, it did not make such disclosure available to the investing public. *Id.*

<sup>167</sup> *Id.* at 13 (quoting an internal agency email) (emphasis added).

<sup>168</sup> *Id.* at 16–17. The SEC Summary Report also indicates that these rating agencies lacked sufficient analytical resources and were understaffed and overworked. *See id.* at 12–17.

This dynamic is heightened in a situation where there is a concentration of issuers. Because of the concentration of MBS and MBS-related CDO issuers, any one issuer could exercise considerable influence over the rating agencies; they could deliver—or withhold—a significant amount of business.<sup>169</sup>

The result is that short-term competitive pressures and profitability outweighed the need for reputational protection, and the threat of reputational harm did not deter these rating agencies from engaging in a fly-by-night, race-to-the-bottom strategy regarding MBS credit enhancements. Rating agencies took full advantage of their reputational standing to engage in activities to derive short-term profits. Now, their reputations have been seriously damaged,<sup>170</sup> regulations have been imposed,<sup>171</sup> and further regulations are under consideration. However, it must be noted that extensive reputational damage came only after several years of poor behavior, and only as a result of a major economic downturn that prompted many investors, journalists, regulators, and policy-makers to examine the conduct of the rating agencies and expose their poor behavior. In the short- to medium-term, until an agency's reputation has been re-acquired, the reputational reasons to maintain (indeed, to improve) integrity and provide accurate and credible ratings may be strong.<sup>172</sup> However, regardless of the current strength of the self-regulatory reputational mechanism, as reputational capital is re-acquired and memories of the misconduct fade, the risk increases that the credit rating agencies will gamble such reputational capital for additional short-term profit.

#### IV. CREDIT RATING AGENCY REFORM ACT OF 2006

On September 29, 2006, Congress passed the Credit Rating Agency Reform Act (the "Act").<sup>173</sup> It took effect on June 26, 2007.<sup>174</sup> Prior to the Act's enactment, credit rating agencies in the U.S. were largely unregulated. The Act was enacted in the wake of the collapse

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<sup>169</sup> See *id.* at 32. The SEC's Office of Economic Analysis noted that the concentration of arrangers with the influence to determine which rating agency to hire "heightened the inherent conflicts of interest that exist in the 'issuer pays' compensation model." *Id.* The OEA referred specifically to "arrangers" instead of issuers, arrangers being the sponsors of the various special purpose issuers. See *id.*

<sup>170</sup> See Lucchetti, *supra* note 69.

<sup>171</sup> See *infra* Part IV.

<sup>172</sup> Though the same could have been true in the aftermath of the Enron debacle, following the outing of the credit rating agencies, they marched immediately into the subprime debacle.

<sup>173</sup> U.S. SEC, SUMMARY REPORT, *supra* note 1.

<sup>174</sup> U.S. SEC, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 1 (June 2008) [hereinafter 2008 NRSRO REPORT].

of several large and well-rated companies such as Enron and WorldCom and was designed to regulate the credit rating industry in order to prevent similar investment debacles in the future.<sup>175</sup> This section briefly describes the Act's goals and its most significant content and addresses its most problematic issue—that the Act permits rating agencies to continue to use the issuer-pays model.

The Act establishes an express process by which a credit rating agency can be deemed to be a “nationally recognized statistical rating organization” (“NRSRO”).<sup>176</sup> Hence, it is designed to reduce the barriers to entry into the industry and, thus, increase competition among rating agencies. With increased competition, some argue, the performance of the industry will improve, and ratings will become more accurate and credible.<sup>177</sup>

The NRSRO application request must contain information regarding the applicant's performance measurement statistics,<sup>178</sup> its procedures and methodologies for determining credit ratings,<sup>179</sup> its conflicts of interest, and its policies for managing these conflicts of interest.<sup>180</sup> But there are no substantive requirements that its performance measurement statistics or its procedures and methodologies be of a certain quality. In addition, the Act does not prohibit or necessarily dissuade the issuer-pays conflict of interest. However, the application must include written certifications from at least ten institutional investors stating that they have used the applicant's credit ratings for the three preceding years.<sup>181</sup> This written certification requirement would appear to be a proxy for a qualitative review of the performance, procedures, methodologies, and management of the conflicts of interest of the applicant agency.

Provided the applicant submits the listed documentation, the SEC is obligated under the Act to register the applicant as an NRSRO, unless the SEC determines that: (i) the applicant does not have “adequate financial and managerial resources to consistently produce

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<sup>175</sup> See Ng, *supra* note 49. The preamble to the Act states that it is an act “to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.” Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327. In Section 2 of the Act, Congress notes that the agencies are “of national importance.” *Id.*

<sup>176</sup> 15 U.S.C. § 78o-7(a) (2006).

<sup>177</sup> See, e.g., Hill, *supra* note 36, at 85 (“My proposal is gradually to increase the number of NRSROs and revisit the issue of eliminating the NRSRO designation in five years, or . . . [when] new firms . . . establish their reputations . . .”). But see Partnoy, *Not Like Other Gatekeepers*, *supra* note 36, at 91 (“[O]pening the market to new NRSROs seems a weak and perhaps counterproductive choice, even if it would be superior to the current approach.”).

<sup>178</sup> See 15 U.S.C. § 78o-7(a)(1)(B)(i).

<sup>179</sup> See *id.* § 78o-7(a)(1)(B)(ii).

<sup>180</sup> See *id.* § 78o-7(a)(1)(B)(vi).

<sup>181</sup> See *id.* § 78o-7(a)(1)(B)(ix).

credit ratings with integrity and to materially comply with the procedures and methodologies” described in their application package and with certain other prescribed requirements regarding the misuse of nonpublic information, the management of conflicts of interests, the designation of a compliance officer, and the prohibition of certain conduct<sup>182</sup> (each of these requirements is discussed below); or (ii) the applicant has committed certain securities-related crimes or fraudulent acts.<sup>183</sup> The process of registering a credit rating agency as an NRSRO is, then, not a form of regulation as much as it is mere recognition of status.

Additionally, much of the materials the agency delivers as a part of its application package are to be made publicly available upon its registration as an NRSRO.<sup>184</sup> This publicly available material must be kept up-to-date.<sup>185</sup> An NRSRO is required to update the information contained in its application materials at least once a year and, with certain exceptions, any time the information in its application becomes materially inaccurate.<sup>186</sup> Additionally, the SEC has recently announced that it has adopted rules requiring NRSROs (i) to make a detailed record of any rating actions (e.g., initial issuance, change in grade, placement on a watch list),<sup>187</sup> and (ii) to make this information, for 10 percent of their ratings paid for by issuers, publicly available within six months of any rating action.<sup>188</sup> These public disclosure requirements are designed to permit market participants to independently evaluate the application materials and determine the degree to which they will rely on this agency’s ratings.<sup>189</sup>

The goal of decreasing the barriers to becoming an NRSRO appears to have been somewhat realized. Immediately prior to the effective date of the Act,<sup>190</sup> there were only a few NRSROs

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<sup>182</sup> See *id.* § 780-7(a)(2)(C).

<sup>183</sup> See *id.*

<sup>184</sup> See *id.* § 780-7(a)(3).

<sup>185</sup> See *id.* § 780-7(b).

<sup>186</sup> See *id.*

<sup>187</sup> Amendments to Rules, *supra* note 96, at 6,460–72, 6,482 (announcing the final version of new rule, 17 C.F.R. § 240.17g-2(a)(8), to be effective on April 10, 2009).

<sup>188</sup> *Id.* (announcing the final version of amended rule, 17 C.F.R. § 240.17g-2(d), to be effective on April 10, 2009). This information would be made publicly available through the NRSRO’s corporate web site. *Id.*; see also Proposed Rules, *supra* note 96, at 36,228–30.

<sup>189</sup> Amendments to Rules, *supra* note 96, at 6,461. The SEC has also announced that it will propose a rule requiring NRSROs to disclose “ratings history information” for all of their current credit ratings solicited and paid for by issuers that were initially issued on or after June 25, 2007, the effective date of the Credit Rating Agency Reform Act. Disclosure of any rating action would not need to be disclosed until twelve months after the date of the rating action. U.S. SEC, FACT SHEET, *supra* note 96 (discussing proposed amendments to Rule 17g-2).

<sup>190</sup> 2008 NRSRO REPORT, *supra* note 174, at 1.

recognized by the SEC,<sup>191</sup> as of February 1, 2009, ten had been registered.<sup>192</sup>

The SEC is charged with ensuring that, when an NRSRO rates securities, it uses only those procedures and methodologies that are described either in its application (or its updated application) or in other documentation required by the SEC to be kept and possibly publicly disclosed.<sup>193</sup> However, both the SEC and the states are expressly forbidden under the Act from regulating “the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings.”<sup>194</sup> Relatedly, the Act also expressly forbids any NRSRO from implying that its registration as an NRSRO conveys upon it any sponsorship, recommendation, or approval by the federal government.<sup>195</sup>

The Act and SEC rules promulgated under the Act also require that each NRSRO establish, maintain, and enforce policies in effect to prevent the misuse of material nonpublic information provided to it by issuers.<sup>196</sup> SEC rules promulgated under the Act<sup>197</sup> also prohibit NRSROs from earning more than 10 percent of their annual revenues from a single issuer<sup>198</sup> and from rating the securities of issuers who are affiliated with the NRSRO or with a person associated with the NRSRO.<sup>199</sup> These rules prohibit the NRSRO from issuing or maintaining a rating on an issuer if certain conflicts of interest exist, including if (i) the NRSRO owns any securities or has any other direct ownership of the issuer, or (ii) a credit analyst that participated in determining the rating or any person responsible for approving a rating directly owns securities of, or has any other direct ownership

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<sup>191</sup> See Ng, *supra* note 49 (listing S&P, Moody’s, Fitch, Dominion Bond Ratings Service, and A.M. Best Co.).

<sup>192</sup> See U.S. SEC, Nationally Recognized Statistical Rating Organizations (“NRSROs”), available at <http://www.sec.gov/divisions/marketreg/ratingagency.htm> (last visited Feb. 1, 2009).

<sup>193</sup> See 15 U.S.C. § 78o-7(c) (2006).

<sup>194</sup> *Id.* § 78o-7(c)(2). Curiously, the SEC has the authority to suspend the registration of an NRSRO if it fails to “maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.” *Id.* § 78o-7(d)(5). But without being able to opine as to the substance of the ratings or the substance of the procedures and methodologies, the SEC may not be able to judge whether or not a rating has integrity or to justify any decision that a rating does not have integrity.

<sup>195</sup> See *id.* § 78o-7(f)(1).

<sup>196</sup> See, e.g., *id.* § 78o-7(g); 17 C.F.R. § 240.17g-4 (2008). Such policies must be reasonably designed to prevent the inappropriate dissemination of nonpublic information, trading on or otherwise benefiting from that information, and early dissemination of a pending credit rating action. See *id.*

<sup>197</sup> See 15 U.S.C. § 78o-7(h)(2).

<sup>198</sup> 17 C.F.R. § 240.17g-5(c)(1) (2008).

