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On Regulating Conflicts of Interest in the Credit Rating Industry

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ON REGULATING CONFLICTS OF INTEREST IN THE CREDIT RATING INDUSTRY

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INTRODUCTION

Credit rating agencies play a critical role in the health and stability of the financial system. They offer ratings of debt instruments that indicate the probability of default or delayed payment with respect to those instruments, thus rectifying information asymmetries between issuers and investors. Private debt contracts often contain rating triggers that permit investors to take actions against an issuer if a rating falls below a specified threshold. When this threshold is reached, investors might be able to demand higher interest rates or even an immediate repayment of downgraded debt securities. Ratings are also taken into account in institutional investors' in-house investment rules and rating changes can force managers to adjust their portfolio holdings.

Financial market regulators worldwide refer to private credit ratings in rules and regulations. For example, under Rule 15c3-1 under the United States Securities Exchange Act of 1934 (the Exchange Act)[1], a broker-dealer subscriber holding debt securities would be able to apply lower haircuts (adjustments to securities' valuations) when computing its net capital if these securities are rated investment grade by two rating agencies that are recognized as Nationally Recognized Statistical Rating Organizations (NRSROs) by the Securities and Exchange Commission (SEC).[2] In regulations adopted by the SEC under the Securities Act of 1933, offerings of certain nonconvertible debt, preferred securities, and asset-backed securities that are rated investment grade by at least one NRSRO can be registered on Form S-3 (the "short-form" registration statement) without the issuer satisfying a minimum public float test.[3]

1. Codified as amended at 15 U.S.C. §§ 78a–78lll (2006). Following common securities law practice, sections of the Exchange Act will be referenced by their original numbering rather than that of their codification.

2. 17 C.F.R. § 240.15c3-1(c)(2)(vi)(F) (2009). The SEC's proposal to replace references to credit ratings in the net capital requirements of broker-dealers with subjective risk assessment standards was strongly opposed by financial market participants on the grounds that the change would increase uncertainty, decrease transparency, and decrease market confidence. References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 33-9069, 74 Fed. Reg. 52,374, 52,378 (proposed Oct. 5, 2009). As of January 1, 2010, the SEC's proposal has not been adopted.

3. Form S-3 (17 C.F.R. § 239.13 (2009)) is the short form used by eligible domestic companies to register securities offerings under the Securities Act of 1933. On Dec. 27, 2007, the SEC adopted amendments to the eligibility requirements of Form S-3 to allow primary securities offerings on Form S-3 without regard to the size of their public float or the rating of debt they are offering, so long as they satisfy the other eligibility conditions of the applicable form and do not sell securities valued in excess of one-third of their public float in primary offerings pursuant to the new in-

Internationally, most countries have adopted the Basel II Revised International Capital Framework that describes a comprehensive measure and minimum standard for capital adequacy for banking institutions. The framework has different capital requirements for commercial loans based on the loans' credit risks. The credit risk assessment can be provided by internal rating systems or by a standardized approach using external credit ratings.[4] The implementation of Basel II means that credit ratings have become an integral part of the methodology used to determine many financial institutions' net capital reserve requirements worldwide.

Yet criticisms of credit rating agencies are manifold. Concerns have been raised regarding the inadequate training and qualifications of credit rating analysts,[5] the inordinate entry barriers for potential competitors,[6] anticompetitive practices of major rating agencies,[7] the lack of adequate transparency in providing information to the market about ratings granted,[8] the preferential subscriber access to information,[9] the inadequacy of rating models used in rating structured finan-

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structions on these forms over any period of twelve calendar months. Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Exchange Act Release No. 33-8878, 72 Fed. Reg. 73,533, 73,534 (Dec. 27, 2007).

4. BASEL COMM. ON BANKING SUPERVISION, INT'L CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS ¶¶ 50–51 (June 2006), http://www.bis.org/publ/bcbs128.pdf.

5. U.S. SEC. AND EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKET 31 (Jan. 24, 2003), http://www.sec.gov/news/studies/credratingreport0103.pdf [hereinafter SEC REPORT OF 2003].

6. *Id.* at 37. There is a widespread view that one of the most significant natural barriers into the credit rating business is the current dominance of a few highly-regarded, well-capitalized rating agencies that pioneered the industry many decades ago. The business of issuing credit ratings on securities originated in the early 1900s and, until the mid-1970s, only a handful of firms issued credit ratings on securities.

7. "Fitch complained that Standard & Poor's and Moody's were attempting to squeeze it out of certain structured finance markets by engaging in the practice of 'notching'—lowering their ratings on, or refusing to rate, securities issued by certain asset pools . . . unless a substantial portion of the assets within those pools were also rated by them." SEC REPORT OF 2003, *supra* note 5, at 24.

8. *Id.* at 22.

9. *Id.* at 35. Two issues related to selective disclosures are: (1) release of information concerning a rating action to subscribers before public issuance of the rating; and (2) the extent to which information concerning a rating is made available to subscribers but not to the general public. The ability of preferential subscribers to access important information about issuers and credit ratings creates an unfair information asymmetry in the marketplace.

cial products,[10] and most importantly, the conflicts of interest on the part of rating agencies.[11]

In the United States, credit rating agencies were largely unregulated until the enactment of the Credit Rating Agency Reform Act of 2006.[12] This legislation created a new section—Section 15E of the

10. Structured finance relies on mathematical modeling of expected default rates and correlation of default within the underlying asset pools. The dramatic loss in value of mortgage related debt derivatives in the current financial crisis indicates that these models are likely flawed. *See* TECHNICAL COMMITTEE, INT'L ORGANIZATION OF SECURITIES COMMISSIONS, REPORT ON THE SUBPRIME CRISIS 12-13 (May 2008).

11. SEC REPORT OF 2003, *supra* note 5, at 23.

12. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327. The history of the regulation of credit rating agencies prior to the Credit Rating Agency Reform Act of 2006 can be summarized as follows: The term "NRSRO" was initially adopted in 1975 solely for determining capital charges on different grades of debt securities under the Exchange Act Rule 15c3-1 (the Net Capital Rule). In 1994, the SEC issued a concept release soliciting public comments on the SEC's use of NRSRO ratings in regulations. Concerns had been expressed about the fact that the SEC rules did not define "NRSRO" and that there was no formal mechanism for monitoring the activities of NRSROs. As a result, the SEC believed it appropriate to solicit public comment on the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for designating NRSROs and monitoring their activities. Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-34616, 59 Fed. Reg. 46,314 (Sept. 7, 1994). As a response to the above concept release and the comments received thereon, the SEC, in 1997, proposed to amend the Net Capital Rule to define the term "NRSRO." The proposed amendments set forth criteria to be considered by the SEC in recognizing rating organizations as NRSROs and establish an application process for NRSRO recognition. *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-39457, 62 Fed. Reg. 68,018 (Dec. 30, 1997). However, due to concerns regarding, among other things, the initiation of broad-based SEC and Congressional reviews of credit rating agencies, the SEC did not act upon its rule proposal. On March 20, 2002, the Senate Committee on Governmental Affairs held a hearing—entitled "Rating the Raters: Enron and the Credit Rating Agencies"—that focused on the role of credit rating agencies in the Enron collapse. That hearing sought to elicit information on why the credit rating agencies continued to rate Enron a good credit risk until four days before the firm declared bankruptcy, and to determine how future Enron-type calamities could be avoided. On October 7, 2002, the staff of the Senate Committee on Governmental Affairs issued a report entitled "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs," which contains, among other things, the results of the Committee staff's investigation into the actions of the three NRSROs in the years prior to Enron's collapse. STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 76–99 (Comm. Print 2002). In 2002, Congress enacted the Sarbanes-Oxley Act. The primary purpose of the Sarbanes-Oxley Act was to enhance the integrity of the U.S. capital markets and restore investor confidence in the wake of recent financial scandals. Among other things, the Sarbanes-Oxley Act directed the SEC to examine how to enhance regulatory oversight of rating agencies. In March 2003 the SEC issued an order directing investigation into the role of rating agencies in the U.S. securities market. Pursuant to this order the SEC staff conducted formal examinations of each of the three major credit rating agencies (Standard & Poor's, Moody's, and Fitch, collectively the Big Three). However, the effec-

Exchange Act—that establishes a regulatory framework for a registration and recognition process to which rating agencies must adhere in order to hold the NRSRO status. Section 15E requires an NRSRO to establish, maintain, and enforce written policies and procedures to address conflicts of interest;[13] to provide required information, including any conflict of interest relating to the issuance of credit rating by the rating agency, to the SEC upon filing the registration statement by the rating agency for its NRSRO recognition;[14] and to update information contained in the initial registration statement on an annual basis.[15] Section 15E also prohibits coercive practices of rating agencies,[16] and grants authority to the SEC to issue rules to prohibit or require the management and disclosure of conflicts of interest,[17] but prohibits the

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tiveness of the SEC's examination was hampered by the lack of recordkeeping requirements tailored to credit rating agencies' activities. In January 2003, the SEC completed another special study on the role and functions of rating agencies in the financial market. SEC REPORT OF 2003, *supra* note 5, at 1. In June 2003 the SEC issued a concept release entitled "Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws" that sought public comments on various issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under the federal securities laws, and the level of oversight to apply to credit rating agencies. Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Exchange Act Release No. 33-8236, 68 Fed. Reg. 35,257, 35,258 (June 12, 2003). In April 2005, the SEC proposed rules in a release entitled "Definition of Nationally Recognized Statistical Rating Organization" that set forth conditions for NRSRO recognitions. Definition of Nationally Recognized Statistical Rating Organization, Exchange Act Release No. 33-8570, 70 Fed. Reg. 21,306 (Apr. 25, 2005). Shortly thereafter, Congress enacted the Credit Rating Agency Reform Act of 2006.

13. Exchange Act § 15E(h)(1) provides: "Each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business." 15 U.S.C. § 78o-7(h)(1) (2006).

14. Exchange Act § 15E(a)(1)(B)(vi), 15 U.S.C. § 78o-7(a)(1)(B)(vi) (2006).

15. Exchange Act § 15E(b) requires a registered credit rating agency to update its registration statement no later than 90 calendar days after the end of each year, listing any material change in information that occurred in the previous calendar year. 15 U.S.C. § 78o-7(b) (2006).

16. Exchange Act § 15E(i)(1) provides: "The Commission shall issue final rules in accordance with subsection (n) to prohibit any act or practice relating to the issuance of credit ratings by a nationally recognized statistical rating organization that the Commission determines to be unfair, coercive, or abusive. . .." 15 U.S.C. § 78o-7(i)(1) (2006).

17. Exchange Act § 15E(h)(2) provides: "The Commission shall issue final rules in accordance with subsection (n) to prohibit or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization. . .." 15 U.S.C. § 78o-7(h)(2) (2006).

SEC from regulating the substance of credit rating.[18] Section 15E also grants the SEC the authority to revoke the registration of any NRSRO that fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity.[19]

Pursuant to the authority granted by the Credit Rating Agency Reform Act of 2006, the SEC adopted detailed rules on NRSRO recognition conditions and registration procedures in July 2007.[20] The current worldwide financial crisis and the role that rating agencies played in various stages of the turmoil prompted the SEC to continue its push for refining rating agency oversight. In 2009, the SEC adopted a series of regulatory changes to enhance further the transparency of rating methodologies and performances, and to strengthen NRSROs' recordkeeping and reporting obligations in order to assist the SEC in monitoring NRSROs' compliance with regulation.[21] In addition, as of January 1, 2010, the SEC still has a number of proposed rule changes open for public comments that seek to improve transparency of credit ratings and increase public disclosures about conflicts of interest.[22]

Given the multitude of regulatory actions taken by the U.S. Congress and the SEC in recent years and the continuous search for better regulatory measures to address conflicts of interest, it is important, as

18. Exchange Act § 15E(c)(2) provides: "The rules and regulations that the Commission may prescribe pursuant to this title, as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations. Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." 15 U.S.C. § 78o-7(c)(2) (2006).

19. Exchange Act § 15E(d)(5), 15 U.S.C. § 78o-7(d)(5) (2006).

20. *See* Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations. Exchange Act Release No. 34-55857, 72 Fed. Reg. 33,563, 33,564 (June 18, 2007) [hereinafter June 2007 Adopting Release].

21. *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342, 74 Fed. Reg. 6456 (Feb. 9, 2009) [hereinafter Feb. 2009 Adopting Release]; References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-60789, 74 Fed. Reg. 52,538 (Oct. 9, 2009) [hereinafter Oct. 2009 Adopting Release]; Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-61050, 74 Fed. Reg. 63,832 (Dec. 4, 2009) [hereinafter Nov. 2009 Adopting Release].

22. *See* Credit Ratings Disclosure, Exchange Act Release No. 34-60797, 74 Fed. Reg. 53,086 (Oct. 15, 2009) [hereinafter Oct. 2009 Proposing Release]; Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-61051, 74 Fed. Reg. 63,866 (Dec. 4, 2009) [hereinafter Nov. 2009 Proposing Release].

Daniel Curry, President of Dominion Bond Rating Service (DBRS),[23] pointed out in his opening remarks at the SEC Roundtable discussion held in April 2009,[24] for regulators to "take stock of what has been accomplished to see where we are now and to identify what if anything is left to do."[25] That is the focus of this paper.

In Part I, the paper will discuss the specific settings in which conflicts of interest on the part of credit rating agencies arise. In Part II, the paper will discuss how each type of conflict of interest is regulated in the current statutes, SEC rules, and the internal codes of conduct of credit rating agencies. In Part III, the paper will identify regulatory inadequacies and suggest how they can be addressed in future rule changes. The final section provides concluding remarks.

Conflicts of interest arise at both the individual rating analyst level and the rating agency level. This paper shows that the existing regulatory framework has an extensive coverage for conflicts at the individual analyst level, and that some conflicts at the rating agency level have been addressed through prohibitions recently added to the regulation, but that conflicts arising from the rating agency's issuer-pay business model and the potential influence of large subscribers to credit ratings are not fully addressed through the current "disclosure plus enhanced surveillance" framework. This paper advocates the adoption of the SEC's pending proposals on the "point-of-sale" disclosures about conflicts of interest by pointing to the inadequacies of the current regulation and the disparity between the disclosure requirements of credit rating agencies and research analysts (who also face conflicts of interest). This paper further reveals the inability of the current NRSRO performance reporting requirements to capture selective rating inflations performed on ratings of the NRSRO's largest issuer clients, and proposes changes to enhance the power of the statistics in detecting such kinds of rating bias.

23. DBRS is an international rating agency headquartered in Toronto, Canada. It offers credit analysis of corporate, financial institutions, and government issues of debt in North America, Europe, Asia and Latin America.

24. On April 15, 2009, the SEC held a roundtable to discuss, among other issues, whether the SEC should consider additional rules to align the rating agencies' interests more closely with those of investors, and whether users of ratings have all the information they need to make the most informed decisions. *See* U.S. Sec. & Exch. Comm'n, Roundtable to Examine Oversight of Credit Rating Agencies 4 (Apr. 15, 2009), *available at* http://www.sec.gov/spotlight/cra-oversight-roundtable/cra-oversight-roundtable-transcript.txt [hereinafter SEC Roundtable Transcript].

25. *Id.* at 8.

I.
Conflicts of Interest in the Credit Rating Industry

A. *Conflicts of Interest at the Analyst Level*

Conflicts of interest are alleged to exist at both the individual credit analyst level and the rating agency level. At the analyst level, the conflict mainly arises from the following activities and/or relationships:

Ownership of securities of rated entities: This type of conflict involves employees of a rating agency who own securities or money market instruments of issuers or obligors subject to credit ratings by the rating agency. The concern is that allowing persons within the rating agency to own securities could lead to situations where an inappropriate credit rating is issued so as to favor the trading positions of such persons. This conflict exists even if the persons who own securities are not directly involved in the rating process. For example, a credit analyst may be influenced by a colleague whose job function is unrelated to rating, but who holds securities that the analyst rates. The analyst may be tempted into providing an unduly positive rating so that the holdings of his colleague will appreciate in value.

Employment position or directorship at a rated entity: This type of conflict arises when employees of a rating agency serve as directors or officers of rated entities. The concern is that such positions may lead to unduly positive ratings that benefit the rated entity. For example, Clifford L. Alexander, Jr., former chairman of Moody's, served on the board of WorldCom/MCI for nineteen years. During this period, WorldCom/MCI received favorable ratings even after the market-implied rating from credit spreads had fallen below investment-grade.[26]

Business relation beyond ordinary course of business or special personal relationship: This conflict involves employees of credit rating agencies whose business relationship with a rated entity exceeds that of an ordinary course of business relationship or employees who maintain a special personal relationship with the rated entity. An example of the former scenario involves an analyst who borrows money at below market rate from a rated entity. He may be influenced to use the issuance of a favorable rating as a condition for maintaining the favorable borrowing terms. A special personal relationship might in-

26. Alec Klein, *Moody's Board Members Have Ties to Clients*, WASH. POST, Nov. 22, 2004, at A9.

volve a credit rating analyst whose relative or spouse works for a rated issuer, obligor, or the underwriter of a rated security.

Receipt of gifts from rated entities: This conflict involves credit rating analysts who receive gifts from rated entities that exceed nominal value and thus lose impartiality in rating the entities or their securities.

The determination of analysts' compensations based on rating fees: This conflict involves analysts whose compensations are wholly or partly determined by the rating fees that they generate for the rating agency. Debt issuers engage in "rate shopping" for the most favorable ratings. Rating agencies that give out low ratings face a higher probability that debt issuers do not use their ratings and thus do not pay rating fees. If rating analysts are compensated based on the fees they help generate, they have an incentive to issue high ratings so that their ratings are selected and they receive their share of the compensation.

B. *Conflicts of Interest at the Rating Agency Level*

Conflicts at the rating agency level are at the center of the conflict of interest problem in the credit rating industry. Most discussions and debates on how to resolve rating agency conflicts revolve around how to eliminate or at least reduce the agency-level conflicts. Such conflicts typically arise in the following settings:

Affiliated underwriter or issuer: This conflict involves a rating agency rating debt securities that are underwritten by an affiliate that is a broker or dealer engaged in the business of underwriting securities or money market instruments.[27]

Ancillary services to rated entities: This conflict involves a rating agency that rates securities of an issuer for whom the rating agency also provides ancillary services, such as debt restructuring or risk management consulting. Most of the rating agencies provide ancillary services in addition to the core business line of credit rating.[28] The concern with respect to ancillary services is that the rating agency may issue a more favorable than warranted credit rating in order to obtain business from the rated entity for the ancillary services. Rating agencies argue that they have established extensive policies and procedures

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27. This type of conflict is identified in Exchange Act § 15E(h)(2)(D). 15 U.S.C. § 78o-7(h)(2)(D) (2006).

28. There are a few exceptions such as DBRS, which does not provide ancillary services and prohibits its analysts from making proposals or recommendations regarding the design of the products that it rates. *See* DBRS Business Code of Conduct § C.1.14 (June 2009), *available at* http://www.dbrs.com/research/228896.

to manage potential conflicts in this area, including substantial firewalls that separate the rating business from the influence of ancillary business, as well as a policy that rating analysts generally do not participate in the marketing of ancillary services. However, at an SEC hearing, one buy-side participant testified that she was aware of at least one instance in which analysts from a rating agency were involved in marketing advisory service to her firm.[29] In addition, in the case that ancillary services involve private rating assessments, rating analysts actually perform the ancillary assessment.

The provision of ancillary services by credit rating agencies is also a source of conflict of interest that may harm issuers: rating decisions of agencies may be influenced by an issuer's decision whether or not to purchase additional services offered by them. Issuers may be pressured into subscribing to such services simply "out of fear that their failure to do so could adversely impact their credit rating (or, conversely, with the expectation that purchasing these services could help their credit rating)."[30] An example cited as an alleged abuse of power is a series of downgrades of Hannover Re, one of the world's largest reinsurance companies, by Moody's. Hannover Re was approached by Moody's in 1998 to subscribe to Moody's rating services, but declined the offer because it had already retained Standard & Poor's and A.M. Best Company (a smaller credit rating agency) for this purpose. Moody's then rated Hannover on an unsolicited basis with an initial rating of Aa2, one notch below that given by Standard & Poor's, and subsequent ratings of Aa3 (in January 2001) and A2 (in November 2001), and Baa1 (in March 2003). Those ratings were two to four notches lower than the ratings given by Standard & Poor's and A.M. Best. Moody's final downgrade sparked a ten percent drop in the price of the insurance company and surprised many analysts, because there was no new public information to justify this downgrade. Hannover management alleged that this series of downgrades was "pure blackmail," and that they were told on many occasions that their rating would be impacted positively if they subscribed to Moody's service.[31]

29. U.S. Sec. & Exch. Comm'n, Hearings on the Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (2002) (statement of Cynthia L. Strauss, Director of Taxable Bond Research, Fidelity Investments Money Management, Inc.), *available at* http://www.sec.gov/news/extra/credrate/credrate111502.txt (full hearing transcript).

30. SEC Report of 2003, *supra* note 5, at 43.

31. Patrick Van Roy, *Is There a Difference Between Solicited and Unsolicited Bank Ratings and, If So, Why?* 7–8 (Nat'l Bank of Belgium, Working Paper, Jan. 17, 2006),

Large subscriber influence: This conflict involves credit rating agencies being paid by subscribers for access to credit ratings and for other credit rating services where the value of the security holdings or the status of regulatory compliance of the subscribers depends on the ratings of the securities. For example, a broker-dealer subscriber may have an interest in seeing that the debt securities it holds are rated not lower than investment grade so as to benefit from the lower haircuts when computing its net capital under the Exchange Act Rule 15c3-1.[32] Also, a fund manager who is prohibited by the fund's prospectus from investing in debt securities below a certain grade may have an interest in a particular credit rating. For fear of losing subscription revenue, rating agencies may be pressured into issuing an inappropriate rating or delaying appropriate rating actions if the rating or delay in action will benefit their large subscriber clients.

Issuer-pay business model: This conflict arises from the fundamental business model of rating agencies charging issuers of the securities for the provision of credit rating. Typically, a rating agency is paid only if the credit rating is "issued"—that is, the rating is used in conjunction with the debt issue. A successful issuance of debt securities typically requires the issuer to procure credit ratings from one or multiple rating agencies. Issuers engage in "rate shopping" by moving from one rating agency to another until they get a favorable rating.[33] Except in cases where the rating from a particular rating agency is required by investors, rating agencies that give out lower (although honest) ratings risk their ratings not being selected and thus losing revenue to their less honest peers. According to the information contained in Form NRSRO, issuer-paid credit ratings account for over ninety percent of the outstanding credit ratings issued by NRSROs.[34] With the exception of Egan-Jones Ratings Company, which does not charge issuers for ratings and relies instead on the compensation from subscribers as the key source of its revenue, all NRSROs charge issuers for credit ratings.

The issuer-pay model creates a conflict of interest because the rating agency may be inclined to downplay the credit risk in order to

available at http://ssrn.com/abstract=802085. *See also* Alec Klein, *Spitzer Examining Debt Ratings By Moody's*, WASH. POST, July 30, 2005, at D1.

32. *See* 17 C.F.R. § 240.15c3-1(c)(2)(vi)(F) (2009).

33. *See* 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.

34. Issuer-paid rating accounts for a small fraction of revenue received by some small rating agencies such as LACE Financial Corporation. *See* LACE Financial Corp., Required Financial Reports and Accounting Records Prohibited Conflicts (Form NRSRO: Exhibit 7), at 1 (Feb. 6, 2008).

retain the issuer's business. In addition, a report by the SEC in 2008[35] revealed that rating managers and analysts participated in fee discussions with issuers. These managers and analysts may be inclined to let business considerations undermine the objectivity of the rating process. For example, persons involved in approving the methodologies and processes used to determine credit ratings could be reluctant to adjust a model more conservatively if doing so would make it more difficult to negotiate fees with issuers.

The issuer-pay business model also creates a potential conflict of interest that hurts issuers: rating agencies may issue unsolicited ratings to force issuers to pay for ratings that they did not request. A well-known case in which coercion was alleged was *Jefferson County School Dist. No. R-1 v. Moody's Investor's Services, Inc.*[36] In 1993, Jefferson County (Colorado) school district decided to issue new bonds to take advantage of lower interest rates. It decided to hire Standard & Poor's and Fitch for provision of credit rating instead of Moody's, whom the district had previously used. The bonds sold well initially until Moody's published an article at its own initiation regarding the bonds' "negative outlook" in an electronically distributed information service sent to subscribers and news services. Several buyers immediately canceled their orders, and the school district was forced to reprice the bonds and pay a higher rate. The school district sued Moody's, alleging that this "negative outlook" was coercive and had increased the cost of issuing the bonds by $769,000. Moody's defense was that its evaluation of the school district's bonds was an "opinion" protected by the First Amendment.[37]

Rating agencies justify their need to assign unsolicited ratings by claiming that there is a demand for them from financial markets. For this reason, Standard & Poor's "assign[s] and publish[es] ratings for all public corporate debt issues over $100 million—with or without a request from the issuer."[38] Rating agencies also use unsolicited ratings as a way of establishing a track record before breaking into a new market. For example, when Standard & Poor's attempted to enter the

35. *See generally* Staff of the Sec. and Exch. Comm'n, Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies (July 2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

36. 175 F.3d 848 (10th Cir. 1999).

37. *Id.* at 850–51.

38. Standard and Poor's, Corporate Ratings Criteria 16 (2008), *available at* http://www.nafoa.org/pdf/CorprateCriteriaBook-2008.pdf.

Japanese credit ratings market in the late 1990s, it had assigned 150 unsolicited ratings as of January 2000.[39]

There is empirical evidence that unsolicited ratings are lower than solicited ratings.[40] Rating agencies explain this phenomenon by pointing out that issuers are often uncooperative in providing information when rating agencies attempt to issue unsolicited ratings. Therefore, rating agencies are more conservative when they give a rating at the lower end of an appropriate rating band.

C. The "Reputation Hypothesis"

Rating agencies argue that conflicts of interest at the agency level do not exist in practice. They argue that their reputation is their biggest asset, which they cannot afford to lose just for the sake of retaining the business of some issuers. The basic idea behind the reputation mechanism in the rating industry works as follows: rating agencies can easily be monitored ex post by a comparison of rating assessments with actual defaults. Agencies with a strong performance record build up their reputation with issuers and investors for their accurate risk assessments. Because of this good reputation, investors believe in the rating quality ex ante and value the agency's analysis highly. Issuers in turn seek ratings from agencies with high reputations because good ratings from those agencies' ratings promise the largest reduction in borrowing costs. Thus, reputable rating agencies can demand a high price for their rating assessments, generating above market returns compared with agencies with no reputation. If investors doubt the accuracy or independence of the ratings of a particular agency, they will discount the value of the ratings and refuse to grant issuers a reduction in borrowing costs. Rating agencies may collude with issuers to inflate ratings in exchange for a short-term increase in rating revenue, but in the long run the loss of reputation leads to a loss of revenue that more than offsets any temporary gain from contracting with issuers.[41]

Scholars have pointed out several mechanisms that facilitate the development of reputational sanctions.[42] First, ratings are publicly disclosed and are accessible to investors who can compare ex post the

39. Winnie P.H. Poon, *Are Unsolicited Credit Ratings Biased Downward?*, 27 J. BANKING & FIN. 593 (2003).

40. *See* Christina Bannier, Patrick Behr & Andre Güttler, *Rating Opaque Borrowers: Why are Unsolicited Ratings Lower?*, 14 REV. FIN. (forthcoming 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1107070.

41. *See* TECHNICAL COMMITTEE, INT'L ORGANIZATION OF SECURITIES COMMISSIONS, REPORT OF THE ACTIVITIES OF CREDIT RATING AGENCIES 3 (2003).

42. Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 50–51 (2004).

ratings with the default rates of the obligors. Second, other information intermediaries exist, such as sell-side credit analysts who frequently provide opinions about the appropriateness of a credit rating or an explicit forecast of a credit rating change.[43] Third, a rating agency may render an unsolicited rating on any issuer that has already been rated by a biased or incompetent agency.[44] Finally, in the United States at least, investors typically require issuers to seek ratings from the two largest rating agencies—Standard & Poor's and Moody's. Because of the two-rating norm, Moody's and Standard & Poor's are able to withstand the pressure issuers might exert to obtain higher ratings. The issuers' threats to go elsewhere are not credible.

At the empirical level, a survey among rated issuers found only 2.7% of them who would agree with the assertion that the issuer-pay model causes agencies to assign high ratings in order to satisfy issuers.[45] A recent study by Covitz and Harrison shows that the conflict of interest does not influence actions of credit rating agencies significantly.[46] The study examines the delay in rating downgrades through which a rating agency may act in the interest of issuers. Because a delay in downgrading postpones the concomitant increase in funding costs and the escalation of financial stress through the application of rating triggers, the authors hypothesize that rating agencies whose decisions are primarily dictated by advancing the interests of issuers in order to maximize revenue prospects will delay in downgrading large clients and in downgrading from investment grade to high yields ("Fallen Angel") where the downgrading is particularly costly to issuers. The authors measure rating agency delay by the degree to which the bond market anticipates rating changes. The paper defines bond market anticipation as the degree to which corporate bond spreads move leading up to the month of rating change (or "prior period

43. The goal of sell-side debt analysts is to identify mispriced debt securities, communicate this information to the firms' clients and, ultimately, generate trade for their firms. Accordingly, debt recommendations and forecasts of debt returns are supplied by sell-side debt analysts, but not by credit rating agencies. Reflecting the importance of credit rating changes for debt prices, these analysts often comment on the credit ratings. *See* Rick Johnston, Stanimir Markov & Sundaresh Ramnath, *Sell-side Debt Analysts*, 47 J. ACCT. & ECON. 91 (2009).

44. *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 650–51 (1999).

45. *See* H. Kent Baker & Sattar A. Mansi, *Issuer Assessments of Credit Rating Agencies by Investment Grade*, 11 J. INVESTING 55 (2002).

46. *See* DANIEL M. COVITZ & PAUL HARRISON, FED. RESERVE BD., TESTING CONFLICTS OF INTEREST AT BOND RATING AGENCIES WITH MARKET ANTICIPATION: EVIDENCE THAT REPUTATION INCENTIVES DOMINATE (Dec. 2003), *available at* http://www.federalreserve.gov/pubs/feds/2003/200368/200368pap.pdf.

spread change") relative to their movement through the rating migration month.[47] If a rating change is timely, either in the sense that it quickly reflects observable information or reveals new information, this ratio will be close to zero. In contrast, a value near one indicates that the market largely anticipated the rating change. A multivariate regression of the above measure of market anticipation on a dummy variable for large clients, a dummy variable for "Fallen Angel" and certain control variables reveals that the estimated coefficients on the above two dummies are negative and statistically significant.[48] These results suggest that market anticipation of credit rating changes (a proxy for rating delay) is actually *less* for large issuers and issuers that fall from investment grade to non-investment grade. This result is inconsistent with the hypothesis that rating agencies act in the interests of issuers due to conflicts of interest. The authors acknowledge that their reliance on monthly (versus daily) spread data reduces statistical power. Critiques have pointed out that the authors' assumption that conflict of interest would explain delays in rating downgrades from investment to non-investment grade is questionable, since large rating agencies have other, non-conflict related incentives to delay the issuance of rating downgrades.[49] However, while delays in downgrading for large issuers could have been explained by factors other than conflicts of interest, the finding by Covitz and Harrison that rating agencies are more *timely* in downgrading large issuer clients and "Fallen Angels" indeed lends support to the reputation hypothesis.

Arguments and evidence refuting the reputation hypothesis are also plenty. At the theoretical end, a recent paper by Patrick Bolton, Xavier Freixas, and Joel Shapiro[50] models how strategic contracting (or colluding) between a rating agency and its issuer client can affect information revelation in a monopolistic and duopolistic market structure. In their model, the debt issuer is free to shop for the most favorable rating and rating agencies are compensated only if their ratings are selected and issued to the public. If a rating turns out to be

47. Expressed in formula, Anticipation = 100*[Prior Period Spread Change]/[Total Period Spread Change]. *See id.* at 14.

48. *Id.* at 15–17.

49. *See* Fabian Dittrich, The Credit Rating Industry: Competition and Regulation 92 (July 13, 2007) (unpublished doctoral dissertation, University of Cologne), *available at* http://ssrn.com/abstract=991821. Dittrich cites the example of the delay by Moody's, Standard and Poor's, and Fitch in downgrading Enron in 2001 attributing the delay to "the devastating consequences a downgrade would have had through rating triggers and the impact of rating-based regulations."

50. Patrick Bolton, Xavier Freixas & Joel Shapiro, *The Credit Ratings Game* (Nat'l Bureau of Econ. Research, Working Paper No. 14712, 2009), *available at* http://www.nber.org/papers/w14712.pdf.

inaccurate, investors punish the rating agency by ignoring its reports in the future.[51] The model assumes that there are two types of investors: naïve and sophisticated. Naïve investors take the ratings at face value without understanding the rating agency's incentive in the game to inflate the rating, while sophisticated investors understand the agency's incentive but cannot determine at the time the rating is issued whether it truthfully reflects the information observed by the agency.[52] The authors show that equilibrium exists in a duopolistic market structure in which *both* rating agencies inflate their rating if the fraction of naïve investors in the market is high and the reputation cost of rating inflation is low.[53] Although the model assumes that reputation cost is incurred when default occurs, the derived equilibrium can also be applied in absence of default to the situation where the incumbent agency's performance record is inferior to its peers.