<sup>199</sup> See, e.g., *id.* § 240.17g-5(c)(3); *id.* § 240.17g-5(c)(4).

interest in, an issuer that is subject to the rating.<sup>200</sup> Furthermore, the SEC has recently announced that it has adopted a rule expressly prohibiting an NRSRO from issuing a rating on a security if that NRSRO or any of its analysts has made recommendations to the issuer or other parties responsible for structuring the security about the corporate or legal structures, assets, liabilities, or activities of the issuer.<sup>201</sup> Additionally, the SEC has recently adopted a rule prohibiting an NRSRO analyst or anyone else involved with approving a rating from accepting gifts from issuers, underwriters, or sponsors of securities being rated.<sup>202</sup> Also, as stated above, NRSROs are now required to have organizational firewalls separating securities analysis and rating determination operations from fee negotiation and business development operations.<sup>203</sup>

SEC rules also prohibit an NRSRO from having the following conflicts of interest *unless* the NRSRO has publicly disclosed the conflict and enforces “written policies and procedures to address and manage” the conflicts<sup>204</sup>—conflicts of interest relating to, among others: (i) any compensation the NRSRO receives from issuers<sup>205</sup> (e.g., those conflicts of interest included in the issuer-pays conflict); (ii) any ancillary services provided to issuers;<sup>206</sup> (iii) any business, ownership, financial, or personal relationships between persons within an NRSRO and any issuer;<sup>207</sup> and (iv) any affiliation of the NRSRO with any underwriters of any securities that are the subject of a credit rating.<sup>208</sup> The Act also grants the SEC authority to require that

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<sup>200</sup> See *id.* § 240.17g-5(c)(2). The SEC has stated that “direct” ownership interests do not include indirect ownerships such as through mutual funds or blind trusts. Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564, 33,598–99 (June 18, 2007).

<sup>201</sup> Amendments to Rules, *supra* note 96, at 6,465–69, 6,483 (announcing the final version of new rule, 17 C.F.R. § 240.17g-5(c)(5), to be effective on April 10, 2009).

<sup>202</sup> *Id.* at 6,468, 6,483 (announcing the final version of new rule, 17 C.F.R. § 240.17g-5(c)(7), to be effective on April 10, 2009).

<sup>203</sup> See *supra* notes 113–115 and accompanying text.

<sup>204</sup> *Id.* § 240.17g-5(a).

<sup>205</sup> See 15 U.S.C. § 78o-7(h)(2)(A) (2006); 17 C.F.R. § 240.17g-5(b)(1) (2008); 17 C.F.R. § 240.17g-5(b)(2); see also 17 C.F.R. § 240.17g-5(b)(5). Rules 17g-5(b)(1) and 17g-5(b)(2) relate to payments by issuers and obligors, whereas Rule 17g-5(b)(5) relates to payments from subscribers and addresses situations where the subscriber hopes that a security attains a certain (high or low) rating which would thus benefit the subscriber. Additionally, the SEC considered proposing another rule that would expressly require that NRSROs manage and disclose any conflicts of interest that arise as a result of repeatedly being paid by issuers and other sponsors of structured financial products. See Proposed Rules, *supra* note 96, at 36, 219–22.

<sup>206</sup> See 15 U.S.C. § 78o-7(h)(2)(B); 17 C.F.R. 240.17g-5(b)(3).

<sup>207</sup> See 15 U.S.C. § 78o-7(h)(2)(C); 17 C.F.R. 240.17g-5(b)(6); 17 C.F.R. § 240.17g-5(b)(7).

<sup>208</sup> 15 U.S.C. § 78o-7(h)(2)(D); 17 C.F.R. § 240.17g-5(b)(8).

NRSROs make certain reports and keep certain records<sup>209</sup> and authority to conduct examinations on NRSROs.<sup>210</sup>

In June 2008, in order to address some of the abuses discovered during examinations of Moody's, S&P, and Fitch<sup>211</sup> and to increase NRSRO transparency, the SEC proposed a number of additional rules with respect to NRSROs. Many of these proposals have been adopted and have been discussed above. Among the proposed rules was one that would prohibit NRSROs from issuing a rating on a structured security (including MBSs and CDOs) without disclosing information about the underlying assets.<sup>212</sup> This was hoped to serve two purposes: other rating agencies would have an opportunity to issue unsolicited ratings on the security and expose any of the hired agency's inaccuracies, and investors would be able to better conduct their own risk analysis and discipline any agency that issues inaccurate ratings.<sup>213</sup> However, in December 2008, after considering the public comments to the proposal rule, the SEC announced that it would amend some of the details of this proposal. In particular, the new version of the proposed rule would restrict disclosure of information about the underlying assets to other NRSROs only; the investing public and non-NRSRO rating agencies would *not* be privy to this underlying information.<sup>214</sup> As of the date of this Article, the SEC has not made a final determination with regard to this (weaker) proposal.

Prior to the passage of the Act, there had been accusations that the largest rating agencies occasionally took advantage of their dominant position to engage in overly aggressive or anti-competitive practices.<sup>215</sup> Among the accusations were allegations that the

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<sup>209</sup> See 15 U.S.C. § 78o-7(h)(1)(B)(x) (2006); 15 U.S.C. § 78q(a)(1).

<sup>210</sup> See 15 U.S.C. § 78u-(a)(1).

<sup>211</sup> This examination was conducted in order to determine the role of the credit rating agencies in the economic turmoil surrounding the subprime crisis. U.S. SEC, SUMMARY REPORT, *supra* note 1, at 1.

<sup>212</sup> See Proposed Rules, *supra* note 96, at 36,219–21.

<sup>213</sup> See U.S. SEC, SUMMARY REPORT, *supra* note 1, at 27 (discussing the intention of the proposed rule).

<sup>214</sup> U.S. SEC, FACT SHEET, *supra* note 96 (discussing the Re-Proposed Amendments to Rule 17g-5.)

<sup>215</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 24 (“There were reports from some hearing participants that the largest rating agencies have abused their dominant position by engaging in certain aggressive competitive practices.”). *E.g.*, Suzanne Woolley et al., *Now It's Moody's Turn for a Review*, BUS. WK., Apr 8, 1996, at 116 (reporting various allegations that rating agencies use unsolicited ratings to improperly pressure bond issuers to use their rating services); *Credit-Rating Agencies. AAArgh!*, THE ECONOMIST, Apr. 6, 1996, at 80 (reporting several abusive practices including the fact that Moody's admitted to sending invoices to issuers whose securities Moody's rated despite the fact that the issuer had not requested the rating service, and noting that in some cover letters to these invoices, Moody's wrote that the billed issuer should “reflect on the propriety of failing to pay for the substantial benefits that the issuer reaps from our efforts”).

dominant rating agencies (i) would refuse to rate an issuer's security (accurately or at all) unless that issuer purchased ancillary services,<sup>216</sup> (ii) would threaten to lower a rating unless the issuer purchased ancillary services,<sup>217</sup> and (iii) would refuse to rate an issuer's security based on a pool of assets (accurately or at all) unless the rating agency was awarded the business of rating a substantial portion of the assets within the pool.<sup>218</sup> SEC rules promulgated pursuant to the Act prohibit NRSROs from engaging in certain unfair, coercive and abusive acts, including those described in this paragraph.<sup>219</sup>

The Act has several other provisions, including the requirement that each NRSRO (i) designate a compliance officer responsible for administering the policies and procedures designed to manage nonpublic information and conflicts of interest and for ensuring compliance with all securities laws and regulations, and (ii) regularly furnish financial statements to the SEC. The discussion above noted that credit rating agencies are largely not civilly liable for the inaccuracies of their ratings.<sup>220</sup> Nothing in the Credit Rating Agency Reform Act creates any private rights of action,<sup>221</sup> leaving NRSROs relatively insulated from litigation.

#### V. PROBLEMS WITH THE CURRENT REGULATORY ENVIRONMENT

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

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<sup>216</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 23; Pinto, *supra* note 36, at 344.

<sup>217</sup> U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 42–43; Pinto, *supra* note 36, at 344.

<sup>218</sup> The practice of refusing to rate a security based on a pool of assets unless the rating agency was awarded the business of rating the assets within the pool is referred to as “notching.” U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 24.

<sup>219</sup> See 15 U.S.C. § 78o-7(i)(1) (2006); 17 C.F.R. § 240.17g-6(a) (2008).

<sup>220</sup> See *supra* note 97.

<sup>221</sup> See 15 U.S.C. § 78o-7(m).



### A. Issuer-Pays Conflict of Interest Persists

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

### B. Limits to Disclosure

The Credit Rating Agency Reform Act and SEC rules issued pursuant to that Act require that each NRSRO publicly disclose (either through its website or otherwise) select materials contained in its most current NRSRO application.<sup>222</sup> These materials include, among other things: (i) its credit rating performance measurement statistics over short-term, medium-term, and long-term periods; (ii) the procedures and methodologies it uses to determine ratings; (iii) its organizational structure; (iv) whether or not it has a code of ethics, and, if not, the reasons it does not; and (v) any conflicts of interest relating to the issuance of ratings.<sup>223</sup> Additionally, the SEC is currently proposing a rule prohibiting an NRSRO from rating a structured security unless it also discloses to other NRSROs all the information on the underlying assets the NRSRO used to determine the rating.<sup>224</sup> Making such information available, the SEC has argued, would better enable other rating agencies to conduct unsolicited ratings on the securities and thus better enable investors to evaluate the hired rating agencies' performance.<sup>225</sup>

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<sup>222</sup> See *id.* § 780-7(a)(e); 17 C.F.R. § 240.17g-1(i).

<sup>223</sup> See 15 U.S.C. § 780-7(a)(1)(B).

<sup>224</sup> U.S. SEC, FACT SHEET, *supra* note 96 (discussing the Re-Proposed Amendments to Rule 17g-5); see also *supra* notes 211–14 and accompanying text.

<sup>225</sup> Proposed Rules, *supra* note 96, at 36,219 (“The intent behind this disclosure is to create the opportunity for other NRSROs to use the information to rate the instrument as well. Any

The rationale for the disclosure paradigm generally as a method for securities regulation is the faith that “sophisticated investors . . . [will] bring market prices into line with disclosure.”<sup>226</sup> In the case of credit rating agencies, the disclosure of methodologies, procedures, permitted conflicts of interests, and policies to manage conflicts of interest appears to be designed to allow investors to appropriately figuratively price or discount the ratings’ informational value, and, consequently, better price debt and debt-like securities. It is argued that another consequence of such disclosure is to expose the NRSRO to greater scrutiny and inflict market discipline when appropriate.

However, there is a growing literature critiquing the disclosure paradigm and questioning its ability to bring market prices in line with fundamental values.<sup>227</sup> Building on this literature, the following discussion addresses the obligation and the inevitability of the disclosing rating agencies to limit disclosure, the limits of the investment community to fully analyze disclosed material, and the limits of other NRSROs to analyze disclosed materials.

### 1. *The Disclosing Rating Agency*

There are limits to how transparent an NRSRO can be. In order to most fully conduct a detailed evaluation of the creditworthiness of an issuer, credit rating agencies must obtain information about the issuer and the security. Often some of this information is confidentially provided directly from the issuer to the credit rating agency and is not publicly available. It can be argued that their access to this nonpublic information and their synthesis of both public and nonpublic information into a generalized rating is the primary source of value to the investing world. However, credit rating agencies cannot make the nonpublic information public; it must remain confidential.<sup>228</sup> The

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resulting ‘unsolicited ratings’ could be used by market participants to evaluate the ratings issued by the NRSRO hired to rate the product and, in turn, potentially expose an NRSRO whose ratings were influenced by the desire to gain favor with the arranger in order to obtain more business.”)

<sup>226</sup> Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 6 [hereinafter Schwarcz, *Rethinking*].

<sup>227</sup> See, e.g., *id.* at 23, 34 (arguing that, when a transaction is so complex as to be “disclosure impaired,” supplemental measures that would buttress disclosure and provide “cost-effective . . . protections that minimize [informational] asymmetry or mitigate its consequences” ought to be required, and specifically arguing that if there are any conflicts of interest in the transaction, the transaction should be prohibited); see also Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOKLYN L. REV. 763; HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* (1979).