Retail investors in the US bond market are indeed participating in great numbers. According to the Trade Reporting and Compliance Engine (TRACE) of the Financial Industry Regulatory Authority (FINRA),[54] about sixty-five percent of reportable trades in corporate bonds are valued at less than $100,000 (the benchmark for retail trades).[55] In regard to the reputation sanction, Part III of this paper will show that a moderate inflation by one rating notch for large issuer clients has no negative effect on the rating agency's performance statistics that are required to be disclosed under the current regulations. In sum, a large number of investors are naïve and reputation cost is low; the equilibrium conditions derived by Bolton, Freixas, and Shapiro exist.

The two-rating norm and the dominance of Standard & Poor's and Moody's, which arguably make "rate shopping" difficult in traditional markets, are not yet established or entrenched in international markets and new rating sectors such as structured finance products. If

51. In practice it is often difficult to determine ex post whether a credit rating agency misled investors, as rating agencies inevitably argue that the deteriorating financial condition of the issuer was not foreseeable at the time rating was issued. Still, it is generally easier to make such a determination ex post rather than ex ante.

52. Bolton et al., *supra* note 50, at 8.

53. *Id.* at 18.

54. FINRA is the largest independent regulator for all securities firms doing business in the United States. It was created in July 2007 through the consolidation of National Association of Securities Dealers (NASD) and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. TRACE is a trade reporting and dissemination system recently operated by NASD to provide real-time transaction prices for bonds.

55. TECHNICAL COMMITTEE, INT'L ORGANIZATION OF SECURITIES COMMISSIONS, TRANSPARENCY OF CORPORATE BOND MARKETS 4 (2004).

multiple ratings are required for debt issues of foreign entities, one of the rating agencies is typically an agency of the issuer's home country. Major rating agencies such as Standard & Poor's, Moody's, or Fitch would have to compete for the remaining slot.[56] In the structured finance market, although many deals are rated by three agencies that are typically Standard & Poor's, Moody's, and Fitch (a pioneer in rating structured finance products), a large fraction of the deals are rated by only two agencies and the "Big Three" would have to compete against one another for the job.[57] In a recent study by Becker and Milbourn,[58] the authors examine the impact of competition in the credit rating industry on the quality of ratings under the assumption that rating agencies are reputation conscious. They use the growth of Fitch's market share as the measure of competition faced by other rating firms to show that as competition increases, ratings issued by Standard & Poor's and Moody's are higher (i.e., moved closer to top AAA rating), and that the correlation between bond yields and ratings (a measure of the informativeness of ratings) fall.

Credit rating agencies' desire to generate revenues by providing ancillary services also incentivizes them to give unduly high ratings. Ancillary services provide a substantial fraction of the revenue of most agencies. For example, Moody's revenue from ancillary services was about $550 million in 2008, which comprised about thirty percent of the total revenue generated by the agency.[59] An issuer client could simply threaten to cut back on the rating agency's provision of lucrative consulting services if the agency did not agree to the client's preferred rating treatment. The provision of ancillary services by accounting firms has compromised their independence in auditing, as is evidenced by Arthur Anderson's role in the Enron scandal.[60]

56. *See* MOORAD CHOUDHRY, THE BOND AND MONEY MARKETS: STRATEGY, TRADING, ANALYSIS 323 (2001); *see also* Arturo Estrella et al., Credit Ratings and Complementary Sources of Credit Quality Information 44–46 (Basel Comm. on Banking Supervision, Working Paper No. 3, 2000). The numbers of credit ratings performed on debt issuances from non-U.S. companies were unevenly spread among major international agencies—typically one agency had a disproportionally higher participation rate than the others—suggesting that major international agencies had unequal opportunities to be selected for rating non-U.S. issuers.

57. *Id.*

58. Bo Becker & Todd Milbourn, *Reputation and Competition: Evidence from the Credit Rating Industry* (Harvard Bus. Sch., Working Paper No. 09-051, June 2009).

59. *See* Moody's Corp., Annual Report (Form 10-K), at 92–93 (Mar. 2, 2009).

60. *See* John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 292 (2004); Jeffrey Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1237–38 (2002).

There is also evidence that rating agencies "herd" with one another on the upside so that a positive rating action by one leading agency is closely followed by others. In a recent paper by Andre Güttler,[61] the author uses rating actions of Moody's and Standard & Poor's during the period of January 1994 to December 2005 to examine whether and to what extent the ratings of these two major agencies converge. The study shows that Moody's ratings track those of Standard & Poor's in upgrades but not in downgrades. This upside-only herding phenomenon suggests that herding is unlikely to be caused by the similarity of rating agencies' models and methodologies or by the lack of adequate manpower in performing rating functions, but rather by rating agencies' more relaxed attitude in delivering good news that pleases their issuer clients (even if they turn out to be wrong) and a more conservative attitude in delivering bad news that alienates their issuer clients (even if they turn out to be right). The upside herding behavior makes it difficult for investors to detect rating inflations by any particular rating agency despite the parallel existence of multiple rating agencies in the market.

In sum, there is at least a high probability that reputation alone does not offer a complete sanction against conflicts of interest at the rating agency level. Regulatory intervention is needed to eliminate or at least minimize rating agencies' incentives to engage in inappropriate rating actions and to maximize the investing public's awareness of risks that arise from such conflicts of interest.

II.
The Current Regulation of Conflicts of Interest

The current framework for the regulation of credit rating agencies in the U.S. consists of four components: (1) the SEC rules initially adopted in June 2007[62] and amended a number of times in 2009,[63] pursuant to the guidelines set forth in Section 15E of the Exchange Act;[64] (2) the internal codes of conduct and rating procedures of credit rating agencies; (3) the agreement between New York State Attorney General Andrew Cuomo and the "Big Three" rating agencies entered in June of 2008 (the Cuomo Agreement) that imposes additional re-

61. Andre Güttler, *Lead-lag Relationships and Rating Convergence Among Credit Rating Agencies* (European Bus. Sch., Research Paper Series No. 09-14, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1488164.

62. *See* June 2007 Adopting Release, *supra* note 20.

63. *See* Feb. 2009 Adopting Release, *supra* note 21; Oct. 2009 Adopting Release, *supra* note 21; Nov. 2009 Adopting Release, *supra* note 21.

64. 15 U.S.C. § 78o-7 (2006).

quirements with regard to the ratings of residential mortgage debt securities;[65] and (4) the potential liabilities of credit rating agencies for inappropriate rating actions that arise from common law doctrines such as professional negligence. This section of the paper discusses in detail how conflicts of interest in the credit rating industry are currently regulated under the framework consisting of the above components. The existing regulation primarily takes effect through the SEC's authority to grant the NRSRO status to a credit rating agency upon the latter's satisfaction of the conditions set forth in the SEC Rules at the time of its initial application, and through the SEC's authority to withdraw the credit rating agency's NRSRO status if the rating agency fails to continuously meet the NRSRO requirements.[66] An entity may act as a "credit rating agency" as defined in Section 3(a)(61) of the Exchange Act[67] without being required to register with the SEC for NRSRO recognition. In this sense, registration as an NRSRO is more voluntary than the registration as a broker-dealer.[68] However, partly because the NRSRO status is perceived as an endorsement by the government of the quality of the rating agency, partly because investors are often bound by investment guidelines that require ratings provided by agencies holding the NRSRO status, and partly because ratings of NRSROs provide lower regulatory compliance costs, the NRSRO status is important to the survival of any entity in the credit rating business. Currently ten credit rating agencies have registered with the SEC as NRSROs. They are: Standard & Poor's, Moody's, Fitch, AM Best, Japan Credit Rating Agency, Ltd (JCR), Rating and Investment Information, Inc. (R&I), DBRS, LACE Financial, Egan-Jones, and Realpoint LLC.

65. *See* Tomoeh Murakami Tse, *Rating Agencies Agree to Changes*, WASH. POST, June 6, 2008, at D2.

66. *See supra* text accompanying notes 12–20.

67. This section defines a credit rating agency as any person "engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; employing either a quantitative or qualitative model, or both, to determine credit ratings; and receiving fees from either issuers, investors, or other market participants, or a combination thereof." Exchange Act § 3(a)(61), 15 U.S.C. § 78c(a)(61) (2006).

68. Section 15(a)(1) of the Exchange Act generally makes it unlawful for any broker or dealer to use the mail (or any other means of interstate commerce, such as the telephone, facsimiles, or the Internet) to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless that broker or dealer is registered with the SEC in accordance with Section 15(b) of the Exchange Act. 15 U.S.C. §§ 78o(a)(1), (b) (2006).

A. *Regulations Targeting Conflicts of Interest at the Rating Analyst Level*

As discussed in Part I of this paper, key sources of conflicts of interest at the individual rating analyst level are as follows: (1) analysts own securities subject to their rating, (2) they serve as directors or take other employment positions at entities subject to their rating, (3) they maintain business relations with the rated entities that exceed an ordinary course of business, or they maintain special personal relationships with the rated entities, (4) they receive gifts from entities subject to rating, and (5) they are compensated based on the amount of the revenues that the credit rating agency generates from debt issuers who are subject to their rating. These conflicts are regulated under Section 15E of the Exchange Act and the SEC Rules and are managed by the codes of conduct of credit rating agencies through provisions discussed below.

Prohibition of securities ownership by analysts who participate in ratings: Paragraph 2 of the Exchange Act Rule 17g-5(c)[69] prohibits an NRSRO from issuing a credit rating with respect to a person (excluding a sovereign nation or an agency of a sovereign nation) where either the NRSRO, a credit analyst who participated in determining the credit rating, or a person responsible for approving the credit rating, directly owns the securities of the rated person. Indirect ownership such as ownership of mutual funds or blind trusts is permitted because indirect ownership means that investors do not have control over decisions on buying and selling securities held by those investment vehicles. Therefore, it is difficult for rating analysts to influence the price of such securities by issuing credit ratings.[70]

The internal rules of credit rating agencies are more restrictive than the SEC Rules in that they prohibit not only ownership of rated securities by employees who participate in the rating process, but also the ownership of rated securities by the employees' immediate family members. Moreover, the restriction applies not only to the rated securities themselves but also to securities guaranteed by rated entities and derivative securities whose value depends on the value of the rated securities. Holdings in diversified investment funds are typically permitted. For example, the Fitch Code of Conduct provides that "employees who are involved in the rating process (or their spouses, partners or minor children) are prohibited from buying, selling or engaging in any transaction in any security or derivative of any security

69. *See* 17 C.F.R. § 240.17g-5(c)(2) (2009).
70. *See* June 2007 Adopting Release, *supra* note 20, at 33,598–99.

issued, guaranteed, or otherwise supported by any entity within such employee's area of primary analytical responsibility."[71] Similar restrictions are found in the internal rules of other registered NRSROs.[72] Ownership of securities by employees of an NRSRO who are not involved in the credit rating process is not listed as a conflict of interest in Exchange Act Rule 17g-5(b).[73] A restriction on the ownership of securities by non-rating employees would create a particular hardship for employees of NRSROs that issue credit ratings with respect to most public companies. Nevertheless, some rating agencies (such as DBRS, Egan-Jones, LACE Financial, R&I) prohibit their employees and their family members from directly owning securities that the rating agencies rate regardless of whether they participate in the rating process.[74] In addition, rating agencies typically require their employees to disclose securities ownership[75] and information about securities trading accounts[76] to the rating committee or designated officers.

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71. *See* Fitch Code of Conduct § 2.2.14 (2009), *available at* http://www.fitchratings.com/web_content/credit_policy/code_of_conduct.pdf.

72. "Employees who are involved in the rating process (or their spouses, partners or minor children) are prohibited from buying, selling or engaging in any transaction in any Security or Derivative of any Security issued, guaranteed, or otherwise supported by any entity within such Employee's area of primary analytical responsibility." Moody's Code of Professional Conduct § 2.14 (2008), *available at* http://www.moodys.com/professional conduct. Likewise, Standard & Poor's Code of Ethics provides: "No covered employee shall participate in or influence the determination of a rating for any particular issuer or security of an issuer if the covered employee or immediate family member owns securities of the rated issuer or any entity related to the rated issuer, the ownership of which may cause or may be perceived as causing a conflict of interest." Standard & Poor's Code of Ethics for Credit Market Services and Segment § A.4.C.2 (2007), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/1.%20Standard%20&%20Poors%20Code%20of%20Ethics%20for%20Credit%20Market%20Services%20and%20Segment%20. . . .pdf. For sample restrictions of small rating agencies, *see* R&I Conflict of Interest Management Policy, at 3, *available at* http://www.r-i.co.jp/eng/rating/nrsro/detail/exhibit_7_5.pdf.

73. 17 C.F.R. § 240.17g-5(b) (2009).

74. For example, DBRS Code of Conduct § 2.14 (2009), *available at* http://www.dbrs.com/research/228896, provides: "Analytical Personnel and members of their Immediate Families are prohibited from buying, selling, or owning the Securities of Issuers rated by DBRS. Furthermore, DBRS also prohibits, with limited exceptions, the investment by other DBRS Staff, in the Securities of Issuers that DBRS rates. These investment prohibitions do not apply to holdings in diversified collective investment schemes and Securities of a sovereign government or agency of a sovereign government."

75. For example, DBRS Code of Conduct, *supra* note 74, § 2.13 provides: "Analytical Personnel must also inform the relevant Rating Committee of . . . the Analytical Personnel['s] own[ership of] the Securities of an entity related to the Issuer, other than pursuant to the exceptions noted in Section 2.14 below[.]"

76. For example, A.M. Best Code of Conduct § III.2.3(c)(i) (2009), *available at* http://www.ambest.com/nrsro/Code.pdf, provides: "Corporate Agents are required to disclose . . . the name(s) of any company(s) providing brokerage services to the Cor-

Restrictions on officer/director positions at rated entities: Exchange Act Rule 17g-5 (c)(4) prohibits an NRSRO from providing credit ratings to entities where a credit analyst, who participated in determining the credit rating, or a person responsible for approving the credit rating, also is an officer or director of the rated entity.[77] The restriction does not apply to employees who do not participate in the rating process. Nevertheless, the internal rules of some rating agencies prohibit employees from taking such positions regardless of whether they participate in the rating process.[78] Most NRSROs require employees to disclose outside employment and seek approval from designated officers before taking such positions.[79]

Disclosure of business relations that exceed ordinary course of business and disclosure of special personal relationship: Paragraph 7 of Exchange Act Rule 17g-5(b) lists as a conflict of interest if an NRSRO permits its employees to have a business relationship that is beyond an arms length ordinary course of business relationship with a rated entity.[80] However, there is no outright prohibition in the SEC Rules against an NRSRO issuing credit ratings when such conflict exists. The lack of restriction is due to the difficulty in defining exactly what types of business relationships exceed ordinary course of business—the issue must be determined on a case-by-case basis because a relationship that is an arms length ordinary course of business relationship in one situation may not be so in another. The SEC Rules

porate Agent or their Immediate Family Members. Upon request, Corporate Agents are required to provide A.M. Best with original copies of all brokerage account statements, including trade confirmations, for all such accounts held by the Corporate Agent and their Immediate Family Members." Likewise, Realpoint LLC Code of Ethics § III.G (2007), *available at* https://www.realpoint.com/PublicDocs/NRSRO%20Application.pdf, provides: "Every Access Person should direct each broker, dealer, or bank who maintains an account for Covered Securities of which such Access Persons has direct or indirect Beneficial Ownership, to supply to Realpoint's copies of confirmations of all transactions in the account and copies of periodic statements for the account." *See also* Standard & Poor's Code of Ethics, *supra* note 72, § A.IV.B.2.

77. 17 C.F.R. § 240.17g-5(c)(4) (2009).

78. For example, A.M. Best Policy, *supra* note 76, §§ III.2.2(a)(iii)–(iv) provides that no corporate agent may serve in any capacity "on any government or public agency, authority, commission, or regulatory body, to the extent any such service may give rise to an actual or perceived conflict of interest" or "on any self-regulatory body that has any function in the oversight of the insurance, financial services, health care, or capital markets, to the extent any such service may give rise to an actual or perceived conflict of interest."

79. For example, Realpoint Code of Ethics, *supra* note 76, § II.E provides: "You may not serve on the board of directors or other governing board of a publicly traded company, unless you have received the prior written approval of the Compliance Company of Realpoint. Approval will not be given unless a determination is made that your service on the board would be consistent with the interests of our Clients."

80. 17 C.F.R. § 240.17g-5(b) (2009).

simply require NRSROs to establish policies and procedures to manage such conflict and disclose in Exhibit 6 of Form NRSRO[81] the existence of the conflict.[82] Every credit rating agency currently registered as an NRSRO has internal rules that prohibit employees from participating in rating if he or she has a business relationship with the rated entity that is beyond the ordinary course of business.[83] NRSROs also require employees to report any such business relationships to designated officers.[84] Some NRSROs explicitly prohibit employees from borrowing money from rated entities except in the ordinary course of business.[85]

Special personal relationship between a credit rating analyst and a rated entity (such as having a spouse or relative who works for the rated entity) is not explicitly listed as a conflict of interest in Exchange Act Rule 17g-5(b) nor explicitly prohibited in Exchange Act Rule 17g-5(c). However, the internal rules of most credit rating agencies prohibit an employee from participating in credit rating if he maintains any special personal relationship with the rated entity, including, but not limited to, having an immediate family member who works for the rated entity.[86] Rating agencies typically require their employees to

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81. Exchange Act Rule 17g-1(a) provides that a credit rating agency applying to register as an NRSRO must furnish an application on Form NRSRO (Application for Registration as a Nationally Recognized Statistical Rating Organization (NRSRO)). 17 C.F.R. § 240.17g-1(a) (2009).

82. *See* June 2007 Adopting Release, *supra* note 20 at 33,577.

83. For example, Standard & Poor's Ratings Services Code of Conduct § 2.13 (2008), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/Ratings_Services_Code_of_Conduct_December_2008.pdf, provides: "No Analyst shall participate in or otherwise influence the determination of a rating in a rating committee for any particular issuer or issue if . . . [w]ithin the six months immediately preceding the date of the meeting of the rating committee, the Analyst has had a recent employment or other significant business relationship with the rated entity that may cause or may be perceived as causing a conflict of interest." *See also* Fitch Code of Conduct, *supra* note 71, § 2.2.13; Moody's Code of Conduct, *supra* note 72, § 2.13.

84. For example, DBRS Code of Conduct, *supra* note 74, § 2.13, provides: "Analytical Personnel members must also inform the relevant Rating Committee of any of the following situations: . . . (b) the Analytical Personnel had a recent employment or other significant business relationship with the Issuer."

85. For example, Standard & Poor's Code of Ethics, *supra* note 72, § B.3 provides: "No Covered Employee or Immediate Family member may borrow from or be indebted to any issuer or client other than loans from lending institutions or broker-dealers made in the ordinary course of business and on ordinary commercial terms."

86. For example, Fitch Code of Conduct, *supra* note 71, § 2.2.13, provides: "[N]o Fitch employee shall participate in or otherwise influence the determination of Fitch's rating of any particular entity or obligation if the employee . . . has an immediate relation . . . who currently works for the rated entity; or [h]as, or had, any other relationship with the rated entity or any affiliate thereof that may cause or may be perceived as causing a conflict of interest." *See also* Moody's Code of Conduct, *supra* note 72, § 2.13.

disclose to designated authorities any special relationship with the rated entity that could potentially give rise to conflicts of interest.[87]

Restrictions on gifts: Exchange Act Rule 17g-5(c)(7) prohibits an NRSRO from issuing or maintaining a credit rating "where a credit analyst who participated in determining or monitoring the credit rating, or a person responsible for approving the credit rating received gifts, including entertainment, from the obligor being rated, or from the issuer, underwriter, or sponsor of the securities being rated, other than items provided in the context of normal business activities such as meetings that have an aggregate value of no more than $25."[88] The purpose of this rule is to eliminate the potential undue influence that gifts can have on people who are responsible for determining credit ratings. Every credit rating agency currently registered as an NRSRO has internal rules that prohibit employees (not just employees involved in credit rating) from receiving gifts exceeding a minimal monetary value from persons with whom the NRSRO maintains a business relationship.[89] Some rating agencies also prohibit employees' immediate family members from receiving gifts from entities rated by the agency.[90]

Restrictions on analyst compensation: A rating analyst whose compensation depends in whole or in part on the revenues paid by the issuers that he rates has an incentive to issue unduly high ratings in order to attract the business of debt issuers. It is worth noting that neither Section 15E of the Exchange Act nor Rule 17g under the Act

87. For example, Fitch Code of Conduct, *supra* note 71, § 2.2.16 provides: "[A]ny Fitch analyst who becomes involved in any personal relationship that creates the potential for any real or apparent conflict of interest . . . shall, subject to applicable law, disclose such relationship to the appropriate manager or officer of Fitch."

88. *See* 17 C.F.R. § 240.17g-5(c)(7) (2009).

89. *See* JCR Code of Conduct art. 26 (2008), *available at* http://www.jcr.co.jp/english/criterion/pdf/coce_e20081222.pdf; DBRS Code of Conduct, *supra* note 74 § 2.15; Realpoint Code of Ethics, *supra* note 76, § II.D; Fitch Code of Conduct, *supra* note 71, § 2.2.15; Moody's Code of Conduct, *supra* note 72, § 2.15; Standard & Poor's Code of Conduct, *supra* note 83, § 2.15.

90. For example, A.M. Best Code of Conduct, *supra* note 76, §§ III.2.2(c)–(d), provides: "[Corporate Agents not involved in rating] are prohibited from accepting gifts, benefits, services or anything similar (collectively gifts) totaling more than $100 annually from any Restricted Company . . . [Corporate Agents involved in rating] and all members of [their] Immediate Famil[ies] are prohibited from accepting gifts, benefits, services, entertainment, or anything similar (collectively gifts) from Restricted Company[.]" *See also* Egan-Jones Ratings Company Code of Ethics and Business Conduct, "Fair Dealing" section (2008), *available at* http://www.egan-jones.com/assets/docs/Form_NRSRO_July_2008.pdf: "[Employees] and members of [their] family may not accept gifts or special favors (other than an occasional non-cash gift of nominal value) from any person or organization with which the Firm has a current or potential business relationship."

explicitly prohibits an NRSRO from compensating credit analysts based on the fees paid by entities subject to their ratings. This lack of regulatory prohibition could be due to the fact that most rating agencies have internal rules that provide for the separation of analysts' compensation or evaluation from the fees that their ratings generate.[91]

B. Regulations Targeting Conflicts of Interest at the Rating Agency Level

Part I of this paper lists the main sources of conflicts of interest at the credit rating agency level as: (1) the rating agency's affiliation with the underwriter or issuer of the securities subject to rating, (2) the rating agency's provision of ancillary services to rated entities, (3) large subscribers to credit ratings that hold rated securities in their portfolios and thus exert undue influence over credit ratings, and (4) payments by issuers to credit rating agencies for the provision of ratings. The following paragraphs discuss how the current regulatory framework addresses these types of conflicts of interest.

Affiliated underwriter or issuer: Exchange Act Rule 17g-5(c)(3) prohibits an NRSRO from having a conflict relating to the issuance of a credit rating where the rated entity or the underwriter is a person associated with the NRSRO (i.e., a company directly or indirectly controlling, controlled by, or under the common control with, the NRSRO).[92] The SEC believes that the market does not have a need for credit ratings from rating agencies that are affiliated with the underwriter or the issuer when other NRSROs are available to determine credit ratings for these companies. When a need does arise, as in the case where an NRSRO or its affiliated underwriter or issuer cannot obtain a rating from another NRSRO, the SEC will entertain requests for exemption from this prohibition.[93] Credit rating agencies must identify persons associated with the NRSRO who are brokers or dealers in the business of underwriting securities or money market instruments in Exhibit 6 of Form NRSRO.

Provision of ancillary services: Exchange Act Rule 17g-5(c)(5) was added to the SEC Rules in the February 2009 Adopting Release.[94] This paragraph prohibits an NRSRO from issuing or maintaining a

91. *See* A.M. Best Code of Conduct, *supra* note 76, § I.2.11; DBRS Code of Conduct, *supra* note 74, § 2.11; Fitch Code of Conduct, *supra* note 71, § 2.2.11; JCR Code of Conduct, *supra* note 89, at art. 22; Moody's Code of Conduct, *supra* note 72, § 2.11(a); Standard & Poor's Code of Conduct, *supra* note 83, § 2.11.a.

92. 17 C.F.R. § 240.17g-5(c)(3) (2009).

93. *See* June 2007 Adopting Release, *supra* note 20, at 33,599.

94. *See* Feb. 2009 Adopting Release, *supra* note 21, at 6,479.

credit rating with respect to an obligor or security where the NRSRO or a person associated with the NRSRO "made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security."[95] The SEC believes that an NRSRO cannot remain objective when rating its own work or that of an affiliate.[96] Exchange Act Rule 17g-2(a)(5) requires an NRSRO to make a record listing the types of services and products offered by the NRSRO. This record will be useful in helping the SEC to identify potential conflicts of interest that arise from such activities. Furthermore, Section 15E(i)(1)(C) of the Exchange Act[97] and paragraphs (1), (2) and (3) of Exchange Act Rule 17g-6(a) prohibit conditioning or threatening to condition the issuance or modification of a credit rating on the purchase by the obligor or its affiliate of ancillary services from an NRSRO or any person associated with such NRSRO.[98] NRSROs are also required to keep detailed records of all communications with entities to whom rating services are provided and all records of complaints against the NRSRO or any of its rating personnel for at least three years.[99]

Large subscriber influence: Large subscribers to credit ratings whose portfolios include rated securities may pressure credit rating agencies into providing ratings that enhance their portfolio values. Under Exchange Act Rule 17g-5(b)(5), NRSROs are only required to warn investors, in Exhibit 6 of Form NRSRO, that such a conflict exists and to maintain policies and procedures to manage this conflict. The SEC Rules do not prescribe any specific policies or procedures that must be followed by NRSROs, but the SEC has stated that policies and procedures designed to keep persons within the NRSRO who

95. 17 C.F.R. § 240.17g-5(c)(5) (2009).

96. *See* Feb. 2009 Adopting Release, *supra* note 21, at 6,465.

97. 15 U.S.C. § 78o-7(i)(1)(C) (2006).

98. Exchange Act Rule 17g-6(a)(1) prohibits conditioning or threatening to condition the issuance of a credit rating on the purchase by the obligor or its affiliate of ancillary services from an NRSRO or any person associated with such NRSRO. Exchange Act Rule 17g-6(a)(2) prohibits an NRSRO from issuing, or offering or threatening to issue, a credit rating that is not determined in accordance with the NRSRO's established procedures for determining credit ratings based on whether the rated person purchases or will purchase the credit rating or another product or service. Exchange Act Rule 17g-6(a)(3) prohibits an NRSRO from modifying, or offering or threatening to modify, a credit rating in a manner contrary to its procedures for modifying a credit rating based on whether the rated person, or an affiliate of the rated person, purchases or will purchase the credit rating or any other service or product of the NRSRO and its affiliates. 17 C.F.R. § 240.17g-6 (2009).

99. *See* discussion *infra* Part II.C (detailing recordkeeping requirements in the SEC Rules).

participate in the rating process free of the undue influence of clients will be a way of addressing this conflict. To help the SEC examiners in identifying subscribers who may have exercised undue influence on credit ratings, Section 15E(a)(1)(B)(viii) of the Exchange Act[100] and Exhibit 10 of Form NRSRO[101] require that an application for registration as an NRSRO include, on a confidential basis, a list of the twenty largest issuers, underwriters and subscribers that use the credit rating services provided by the credit rating agency by the amount of the net revenue received by the credit rating agency in the fiscal year immediately preceding the date of submission of the NRSRO application. Moreover, Exchange Act Rule 17g-2(a)(4) requires an NRSRO to make an account record for each subscriber to the credit ratings and/or credit analysis reports of the NRSRO.[102]

Paid-by issuer conflict: Numerous provisions in the SEC Rules target this type of conflict.

First, Exchange Act Rule 17g-5(c)(1) prohibits an NRSRO from having a conflict of interest relating to the issuance of a credit rating where the person soliciting the credit rating was the source of ten percent or more of the total net revenue of the NRSRO during the most recently ended fiscal year.[103] This restriction is based on the SEC's conviction that it is difficult for the NRSRO to remain impartial with regard to such a person, given the impact on the NRSRO's income if the person withdrew his or her business. However, this prohibition is unlikely to have any immediate binding effect on major rating agencies in the corporate bond market because these agencies rate thousands of entities, and fees from a single entity typically constitute less than ten percent of the total revenues. In the structured finance market, a large sponsor potentially could reach the ten percent revenue threshold. The SEC has rejected suggestions that exemptions be granted on a case-by-case basis for the reason that ten percent is already a very high threshold.[104] Major rating agencies are required by their internal rules to disclose publicly the identities of persons who contributed to ten percent or more of the agency's revenues in the previous year.[105]

100. 15 U.S.C. § 78o-7(a)(1)(B)(viii) (2006).

101. SEC Form NRSRO, Instructions to Exhibit 10, *available at* http://www.sec.gov/about/forms/formnrsro.pdf.

102. 17 C.F.R. § 240.17g-2(a)(4) (2009).

103. 17 C.F.R. § 240.17g-5(c)(1) (2009).

104. *See* June 2007 Adopting Release, *supra* note 20, at 33,598.

105. For example, A.M. Best Code of Conduct, *supra* note 76, § I.2.8.b provides: "AM Best shall disclose if it receives 10 percent or more of its annual revenue from a single issuer, originator, arranger, client or subscriber (including any affiliates of the

Second, paragraph 6 of the Exchange Act Rule 17g-5(c) prohibits 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."[106] The purpose of this rule is to remove the persons most directly involved in the rating process from fee negotiations and, thereby, to insulate them from a process that could make them more or less favorably disposed toward certain clients. In response to concerns by small NRSROs that they may need to have some analysts or model developers to participate in fee discussions given their limited staffing levels, the SEC has agreed to review requests for exemptions based on the specific circumstances of each case.[107]

Third, as discussed before, an NRSRO must disclose, albeit to the SEC only on a confidential basis, the identities of its largest issuer and subscriber clients.[108] The purpose for requiring NRSROs to make this disclosure is to allow SEC examiners to identify persons that could potentially have undue influence over an NRSRO.[109] A thorough examination of the legislative history of the Credit Rating Agency Reform Act of 2006 fails to reveal any discussion or debate on the rationale for maintaining the confidentiality of the identities of large clients of credit rating agencies.[110] Anecdotally the confidential treat-

issuer, originator, arranger, client or subscriber)." *See also* DBRS Code of Conduct, *supra* note 74, § 2.8; JCR Code of Conduct, *supra* note 89, at art. 20; Moody's Code of Conduct, *supra* note 72, § 2.8(b).

106. 17 C.F.R. § 240.17g-5(c)(6) (2009).

107. *See* Feb. 2009 Adopting Release, *supra* note 21, at 4648.

108. *See* June 2007 Adopting Release, *supra* note 20, at 33,579.

109. *See id.* at 33,580.

110. *See* S. REP. NO. 109-326 (2006); 152 CONG. REC. S10,011 (daily ed. Sept. 22, 2006); 151 CONG. REC. S6,934 (daily ed. June 21, 2005); *see also Assessing the Current Oversight and Operations of Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2006) (statements of Paul Schott Stevens, President, Investment Company Inst., Alex J. Pollock, Resident Fellow, American Enterprise Inst., Vickie A. Tillman, Executive Vice President, Standard & Poor's, Frank Partnoy, Professor, Univ. of San Diego School of Law, Colleen S. Cunningham, President and CEO, Fin. Executives Int'l, Damon A. Silvers, Assoc. General Counsel, AFL-CIO, Jeffrey J. Diermeier, President and CEO, CFA Inst., Sen. Richard Shelby, Chairman, S. Comm. on Banking, Housing, and Urban Affairs, Sen. Paul S. Sarbanes); *Examining the Role of Credit Rating Agencies in the Capital Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2005) (statements of Sen. Paul S. Sarbanes, Raymond W. McDaniel, President and Chief Operating Officer, Moody's Investors Service, James A. Kaitz, President and CEO, Ass'n for Fin. Prof'ls, Stephen W. Joynt, President and CEO, Fitch Ratings, Micah S. Green, President, Bond Market Ass'n, Sean J. Egan, Managing Director,

ment of such information is intended to protect the "proprietary information" of credit rating agencies.[111] The SEC has recently proposed a new rule that would require an NRSRO to disclose, on its website and on an annual basis, the relative standing (e.g., top ten percent, top twenty-five percent, top fifty percent, bottom fifty percent, and bottom twenty-five percent) of each person that paid the NRSRO to issue or maintain a credit rating in terms of the person's contribution to the revenue of the NRSRO for the fiscal year as compared with other persons who provided the NRSRO with revenue.[112] If adopted, this new rule would be a major improvement to the current regulation in providing the public with information necessary to assess the impartiality of credit rating agencies.

Fourth, a number of recordkeeping requirements are imposed on NRSROs to facilitate the SEC in identifying ratings that might have been subject to undue influences from the rated entities. Exchange Act Rule 17g-2(a)(1) requires an NRSRO to make records of original entries into an NRSRO's accounting system, and records reflecting entries to balances in all general ledger accounts of the NRSRO for each fiscal year.[113] These records will provide the SEC examiners with the source information that feeds into the Exchange Act Rule 17g-3 financial reports. In addition, Exchange Act Rule 17g-2(a)(3) requires an NRSRO to make an account record for each person (for example, an obligor, issuer, underwriter, or other user) that has paid for the issuance or maintenance of a credit rating.[114]

Fifth, Paragraph (d) of Rule 17g-2 requires that an NRSRO make available to the public on a six-month delayed basis a random sample of ten percent of the issuer-paid credit ratings and their rating histories.[115] This disclosure requirement applies to each class of credit ratings for which the NRSRO is registered and has issued 500 or more ratings that are paid for by the rated entity or issuer or underwriter of the security being rated. In addition, a new subparagraph (3) was ad-

Egan-Jones Ratings Co., Cathleen A. Corbet, President, Standard & Poor's, Sen. Richard Shelby, Chairman, S. Comm. on Banking, Housing, and Urban Affairs).