<sup>228</sup> SEC Regulation FD permits credit rating agencies to receive nonpublic information from issuers without any obligation to disclose such information publicly. See *supra* note 41.

investing public never knows, therefore, what specific information the credit rating agency uses to determine its ratings.<sup>229</sup>

Furthermore, the ability to generate financial models and make sophisticated and appropriate assumptions is the skill the credit rating agencies market, and it is to be expected that they will keep the details of certain proprietary methodologies and procedures private. Additionally, because of their conflicts of interest, rating agencies may opaquely disclose—or may obfuscate—their actual methods and practices in order to hide the manifestations of their conflicts of interest or their lack of due diligence and care.<sup>230</sup> Most basically, however, the credit rating agencies evaluate information with the use of financial models, methodologies, procedures, and more than a handful of assumptions about the securities, issuers, industry, and economy. It is simply impossible for an NRSRO to collect and disclose all details of an analysis, every explicit and implicit analytical assumption, every step of a model financial, and every assumption and bias of every analyst and ratings committee member. To the extent that nonpublic information, proprietary methodologies, and obfuscation exists, the difficulty and the inability to disclose with complete transparency is compounded. This difficulty is true to some extent for all securities, but for more complex securities—those very securities for which investors may more rely on rating agency ratings—disclosure is even more limited.

## 2. *Limits of Investor Sophistication and Vigilance*

### a. *Coping with Complexity*

The disclosure of complex transactions, structures, and analytical methods “may well be either too detailed for many . . . investors . . . to understand and assimilate, or too superficial to allow investors to fully assess the [structure or] transaction and its ramifications.”<sup>231</sup> In regards to particularly complex products and transactions, such as the structure of MBSs, CDOs, and other structured securities—not to

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<sup>229</sup> See U.S. SEC, 2003 CRA REPORT, *supra* note 34, at 33–34 (noting that whenever there is a ratings change, there appears to be excess volatility in the market price of the issuer’s securities since the investor marketplace must make a guess as to whether or not, and to what extent, the change was a function of nonpublic information).

<sup>230</sup> “[C]onflicts [of interest] can undermine the reliability of disclosure.” Schwarcz, *Rethinking*, *supra* note 226, at 11. Loose disclosure requirements would exacerbate the inclination of rating agencies to engage in such non-illuminating disclosure.

<sup>231</sup> *Id.* at 5 (footnote omitted). For example, Enron’s structured transactions were “so complex that disclosure either would have had to oversimplify the transactions or else provide detail and sophistication beyond the level of both ordinary and otherwise savvy institutional investors in Enron securities.” *Id.* at 6.

mention the myriad of internal analysis dynamics, conflicts of interests, and attempts (both sincere and otherwise) to manage such conflicts within a particular credit rating agency—disclosure is particularly problematic and may be particularly insufficient to remedy informational asymmetry.<sup>232</sup>

Otherwise sophisticated institutional investors may struggle to understand complex disclosures or satisfactorily read between the lines of overly simplistic disclosures.<sup>233</sup> Even professional securities analysts have a limited ability to fully understand the modern complexities of companies they follow.<sup>234</sup> Indeed, the anecdotal evidence presented earlier seems to indicate that even a credit rating agency, an organization staffed by many hundreds of professionally-trained risk analysts, struggled to understand the risks inherent in the more complex structured products.<sup>235</sup> If these large agencies find themselves without the resources to properly conduct risk analyses, why is it reasonable to expect any investors, other than the most resource-rich and sophisticated, to be capable of doing so?<sup>236</sup> Investors may find it too difficult or too costly to determine what a rating would have been, absent factors such as conflicts of interest; scarcity of financial, managerial, or analytical resources; or an inability to access information.<sup>237</sup>

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<sup>232</sup> See *id.* (stating that in a world of complexity, disclosure can be insufficient to remedy the “information asymmetry”). It is not the intent of this Article to argue for increased transparency or to argue that the current level of expected transparency is justified; it is agnostic on this point but merely suggests that disclosure is not necessarily a panacea. Issuers have nonpublic information that must remain nonpublic, and credit rating agencies, in order to ensure continued access to such information, must be required to keep this information confidential. Furthermore, credit rating agencies must be able to keep some details of their proprietary financial analysis tools confidential. And one cannot require a level of transparency which is either impossible or too costly to achieve.

<sup>233</sup> See, e.g., PARTNOY, *supra* note 84, at 302–05, 331 (arguing that Enron often disclosed its off-balance-sheet transactions, even going as far as to note that they were not completely arms-length transactions, but that the underlying reality of the transactions was so complex that even the chair of the audit committee of Enron’s board of directors, Robert K. Jaedicke, an emeritus professor of accounting at Stanford Business School, “did not grasp” them); Schwarcz, *Rethinking*, *supra* note 226, at 8 (“[E]ven sophisticated institutional investors can lack the ability to understand derivatives transactions . . .”).

<sup>234</sup> See PARTNOY, *supra* note 84, at 268 (noting that even for professional securities analysts, who may intensely follow fifteen public companies, it would take a full day to fully and carefully analyze a mere annual report).

<sup>235</sup> See *supra* Part III.C.3.

<sup>236</sup> Cognitive limitations and people’s tendency to engage in herding behavior when facing ambiguous choices may also hamper the ability of third parties to evaluate complex disclosures. See Schwarcz, *Rethinking*, *supra* note 226, at 15 (“Complexity heightens ambiguity, which in turn . . . allows people to see what they are already inclined to believe. Thus, the inclination to follow the crowd is not surprising. Moreover, even for market professionals, it would be difficult to change this behavior.” (footnote omitted)); *infra* Part V.B.2.c.

<sup>237</sup> See Schwarcz, *supra* note 64, at 11 (expressing skepticism about the ability of additional CRA disclosure requirements to benefit investors).

However, even if it is the case that only the most sophisticated and resource-rich institutional investors will be capable of successfully scrubbing rating agency disclosures (provided they are sufficiently detailed), evaluating their performance, and conveying their findings to the marketplace, there remains reason to doubt that they will actually do so. These are likely to be the same investors who do not rely on ratings at all (or only to a very little extent) and are the least vulnerable to rating agency inaccuracies. It may seem perverse, but the most sophisticated and resource-rich, who are best-equipped to close the disclosure loop and encourage the disciplining of rating agencies, are also those who are least incented to review rating agency performance. Indeed, the most sophisticated among them may be able to take advantage of market inefficiencies created by inaccurate ratings,<sup>238</sup> and, therefore, may prefer the existence of inaccurate ratings and take no steps to evaluate and discipline the rating agencies.

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

### *b. Evidence*

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

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<sup>238</sup> Perhaps by issuing securities that are rated too high (and therefore, perhaps, priced too high), or buying credit default swaps on securities which are rated too high, or by purchasing securities which are rated too low (and therefore, perhaps, priced too low), or selling credit default swaps on securities which are rated too low. For a description of credit default swaps, see, for example, Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007).

The following anecdotes, which address only institutional investors<sup>239</sup>—presumably those investors that possess superior financial sophistication and analytical resources—should make one wonder whether or not adequate investor sophistication actually exists. There is strong anecdotal evidence that the investing community, including such ostensibly sophisticated institutional investors, is not, on average, sufficiently sophisticated to conduct such monitoring and discounting.

Much has been written about the Enron debacle and the company's bankruptcy filing in December 2001. Though their bankruptcy was a sudden surprise to the vast majority of the investment community,<sup>240</sup> Professor Partnoy has argued that Enron often disclosed its off-balance-sheet transactions, even going as far as to note that they were not completely arms-length transactions<sup>241</sup>—"There were enough key details about [certain special purpose entities created to provide off-balance-sheet transactions] in the footnotes to Enron's financial statements to warn off any investor who read them."<sup>242</sup> Enron's disclosures also identified certain significant conflicts of interest of key employees.<sup>243</sup> Yet Alliance Capital Management, a large mutual fund and "one of the *best-run*,"<sup>244</sup> gobbled up shares to become Enron's largest shareholder by 2001 with 43 million shares. It lost billions. Top managers at Alliance admitted after Enron's bankruptcy that "the fund's managers did not dig into Enron's footnotes, and did not uncover key details or even ask key questions."<sup>245</sup>

While the credit rating agencies' apparent failures with regard to rating subprime mortgage-backed securities have come as a surprise to many, this surprise is itself evidence of an inability to appropriately discount ratings and a lack of complete investing sophistication. There were signals along the way that these ratings should have been viewed with suspicion. As early as 1994, academic and media commentators were publishing observations indicating that something might go awry, that the credit rating agencies were succumbing to

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<sup>239</sup> The vast majority of subprime MBSs and nearly all CDOs are bought and sold by institutional investors. IOSCO, *SUBPRIME REPORT*, *supra* note 9, at 12.

<sup>240</sup> For a detailed description of the growth and decline of Enron, see, for example, PARTNOY, *supra* note 84.

<sup>241</sup> *Id.* at 302–03.

<sup>242</sup> *Id.* at 312.

<sup>243</sup> *Id.* at 331.

<sup>244</sup> *Id.* at 411.

<sup>245</sup> *Id.* (noting, too, that despite the investment loss having "decimated the investors in Alliance's mutual funds," the portfolio manager nevertheless earned over \$4 million in personal compensation in 2000 and \$2 million in 2001).

behaviors incited by their interest in pleasing their issuer-customers and conducting increasingly generous analysis, and that the ratings assigned to MBSs were not accurate or reliable.<sup>246</sup> Did ostensibly sophisticated investors take these developments into account when deciding how credible, accurate, or defensible the MBS ratings were? Given the evidence of broad and deep investor reliance on rating agencies in relation to subprime securities and the extent of the subprime losses, it seems that they did not.

Published accounts of the credit rating agencies and mortgage backed securities since the mid-1990s noted that issuers typically consulted and worked directly with the credit rating analysts to find out how their MBSs and other asset backed securities could be structured to obtain the highest rating for the largest possible pieces of the asset pool—in other words, how to achieve the largest tranche sizes with the very highest ratings.<sup>247</sup> Published accounts since the mid-1990s reported that rating agencies competed on rating criteria in a veritable race-to-the-bottom, each touting their more liberal criteria and their reduced credit enhancement requirements in order to attract more business, and, therefore, “potentially undermining the reliability of the ratings.”<sup>248</sup> Published accounts reported that agencies that adopted such strategies did indeed gain market share.<sup>249</sup> It was well known that the rating agencies were enjoying tremendous revenue

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<sup>246</sup> See, e.g., Partnoy, *Two Thumbs Down*, *supra* note 36 (referring to numerous examples where rating practices did not seem to conform to the “reputational capital” model); Schultz, *supra* note 74 (noting that S&P, Moody’s, and Fitch have all drawn criticism that they have softened their criteria for mortgage-backed securities in order to win clients).

<sup>247</sup> See, e.g., Cantor & Packer, *supra* note 36, at 19. As discussed above, the amount of credit support (e.g., letters of credit, bond insurance, subordinated interests, cash collateral, reinvestment of any excess cash generated by the pools) each tranche has plays a large role in determining how risky that tranche is and, therefore, just how high a rating it could receive. See *supra* note 20 and accompanying text.

<sup>248</sup> See, e.g., Cantor & Packer, *supra* note 36, at 19; Schultz, *supra* note 74 (reporting that S&P had recently adjusted its ratings criteria allowing several securities to maintain their rating even though the new criteria required on average 30 percent less credit support).

<sup>249</sup> See, e.g., Cantor & Packer, *supra* note 36, at 19–21. Until the mid-1980s, S&P was the undisputed leader in the MBS and asset backed securities sector and was the only agency rating mortgage backed securities not backed by a government or quasi-government agency such as the Federal National Mortgage Association (Fanny Mae). But in 1986, Moody’s entered the market with lower credit enhancement requirements—thus offering a less expensive, and therefore more attractive, path to high ratings for the issuer—than S&P for certain mortgage backed securities such that by 1989 Moody’s share of the MBS business exceeded that of S&P. Then in 1990 Fitch entered the market with even more liberal credit enhancement requirements, such that by 1994 Fitch was the MBS market share leader. And in 1992, Duff and Phelps had entered the market, also offering low credit enhancement requirements. By 1993, S&P had only 55 percent of the market share, in a sector where most issuers normally hire two rating agencies, but S&P responded that year with reduced requirements for credit enhancements—such that, within months, S&P regained 15 percent of the market share, largely at Moody’s expense. *Id.* Analysts and the ratings agencies claimed that the on-going decline in credit enhancement levels was due, in part, to their own learning curves about the performance of MBSs. *Id.* at 21.

growth, almost entirely as a result of the growth in these structured transactions,<sup>250</sup> and that there was not only strong incentive to capture as much of this growth as possible, but to contribute to its continued growth.