111. Thanks to my research assistant, Adam Bennett, who made an inquiry to the staff of the Senate Banking Committee in June 2009 about the rationale for this confidential disclosure. The email response from the Committee staff suggested that the confidential treatment was intended to protect the proprietary information of credit rating agencies.

112. Nov. 2009 Proposing Release, *supra* note 22.

113. 17 C.F.R. § 240.17g-2(a)(1).

114. 17 C.F.R. § 240.17g-2(a)(3).

115. The delay in disclosure is intended to minimize the negative economic impact of the rule on some rating agencies that sell rating data to subscribers. *See* Feb. 2009 Adopting Release, *supra* note 21, at 6474.

ded to Paragraph (d) of Rule 17g-2 in the Nov. 2009 Adopting Release which requires an NRSRO to disclose on a delayed basis the ratings histories for all ratings (whether or not issuer-paid) initially determined on or after June 26, 2007.[116] The purpose of these requirements is to provide the public with the data suitable for performing statistical analyses of NRSRO ratings paid by issuers and to allow the public to develop and compare performance metrics across different NRSROs by ratings classes.[117]

Sixth, Rule 17g-5, which was recently amended in the Nov. 2009 Adopting Release, requires an NRSRO that is hired to rate a structured finance product to provide on its website information pertinent to its rating to other NRSROs who have not been hired to rate the product. The purpose of this requirement is to increase the number of credit ratings extant for a given structured finance product and thus provide users of credit ratings with more views on the creditworthiness of the structured finance product. In addition, by opening up the process to more NRSROs, this disclosure requirement will increase the likelihood that any inappropriate rating inflation could be detected through the credit ratings issued by other NRSROs.[118]

Seventh, to deter rate shopping by debt issuers for the most favorable rating and the resultant rating inflation by credit rating agencies, the SEC proposed further rule changes in the October 2009 Proposing Release[119] that would make it mandatory for debt issuers to disclose in offering registration documents any preliminary ratings about the debt issue assigned by any rating agency other than the rating agency selected to provide the final rating. As of January 1, 2010, this proposal has not been adopted into the law but so far there has not been strong opposition to this proposal in the comments submitted by the public. Therefore, it is expected that this proposed disclosure requirement will be finalized into law in the near future.

The Cuomo Agreement[120] imposes additional requirements on the "Big Three" credit rating agencies for residential mortgage-backed securities. Instead of following the typical practice of providing free initial reviews of loan pools and receiving compensation only if the rating agency is finally selected to issue a rating on the product, the "Big Three" agreed to adopt a new fee-for-service mechanism whereby they will be compensated regardless of whether the invest-

116. *See* Nov. 2009 Adopting Release, *supra* note 21, at 63,837.
117. *See* Feb. 2009 Adopting Release, *supra* note 21, at 6461.
118. *See* Nov. 2009 Adopting Release, *supra* note 21, at 63,844.
119. *See* Oct. 2009 Proposing Release, *supra* note 22, at 53,097.
120. *See supra* note 65 and accompanying text.

ment bank ultimately selects them to rate a residential mortgage-backed security. In addition, credit rating agencies will disclose information about all securitizations submitted for their initial review. This disclosure will enable investors to determine whether issuers sought, but subsequently decided not to use, ratings from a credit rating agency.

C. Other Provisions Pertinent to the Management and Control of Conflicts of Interest

Establish internal policies and procedures to manage conflicts of interest: Section 15E(h) of the Exchange Act requires that applicants for NRSRO and existing NRSROs establish, maintain, and enforce procedures to address and manage conflicts of interest.[121] A copy of such procedures must be included in Form NRSRO. SEC rules do not prescribe specific policies or procedures to be adopted by an NRSRO, as the SEC believes that rating agencies are in the best position to establish policies and procedures that fit their specific circumstances.

Disclose rating methodologies and procedures: Section 15E(a)(1)(B)(ii) of the Exchange Act requires that an application for registration as an NRSRO contain information regarding the procedures and methodologies used by the credit rating agency to determine credit ratings.[122] Exchange Act Rule 17g-1 requires that such disclosures be made in Exhibit 2 of Form NRSRO. The disclosure must be sufficiently detailed to provide users of credit ratings with an understanding of the process the applicant or NRSRO uses in determining credit ratings.[123] This requirement is intended to enhance transparency in the rating process so that investors can form an independent assessment of the fairness of ratings issued by NRSROs.

Disclose performance statistics: NRSROs are required to disclose in Exhibit 1 of Form NRSRO performance measurement statistics over one, three, and ten year periods through the most recent calendar year-end. The disclosure must reveal historical ratings transition and default rates within each of the credit rating categories, notches, grades, or rankings used by the NRSRO.[124] The default statistics must include defaults relative to the initial rating.[125] Moreover, NRSROs must describe how they derive their statistics in sufficient

121. 15 U.S.C. § 78o-7(h) (2006).
122. 15 U.S.C. § 78o-7(a)(1)(B)(ii) (2006).
123. SEC Form NRSRO, *supra* note 101, Instructions to Exhibit 2.
124. *Id.* at Instructions to Exhibit 1.
125. *Id.*

detail to allow users of credit ratings to understand the measures.[126] The SEC Rules do not otherwise define or identify particular credit rating performance statistics that must be disclosed. The performance disclosure is intended to provide users with some basis to compare different NRSROs even if the statistics are not derived from similar measures. Moreover, the disclosure could enhance competition by making it easier for smaller credit rating agencies to develop proven track records of determining accurate credit ratings.

Retain detailed records of complaints, rating process, auditing results and communications: Exchange Act Rule 17g-2(b)(8) requires NRSROs to retain records of any written complaints from a person not associated with the NRSRO about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.[127] The purpose of this rule is to give the SEC examiners the opportunity to review files of external complaints and to follow up with the relevant persons within the NRSRO as to how a complaint was handled. The SEC hopes that this provision will "reduce the willingness of an NRSRO to re-assign or terminate a credit analyst to placate a client that desires a different rating."[128]

Exchange Act Rule 17g-2(a)(2) requires an NRSRO to make a record with respect to each of the NRSROs' current credit ratings of the identity of any credit analyst(s) that participated in the determination of the credit rating, the identity of the person(s) who approved the credit rating before it was issued, and whether the credit rating was solicited or unsolicited and the date of the rating action.[129] This record will facilitate SEC examiners in identifying employees of rating agencies who were involved in possibly inappropriate rating actions (such as coercive practices through issuing unsolicited ratings) and thus will assist the SEC examiners in the investigation of alleged rating abuses. This recordkeeping requirement is also intended to foster the accountability of analysts because inappropriate rating actions can easily be traced back to those whose names are associated with the actions.

Exchange Act Rule 17g-2(a)(2) was amended in February 2009 to require NRSROs to make a record documenting the reasons when a final credit rating of a structured finance product materially deviates from the rating implied by a quantitative model if the model is a sub-

126. *Id.*
127. 17 C.F.R. § 240.17g-2(b)(8) (2009).
128. *See* Feb. 2009 Adopting Release, *supra* note 21, at 6464.
129. 17 C.F.R. § 240.17g-2(a)(2) (2009).

stantial component of the rating process.[130] The purpose of this rule is to enhance the recordkeeping process in order to enable SEC examiners, as well as an NRSRO's internal auditors, to understand the methodologies through which analysts developed the credit ratings. Without such a recordkeeping requirement, it would be difficult for SEC examiners to determine whether an NRSRO adhered to its stated methodologies in determining ratings and whether adjustments to the result implied by the model were made by applying appropriate qualitative factors permitted under the NRSRO's documented procedures. The records will help detect any deviation from established rating methodologies because of undue influence from the person seeking the credit rating or other factors prohibited by law.

Exchange Act Rule 17g-2(b)(2) requires an NRSRO to retain internal records, including nonpublic information and work papers, used to form the basis of a credit rating.[131] This requirement applies, for example, to notes of conversations with the management of an issuer or obligor that was the subject of the credit rating and to the inputs and raw results of a quantitative model used to determine the credit rating. Again, the purpose of requiring the retention of internal records is to facilitate the SEC examiners in reviewing whether an NRSRO is adhering to its established procedures and methodologies for determining credit ratings.

Exchange Act Rule 17g-2(b)(4) requires an NRSRO to retain compliance reports and compliance exception reports.[132] In addition, Rule 17g-2(b)(5) requires an NRSRO to retain internal audit plans, internal audit reports, documents relating to internal audit follow-up measures, and all records identified by its internal auditors as necessary to perform the audit of an activity that relates to its business as a credit rating agency.[133] The purpose of this recordkeeping requirement is for SEC examiners to identify any compliance or control concerns raised by the NRSRO's compliance officers and internal auditors and to review how the NRSRO addressed those concerns. Based on its experience in the enforcement of a similar provision with regard to broker-dealers,[134] the SEC believes that requiring credit rat-

130. Credit rating agencies expressed concern over the possibility that the rule could lead to the overemphasis of quantitative models at the expense of applying qualitative factors. Partly due to these comments, the SEC has narrowed the application of the rule to ratings of structured finance products. *See* Feb. 2009 Adopting Release, *supra* note 21, at 6471.

131. 17 C.F.R. § 240.17g-2(b)(2) (2009).

132. 17 C.F.R. § 240.17g-2(b)(4) (2009).

133. 17 C.F.R. § 240.17g-2(b)(5) (2009).

134. 17 C.F.R. § 240.17a-4(b)(5) (2009).

ing agencies to keep such reports will not chill the robust functioning of the compliance and internal auditing departments as feared by some commentators to the rule.[135]

Exchange Act Rule 17g-2(b)(7) requires an NRSRO to retain external and internal communications, including emails, received and sent by the NRSRO and its employees that relate to "initiating, determining, maintaining, changing, or withdrawing a credit rating."[136] The retention of written communications has played an important role in assisting its staff in identifying legal violations and compliance issues with respect to other regulated entities (such as broker-dealers) and will likely perform an equally important role in assisting the SEC in identifying violations and compliance issues in its oversight of NRSROs.

Finally, Exchange Act Rule 17g-2(c) provides that all records required under the above discussed rules must be retained for at least three years after they are made or received.[137]

D. *Civil Liabilities of Credit Rating Agencies*

Civil liabilities, if any, may also function as deterrence to dishonest behaviors by NRSROs and their analysts. However, NRSROs are notoriously insulated from civil liabilities by explicit statutory immunities and the First Amendment. NRSROs are immune from liability for misstatements in a registration statement under Section 11 of the Securities Act of 1933[138] if their ratings appear in a prospectus for a public offering of a security registered under that Act. The exemption of NRSROs from the normal liability provisions of Section 11 of the Securities Act means that NRSROs are not held to a negligence standard of care. Securities Act Rule 436 explicitly provides that a credit rating prepared by an NRSRO is not considered a part of the registration statement filed by the securities issuer under Section 11 of the Securities Act.[139] Thus, the credit rating agency is not responsible for

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135. *See* June 2007 Adopting Release, *supra* note 20, at 33,587.

136. 17 C.F.R. § 240.17g-2(b)(7) (2009).

137. 17 C.F.R. § 240.17g-2(c) (2009).

138. 15 U.S.C. § 77k (2006).

139. Rule 436(g)(1) provides: "Notwithstanding the provisions of paragraphs (a) and (b) of this section, the security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization, or with respect to registration statements on Form F-9 by any other rating organization specified in the Instruction to paragraph (a)(2) of General Instruction I of Form F-9, shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act." 17 C.F.R. § 230.436 (2009).

mistakes in the rating under Section 11 of the Securities Act.[140] Regulation S-K, which contains standard instructions for filing forms under the Securities Act and the Exchange Act, has similar provisions of exemptions.[141]

Credit rating agencies argue that their ratings are "opinions" with regard to the creditworthiness of the rated entity and thus are protected by the First Amendment.[142] This view is shared by leading experts on the U.S. Constitution who believe that credit rating agencies are protected so long as they are not paid to write positive reviews (as opposed to reviews generally), and so long as they are communicating to the public rather than to a few private subscribers or to a particular entity that hires them to give individualized advice.[143]

Credit rating agencies have found themselves in court before. They emerged as the winner on the issue of whether they can be held liable for mistakes in their ratings that are issued to the public in general. In *County of Orange v. McGraw Hill Companies, Inc.*, Orange

140. The SEC is soliciting public comments on whether the provisions in Rule 436 that exempt credit rating agencies from liabilities under Section 11 of the Securities Act of 1933 should be rescinded. *See* Concept Release on Possible Rescission of Rule 436(g) under the Securities Act of 1933, Securities Act Release No. 33-9071, 74 Fed. Reg. 53,114 (Oct. 15, 2009). As of January 1, 2010, those provisions have not been adopted.

141. Item 10(c) of Regulation S-K provides: "In view of the importance of security ratings (*ratings*) to investors and the marketplace, the Commission permits registrants to disclose, on a voluntary basis, ratings assigned by rating organizations to classes of debt securities, convertible debt securities and preferred stock in registration statements and periodic reports. In addition, the Commission permits, pursuant to Rule 134(a)(14) under the Securities Act . . . voluntary disclosure of ratings assigned by any nationally recognized statistical rating organizations (*NRSROs*) in certain communications deemed not to be a prospectus (*tombstone advertisements*). Set forth herein are the Commission's views on important matters to be considered in disclosing security ratings." 17 C.F.R. § 229.10 (2009).

142. For example, the boilerplate disclaimer of liability in Moody's rating announcements state the following: "CREDIT RATINGS ARE MOODY'S INVESTORS SERVICE, INC.'S (MIS) CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. . . . CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. . . . MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE." *See, e.g.*, Press Release, Moody's Investors Service, Moody's Assigns Aa3 to Manhattan Beach USD (CA) 2009 GO Bonds (June 19, 2009) (on file with author).

143. *See, e.g.*, *Approaches to Improving Credit Rating Agency Regulation: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Government*, 111th Cong. 15–16 (2009) (statement of Eugene Volokh, Gary T. Schwartz Professor of Law, U.C.L.A. School of Law).

County sued Standard & Poor's parent company claiming that Standard & Poor's breached the rating agreement by providing rating analysis which wrongly stated the county's financial condition and ability to repay the debt.[144] The county claimed that it would not have marketed the debt securities in 1993 and 1994 without the ratings that the rating agency provided.[145] In addition, the county alleged that the rating agency negligently performed its rating services and should be held to tort liability.[146] The defendant moved for summary judgment.[147] The court held that a credit rating agency's speech was protected by the First Amendment and thus could only be subject to tort liability if it was made with actual malice.[148] The court granted summary judgment to the defendant for ratings performed on debt securities offered in 1993, as there was strong evidence that the county had a solid track record of repaying its debts, and therefore Standard & Poor's did not act with reckless disregard for the truth at that time.[149] The court rejected summary judgment for ratings performed on debt securities offered in 1994 because it believed that there was a genuine issue of material fact with regard to whether Standard & Poor's acted with reckless disregard for the truth.[150] Standard & Poor's settled the case for $140,000 but admitted no wrongdoing. The $140,000 represented a partial refund of the ratings fees paid by the county.

In *Jefferson County School District No. R-1 v. Moody's Investor's Services, Inc.*, the court held that credit ratings are statements of opinion relating to matters of public concern which receive full constitutional protection except for false factual statements.[151] Additionally, the plaintiff's claim for intentional interference with contract and business relations arising from Moody's issuance of negative unsolicited ratings on the plaintiff's debt securities was barred by the First Amendment.[152]

In *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, the plaintiff was the Connecticut Resources Recovery Authority (CRRA) that issued bonds to finance the operation of waste disposal projects.[153] Enron Corporation became involved in the project.[154]

144. 245 B.R. 151, 153–54 (Bankr. C.D. Cal. 1999).
145. *Id.* at 154.
146. *Id.*
147. *Id.* at 153.
148. *Id.* at 154.
149. *Id.* at 160.
150. *Id.* at 161.
151. 175 F.3d 848, 852, 856 (10th Cir. 1999).
152. *Id.* at 857, 858.
153. 511 F. Supp. 2d 742, 752 (S.D. Tex. 2005).