In other words, there was reason to believe that the credit rating agencies were helping to create the ravenous demand for the products that facilitated the subprime mortgage crisis. By 2003, it was widely reported in the popular financial press that an ever increasing proportion of the mortgages originating in the U.S. were subprime mortgages and that default rates were rising.<sup>251</sup> Was it not evident that the expansion of the subprime market was fueled by investor enthusiasm for the U.S. housing market, specifically for highly-rated MBSs and MBS-related CDOs?

Yet, instead of being punished, the credit rating agencies were rewarded by the marketplace; institutional investor appetite for mortgage-backed securities and CDOs based on them increased voraciously until 2007, and the major credit rating agencies profited handsomely as a result. Why? The institutional investors appear to have been generally unable to fully understand the details of the complex structures of these securities<sup>252</sup> or all the risks associated with them. Nonetheless, it appears that for many institutional investors, instead of choosing to avoid these securities, they relied on the ratings. The result was that they considered the securities to be relatively safe, at least relative to the returns being offered.

The *Wall Street Journal's* economics editor David Wessel has recently referred to institutional investor purchases of RMBSs as “myopic”<sup>253</sup> and has stated that

investors who relied on the rating agencies—*particularly supposedly sophisticated pension funds and other institutions*—are at fault, too. Rating firms became a crutch for investors who simply didn't want to spend the time and

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<sup>250</sup> See, e.g., *id.* at 19; Schultz, *supra* note 74.

<sup>251</sup> See, e.g., Patrick Barta, *Mortgage Data Give Mixed Message on Market; Delinquent Loans Decline, But Foreclosures Gain; Stress in Subprime Sector*, WALL ST. J., Jan. 8, 2003, at A2 (quoting a credit analyst as saying that the subprime market is the “next shoe to drop” in consumer finance); David Feldheim, *Asset-Backed Deals Drive Market; Issuance in 2004 May Top \$800 Billion and Is Poised to Surpass Corporate Bonds*, WALL ST. J., Nov. 26, 2004, at C4; Erik Portanger & Paul Beckett, *Banks Vie for Europe's Consumers; GE, Citigroup, BNP Paribas Scrap to Gain the Edge in Fertile Market for Credit Cards, Subprime Loans*, WALL ST. J., Feb. 24, 2003, at C1.

<sup>252</sup> See, e.g., IOSCO, *SUBPRIME REPORT*, *supra* note 9, at 13 (“[S]ome institutional investors when purchasing the more complex CDOs appear to have had little understanding of the instruments or the underlying cash flow and security upon which the instruments derived their value.”); Cantor & Packer, *supra* note 36, at 19; Schultz, *supra* note 74.

<sup>253</sup> David Wessel, *Lessons from the Housing Bubble*, WALL ST. J., May 29, 2008, at A2.



money required to be prudent investors at a time when low interest rates had everyone reaching for higher returns without contemplating the higher risks.<sup>254</sup>

Quoting Peter Fisher, a money manager at BlackRock Inc. and a former Federal Reserve Bank of New York official, Mr. Wessel noted in the same article that “[l]enders need someone to prevent them from competing their way to the bottom.”<sup>255</sup>

In a *Wall Street Journal* editorial, Arthur Levitt, Jr., the former Chairman of the SEC, wrote:

[W]e need investors to accept more responsibility for evaluating structured financial products. Credit ratings agencies play a critical role in the capital markets, but their judgments are guides, not stamps of approval. Too often, institutional investors have been investing in sophisticated credit products on the basis solely of the credit rating and without fully understanding the inherent risks they are undertaking.<sup>256</sup>

More generally, Mr. Wessel, prompted by the institutional investors who invested in MBSs, stated in his *Wall Street Journal* column that “a big title at a big-name company is no guarantee of smart, savvy management.”<sup>257</sup> These institutional investors seemed to be enticed by a bubble—and restricted by their own analytic limitations. As a result, they were unable to appropriately discount the opinions of a perceived authority, the credit rating industry.<sup>258</sup>

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<sup>254</sup> *Id.* (emphasis added).

<sup>255</sup> *Id.* (quoting Peter Fisher, former Federal Reserve Bank of New York official, now at BlackRock Inc.).

<sup>256</sup> Arthur Levitt, Jr., Op-Ed., *Conflicts and the Credit Crunch*, WALL ST. J., Sept. 7, 2007, at A15.

<sup>257</sup> Wessel, *supra* note 69 (further suggesting that at least some senior executives at prestigious financial institutions may suffer from “incompetence, imprudence, [and] short-sightedness”).

<sup>258</sup> The question, for our purposes, is to ask whether or not the investing community took these observations into account and appropriately discounted the opinions of the rating agencies. When asking this question, it is necessary to be particularly wary of hindsight bias and acknowledge that even rational, sophisticated, and fully formed investment decisionmaking can yield undesired results. This is because nearly all investments entail some degree of risk, and what may seem to be a bad investment decision in hindsight may have been an eminently rational one at the time it was made. However, considering the foregoing discussion, anecdotal evidence, and the fact that institutional investors, by at least one estimate, invested approximately \$7.5 trillion into these subprime-based mortgage-backed securities, one just might suspect that institutional investors in fact unsophisticatedly over-relied on the opinions of the rating agencies, did not appropriately discount the AAA and AA ratings that typically were attached to the highest tranches of these securities, and made poor investment decisions.

*c. Behavioral Finance and Bounded Rationality*

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

Behavioral finance is the branch of economics that studies the irrational behavior of investors and other finance industry agents. It is based in part on the findings of cognitive psychologists.<sup>259</sup> For example, through experimentation, psychologists have discovered that people have a tendency to anchor to initial values or judgments and then may make insufficient adjustments in these values or judgments when provided later with more reliable information.<sup>260</sup> Such a bias may have contributed to a belief in the sustainability of increasing U.S. housing prices over the course of the early and mid-2000s or the belief that such prices would not fall.<sup>261</sup> Relatedly, behavioral finance shows that people generally exhibit an availability (or representativeness) bias; they tend to use the memories, recollections, and information that are the most available, recallable, or salient—not necessarily the most relevant—in order to form judgments, valuations, and estimates.<sup>262</sup> In the mid-2000s, the then-current housing prices and the housing boom were more salient pieces of information than the prices and price volatilities of earlier times. This availability bias, combined with the tendency to engage in anchoring, may have exacerbated the belief in the security and the profitability of investing in housing.

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<sup>259</sup> It is also based in part on marketplace-inflicted “limits to arbitrage.” See generally Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in 1B HANDBOOK OF THE ECONOMICS OF FINANCE 1053, 1056, 1105 (George M. Constantinides, Milton Harris & René M. Stulz eds., 2003); see also HERSH SHEFRIN, *BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING* (Oxford Univ. Press 2002); ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000); Cass R. Sunstein, *Introduction*, in *BEHAVIORAL LAW AND ECONOMICS 1* (Cass R. Sunstein ed., 2000).

<sup>260</sup> Barberis & Thaler, *supra* note 259, at 1068. Anchoring may be a particularly influential cognitive process in making judgments about the value of a financial security and the direction of its future market price. Likely anchors in this regard may include the security’s current price, its most recent prices, and the prices of other seemingly related securities, whether or not the relationship between the securities is relevant, and whether or not the relationship is one that points to a relationship in fundamental valuation and changes in values. SHILLER, *supra* note 13, at 149; see also Eldar Shafir & Amos Tversky, *Thinking through Uncertainty: Nonconsequential Reasoning and Choice*, 24 *COGNITIVE PSYCHOL.* 449 (1992).

<sup>261</sup> Despite such anchoring in the market, markets do make dramatic shifts, most dramatically in the form of stock market crashes. Anchoring, when it slips, has the ability to slip dramatically. SHILLER, *supra* note 13, at 155.

<sup>262</sup> Barberis & Thaler, *supra* note 259, at 1068; see also Sunstein, *supra* note 259, at 5.

People also often engage in herding behavior,<sup>263</sup> which in the financial world can often result in economic bubbles<sup>264</sup>—and crashes. Psychologists have described the significant power of social influence on individual judgment.<sup>265</sup> Such influences can be transmitted by society at large or by authority figures.<sup>266</sup> Often this dynamic of having faith in authority figures presents no problem, since those in such positions often are correct in their opinions.<sup>267</sup> The more interesting aspect of these psychology experiments is, however, that people have a tendency to have faith in the reliability of the opinions of authority figures even when their opinions contradict how an independent observer would certainly conclude.<sup>268</sup> Consequently, since rating agencies position themselves as authorities on credit risk, their opinions, both accurate and inaccurate, may be overvalued by investors, especially in situations of complexity or ambiguity—as

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<sup>263</sup> History is ripe with fascinating examples of extreme market bubbles, a type of herding behavior. See, e.g., CHARLES MACKAY, *EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS* (Prometheus Books 2001) (1852) (describing “Tulipmania” and the Great Railway Bubble); SHILLER, *supra* note 13 (describing the 1929 Crash, the October 1987 Crash, and the “Millennium Crash”).

<sup>264</sup> Shiller defines a bubble as “a situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify the price increases and bringing in a larger and larger class of investors, who, despite doubts about the real value of an investment, are drawn to it partly through envy of others’ successes and partly through a gambler’s excitement.” SHILLER, *supra* note 13, at 2.

<sup>265</sup> See, e.g., SOLOMON ASCH, *SOCIAL PSYCHOLOGY* (1952); STANLEY MILGRAM, *OBEDIENCE TO AUTHORITY* (1974).

<sup>266</sup> See, e.g., MILGRAM, *supra* note 265, at 13–54; Morton Deutsch & Harold B. Gerard, *A Study of Normative and Informational Social Influences Upon Individual Judgment*, 51 *J. ABNORMAL & SOC. PSYCHOL.* 629 (1955), discussed in SHILLER, *supra* note 13, at 157–59. In Deutsch and Gerard’s experiment, test subjects were asked a question, the answer to which was not difficult to determine and usually answered correctly by individuals from a control group. The test subjects were told, however, that all others who were being asked the same question were responding with a different answer, a wrong answer. When then requested to answer the question themselves, a third of the time the test subjects, often displaying signs of anxiety, gave the identical wrong answer. *Id.* Herding may be the result of using social proxies in situations where one personally lacks adequate direct information to form an individualized judgment. To disagree with consensus opinion puts one at risk of being thought of as foolish, ignorant, or callous. Sunstein, *supra* note 259, at 9. This is an informational proxy, and is not an unreasonable position to take, especially in matters of complexity or when one does not or cannot process all the relevant underlying data. As Shiller writes, “[t]his behavior is a matter of rational calculation: in everyday living we have learned that when a large group of people is unanimous in its judgment on a question of simple fact, the members of that group are almost certainly right.” SHILLER, *supra* note 13, at 158.

<sup>267</sup> SHILLER, *supra* note 13, at 159 (“[P]eople are respectful of authorities in formulating the opinions about which they will later be so overconfident, transferring their confidence in authorities to their own judgments based upon them.”).