CRRA provided an unsecured loan of $220 million to Enron and structured the repayment of this loan in monthly payments over an eleven-and-one-half-year period.[155] When Enron stopped payments to CRRA in breach of the agreement, CRRA sued, among other defendants, Standard & Poor's, Fitch, and Moody's under the doctrine of negligent misrepresentation for publishing unduly favorable reports on the debtor's creditworthiness.[156] The court held that absent actual malice, the credit rating agencies were entitled to First Amendment protection against the lender's claims of negligent misrepresentation.[157] The court also held that credit rating agencies did not owe a duty of care to CRRA for the loan that it extended to Enron in reliance on the credit ratings because to hold otherwise would chill the participation of credit rating agencies in the operation of the financial market.[158] The court granted the credit rating agencies' motion to dismiss the negligent misrepresentation claim.[159]

In *Commercial Financial Services, Inc. v. Arthur Andersen LLP*, the plaintiff, a debt purchasing and collecting company, sued Arthur Andersen LLP for professional malpractice as a result of its failure to properly audit the financial statements of the trusts that issued the asset-back securities purchased by the plaintiff.[160] Arthur Andersen brought third-party claims for contribution against Standard & Poor's, Moody's, and Fitch by alleging negligent misrepresentation by the credit rating agencies for giving the securities unduly high ratings.[161] The credit rating agencies *were employed by the plaintiff* to rate the certificates issued by the trusts.[162] Arthur Andersen argued that the asset securitization plan was dependent on those ratings, and that the plan could never have been implemented without the favorable ratings.[163] The district court granted the rating agencies' motions to dismiss, but the appellate court reversed, holding that the First Amendment did not shield credit rating agencies from potential liabilities in this particular case because they were retained by the plaintiff to assess the quality of debt the latter was purchasing.[164] The court held that the relationship between these parties went beyond a rela-

154. *Id.* at 753.
155. *Id.*
156. *Id.* at 758.
157. *Id.* at 825.
158. *Id.* at 827.
159. *Id.*
160. 94 P.3d 106, 108 (Okla. Civ. App. 2004).
161. *Id.*
162. *Id.*
163. *Id.*
164. *Id.* at 109, 110.

tionship between a journalist and the subject and was more analogous to that of a client and the client's certified public accountant.[165] A similar reasoning was used by the court in *In re Fitch, Inc.*,[166] to hold that Fitch could not refuse to comply with the plaintiff's subpoena on the grounds of journalistic privilege.

The collapse of the subprime-mortgage market and the dramatic devaluation of credit instruments associated with subprime mortgages have once again put credit rating agencies in the centers of lawsuits. The California Public Employees' Retirement System (Calpers), which manages $178 billion of investments on behalf of 1.6 million public employees in California and their families, is among the latest in a long line of investors to have launched lawsuits against the "Big Three" credit rating agencies. The lawsuit was brought before the California Superior Court in San Francisco in July 2009. Calpers claims that it lost around $1 billion on securities that the agencies had said were as safe as government bonds.[167] The pension fund invested $1.3 billion in bonds issued by three structured investment vehicles (SIVs) whose assets included mortgage derivatives and other repackaged loans.[168] All the bonds were given the gold-plated AAA credit rating, yet all three SIVs collapsed amid the market turmoil of 2007 and 2008.[169]

Investors are voicing their discontent of the immunity enjoyed hitherto by credit rating agencies under the securities law statutes and the First Amendment.[170] It is difficult to predict how this growing public resentment might influence the outcome of the subprime-related cases that have been filed in courts. However, the plaintiffs face an uphill battle given the consensus in prior cases and expert opinions that publicly issued credit ratings are constitutionally protected "opinions."

The current (as of January 1, 2010) state of the regulation of conflicts of interest in the credit rating industry can be summarized as follows: With regard to conflict at the rating analyst level, the law

165. *Id.* at 110.
166. 330 F.3d 104, 111 (2d Cir. 2003).
167. Leslie Wayne, *Calpers Sues Over Ratings of Securities*, N.Y. TIMES, July 14, 2009, at B1.
168. *Id.*
169. *Id.*
170. *See, e.g.*, Statement of Amy Lancellotta, Senior Counsel, Investment Company Institute for the SEC Hearings on Issues Relating to Credit Rating Agencies, Nov. 21, 2002, *available at* http://www.sec.gov/news/extra/credrate/investcoinstit.htm#P64_13886; Mauro Bussani, *Credit Rating Agencies: The Accountability Challenge* (July 7, 2009), https://community.oecd.org/community/gcls/blog/2009/07/07/credit-rating-agencies-the-accountability-challenge.

explicitly prohibits ownership of rated securities by rating analysts and persons responsible for approving credit ratings, and the internal rules of credit rating agencies further extend the restriction to cover employees' immediate family members and securities whose values depend on the rated securities. The law explicitly prohibits employees of credit rating agencies from serving as directors or officers of rated entities if the employees participate in the rating process. The internal rules of many credit rating agencies prohibit such conflict for all employees regardless of whether they are involved in the rating process, and require employees to report to and to seek approval from designated officers before taking any position at a rated entity. The law does not contain a provision that prohibits rating analysts from maintaining special business or personal relationships with a rated entity, as it is difficult to define such a relationship in law which may be applied to a broad range of specific settings where conflicts of interest can arise. However, the internal rules of credit rating agencies impose a general duty on all employees to report any relationship that can potentially give rise to conflicts of interest and prohibit employees from participating in rating if he maintains such special relationship with an entity subject to rating. The law explicitly prohibits credit rating analysts from receiving gifts from rated entities in excess of twenty-five dollars in value. The internal rules of credit rating agencies prohibit all employees (and their family members) from receiving gifts in excess of minimal monetary value from any entity with which the rating agency has a business relationship. Finally, the law does not explicitly prohibit credit rating agencies from setting the analysts' compensation by reference to the rating fees that the analysts generate. All credit rating agencies that are currently registered as NRSROs have such restrictions. In sum, all major sources of conflicts of interest at the rating analyst level are covered in the current regulations through outright prohibitions in law and/or the internal rules of credit rating agencies, and through the reporting requirements implemented by credit rating agencies.

With regard to conflicts of interest at the rating agency level, the law prohibits credit rating agencies from rating securities issued or underwritten by an affiliated entity, or securities of entities to whom the rating agency provided ancillary services, or entities that contributed more than ten percent of the revenues generated by the rating agency in the most recent fiscal year. The law also prohibits rating analysts from participating in fee discussions with debt issuers, underwriters or obligors. Credit rating agencies are required to disclose to the SEC, on a confidential basis, their twenty largest issuers, subscribers and underwriters, and to disclose publicly, on a delayed basis, their ratings performed since June 26, 2007. The law also imposes extensive recordkeeping requirements intended to help the SEC in its examination of credit rating agencies' compliance with the law and investigation of alleged misconducts in the rating process. These restrictions or requirements are not reflected in the internal rules of the credit rating agencies. The Cuomo Agreement further requires the "Big Three" rating agencies to change their fee collection practices, which has been widely followed in the industry, by adopting the fee-for-service mechanism for residential mortgage-backed securities, and to disclose all ratings performed for their clients, regardless of whether the ratings are "selected" for use in the debt offering.

Credit ratings that are issued to the public as opposed to a small number of clients are deemed to be "opinions" of credit rating agencies on the creditworthiness of the rated entity. As such, they are protected by the First Amendment. This means credit rating agencies cannot be held liable for mistakes in their ratings even if they were negligent, as long as their conduct in the rating process was not driven by actual malice.

III.
Improving the Current Regulation of Conflicts of Interest

The discussion in Part II shows that conflicts of interest at the rating analyst level have been largely covered in the current regulation and the internal rules of credit rating agencies. Out of the four key sources of conflicts of interest at the rating agency level, i.e., affiliation with rated entities, provision of ancillary services, large subscriber influence, and the issuer-pay business model, the first two sources have been eliminated through outright prohibitions in the SEC Rules and are unlikely to remain as substantial concerns in the future, except for certain implementation issues such as what constitutes "affiliates" and what types of communications from a credit rating agency to its clients are deemed provisions of ancillary services. Conflicts of interest arising from large subscriber influence and the issuer-pay business model are not prohibited under the current rules (except for the prohibition that credit rating agencies cannot provide ratings if the debt issuer or underwriter contributed ten percent or more of revenues of the rating agency in the most recent fiscal year[171])—the law merely requires credit rating agencies to disclose this conflict and es-

171. *See supra* Part II.B.

tablish policies and procedures to manage this conflict.[172] Internal rules of credit rating agencies address this conflict by segregating analyst compensations from rating fees.[173] The recordkeeping requirements are also expected to have some deterrence effect by increasing the likelihood that violations will be detected.

Conflicts of interest arising from large subscriber influences and the issuer-pay business model remain a concern under the current regulatory regime. Analyst compensation depends on the overall financial well-being of the rating agency and is thus indirectly tied to the rating fees that the analysts generate. Stringent recordkeeping requirements make it difficult for rating agencies to contract explicitly with issuers for rating inflations, but analysts are well-informed of the largest contributors to their employers' revenue and thus are under implicit pressure to issue an "acceptable" rating to retain the business of such clients. Accounting for deviation from established rating procedures and methodologies makes it difficult to inflate the rating on a large scale, but to the extent that rating agencies rely on both quantitative and qualitative factors in determining ratings,[174] a moderate inflation by one or two notches can likely be explained as driven by "qualitative factors" and escapes the surveillance radar of regulators and investors. Future adjustments to the initial rating inflation of even a moderate scale will result in losses for investors.

This section of the paper suggests improvements to the existing SEC Rules to control conflicts of interest at the rating agency level. It first evaluates the proposal that rating agencies should be prohibited from issuing credit ratings when such ratings might substantially impact the securities holdings of large subscriber clients, and from receiving compensation from issuers. It then discusses the inadequacies of the current regulation in providing ex ante warnings of conflicts of interest to investors and in deterring inappropriate rating actions by increasing rating agencies' reputation cost. The paper advocates the adoption of the NRSRO revenue disclosure requirements proposed in the SEC's November 2009 Proposing Release[175] and make sugges-

172. *See supra* Part II.A.
173. *See supra* note 91 and accompanying text.
174. For example, A.M. Best's rating process involves a comprehensive quantitative and qualitative analysis of a company's balance sheet strength, operating performance and business profile. This includes comparisons to peers and industry standards as well as assessments of operating plans, philosophy and management. *See* A.M. Best Co., General Description of the Policies and Procedures Used to Determine Credit Ratings (Form NRSRO: Exhibit 2), at 3 (Apr. 8, 2009).
175. Nov. 2009 Proposing Release, *supra* note 22.

tions on how the current regulation should be changed to enhance the deterrence effect of NRSROs' rating performance disclosures.

A. *The Infeasibility of an Outright Prohibition of Large Subscriber Influence and the Issuer-Pay Business Model*

It is difficult to regulate conflicts of interest arising from large subscriber influences and the issuer-pay business model through outright prohibitions. Subscribers to credit ratings include investment funds that hold a diversified securities portfolio. A prohibition against ratings on securities that are held by large subscriber clients would mean that a rating agency cannot rate most, if not all, securities that are outstanding. A narrower prohibition that applies when credit ratings would significantly impact the portfolio holdings of subscriber clients is also infeasible because it requires the rating agency to know the portfolio mix of its clients in detail—a requirement that is often impossible to fulfill given that many investment funds are privately held and do not disclose information on their portfolio holdings to credit rating agencies.

A prohibition of the issuer-pay business model builds on the assumption that credit rating agencies can sustain their business on the fees they charge to subscribers for ratings and ancillary services. For a firm like Moody's, the prohibition means it would have to pay all operation costs and earn a decent return for shareholders with less than forty percent of the revenues that it is currently making.[176] Indeed, subscription fees were the main source of rating agencies' income until the beginning of the 1970s, but the system vanished because a large number of users "free-rode" on the provision of ratings to a small number of subscribers using photocopying.[177] Rating agencies could not survive on the reduced subscription revenue. Fees paid by issuers supplement the income of rating agencies and enable them to be in a position to offer analytical coverage on a broad range of securities in almost every major financial market—and to make ratings freely available to the market in real-time. Moreover, a subscriber-pay model also contains direct conflicts, given that most major subscribers have a vested financial interest in the ratings of the securities they hold. The subscriber-pay model would give the biggest money managers a huge advantage over smaller firms and individuals because the

176. Less than forty percent of Moody's revenues came from provision of ancillary services and subscription fees in 2008. *See* Moody's Corp., *supra* note 59.

177. Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 41, 47 (Richard M. Levich et al. eds., 2002).

money managers can afford to pay for the analyses. Another alternative to the issuer-pay model is to let exchanges on which the debt instruments are traded pay for the ratings. However, the concern for conflicts of interest also exists in that competition among exchanges for listing and trading volume may pressure exchanges into contracting or shopping for good ratings in order to attract issuers and investors to their respective trading platforms.

There is also a proposal that regulators should stop relying on credit ratings altogether as a reference for determining regulatory obligations and use instead ratings implied from market measures such as credit default swap prices. The price of these financial instruments is mostly reflective of the credit quality of the reference entities. Indeed, Moody's already has done much of the work to generate market-based ratings. Moody's publishes "market implied ratings," which reflect the market price of credit for various issues over time.[178] However, the merits of replacing credit rating agencies' work with market-implied ratings have not been thoroughly investigated. There are at least factors that caution against hasty conclusions on this issue without careful analyses. First of all, market-implied credit ratings are not a perfect mirror of credit quality, as factors such as taxes or liquidity also play a role in the determination of market prices. Secondly, credit ratings issued by rating agencies have a number of structural benefits. Empirical studies have documented independent information value of credit ratings on top of the information implied in credit default swap prices, as all sorts of rating announcements can cause statistically significant reactions in credit default swap prices.[179] Credit rating agencies also realize economies of scale in information production. They produce information once and make it available to many, and usually to the public free of charge. Investors would need to incur high costs to generate this information privately. Although most institutional investors do not rely exclusively on credit ratings for assessing credit risks, they use ratings as a first cut in the portfolio selection process to identify instruments eligible for further consideration and analysis. Without such a tool, investors would have no initial way to screen literally thousands of new instruments that they consider each

178. For a discussion of Moody's market-implied rating, see Moody's, Products & Services, http://www.moodys.com/cust/prodserv/prodserv.aspx?source=StaticContent/Free%20Pages/Products%20and%20Services/mir.htm&viewtemplate=/Templates/mdcHeaderFooter.xml (last visited Oct. 15, 2009).

179. *See, e.g.*, Lars Norden & Martin Weber, *The Comovement of Credit Default Swap, Bond and Stock Markets: An Empirical Analysis* (Ctr. for Econ. Policy Research, Discussion Paper No. 4674, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=635981.

year for investments.[180] In late 1990s, the SEC requested public comments on whether statistical models might serve as a regulatory substitute for NRSRO credit ratings. Market participants "generally agreed that quantitative, statistically-derived credit scores [were] not as useful or as reliable as analytically-derived credit ratings."[181] Time has passed and market conditions have changed, so the previous market poll on this issue should not preclude its re-examination in the current market setting. However, until such re-examination is completed, it is imprudent to eliminate credit ratings by rating agencies and rely entirely on market-implied ratings for regulatory purposes.

In sum, regulators, market participants and scholars have not yet identified a viable substitute for the issuer-pay business model that is clean of conflict of its own and able to provide the broad range of economic benefits that rating agencies are currently bringing to the financial market. As long as the issuer-pay business model is in place, there is the risk that rating agencies issue credit ratings to the needs of their large clients in order to maximize their business prospects. The management of this type of conflict must rely on the effectiveness of a combination of disclosure, surveillance and enforcement measures.

B. Improving the Disclosure-Based Regulation by Enhancing Ex Ante Disclosures

The current regulation can be and should be improved to enhance ex ante disclosures about conflicts of interest to the investing public. Currently, the only disclosure that an NRSRO is required to give to the public about conflicts of interest is a list in Exhibit 6 of Form NRSRO of factors that potentially could give rise to conflicts of interest. This disclosure is nothing but a boilerplate recount of the sources of conflicts of interest that are believed to be plaguing the credit rating industry in general. The SEC's recent proposals in the November 2009 Proposing Release seek to correct this deficiency by requiring NRSROs to disclose on their websites information about the revenue contribution by each person who paid for the issuance or maintenance of credit ratings during the most recent fiscal year and refer to this disclosure in each rating action announcement. As of January 1, 2010, these proposals have not been adopted and the SEC is still seeking

180. *See Approaches to Improving Credit Rating Agency Regulation: Hearings Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 2–3 (2009) (testimony of Gregory W. Smith, Colo. Pub. Employees' Ret. Ass'n), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/gregory_w__smith_testimony.pdf.

181. SEC Report of 2003, *supra* note 5, 15 n.42.

public comments on the advisability of these proposals. This paper advocates the adoption of these proposals for the following reasons:

First, without such a disclosure requirement, the investing public is deprived of means of assessing the risk of conflicts of interest that may have caused inaccuracy in the ratings. It is well understood that conflicts of interest are inherent in the issuer-pay business model and yet investors are uninformed about the weight of the fees paid by the debt issuer in the credit rating agency's total revenue. Although rating agencies are required to disclose their largest twenty issuer, subscriber or underwriter clients in Exhibits 10, 12 and 13 of Form NRSRO, rating agencies can choose to have this disclosure made on a confidential basis to the SEC only.[182] Every rating agency currently registered as NRSRO has opted for this confidential treatment. Investors cannot obtain information on the identities of the largest clients of rating agencies from their NRSRO materials, websites or other public documents, such as annual and quarterly reports of publicly held rating agencies.[183] A telephone inquiry to large rating agencies about the identities of their top twenty clients was responded to with a categorical assertion that such information is proprietary and not subject to the disclosure requirements under the current regulation.[184] Finally, rating agencies do not disclose information about the fees paid by the rated entity in their rating announcements. An examination of an arbitrary sample of five to ten rating announcements in the first half of 2009 that covers a wide range of debt instruments[185] and rating actions (new issue ratings, upgrades, downgrades, outlook changes, rating confirmations) reveals disclosures of conflicts of interest to be nothing beyond mere boilerplate statements. The standard statements in Moody's rating announcements are as follows:

> MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from $1,500 to approximately $2,400,000. Moody's Corporation (MCO) and its

182. *See* June 2007 Adopting Release, *supra* note 20, at 33,579–82.

183. *See, e.g.*, Moody's Corp., *supra* note 59; McGraw-Hill Cos., Annual Report (Form 10-K) (Feb. 27, 2009).

184. Thanks to my research assistant, Jing Zhang, who undertook the effort to contact Moody's and Standard & Poor's for a list of twenty largest subscribers and issuer clients in May 2009.

185. The sample includes ratings on corporate bonds, government agency debt securities, preferred stocks, structured finance products, and issuer ratings of industrial and financial entities for both US and foreign issuers. A list of rating actions included in the sample will be provided upon requests of interested readers.

> wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. . .[186]

The disclosures made by Standard & Poor's are: "Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or third parties participating in marketing the securities."[187] Fitch's standard disclosures are: "Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance and other relevant policies and procedures are also available from the 'Code of Conduct' section of this site."[188] None of the rating announcements discloses whether the subject of the rating is a major client of the rating agency and none of the documents referenced in the rating announcements discloses the identities of the rating agency's largest issuer and subscriber clients.

Second, the current boilerplate disclosure of the existence of conflicts of interest in general and the confidential treatment of credit rating agencies' disclosures of the identities of their large clients starkly contrast with the disclosure requirements imposed on research analysts in recent regulations and give rise to concerns of regulatory inconsistency. There are two important similarities between rating agencies and research analysts: First, they both function as quality certifiers and predictors—rating agencies certify with regard to the credit quality of issuers and predict about their default probabilities, while research analysts certify about the valuations of securities and predict about price movements. Second, their certifications and predictions both have big impacts on the financial market. A recent study by Paul Ryan and Richard Taffler found that sell-side analyst recommendations and earnings forecast revisions explain 17.4% of major market-adjusted price changes and 16.1% of high trading volumes that are triggered by reported news events.[189] The impact of credit rating

186. For a sample rating announcement made by Moody's, see Press Release, Moody's Investors Services, Moody's Assigns Aaa Rating and Stable Outlook to Morris County Improvement Authority's (NJ) $4.9 Million County of Morris Guaranteed Loan Program Bonds, Series 2009 (Town of Newton Project) (Aug. 14, 2009) (on file with author).

187. For a sample rating announcement made by Standard & Poor's, see Press Release, Standard & Poor's, Swire Pacific Ltd.'s US$500 Million Guaranteed Notes Assigned 'A-' Rating (Aug. 13, 2009) (on file with author).

188. For a sample rating announcement made by Fitch, see Press Release, Fitch Ratings, Fitch Affirms Toledo-Lucas County Port Auth.'s (OH) Bond Fund 'BBB-' Rating; Removes Negative Watch (Aug. 14, 2009) (on file with author).

189. Paul Ryan & Richard J. Taffler, *Are Economically Significant Stock Returns and Trading Volumes Driven by Firm-specific News Releases?*, 31 J. BUS. FIN. & ACCT. 49 (2002).

change on securities prices is illustrated in the downgrade of the German ThyssenKrupp Group due to a methodology change of Standard & Poor's and unaccompanied by any change in the default risk of the issuer. The announcement of possible downgrades by the rating agency led to an immediate loss of more than four percent in the company's stock prices.[190]

Both rating agencies and investment banks that employ research analysts face the problem of conflicts of interest. Using optimistic recommendations and ratings to retain and attract future business assignments have been a key concern for both industries. Sell-side analysts work for brokerage houses with the purported role of providing investment research to brokerage clients. The brokerage houses, however, are typically owned by securities firms that also offer investment-banking services. This collocation of research activities with investment banking activities has led to the concern that sell-side analysts promote the securities of investment banking clients through issuing biased research reports.

In 2002, 2003, and 2005, the NASD and New York Stock Exchange (NYSE) amended their rules (NASD Rule 2711 "Research Analysts and Research Reports," NYSE Rule 351 "Reporting Requirements" and NYSE Rule 472 "Communications with the Public") to regulate conflicts of interest by requiring extensive disclosures in research reports and public appearances of research analysts.[191] NASD rules and NYSE rules that regulate research analysts' conflicts of interest are substantially similar and are intended to operate uniformly. The rules require investment banks to disclose in their published research reports whether they have managed or co-managed a public offering of the subject company in the past twelve months, whether they have received compensation for investment banking services from the subject company in the past twelve months, and whether they expect to receive compensation from the subject company in the ensuing three months.[192]

190. Sylvia Ascarelli, *S&P Warns Firms in Europe Over Pension Funding*, WALL ST. J., Feb. 10, 2003, at A12.

191. *See* Order Approving SR-NYSE-2002-09 and SR-NASD-2002-021, Exchange Act Release No. 34-45908, 67 Fed. Reg. 34,968 (May 10, 2002); Order Approving SR-NYSE-2002-49 and SR-NASD-2002-154, Exchange Act Release No. 34-48252, 68 Fed. Reg. 45,875 (Aug. 4, 2003); Order Approving SR-NASD-2004-141 and SR-NYSE-2005-24, Exchange Act Release No. 34-51593, 70 Fed. Reg. 22,168 (Apr. 28, 2005).

192. *See* NASD Rule 2711(h)(2) (2009); NYSE Rule 472(k)(1)(i)(a) (2009).

Disclosure requirements for research analysts differ from the current disclosure requirements for credit rating agencies in at least three aspects:

First, disclosures by research analysts are specific in that they reveal whether the investment bank that employs the research analyst to prepare a research report on the subject company has provided or intends to provide in the near future investment banking services for the subject company. In other words, the disclosures warn investors about conflicts of interest that exist in the issuance of a particular research report and for a particular subject company. NASD and NYSE staff have indicated that they do not believe that vague, so-called "health warnings" that conflicts of interest "may or may not" exist are useful or effective.[193] In comparison, the disclosures of conflicts of interest by credit rating agencies in Exhibit 1 of Form NRSRO are no more than vague "health warnings."

Second, research analysts are required to disclose conflicts of interest in research reports as opposed to any annual registration or certification document. The NASD and NRSE staff believe that a point-of-sale disclosure is necessary as "it would be more effective and useful to investors to know *immediately* whether the member firm or research analyst producing the research report is conflicted, while providing the reader the means to learn more about these conflicts if he or she chooses to do so."[194] Disclosure of conflicts of interest at point-of-sale is also required in other contexts of financial market regulation. For example, the SEC requires that a mutual fund prospectus disclose in a summary section on the front of the prospectus whether a dealer receives revenue sharing or pays differential compensation with respect to the sale of mutual funds.[195] In contrast, a comparable "point-of-sale" (or "point-of-report") disclosure is not required of credit rating agencies when they announce rating actions.

Third, disclosures of conflicts of interest contained in research reports are made to investors who have an interest in buying a copy of that report rather than to the regulatory agency on a confidential basis. The concern about disclosing proprietary information was also raised in comments to the research analyst regulation by those who feared

193. *See* NASD REGULATION, INC. & NYSE, INC., JOINT REPORT ON THE OPERATION AND EFFECTIVENESS OF THE RESEARCH ANALYST CONFLICT OF INTEREST RULES 40 (Dec. 2005), *available at* http://www.finra.org/web/groups/industry/@ip/@issues/@rar/documents/industry/p015803.pdf.

194. *Id.* at 39 (emphasis added).

195. *See generally* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Exchange Act Release No. 33-8998, 17 C.F.R. pts. 230, 232, 239 (Jan. 13, 2009).

that references to the provision of future investment banking services in the disclosure might be signaling or tipping about non-public transactions involving the subject company.[196] The NASD responded by pointing out that such a disclosure is broad enough to avoid disclosure of non-pubic information and that in some rare cases a member firm may have to choose between making the disclosure and refraining from issuing research, in order to preserve client confidences in connection with an investment banking transaction.[197] In the case of credit rating agencies, the concern about proprietary information appears tenuous as it is difficult to comprehend how a public disclosure of the twenty largest issuer and subscriber clients and the rating fees they paid *in the past* sacrifices the proprietary information of rating agencies and their clients. Even if, for argument's sake, rating agencies have a legitimate interest in not disclosing the specific amount of revenues paid by the rated entities or subscribers, they can simply disclose the identities of their largest issuer and subscriber clients without disclosing the revenues those clients pay. Investors would then be given an opportunity to do their own due diligence should they suspect the risk of rating inflation due to the large client status of the rated entity or due to the substantial weight that the rated security carries in the portfolio of a large subscriber client of the rating agency. This simple ex ante disclosure would alert investors of the risk of conflicts of interest in the context of a specific rating action where the probability of such risk is the highest.

C. Improving the Disclosure-Based Regulation by Sharpening the Disclosure of Performance Statistics

The SEC Rules require that NRSROs disclose their performance statistics in Exhibit 1 of Form NRSRO. The purpose of this disclosure is to allow users of credit ratings to compare the rating quality across different agencies so that agencies with inferior performance records incur reputation cost with investors.[198] Rating agencies are concerned about the reputational effect of their performance records and thus would have no incentive to assign unjustified ratings to preferred cli-

196. *See, e.g.*, Sullivan & Cromwell, *Comments to Proposed Rules Regarding Research Analyst Conflict of Interest File Nos. SR-NASD-2002-21 and SR-NYSE-2002-9* (Apr. 18, 2002), *available at* http://www.sec.gov/rules/sro/nd200221ny200209/sullivancromwell1.htm.

197. *See* Philip A. Shaikun, Assistant General Counsel, NASD Regulation, Inc., *SR-NASD-2002-21 (Proposed Rule Change Relating to Research Analyst Conflicts of Interest)—Response to Comments* (May 2, 2002), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p000444.pdf.

198. *See* June 2007 Adopting Release, *supra* note 20, at 33,574.

ents which may hurt their performance records in the long run. Discussions in the previous paragraphs of this section suggest that moderate rating inflations for large issuer or subscriber clients of the rating agency remain a concern, even with the implementation of the recordkeeping requirements and the insulation of analyst's compensation from rating fees. The performance disclosure requirements should function as the last line of defense by magnifying the cost to a rating agency's reputation if it engages in inappropriate rating actions. This requires a disclosure mechanism that directly aligns inadequate ratings with inferior performance statistics. The current performance disclosure requirements fail to achieve this.

The instructions to Exhibit 1 of Form NRSRO require performance measurement statistics to show a historical ratings transition and default rates within each of the credit rating categories, notches, grades, or rankings used by the NRSRO.[199] The Exchange Act does not otherwise define or identify the particular credit rating performance statistics to be provided by NRSROs. Credit rating agencies typically disclose rating transition matrices that reflect the change of ratings from one category or notch to any other category or notch within a specified period of time. The rating migration can be expressed in the absolute number of rating changes or percentage of rating changes. Table 1 reproduces the 2008 transition matrix for corporate issuer ratings reported by Standard & Poor's in its Form NRSRO. It shows that 82.4% of corporate issuers which were rated AAA at the beginning of 2008 remained at that rating level at the end of 2008, that 11.8% of those with AAA rating at the beginning of 2008 were downgraded to AA- rating by the end of the year, and that 5.9% became nonrated entities due to the withdrawal of the ratings. The matrix also shows that the AAA rated group had a default rate of 0% during 2008, while the BBB- rated group (the lowest investment grade) had a default rate of 0.3%. The transition matrices are the most important disclosure items in the performance reports of credit rating agencies, and indeed for some rating agencies, transition matrices are the only items included in the performance reports.[200]

Some rating agencies also provide statistics on the number and/or percentage of overall downgrades and upgrades,[201] the number of

199. SEC Form NRSRO, Instructions to Exhibit 1, *available at* http://ftp.sec.gov/about/forms/formnrsro.pdf.

200. *E.g.*, Egan-Jones Ratings Co., Credit Ratings Performance Measurement Statistics (Form NRSRO: Exhibit 1) (Mar. 27, 2009).

201. *See, e.g.*, Fitch, Inc., Global Corporate Finance Rating Movements Across Major Rating Categories (Form NRSRO: Exhibit 1, Attachment), at 2 (Mar. 5, 2009).

TABLE 1: SAMPLE RATING TRANSITION MATRIX*

From/to (%)	AAA	AA+	AA	AA−	A+	A	A−	BBB+	BBB	BBB−	BB+	BB	BB−	B+	B	B−	CCC/C	D	NR
AAA	82.4			11.8								0	0	0	0	0	0	0	5.9
AA+		57.1	28.6	14.3								0	0	0	0	0	0	0	0.0
AA		6.6	70.5	13.1	4.9		1.6			1.6		0	0	0	0	0	0	0	1.6
AA−				81.5	3.7	5.6	1.9			0		0	0	0	0	0	0	0	7.4
A+				2.9	70.9	16.5	1.9			0	1.0	0	0	0	0	0	0	0	6.8
A			0.5		3.9	80.5	8.3		0.5	0	0	0	0	0	0	0	0	0	6.3
A−			0.7			6.4	78.9	7.9	1.4	1.1	0.4	0	0	0	0	0	0	0	3.2
BBB+							6.1	74.6	12.5	1.2	0.0	0	0	0	0	0	0	0	5.5
BBB							0.3	5.7	79.0	7.8	0.5	0.5	0.5	0	0	0.3	0.3	0	5.1
BBB−								0.3	5.7	74.5	8.1	1.7	2.4	0.3	0.3	0	0.3	0.3	6.0
BB+									0.5	14.5	62.2	7.8	8.3	0.5	1.6	0	1.6	0	3.1
BB									0	2.7	14.5	60.5	9.5	1.1	1.9	0.4	1.1	0.8	7.6
BB−									0.5		1.0	9.8	59.9	12.8	2.3	1.3	0.8	0.8	11.0
B+									0.2		0.2	0.5	7.1	61.3	11.1	4.0	2.5	3.3	9.8
B												0.2		5.0	53.7	17.0	10.6	3.3	10.3
B−								0.5				0		0.5	8.8	51.2	14.9	7.9	16.3
CCC/C												0		1.2	1.2	6.1	43.9	29.3	18.3

* Standard & Poor's, Form NRSRO, Exhibit 1, "Corporate Issuers—default and transition tables."

downgrades from investment grade to non-investment grade ("fallen angels"),[202] the frequency of rating changes,[203] the frequency of large rating changes,[204] the number and percentage of total defaults,[205] and the time to default.[206] A few rating agencies such as Moody's and Standard & Poor's have also used cumulative accuracy profiles (or Gini coefficients)[207] and accuracy ratios.[208]

The inability of the current performance disclosures by credit rating agencies to reflect selective rating inflations for large clients is demonstrated by a manipulation of the reported 2008 corporate issuer bond transition matrix of Standard & Poor's, AM Best, JCR and R&I. The first two agencies are active in the corporate bond rating market and each rated more than 3,000 issuers in 2008. Standard & Poor's, together with Moody's, dominates corporate bond ratings and is inevitably one of the two agencies selected under the two-rating norm for corporate bonds. AM Best is a major rating agency, but its market share is strong only in the rating of insurance companies. JCR and R&I are small players in corporate bond ratings. These four companies represent rating agencies of different sizes, market shares and market influence. Suppose a rating agency has twenty largest corporate issuer clients whose ratings are inflated by one notch. The twenty inflated ratings are distributed according to the distribution of different rating grades at the beginning of the performance reporting period. For example, if a rating agency has 1,000 outstanding corporate issuer ratings at the beginning of 2008, and ten percent of the rated entities are assigned AAA, two inflated ratings (or ten percent of the total of twenty inflated ratings) would be assigned to the AAA category. That

202. *See, e.g.*, DBRS Ltd., 2008 DBRS Corporate Rating Transition and Default Study (Form NRSRO: Exhibit 1, Attachment), at 5 (Aug. 10, 2009).