<sup>268</sup> *Id.* (“[Milgram’s experiments] demonstrate that people are ready to believe . . . authorities even when they plainly contradict matter-of-fact judgment.”).

when estimating the risk and values of complex structured securities.<sup>269</sup>

One of the necessary characteristics of a powerful herd-producing “infection” is the existence of a salient and tell-able story to support the infection.<sup>270</sup> In the case of the subprime debacle, the salient story may have been that housing prices generally do not go down nationwide. Observing that the credit rating agencies were issuing ratings consistent with their beliefs about the housing market and the riskiness (or relative lack thereof) of mortgage related securities, investors may have been less inclined to doubt the credibility of the rating agencies or to perceive, let alone criticize, the rating agencies’ inability to manage the issuer-pays conflict of interest. Ironically, then, the housing bubble was created in part by the volume of credit poured into the U.S. housing market by mortgage related securities investors and may have also contributed to investors’ beliefs in the relative risklessness of these securities.<sup>271</sup> Investing in the housing market, then, contributed to their faith in the housing market, because such investing bolstered that market. This circular dynamic was unsustainable.<sup>272</sup>

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<sup>269</sup> No less of an authority than Alan Greenspan, the then-Federal Reserve Board Chairman, stated in 2004 that there can be no housing bubble since the “high cost and inconvenience of moving [one’s household] ‘are significant impediments to speculative trading and . . . development of price bubbles.’” Ip et al., *supra* note 69 (quoting former Federal Reserve Board chairman Alan Greenspan) (omission in original). Mr. Greenspan would later confess in regards to the subprime crisis, “Those of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief.” Kara Scannell & Sudeep Reddy, *Greenspan Admits Errors to Hostile House Panel*, WALL ST. J., Oct. 24, 2008, at A1 (reporting Mr. Greenspan’s remarks to the U.S. House of Representatives Oversight Committee).

<sup>270</sup> SHILLER, *supra* note 13, at 166–69.

<sup>271</sup> See Richard Thaler & Cass Sunstein, *Human Frailty Caused This Crisis*, FIN. TIMES (ASIA EDITION), Nov. 12, 2008, at 11 (arguing that bounded rationality and limited self control, on the part of mortgagors and on financial institutions, caused the current economic crisis and stating, “when things get complicated [humans] flounder.”); ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY’S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT 1, 4 (2008) (“The subprime crisis . . . is, at its core, the result of a speculative bubble in the housing market that began to burst in the United States in 2006 . . . . The view that the ultimate cause of the global financial crisis is the psychology of the real estate bubble . . . has certainly been expressed before. But it would appear that most people have not taken this view to heart, and at the very least that they do not appreciate all of its ramifications.”).

<sup>272</sup> Informed institutional investors often contribute to the formation of bubbles and securities misvaluations because of “limits to arbitrage.” See, e.g., Barberis & Thaler, *supra* note 259, at 1056–65; see also Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, J. ECON. PERSPECTIVES, Vol. 17(2), Spring 2003, at 3, 24–25 (arguing that even informed investment fund managers who believe that a stock is overvalued will nonetheless often follow the crowd and hold the stock since doing so, among other things, reduces their risk that they will be blamed by their sponsor for poor performance); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465 (1990).

It should be noted that bounded rationality and other human cognitive limitations of course affect analysts in credit rating agencies, too. Although there is ample evidence to believe that the credit rating agencies acted with a significant degree of bad faith when rating mortgage related securities, a more generous evaluation of their involvement in the creation of the subprime crisis would posit that these agencies, like investors, were convinced of the security of the value of the housing stock ultimately underlying mortgage related securities.<sup>273</sup> In this interpretation, rating agency analysts acted in good faith but were bounded by their own limited rationality and biased heuristics. Intuition would seem to suggest, however, that given the force of the issuer-pays conflict of interest, ratings agency analysts' rationally bounded and cognitive limitations might be marshaled by issuers or otherwise affected in such a way that analysts would be more inclined than not to bias their credit evaluations in favor of issuers. In other words, because of the interaction between the issuer-pays conflict of interest on one hand and their own bounded rationality on the other, credit rating agencies personnel are unknowingly susceptible to being persuaded by specious arguments urging higher ratings.

It should also be noted that not every institutional investor relied on the opinions of the credit rating agencies with regard to the subprime-based MBSs. Given the thousands of institutional and wealthy individual investors, analysts, and financial managers, some, if not many, will be particularly rational, skillful, and sophisticated. Indeed, some appear in retrospect to have been appropriately wary of credit rating agencies' opinions regarding MBSs.<sup>274</sup> Furthermore,

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<sup>273</sup> See SHILLER, *supra* note 271, at 50–51 (“[T]he rating agencies that pass judgment on mortgage securities persisted in giving AAA ratings to mortgage securities that ultimately were vulnerable because they too believed that there would be no bursting of the bubble. Even if [the rating agencies] did harbor some doubts about the continuation of the boom, they were not about to take the drastic step of cutting ratings on securitized mortgage products on the basis of the theory, not widely held, that home prices *might* actually fall. That would have been an unusually courageous step—and one that was all too easily postponed in favor of other business decisions that were easier to make, until it was too late.”); see also, Richard J. Herring, *Credit Risk and Financial Stability*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM, *supra* note 36, at 345, 353–60 (discussing how two heuristics characteristic of human psychology—the availability heuristic and the threshold heuristic—lead to cognitive biases in the estimation of low-probability, high-loss hazards, which may in turn cause the financial system to become increasingly vulnerable to major losses during periods of financial stability).

<sup>274</sup> Because of their size and human, technological, and economic resources, large institutions with greater amounts of information gathering and analytical capabilities are likely to exhibit superior sophistication and investing skill. See, e.g., Schultz, *supra* note 74 (quoting and then paraphrasing Edward Toy, a portfolio manager at Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), in regards to mortgage backed securities). At the time, TIAA-CREF was the world's largest pension fund with \$125 billion in assets. According to Mr. Toy, “As much as [TIAA-CREF] do[es] [its] own underwriting, [it]

some not only concluded that MBSs were overrated by the credit rating agencies and by the marketplace, but made money betting against the U.S. housing market.<sup>275</sup>

### 3. Other Credit Rating Agencies

Disclosure by an NRSRO of its rating procedures and methodologies and, as would be required under a rule currently proposed by the SEC, of basic information on the underlying assets it uses to rate each structured security will enable other NRSROs to conduct unsolicited ratings on the same securities and effectively opine about the accuracy of the disclosing NRSRO's rating. In theory, this process of obtaining second (and third and fourth) creditworthiness opinions will both provide investors with additional information and inflict some degree of discipline on disclosing NRSROs who do not want their ratings to be criticized as persistently inaccurate. If, over time, an agency's solicited ratings are perceived to be less accurate than the unsolicited ratings of other rating agencies, the reputation of the disclosing NRSRO will, in theory, suffer as investors come to rely less on their ratings and issuers consequently divert their business to other agencies believed to issue more accurate unsolicited ratings.

However, it is not evident that adequate incentives exist for rating agencies to conduct a sufficient number of such unsolicited ratings. As an initial matter, rating agencies incur direct costs from doing the analysis associated with conducting unsolicited ratings, yet receive no fees from conducting them. Secondly, if benefits are to be derived from issuing unsolicited ratings, such benefits are likely to be realized only after a prolonged period—likely many years, if not a decade—of

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still rel[ies] on the rating agencies to provide good, solid information and an objective viewpoint as to where things are going' . . . 'To the extent they themselves are competing for business, they lose credibility.'" *Id.* (quoting Edward Toy, a TIAA-CREF portfolio manager). "If new criteria put out by [the rating agencies] don't meet [TIAA-CREF]'s standards, the pension fund may stipulate its own credit levels and put the agency ratings on the shelf. . . . To the extent this results in a lower credit-enhancement level, [TIAA-CREF] will probably start demanding [lower prices] on the securities it purchases, Mr. Toy says. 'If it means we start [passing on some deals], so be it,' he adds." *Id.* (quoting Edward Toy, a TIAA-CREF portfolio manager). Yet "smaller investors can't be so dismissive. Most don't have the extensive research staffs maintained by larger investment firms and so rely on [credit] agency analysis." *Id.*

<sup>275</sup> See, e.g., Jed Horowitz & Kate Kelly, *How Long Can Goldman Dance?; Wall Street Firm Sidesteps Subprime, Up to a Point; Average \$662,000 Payday*, WALL ST. J., Dec. 19, 2007, at C3; Gregory Zuckerman, *Trader Made Billions on Subprime; John Paulson Bet Big on Drop in Housing Values; Greenspan Gets a New Gig, Soros Does Lunch*, WALL ST. J., Jan. 15, 2008, at A1 (reporting that John Paulson earned \$15 billion in 2007 for his hedge funds by betting on the fall of the housing market).

issuing such ratings. It takes time for one's reputation to grow, especially in the case of a rating agency issuing creditworthiness opinions. Here, patterns of accuracy (or inaccuracy) only reveal themselves over time, if at all, as enough debtors perform or default on their obligations, and such performance can be compared to the earlier ratings issued by a rating agency. Such prolonged periods also give NRSROs, whose ratings might be assessed and perhaps called into question by such unsolicited ratings, ample opportunity to seek short-term (and, indeed, medium-term) profits by issuing inaccurately high ratings. NRSROs issuing inaccurate ratings are simply unlikely to be "caught" in the short-term.

Thirdly, any benefits received from issuing unsolicited ratings are uncertain and, given the costs involved with issuing unsolicited ratings, such uncertainty may discourage a rating agency from issuing them. This uncertainty stems from the existence of three post-issuance scenarios. In one scenario, the unsolicited rating may be accurate, even more accurate than the solicited rating, but such increased accuracy may never be clearly demonstrated by debtor performance. In another scenario, the disclosing NRSRO may have issued an accurate rating, in which case there is no opportunity for the rating agency issuing unsolicited ratings to be perceived as more accurate than the disclosing NRSRO that issued the solicited rating. In the third scenario, unsolicited ratings, even those issued in good faith, may turn out to be inaccurate. Over time, such inaccuracies may reveal themselves, and reputational harm would ensue. To compound the threat of issuing inaccurate unsolicited ratings, the chance of inaccuracy increases to the extent rating agencies issuing unsolicited ratings do not have access to non-public information from the issuer.

Fourthly, in the case of new or small rating agencies, there may be a risk associated with issuing ratings, unsolicited or otherwise, appreciably different from the rating issued by the established (reputable) NRSROs. A rating agency which opines differently from the big boys—the NRSROs with plentiful resources and (deservedly or otherwise) good reputations—bears the risk that the investor community, at least in the short-term, will view its opinions as inaccurate, even when its ratings are relatively accurate. This fact may dissuade less established, risk-averse rating agencies from issuing different, though more accurate, unsolicited ratings.

Finally, a rating agency may indeed be inclined to issue unsolicited ratings, but for the purpose of soliciting future business—not for the purpose of providing investors with an accuracy check on previously issued NRSRO ratings—thus possibly undermining one of the goals

of the disclosure requirements. For example, a rating agency using the issuer-pays model may initially issue a particularly low unsolicited rating on a security deliberately in order to encourage the issuer to approach the agency and pay for the ability to engage in a dialogue and convince the rating agency to increase its rating. Alternatively, a rating agency may issue a particularly favorable rating in order to attract future issuer business as these issuers seek out agencies that are willing to provide a generous, racing-to-the-bottom service.

### *C. Potential Unintended Consequences of Regulation*

In the years prior to the passage of the Credit Rating Agency Reform Act, many commentators proposed that one of the solutions to the problems posed by the credit rating agencies was to recognize additional NRSROs and increase competition between them.<sup>276</sup> The Act has established a relatively transparent administrative process for registering NRSROs, and, since the Act's effective date in 2007, ten NRSROs have been registered, several more than were recognized immediately prior to the effective date.<sup>277</sup> As competition intensifies, observers will be able to better assess whether or not such increased competition has satisfactorily addressed the problems associated with the credit rating agencies.

However, in an environment where there may be greater numbers of NRSROs, it can be expected that, as a result of natural variation, some agencies will tend to rate higher than other agencies. This would be true even if all agencies were free of issuer capture. The more competitors there are, the more likely it is that some agencies will rate particularly highly, both relative to the other NRSROs and relative to an accurate rating. The current and proposed regulations will not prevent issuers from shopping for ratings, and issuers will gravitate to those agencies that typically offer the most favorable ratings at the lowest cost (costs include not merely the fees charged by the rating agency but any costs incurred by investors discounting the rating).<sup>278</sup> The existence of rating-dependent regulations intensifies issuers' demand for satisfactory ratings.<sup>279</sup>

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<sup>276</sup> See *supra* note 177 and accompanying text.

<sup>277</sup> See *supra* notes 190–92 and accompanying text.

<sup>278</sup> It is reasonable to ask whether or not, if issuers are likely to successfully determine which agency or agencies give the highest ratings, investors too will be able to come to a similar determination and then appropriately discount the ratings from that agency or those agencies. However, given the much closer working relationship between issuers and rating agencies than between investors and rating agencies, and the intimate knowledge held by issuers of their own securities, it would seem that issuers are far better positioned to recognize rating inflation.

<sup>279</sup> See, e.g., Partnoy, *Not Like Other Gatekeepers*, *supra* note 36, at 90 (“[T]here is an argument that opening the [NRSRO] market to competition could make regulatory licenses



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

Thus, in an environment where issuers demand generous ratings and choose which rating agencies to hire and numerous NRSROs more intensely compete for business, it seems inevitable that securities will, on average, be rated too highly. In other words, despite these regulations and the effectiveness of any firewalls to manage the issuer-pays conflict of interest, there is still a race-to-the-bottom, and valuations industry-wide are likely to be skewed high.<sup>280</sup> And in this particularly competitive business environment, we have already seen that the bottom may be quite low. In order to compensate for this persistent level of ratings inaccuracy, investors must always discount appropriately.<sup>281</sup>

Another possible unintended consequence of the current regulatory regime concerns the legitimization that both an NRSRO designation and regulatory oversight convey. Some have argued that the source of an NRSRO's positive reputation may not be based so much on its ratings performance but on the fact that it has been recognized by the SEC as an NRSRO.<sup>282</sup> When evaluating the credibility of an NRSRO

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more important, by creating incentives for rate shopping among issuers.”). Rating-dependent regulations pose several problems and have been criticized by a number of commentators. See, e.g., *id.* at 89 (suggesting that the regulatory use of ratings as benchmarks be abandoned); Partnoy, *Two Thumbs Down*, *supra* note 36 (elaborating on the same argument).

<sup>280</sup> By way of contrast, a credit rating industry following a subscriber-pays revenue model would not necessarily experience such a race-to-the-bottom, but rather, perhaps, a race-to-the-top (except to the extent that regulated institutional investors might attempt to encourage unjustifiably high ratings in an effort to invest in higher yield securities that would otherwise be unavailable under rating dependent regulations).

<sup>281</sup> On the other hand, it may be possible that newly registered NRSROs will be somewhat unwilling to issue ratings substantially different from the ratings of the large, established NRSROs. If a new NRSRO believes that its ratings, though different from those issued by other NRSROs, are in fact more accurate, publishing such different ratings carries the risk of being perceived by the marketplace as less accurate if the market's benchmarks are effectively the ratings of those large NRSROs with long histories and established reputations. To some extent, therefore, it may be possible that, until a newly registered NRSRO achieves a strong and widespread reputation within the marketplace, it will engage in herding behavior and will follow the lead of the established NRSROs. In such a situation the immediate added value of the new NRSRO is nil, if not negative.

<sup>282</sup> See, e.g., Partnoy, *Not Like Other Gatekeepers*, *supra* note 36 (arguing that the only value provided by an NRSRO is the regulatory license it can offer issuers); Partnoy, *Two Thumbs Down*, *supra* note 36 (same).

subject to a federal regulatory regime, many investors may now rely, not merely on an agency's recognition as an NRSRO, but also on the supposed strength of the regulations and the assumed vigilance of others (e.g., the SEC, the marketplace) to adequately discipline the NRSRO. The incentive for each member of the marketplace to conduct independent evaluations is thus reduced, and an exercise in widespread free-ridership may result. Since NRSROs are regulated and subject to evaluation by the marketplace, the free-rider concludes, NRSROs must be reputable and their ratings accurate. An overabundance of such free-ridership may enable NRSROs to "slip by" or fly-by-night without damaging their reputations at all.<sup>283</sup> Such a dynamic would, therefore, demand even greater willpower or commitment on the part of the investor community to adequately process NRSROs' disclosures and independently evaluate the accuracy and credibility of their ratings, but that commitment may be undermined perversely by the mere existence of the regulatory environment.

#### VI. PUBLICLY FUNDED CREDIT RATINGS

This Article has highlighted both the significance of the credit rating industry in modern capital markets and some of the problems inherent in the credit rating industry under the current regulatory regime, in particular problems associated with the issuer-pays conflict of interest. One of the ways to address many of these problems is for the rating agency industry to abandon the issuer-pays revenue model. This seems unlikely.<sup>284</sup> As described previously, the issuer-pays model solves the problem of procuring adequate analytical resources and eliminates the need to keep ratings confidential from non-subscribers. It also is a very profitable model. The issuer-pays model could be prohibited, but such a step would seem drastic at this stage—and the argument that it is appropriate for investors to bear some burden to evaluate and assess the merits of credit ratings and to discount them appropriately in the light of the existence of the issuer-pays conflict of interest is not unpersuasive.

Others have proposed potential ameliorative steps to reduce the problem of the issuer-pays conflict. Some of these suggestions

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<sup>283</sup> Or, the marketplace may conduct independent analysis of NRSRO performance, deem NRSROs to be performing at a certain level of reliability, and stop devoting its energy to such independent evaluation, thus opening up the opportunity for inferior agency practices to creep back in.

<sup>284</sup> See *supra* Part I.B.

include: (i) increasing competition between NRSROs;<sup>285</sup> (ii) subjecting the credit rating agencies to civil liability for issuing inaccurate credit ratings;<sup>286</sup> (iii) abandoning the use of rating dependent regulations altogether and replacing them with regulations which refer to alternative risk measurements;<sup>287</sup> and (iv) having issuers pay into an independently managed pool, the managers of which allot credit evaluation assignments and payments to participating rating agencies.<sup>288</sup> This Article discussed some of the potential negative unintended consequences of increasing competition between NRSROs in Part V.C. above. It is beyond the scope of this Article to take a position on the proposals to subject the rating agencies to civil liability, to abandon ratings-dependent regulations altogether, or to establish a revenue and assignment pool. However, the remainder of this Article will discuss another, novel, ameliorative possibility: better aligning the interests of ratings bodies to the interests of the public by using public funds to pay for publicly available risk analysis.

A current topic of discussion within a number of academic literatures is the private ordering of public functions.<sup>289</sup> The private-sector credit rating agencies often are used as examples of such private ordering.<sup>290</sup> The credit rating agencies provide a service to the investing public. They also provide a service to the general public, since the economic well-being of the general public is in large part a function of the well-being of the economy generally. The *raison d'être* of private sector, for-profit credit agencies, however, is not, in fact, public service. Given that credit rating agencies perform a public function effectively for the benefit of the investing public and the

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<sup>285</sup> See, e.g., *supra* note 176–77 and accompanying text.

<sup>286</sup> See, e.g., Pinto, *supra* note 36, at 351–55; Partnoy, *Not Like Other Gatekeepers*, *supra* note 36, at 95–96.

<sup>287</sup> E.g., Partnoy, *Two Thumbs Down*, *supra* note 36, at 704–09 (arguing for the abandonment of ratings dependent regulations and replacing the ratings benchmark with risk measurement which references credit spreads).

<sup>288</sup> E.g., Aaron Unterman, *Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 102–03 (2009).

<sup>289</sup> See, e.g., Symposium, *Public Values in an Era of Privatization*, 116 HARV. L. REV. 1212; Symposium, *Conference on Democracy and the Transnational Private Sector*, 15 IND. J. GLOBAL LEGAL STUD. 1 (2008); Laura A. Dickinson, *Public Law Values in a Privatized World*, 31 YALE J. INT'L L. 383 (2006); Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367 (2003); JOHN BRAITHWAITE, REGULATORY CAPITALISM: HOW IT WORKS, IDEAS FOR MAKING IT WORK BETTER 8–11, 20–23 (2008); BRAITHWAITE & DRAHOS, *supra* note 61.

<sup>290</sup> See, e.g., BRAITHWAITE, *supra* note 289, at 23, 25; King & Sinclair, *supra* note 79, at 353, 358 (“[Credit rating agencies] have acquired public authority due to their public professional expertise, their specialist knowledge, and their reputation and acceptance by market actors.”); Saskia Sassen, *Regulating Immigration in a Global Age: A New Policy Landscape*, 570 ANNALS AM. ACAD. POL. & SOC. SCI. 65, 71–73 (2000).

economy generally, it is eminently reasonable for such public beneficiaries to pay for the services a credit rating agency provides.<sup>291</sup>

Over the course of the 2000s, however, the major American private credit rating agencies have negligently executed their public function; they have taken advantage of their authority, have preferenced their pecuniary interests over the public interest, and have been identified as a primary contributor to the subprime meltdown, disappearing wealth, and the worldwide credit crisis. This being the case, it is worthwhile to consider whether these private-sector entities require a public-sector competitor or complement or publicly-oriented incentives to adequately execute their public function.

This vital public function may be better executed within a plural governance structure, one in which both private and public entities participate. Private, for-profit credit rating agencies (and the reputation-protecting, self-regulating approach discussed herein) have a role to play, but their performance and the effects of a regulatory regime founded largely on public disclosure can be augmented and improved by the participation of a public willing to pay for substantive risk analysis conducted for the public good.<sup>292</sup> This can be done in at least three possible ways: (i) by creating a taxpayer-funded public institution whose role is to conduct and provide substantive risk analysis; (ii) by having the government pay selected private rating agencies for rating services; and (iii) by providing tax or other financial incentives to private rating agencies that provide accurate ratings. Each of these proposals would have their own implementation challenges, and it is not assumed that any would provide a perfect solution to the existence of the issuer-pays conflict of interest. However, each would better align the interests of the ratings body to the interests of the public and may contribute to a more effective financial governance regime. The following discussion briefly introduces each of these three ideas in turn. While it is beyond

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<sup>291</sup> The funding source discussed here is a general tax on the general population. But it may be more politically expedient, especially considering the fact that the most direct beneficiaries of such a public agency are investors, for a tax to be levied on certain securities trades and/or on particular institutional investors and for the proceeds of this tax to be earmarked for the public rating agency. It should be noted that it is not the intention of this Article to imply that all services which seem uniquely “public” should be provided by public, tax-funded entities. Indeed, public services can be, and are often, provided solely by private entities. However, some public services may be more effectively provided by public entities or by a collection of both public and private entities.

<sup>292</sup> The *Wall Street Journal* may have, inadvertently or not, hinted at such an idea when it stated in an Opinion-Editorial, “[h]opefully [the Credit Rating Agency Reform Act] will prove to be effective in mitigating the central problem with ratings agencies—their conflict of interest. If not, then we should consider more direct methods to change who pays for ratings fees.” Levitt, *supra* note 256.

the scope of this Article to provide the level of detail that would be necessary to discuss the operational implementation of each program or to comprehensively analyze all the obstacles and difficulties associated with each, it will provide their fundamental characteristics in the hopes of spurring further discussion and debate about their respective potentials.