203. *See, e.g.*, Moody's Investors Service, The Performance of Moody's Corporate Bond Ratings: December 2007 Quarterly Update (Form NRSRO: Exhibit 1, Attachment), at 4 fig.2 (Mar. 28, 2008). Rating change ratio is the percentage of rated issuers that have experienced rating change during a specified period of time. A low rating change ratio reflects stability in ratings assigned and is an indicator of reliability in ratings assigned.

204. *Id.*

205. *See, e.g.*, Standard & Poor's Rating Services, Default, Transition, and Recovery: 2009 Annual Global Corporate Default Study and Rating Transitions (Form NRSRO: Exhibit 1, Attachment), at 2–3 tbl.1 (Mar. 17, 2010).

206. *See, e.g.*, DBRS Ltd., *supra* note 202, at 12–13.

207. *See, e.g.*, Standard & Poor's, *supra* note 205, at 6–7 tbl.2. The cumulative accuracy profile is constructed by plotting, for each rating category, the proportion of defaults accounted for by firms with the same or a lower rating against the proportion of all firms with the same or a lower rating.

208. *See, e.g.*, Moody's Investors Service, *supra* note 203, at 13. The accuracy ratio is the ratio of the area between the cumulative accuracy profile curve and the 45-degree line to the maximum possible area above the 45-degree line, which is one-half.

means 98 out of the 100 AAA ratings are justified and the remaining two deserve only the next rating category (i.e., AA+). From the perspective of the rating agency, the worst thing that can happen to these inflated ratings is for their inadequacy to be revealed sometime after the ratings are issued due to the gradual infiltration of information to the market. Under such a scenario, downgrades would be inevitable, and such downgrades are included in the calculation of the rating agency's performance statistics. If downgrades result in a significant deterioration in the rating agency's performance statistics, the rating agency would refrain from engaging in rating inflation for fear of incurring reputation cost. If downgrades result in changes in the performance statistics that are undetectable by investors and regulators, reputation cost is low and the performance disclosure requirements would fail to deter rating inflations for the rating agency's favored clients.

The reported 2008 transition matrix of each sample rating agencies is changed to reflect the initial rating inflations and subsequent downgrades (i.e., the worst case scenario from the perspective of the rating agency) to the justified rating level within the same performance reporting period. The original matrix is then compared with the re-constructed matrix to see if the difference is visually substantial and statistically significant under the Pearson Chi-square test.[209]

The visual significance depends on the size of the total number of issuers included in the calculation of performance statistics. For example, Standard & Poor's rated approximately 4,000 corporate bond issuers in 2008, and thus twenty inflated ratings account for 0.5% of the total rated issuers, which leads to a difference of 0.3% to 1% at different grade notches in the transition matrix. The same result holds for AM Best, another major player in the corporate bond rating market, one focused on rating insurance companies. For small rating agencies such as JCR, which rated about 450 corporate issuers in 2008, twenty rating inflations account for about five percent of the total rated entities. That translates into a difference of three to five percent between the original and re-constructed transition matrix at different grade levels. This result holds for R&I which rated about 650 corporate bond issuers in 2008. To conserve space, this paper

209. Pearson's Chi-square test is a non-parametric test for a difference in proportions between two or more independent samples. It can also be used to test if the two categorical variables are associated. For a discussion of the mathematical properties of the Chi-square test, *see* Eric Weisstein, *Chi-Squared Test*, *in* WOLFRAM MATHWORLD, http://mathworld.wolfram.com/Chi-SquaredTest.html (last visited Mar. 1, 2010).

TABLE 2: COMPARISON OF ORIGINAL AND RECONSTRUCTED TRANSITION MATRIX OF STANDARD & POOR'S*

	A+	A	A–	BBB+	BBB	BBB–	BB+	BB	BB–	B+	B	B–	CCC/C
A+	69.9% (70.9%)	17.5% (16.5%)											
A		80.0% (80.5%)	8.8% (8.3%)										
A–			78.6% (78.9%)	8.2% (7.9%)									
BBB+				74.0% (74.6%)	13.1% (12.5%)								
BBB					78.4% (79.0%)	8.4% (7.8%)							
BBB–						73.8% (74.5%)	8.7% (8.1%)						
BB+							61.1% (62.2%)	8.8% (7.8%)					
BB								60.1% (60.5%)	9.9% (9.5%)				
BB–									59.4% (60.0%)	13.3% (12.8%)			
B+										60.8% (61.3%)	11.6% (11.1%)		
B											53.3% (53.7%)	17.3% (17.0%)	
B–												50.7% (51.2%)	15.3% (14.9%)

* Based on data from Standard & Poor's, Corporate Issuers—Default and Transition Tables (Form NRSRO: Exhibit 1, Attachment), at 2 (Apr. 20, 2009).

TABLE 3: COMPARISON OF ORIGINAL AND RECONSTRUCTED TRANSITION MATRIX*

	AA	AA–	A+	A	A–	BBB+	BBB	BBB–	BB+
AA	95.8% (100%)	4.2% (0%)							
AA–		96.9% (100%)	3.1% (0%)						
A+			86.7% (91.1%)	8.9% (4.4%)					
A				81.0% (86.2%)	13.8% (8.62%)				
A–					79.5% (84.1%)	8.0% (3.4%)			
BBB+						82.0% (86.9%)	11.5% (6.6%)		
BBB							74.7% (78.7%)	8.0% (4%)	
BBB–								66.7% (71.1%)	17.8% (13.3%)

* Based on data from Japan Credit Rating Agency, Ltd., One-year Transition Matrix (for period from 31 Dec. 2007 to 31 Dec. 2008): Corporate Issuers (Form NRSRO: Exhibit 1, Attachment), at 6 (Mar. 27, 2009).

reports only comparison results of Standard & Poor's and JCR. The comparison results for AM Best and R&I will be provided upon request from readers. Numbers in parentheses are the original numbers in the reported transition matrix, and the numbers without parentheses are reconstructed numbers that include twenty rating inflations. Grade levels unaffected by the rating inflation are omitted from the tables. For example, Table 3 does not contain comparison results for grades at AAA or below BBB- because none of the twenty inflated ratings are assigned to those grades based on the rating distribution of JCR at the beginning of 2008. Statistically, the differences between the original and re-constructed transition matrix are insignificant at a five percent level across all rating notches for every sample rating agency.[210]

Table 4 further compares default ratios, rating changes, downgrade ratios and downgrade-to-upgrade ratios calculated based on the original and the re-constructed transition matrix for each sample rating agency. The one-notch rating inflations for large issuer clients affect the Overall Rating Change Ratio, Downgrade Ratio, Fallen Angels, and the Downgrade/Upgrade Ratio, but not the Overall Default Ratio, Investment Grade Default Ratio, or the Large Rating Change Ratio. For Standard & Poor's and AM Best, both of whom rated a large number of long-term corporate bonds, the differences between original and reconstructed performance statistics are statistically insignificant across the board. For JCR and R&I, the difference between the original and the reconstructed Downgrade Ratio is statistically significant, but the difference for the Fallen Angel measure is not. The Overall Rating Change Ratio is significantly different for JCR but not for R&I, while the Downgrade/Upgrade Ratio is significant for R&I but not for JCR. In sum, the rating inflations do not result in any significant difference in the performance statistics for large rating agencies. They result in significant statistical differences in some but not all performance statistics for small rating agencies.

Table 5 reports the performance ranking among Standard & Poor's, AM Best, JCR and R&I with regard to the statistics listed in Table 4 when the statistics are calculated based on the original transition matrix, and contrasts that ranking with the new ranking of Standard & Poor's and JCR based on the re-constructed transition matrix. New rankings for AM Best and R&I based on the re-constructed transition matrix are not calculated because these two agencies are used as

210. For Standard & Poor's, the p-value of the Pearson Chi-square test ranges from 0.71 at the lowest to 0.93 at the highest. For AM Best, the p-value ranges from 0.25 at the lowest to 0.92 at the highest. For JCR, the p-value ranges from 0.21 at the lowest to 0.65 at the highest. For R&I, the p-value ranges from 0.17 to 0.76.

TABLE 4: COMPARISON OF PERFORMANCE STATISTICS

	Standard & Poor's	AM Best	JCR	R&I
Overall Default Ratio				
- Original	2.07%	0.08%	0.66%	0.15%
- Inflated Rating	2.07%	0.08%	0.66%	0.15%
- Pearson Chi-sq p-value	N/A	N/A	N/A	N/A
Investment Grade Default Ratio				
- Original	0.06%	0.03%	0.23%	0%
- Inflated Rating	0.06%	0.03%	0.23%	0%
- Pearson Chi-sq p-value	N/A	N/A	N/A	N/A
Overall Rating Change Ratio				
- Original	25.86%	14.33%	14.38%	14.31%
- Inflated Rating	26.37%	14.88%	18.81%	17.38%
- Pearson Chi-sq p-value	0.60	0.51	0.07*	0.20
Large Rating Change Ratio				
- Original	7.15%	5.49%	3.76%	1.54%
- Inflated Rating	7.15%	5.49%	3.76%	1.54%
- Pearson Chi-sq p-value	N/A	N/A	N/A	N/A
Downgrade Ratio				
- Original	18.19%	8.87%	6.64%	1.69%
- Inflated Rating	18.70%	9.42%	11.06%	4.80%
- Pearson Chi-sq p-value	0.56	0.42	0.02**	0.002**
Fallen Angels				
- Original	2.89%	0.52%	2.48%	0.31%
- Inflated Rating	3.01%	0.58%	2.93%	0.47%
- Pearson Chi-sq p-value	0.84	0.75	0.68	0.65
Dowgrade/Upgrade Ratio				
- Original	2.30	1.62	0.86	0.13
- Inflated Rating	2.37	1.72	1.43	0.38
- Pearson Chi-sq p-value	0.77	0.64	0.12	0.001**

* significant at 10% level.
** significant at 5% level

the control group in the comparison of performance ranking changes with and without the rating inflation. Default Ratios and Large Rating Change Ratios are not affected by the one-notch rating inflations and thus the rankings of rating agencies in these measures are not included in this table.

Without rating inflations, Standard & Poor's ranked fourth and JCR ranked third in terms of the Overall Rating Change Ratio. Their rankings remain the same after rating inflations. Likewise, without inflations, Standard & Poor's ranked fourth and JCR ranked second in both the Downgrade Ratio and the Downgrade/Upgrade Ratio. Their rankings remain the same after rating inflations. With regard to downgrades from investment grades to speculative grades (i.e., "Fallen Angels"), Standard & Poor's ranked fourth and JCR ranked third prior to rating inflations. The rating inflations improve Standard & Poor's ranking to third at the expense of JCR. This is because rating inflations for the twenty largest issuers account for a tiny fraction of all

TABLE 5: PERFORMANCE RANKING

	Standard & Poor's	AM Best	JCR	R&I
Overall Rating Change Ratio				
- Original ratio	25.9%	14.3%	14.4%	14.3%
- New ratio	26.4%		16.2%	
- Original ranking	4	2	3	1
- New ranking	4	2	3	1
Downgrade Ratio				
- Original ratio	18.2%	8.9%	6.6%	1.7%
- New ratio	18.7%		8.4%	
- Original ranking	4	3	2	1
- New ranking	4	3	2	1
Fallen Angels				
- Original ratio	2.9%	0.5%	2.5%	0.3%
- New ratio	4.0%		4.2%	
- Original ranking	4	2	3	1
- New ranking	3	2	4	1
Downgrade/Upgrade Ratio				
- Original ratio	2.3	1.6	0.9	0.1
- New ratio	2.4		1.1	
- Original ranking	4	3	2	1
- New ranking	4	3	2	1

issuers rated by Standard & Poor's but a larger proportion of issuers rated by a smaller agency such as JCR.

The above results suggest that under the current performance disclosure requirements, moderate rating inflations by large credit rating agencies for their largest issuer clients may not negatively impact their performance statistics; rating inflations by small agencies negatively impact some of their performance statistics but the impacts are not universally present for all small agencies. Rating inflations may not negatively affect the performance ranking of major rating agencies relative to their peers and small rating agencies which do not engage in rating inflations, and may indeed improve their rankings relative to small agencies which also engage in rating inflations.

The performance disclosure requirements should be improved so that rating inflations by rating agencies are more likely to cause their performance statistics to deteriorate. This can be achieved by a simple requirement that rating agencies report performance statistics for the twenty largest issuer clients as a separate group. When the size of the reporting group is small, adjustments arising from previous rating inflations are magnified.

Table 6 shows the p-value of the Fisher's Exact Test[211] for the significance of the difference in the numbers of downgrades between

211. Fisher's exact test is a statistical significance test used in the analysis of contingency tables where sample sizes are small. For a discussion of the test in detail, *see*

TABLE 6: FISHER EXACT TEST p-VALUE FOR DIFFERENCES IN DOWNGRADE NUMBER COUNTS

	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1	0.50															
2	0.24	0.50														
3	0.16	0.30	0.50													
4	0.05**	0.17	0.33	0.50												
5	0.02**	0.09	0.20	0.35	0.50											
6	0.01**	0.05**	0.12	0.23	0.36	0.50										
7		0.02**	0.06	0.14	0.24	0.37	0.50									
8			0.03**	0.08	0.15	0.25	0.37	0.50								
9			0.02**	0.04**	0.09	0.16	0.26	0.37	0.50							
10				0.02**	0.05**	0.10	0.17	0.26	0.38	0.50						
11					0.02**	0.05**	0.10	0.17	0.26	0.38	0.50					
12						0.03**	0.06	0.10	0.17	0.26	0.38	0.50				
13							0.03**	0.06	0.10	0.17	0.26	0.37	0.50			
14								0.03**	0.06	0.10	0.17	0.26	0.37	0.50		
15									0.03**	0.05**	0.10	0.16	0.25	0.37	0.50	
16										0.02**	0.05**	0.09	0.15	0.24	0.36	0.50
17											0.02**	0.04**	0.08	0.14	0.22	0.35
18												0.02**	0.03**	0.06	0.12	0.20
19														0.02**	0.05**	0.09

** significant at 5% level

two reporting entities (i.e., two credit rating agencies) when the total observations in the each group is twenty. The numbers suggest that when two rating agencies differ in downgrade number counts by as few as three to five incidences, the difference would be statistically significant. For example, when an agency that inflates ratings is compared with an agency that does not, it takes only three inflations before the performance statistics of the first agency are negatively affected. This contrasts the previous result that ratings inflations for all twenty large issuer clients can go unnoticed when the reporting group consists of thousands of issuers.

The key points of the discussions in this section can be summarized as follows: First, conflicts of interest arising from large subscriber influence and the issuer-pay business model remain a concern under the current regulatory regime. Second, the issuer-pay business model cannot be banned until regulators have found a substitute that is proven to be superior. However, disclosure requirements should be enhanced to require rating agencies to disclose in rating reports whether the subject of the credit rating belongs to the large client group, and to report the performance statistics for large issuer clients as a separate group.

Conclusion

The collapse of Enron in 2001 and the failure of credit rating agencies to discern and warn investors about this impending disaster elicited concerns about the incompetence of credit rating agencies in fulfilling their role as the credit market watchdog and highlighted the need for regulatory oversight that keeps the credit rating industry in check. The public anger over the deficiencies of the credit rating agencies that contributed to the subprime crisis and the current financial turmoil also fomented the rapid design and implementation of a series of new regulations. The Credit Rating Agency Reform Act was enacted in 2006, followed by the adoption of the SEC rules in 2007 and their multiple amendments in 2009 based on roundtable discussions, congressional hearings and public comments submitted to the SEC, the Treasury Department and the U.S. Congress. As of January 1, 2010, the SEC still has two sets of proposed rule changes and one concept release on the topic pending public comments.

Conflicts of interest are perceived as a major problem plaguing the credit rating industry. Rules targeting conflicts of interest form the

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Eric Weisstein, *Fisher's Exact Test, in* WOLFRAM MATHWORLD, http://mathworld.wolfram.com/FishersExactTest.html (last visited Mar. 1, 2010).

central part of the current regulation. What are the specific issues that give rise to conflicts of interest, how are those issues addressed in the existing rules, what issues remain unresolved and how should their regulations be improved are questions that concern investors, regulators and scholars. The answers to those questions would help set the scope for future regulatory initiatives.

This paper provided a detailed description of key sources of conflicts of interest in the credit rating industry, and followed with an examination of how conflicts of interest are regulated under the current statutes, rules, and internal codes of conduct of credit rating agencies. The analysis showed that the influence of large issuers and subscribers for the credit rating services remains a conflict of interest source that could lead to bias in credit ratings. The current disclosure-based regulation does not provide meaningful risk warnings to investors, and the performance reporting requirements fail to capture preferential rating treatments given to large issuer clients. Simple measures, such as eliminating the confidential treatment for the identities of large issuer, underwriter, and subscriber clients of credit rating agencies and requiring performance statistics to be provided with regard to large issuer clients as a separate group, would greatly enhance ex ante warnings to investors and the deterrence effect of performance reporting with little additional cost to both credit rating agencies and their regulators.