### *A. The Public Agency*

#### *1. Basic Description*

The government could establish a taxpayer-funded government agency that conducts substantive risk analysis similar to the risk analysis currently carried out by the private credit rating agencies. This public agency could be given the authority to determine for itself which securities and which issuers to evaluate. This body could be permitted to conduct substantive, merit-based credit evaluations and other analysis on any security and any issuer, or on any class of security generally, but could be expected to primarily use their limited resources to rate those securities and those issuers that might most significantly adversely affect the general public. Such securities are most likely those that are the most complex and opaque, those for which the investing public might appear to have an "irrational exuberance," and those with the most potential to have an adverse effect on the well-being of public beneficiaries and the financial market as a whole. Often this will consist of large issuances, large security categories, and new security categories.<sup>293</sup>

In order to minimize political biases, it would be imperative that this public agency be independent and shielded as much as possible from political pressure.<sup>294</sup> This agency would also have to operate with a great deal of transparency. It should make all of its analytical tools and financial models, methodologies, procedures, and assumptions publicly available and subject to public comment. There would be no proprietary risk analysis models to protect; the public would be entitled to access all of its information, except nonpublic information received from issuers. Subject to the requirements of confidentiality, this agency would make all of its reports and evaluations, detailed and otherwise, readily publicly available.

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<sup>293</sup> It may be politically necessary to restrict such a public agency from opining on the credit risk of political jurisdictions, including U.S. states and foreign governments.

<sup>294</sup> The Federal Reserve or the Supreme Court may provide an example of political independence.

In order to make the most informed evaluations, this agency ought to have the power to request nonpublic information from issuers. An issuer could choose whether or not to participate in the process, and all nonpublic information made available would be required to be kept confidential and used in accordance with applicable securities regulations. Certain protections may be warranted in order to encourage issuers to cooperate and to better ensure the efficacy of this body's work. Such protections might include making all non-publicly available information unavailable for any regulatory, tax, or criminal enforcement action.<sup>295</sup> Issuers must have incentives to participate in the process. Refusal to participate could be prompted by a strong desire to keep trade secrets, to keep adverse information away from the rating analysts, or to hide criminality, or because of some generalized suspicion of the government's intentions and processes. In cases where an issuer refuses to participate in the process and refuses to make its nonpublic information available, the public agency could publicly announce that the issuer chose not to participate. Such lack of cooperation would then itself be public information, which the investing public could use to inform its investing decisions.

This agency must also be provided with enough funding to enable it to have the information collection and analytical capacity to make credible and accurate ratings. Such funding must include a sizable compensation budget in order to attract the most highly skilled, public service oriented analysts and managers from the private-sector to assure the quality and credibility of the agency's ratings.

## *2. Benefits of the Public Agency*

This agency would provide a number of benefits. The most obvious benefits result from the fact that this agency would not be faced with the conflicts, biases, and costs created when issuers pay for rating services. Since this agency would operate from the influential platform of a government agency with a voice of presumed authority and since its methodologies and procedures will be readily publicly available, it is likely that its methodologies and procedures will be regularly and rigorously examined and commented on by leading academics in the field and that a dialogue between the public agency and private experts will be created, thus increasing the accuracy of the

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<sup>295</sup> The U.S. federal tax code provides for similar protections that effectively encourage illegal immigrants to pay personal income taxes. See Cynthia Bloom, *Rethinking Tax Compliance of Unauthorized Workers After Immigration Reform*, 21 GEO. IMMIGR. L.J. 595, 596–603 (2007) (discussing how Section 6103 of the Internal Revenue Code “has prohibited the IRS from taking the initiative to reveal the lack of immigration authorization to the immigration authorities”).

agency's opinions. These exchanges, together with equal access to information and analytical resources,<sup>296</sup> provide reason to anticipate that the ratings and other opinions of this public agency may be, on average, more accurate than those of the private rating agencies.<sup>297</sup>

Of course, it is possible, but not inevitable, that such a public agency may be subject to its own biases (e.g., over conservatism, political capture), thus reducing the accuracy of its creditworthiness opinions. However, whatever biases this agency might have would be different than those embedded in the issuer-pays conflict of interest associated with most private credit rating agencies.

Given its unbiased, or differently biased, analysis, the opinions issued by this body would provide informational value different from that embedded in ratings issued by the private-sector agencies. Consequently, the opinions of such a public agency would challenge and inject texture into the environment of private ratings. Individual members of the investment public, when making investment decisions, would be in a position to take into consideration—in addition to their own independent analysis and the opinions of the private credit rating agencies—the ratings and information provided by this independent public agency. Thus the investment community will be able to make more informed, more skeptical, and, on average, more appropriate investment decisions.

Under this proposal, no recommendation is being made to change the current credit rating agency regulatory scheme or to change or eliminate the private rating agencies. The private rating agencies would function within the existing regulatory scheme, in parallel with the public agency, and investors could decide how to use, how to interpret, and to what extent to rely on each of their respective opinions. In essence, the public agency would only be providing additional information—risk opinions not tainted by biases in favor of

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<sup>296</sup> Including technological resources and human skills.

<sup>297</sup> It is not this Article's claim that this public agency would always necessarily issue more reliable ratings than the private credit rating agencies. See Schwarcz, *Rethinking*, *supra* note 226, at 26–27 (“There is little current literature on government certification of securities quality because, until recently, disclosure was seen as the complete answer.”). The individuals staffing this body would cope with limited institutional, analytical, and informational resources, competing pressures, uncertainty, professional biases, and cognitive limitations. This agency would not be able to be completely transparent, in part because of the difficulty of revealing all analytical processes and the limits to self-knowledge, but also because nonpublic information must be kept confidential. Analysts' personal conflicts of interest must still be managed. However, this agency would be immune from the perverse agency conflicts of the issuer-pays conflict. It would not face competitive pressure and would not be faced with the conflicts of interest associated with ancillary services. It may also be able to analyze more carefully and thoroughly, without the time pressure of producing product for its clients.

issuers—and investors would be free, as they are now, to make their own investment decisions.

A public credit rating agency would also give legislators and regulators another option to choose from and use in establishing ratings-dependent regulations. When crafting investment-restricting regulations, regulators would be able to choose the ratings of the public agency as regulatory risk benchmarks or may choose a set of options, one of which may be the public agency's ratings.<sup>298</sup> When discussing rating-dependent regulations and the NRSRO designation, Professor Richard Sylla and others have hinted at the value of a public-sector rating process. For example, Richard Sylla has asked:

Should representative governments be in the business of passing out [NRSRO] designations if the designees are thereby allowed to profit from selling regulatory licenses? Or, if ratings are to be incorporated in financial regulations, is it possible that regulatory authorities have a responsibility to come up with, and apply, their own ratings?<sup>299</sup>

In an environment of increasingly global interconnectedness, this governance issue is particularly important. Aaron Unterman's argument encouraging the establishment of an "international capital organization" not only highlights the importance of this issue,<sup>300</sup> it also strongly hints that the issuance of credit ratings should not be left solely to private-sector credit rating agencies.<sup>301</sup> Mr. Unterman explicitly states that such a public credit regulatory body "should also monitor and report on macroeconomic developments and trends of concern to capital market operation,"<sup>302</sup> and that such an international entity "could play an influential role, monitoring information received by rating agencies for systemic threats, and offering ratings guidance and instruction to [rating agencies]."<sup>303</sup>

The suggestion that there should be a government entity explicitly charged with protecting consumers of financial products has gained

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<sup>298</sup> It is beyond the scope of this Article to opine as to the desirability of rating-dependent regulations. *But see* Partnoy, *Not Like Other Gatekeepers*, *supra* note 36 (arguing for the discontinuation of ratings-dependent regulations).

<sup>299</sup> Sylla, *supra* note 37, at 38.

<sup>300</sup> Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 131–32 (2008).

<sup>301</sup> *Id.* at 131 ("The role of credit ratings in the international capital market is paramount and should not be entrusted to private firms.").

<sup>302</sup> *Id.*

<sup>303</sup> *See* Unterman, *supra* note 288, at 106. "It is highly unlikely that an objective international agency overseeing the ratings industry would have allowed the unrealistic ratings which plagued the market, and contributed to the current crisis." *Id.* at 107.



considerable traction in the recent year. The Department of the Treasury and eminent scholars Professor Elizabeth Warren and Professor Robert Shiller have each outlined plans for a consumer product safety commission. Although their suggestions appear to focus on the protection of individual financial product consumers (e.g., mortgagors and credit card holders) and do not explicitly call for anything termed a governmental rating agency, their suggestions do clearly incorporate the idea that a government entity be actively engaged in the substantive evaluation and dissemination of financial products risk.<sup>304</sup>

### *3. Responses to Certain Arguments Against the Establishment of a Public Agency*

Some may be opposed on free market principles to the suggestion that the government conduct merit-based evaluations of private enterprise securities issuers, but such activity by government authorities and quasi-governmental organizations is not unprecedented. State securities regulators often conduct merit-based evaluations of securities pursuant to “blue sky” laws in order to determine whether or not certain securities can be marketed within the state.<sup>305</sup> The Securities Valuation Office (“SVO”) of the National Association of Insurance Commissioners (“NAIC”) conducts substantive risk analysis to determine how it will evaluate the riskiness of certain securities held by insurance companies, especially in cases where there is a split rating or a disagreement between two or more private credit rating agencies.<sup>306</sup>

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<sup>304</sup> U.S. DEP’T OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 14, 19–21 (2008) (summarizing the Treasury Department’s proposal to establish a Business Conduct Regulator because “[b]usiness conduct regulation . . . includes key aspects of consumer protection”); SHILLER, *supra* note 271, at 129 (“[A step to correct] the inadequacies of our information infrastructure, as outlined by legal scholar Elizabeth Warren, would be for the government to set up what she calls a financial product safety commission, modeled after the Consumer Products Safety Commission. Its primary mission would be to protect the financial consumer, to serve as an ombudsman and advocate. It would provide a resource for information on the safety of financial products and impose regulations to ensure such safety. Remarkably, such concern for the safety of financial products is not the primary charge of any major financial regulatory agency in the United States today.”).

<sup>305</sup> THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATIONS § 8.1, at 320–22 (5th ed. 2005) (discussing blue sky laws’ merit-based paradigm).

<sup>306</sup> See National Association of Insurance Commissioners, NAIC Securities Valuation, <http://www.naic.org/svo.htm> (last visited Feb. 1, 2009) (“[The SVO] is responsible for the day-to-day credit quality assessment and valuation of securities owned by state regulated insurance companies.”); see also Cantor & Packer, *supra* note 36, at 6, 9 (“[T]he SVO staff is free to assign a rating that differs from the bond’s public credit rating as long as their judgment implies a downgrade from the corresponding public credit rating. In practice, the SVO concentrates its resources on (1) determining a quality category for unrated private placement

Some may argue that an independent taxpayer-funded rating agency would be unable to attract skillful analysts and would likely do a worse job at evaluating risk than private agencies.<sup>307</sup> It appears true that analyst and manager compensation must be appropriately high in order to establish and maintain a satisfactory level of institutional risk analysis skill. However, working in such a public interest oriented agency may be particularly appealing to skillful, intelligent, public interest minded financial analysts and economists, and the compensation need not necessarily be equal to that offered in private practice. Such a public agency, especially if it becomes highly reputable, may be a place for experienced analysts to cap an honorable career and a place for young, ambitious, highly skilled analysts to begin one.<sup>308</sup>

Others may argue that the establishment of a public agency may undermine the market for private credit rating analysts, thereby eliminating any reduced information asymmetry resulting from the private analysts.<sup>309</sup> However, according to this proposal, the public agency would only provide information to investors, and the marketplace of investors would decide which agencies' opinions it will value. Increasing competition between NRSROs has been advocated as a way to improve the accuracy of the agencies and eliminate those agencies whose opinions were not valued,<sup>310</sup> a public agency would merely participate in that competition. The loss of any private jobs would merely be the result of the consensus of the marketplace that the information provided by the public agency so seriously undermined the reliability of a private-sector rating agency that it could no longer charge the fees it had been charging or could no longer survive.<sup>311</sup>

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securities and (2) resolving differences of opinion among the agencies, where the SVO may choose either the higher or lower rating. At the cost of establishing the capacity to undertake independent analysis, the NAIC has developed a discretionary use of ratings that calls for judgment in the interpretation of split ratings and permits certain ratings to be discounted if they are viewed as too high.”).

<sup>307</sup> See, e.g., Schwarcz, *Rethinking*, *supra* note 226, at 27–28.

<sup>308</sup> See JOHN BRAITHWAITE, *MARKETS IN VICE, MARKETS IN VIRTUE* 202 (2005) (discussing the integration of private and public markets and how the public markets might be able to attract the best professionals).

<sup>309</sup> See, e.g., Schwarcz, *Rethinking*, *supra* note 226, at 27–28.

<sup>310</sup> See *supra* note 177 and accompanying text.

<sup>311</sup> Of course, given that this agency will have the platform of a federal government agency, the authority of its voice may be overvalued, but at least its voice will be untainted by the pervasive conflict faced by the private agencies, which has created havoc in entire economies and threatens to do so again.

*B. Government Paying for Private Rating Services*

Instead of using public funds to establish an independent body to conduct credit risk analysis, public funds could be used to hire private credit rating agencies that shun the issuer-pays revenue model or, as a result of government funding, are willing to move away from the issuer-pays model to conduct credit analysis on selected securities. In this regard the public would act effectively as the paying client of a credit rating agency that relies on the subscriber-pays revenue model.

Earlier this decade, investigations into and criminal charges against several Wall Street investment banks and brokerage firms, whose securities analysts were believed to be issuing overly favorable opinions on public equity securities as a result of the conflicts of interests experienced by the analysts,<sup>312</sup> led to the establishment of the so-called independent research mandate. The independent research mandate, part of a larger settlement reached between these Wall Street firms and various federal, state, and industry regulators, required that these firms pay independent securities research firms to conduct research on equity securities and make this independent research available to their customers.<sup>313</sup> The independent research mandate provides an analogue—although an inexact one—to the proposal made here that public funds be used to pay for independent credit analysis.<sup>314</sup>

In this scenario, although it eliminates the conflict of interest associated with the issuer-pays revenue model, the hired agencies may be tempted to issue overly conservative ratings instead of the most accurate ratings on the belief that such conservatism might be favored by the government regulators charged with awarding contracts to the rating agencies. Since they are involved in an activity

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<sup>312</sup> See *supra* note 93 and accompanying text.

<sup>313</sup> See Press Release, U.S. SEC, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), available at <http://www.sec.gov/news/press/2003-54.htm>; U.S. SEC, SEC FACT SHEET ON GLOBAL ANALYST RESEARCH SETTLEMENTS, Apr. 28, 2003, available at <http://www.sec.gov/news/speech/factsheet.htm> [hereinafter U.S. SEC, GLOBAL ANALYST FACT SHEET].

<sup>314</sup> The analog is inexact in that under the independent research mandate Wall Street firms select and pay the independent securities analysis firms (although arguably these payments are derived at least in part from revenues generated indirectly from the investing public). The independent research mandate was to last for only five years and required that the firm pay only a total of \$432.5 million for independent research. U.S. SEC, GLOBAL ANALYST FACT SHEET, *supra* note 313. There is some doubt that the investing public actually made much use of the independent research mandate. See, e.g., Judith Burns, *Independent Stock Research Hasn't Been a Must-See*, WALL ST. J., Nov. 26, 2005, at B3 (noting that in the first year of availability few investors accessed the independent research reports and some of the information provided may have been untimely and less than useful).

which is designed to promote financial stability and the efficient workings of the capital markets, such regulators might reasonably be perceived (correctly or incorrectly) to favor overly conservative credit evaluations more protective of the investing public. Nevertheless, despite this possible bias, the ratings issued by hired agencies would provide informational value different from that embedded in ratings issued by other private-sector agencies, and investors could take into consideration the ratings and information provided by the hired agencies when making their investment decisions. These ratings' potential conservative bias, however, may make them inappropriate candidates to be used as the reference ratings in rating-dependent regulations. Such a bias would unduly dampen the flow of money within the capital markets.

Professor Roger B Myerson, a 2007 Nobel Prize winner in economics for his work on the design of economic institutions,<sup>315</sup> recently seemed to suggest that having the government pay private rating agencies for rating services in certain circumstances was preferable to the current system. He wrote, "Should debt securities that are held by regulated banks and pension funds be rated by multiple independent credit reports that have been commissioned by a federal agency, or should we continue to let the issuers of debts decide who will rate their risks?"<sup>316</sup>

### *C. Tax Incentives to the Rating Industry*

Instead of providing direct public payments to the rating agencies to conduct risk analysis as discussed above, it may be possible to provide tax credits to those private rating agencies that are able to demonstrate they have provided accurate risk analyses. In such a proposal, it would be necessary to devise some measurement of ratings accuracy and then establish accuracy benchmarks. Rating agencies that meet these benchmarks would receive tax credits, thus incentivizing them to provide accurate ratings—a force that could counteract the influence of the issuer-pays conflict of interest. This counteracting force could be strengthened or weakened by lowering or raising the accuracy benchmarks and/or by raising or lowering the amount of tax credits available.

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<sup>315</sup> Press Release, The Royal Swedish Academy of Sciences, The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2007 (Oct. 15, 2007), available at [http://nobelprize.org/nobel\\_prizes/economics/laureates/2007/press.html](http://nobelprize.org/nobel_prizes/economics/laureates/2007/press.html).

<sup>316</sup> *Questions for Mr. Geithner*, N.Y. TIMES, Jan. 21, 2009, at A31 (one of the three questions Professor Myerson would have liked Timothy Geithner, President Obama's nominee for Treasury Secretary, to answer during his appearance before the Senate Finance Committee).

The most obvious difficulty in such a scheme would be the creation of the accuracy measurements and the creation of a verification program. The measurements would likely entail an evaluation of the accuracy of each agency's historic ratings over some recent number of years. Tax credits would be earned, therefore, only a certain number of years after the ratings have been issued, so a chronological mismatch between the historical rating performance and current financial reward would be inevitable. The amount of tax credits each rating agency earns could be made publicly available in order to provide the investing public with additional information about the historic accuracy of these credit rating agencies. Such a tax reward system, however, would not necessarily signal which rating agencies were providing accurate ratings in real time.

It may also be impossible to reward only deserving agencies and completely avoid rewarding non-deserving agencies, since there will be at times a misalignment of actual agency performance and apparent (or retrospective) performance.<sup>317</sup> Any historical, retrospective analysis of actual debtor performance would not necessarily differentiate, for example, those agencies that had been conducting risk analysis with high levels of skill, competence, and diligence from those that were merely the beneficiaries of good luck. Many times ratings that prove to be accurate in retrospect (based on whatever measurement methodology is used and thus entitling a rating agency to tax benefits) will have resulted from good luck benefiting an agency that in reality had conducted sloppy analysis. Conversely, many times ratings that prove to be inaccurate in retrospect and do not elicit tax benefits may have indeed been determined with particular skill, diligence, and competence, and it is only bad luck (from the perspective of the credit rating agency) that yielded the conclusion that the rating was inaccurate. Sometimes, for example, creditworthy debtors default, and often risky debtors pay on schedule. The sheer number of ratings conducted by most rating agencies and the need to reward agencies based on their average performance, however, may neutralize this potential misalignment.

#### CONCLUSION

The reforms contained in and directed by the Credit Rating Agency Reform Act have only recently been implemented. Though this Article argues that there are substantial reasons to doubt the effectiveness of these reforms and that these reforms have not

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<sup>317</sup>It is important to keep in mind that a rating is an evaluation or prediction of the uncertain future.

adequately addressed the problem of the issuer-pays conflict of interest, much of the current regulatory regime exists to try to enable the marketplace to try to manage this very problem. Perhaps, going forward, investors will come to adequately discount the opinions of the rating agencies; perhaps rating agencies will find that there is rarely an occasion when short-term profit incentives outweigh any threat to their reputations; perhaps rating agencies that shun the issuer-pays model will displace the traditional rating agencies. Perhaps. Time will tell to what extent the Act is effective—if, indeed, it is effective at all.<sup>318</sup> Unfortunately, it would appear to be a difficult task to determine the actual effectiveness of these reforms, and it may even require another economic downturn or securities debacle to reveal persistent rating agency misbehavior.<sup>319</sup> Nevertheless, a very healthy skepticism of these reforms' effectiveness is eminently warranted, especially in light of the empirical and anecdotal evidence presented here.

Mortgage-backed securities and the collateralized debt obligations based on them are complex securities, and, as a result, many investors appear to have relied on ratings as informational, analytical, and risk assessment proxies for their own due diligence. In the case of subprime mortgage-backed securities and related products, such reliance may have been misplaced and seems to have cost investors dearly. But mortgage-backed securities are only one of several complex and opaque securities instruments available today to the investment community.<sup>320</sup> Financial innovation is likely to produce more and increasingly complex and/or opaque investment products. Furthermore, capital markets are increasingly interrelated, interdependent, and global, which contributes to the potential to create increasingly complex securities and systemic risk.<sup>321</sup>

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<sup>318</sup> New York State's attorney general, Andrew Cuomo, announced in 2004 that the state had reached an agreement with Moody's, S&P, and Fitch pursuant to which firms would be paid for conducting unsolicited ratings and would be required to conduct some level of due diligence regarding residential MBSs. Aaron Lucchetti, *Bond-Rating Shifts Loom in Settlement—N.Y.'s Cuomo Plans Overhaul of How Firms Get Paid*, WALL ST. J., June 4, 2008, at C1. However, the agreement has not been formalized, the details of the agreement have not been released (including details regarding fees and payments), and the agreement is to terminate in three years. *Id.*; see also Amir Efrati & Aaron Lucchetti, *U.S. News: Cuomo Blazes Own Trail as Wall Street Cop*, WALL ST. J., Aug. 11, 2008, at A3.

<sup>319</sup> See White, *supra* note 47, at 49–50 (“There is no absolute standard against which an industry can be judged, and judgments with respect to innovation within the credit rating industry do seem particularly difficult.”).

<sup>320</sup> Others include collateralized debt obligations generally, credit default swaps, other derivative instruments, hybrid and/or synthetic versions of each and even hedge funds whose investment strategies are kept relatively opaque to its own investors. See *supra* note 35 and accompanying text.

<sup>321</sup> See IOSCO, SUBPRIME REPORT, *supra* note 9, at 7.

In a world of increasing complexity and opacity, investors may find it increasingly difficult to engage in their own risk assessments, and, even if they could do so, for all of them to do so would be increasingly inefficient. Rather, investors may continue to rely on rating agencies, financial analysts, and other informational proxies to provide reliable information about the risks and values of securities and on the most resource-rich and skillful institutional investors to bring market prices in line with fundamental values and to discipline analyst and rating agency misbehavior. Those truly sophisticated and resource-rich industry players, however, may take advantage of the increasing informational asymmetry and their investment capabilities by innovating, creating, and selling complex financial products and pocketing fees along the way or by creating trades in hard-to-value (and therefore often mis-valued) securities designed for the purpose of receiving abnormal returns.<sup>322</sup> Furthermore, some undeserving participants within the industry are likely to be positioned, like subprime mortgage originators and mortgage brokers, to divert a portion of the generous flow of funds from investors into their own personal coffers.

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

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<sup>322</sup> It is not this Article's intention to discourage financial innovation. Financial innovation is often beneficial. For example, innovation may disperse risk and lead to increased overall financial stability and often allows otherwise restricted investors to participate in desirable investments.