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Credit Rating Agencies and Conflicts of Interest

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Credit Rating Agencies & Conflicts of Interest

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Abstract

Credit Rating Agencies & Conflicts of Interest

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Credit rating agencies are controversial yet influential financial gatekeepers. Many have attributed the recent failures of credit rating agencies to conflicts of interest, such as the agencies' issuer-pays business model and the agencies' provision of ancillary services. This report identifies these conflicts; examines recently-finalized Security and Exchange Commission (SEC) regulations proscribing these conflicts; and suggests other possible regulatory measures. The strategies available to regulators are diverse and differ widely in their political and administrative feasibility. These strategies include outright prohibition of conflicts; removing regulatory references to credit ratings; enhancing agency liability; organizational firewalls; performance disclosures; demonstrating due diligence and its results; increasing competition; staleness reforms; internal governance; administrative registration; and requiring alternative business models. While the report primarily focuses on how the most recent financial crisis—and the related market for asset-backed securities—highlighted conflicts of interest at credit rating agencies, this report also examines how credit ratings—and their limitations—affect sovereign debt markets.

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Part I: Introduction

Several institutional failures precipitated the financial crisis of 2008,[1] but no one actor has been so universally reviled as the credit rating agencies.[2] Materials concerning the financial crisis never fail to mention the incompetency or the complacency of the credit rating agencies. The Financial Crisis Inquiry Commission referred to credit rating agencies as "essential cogs in the wheel of financial destruction."[3] Michael Lewis[4] characterized agency employees as aloof, under-qualified outsiders.[5] Others decried the credit rating agencies' profit motives, stating that the credit rating agencies "handed out

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[1] *See* FINANCIAL CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY COMMISSION REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [hereinafter referred to as "FCIC Report"] (summarizing the main factors in the financial crisis); MATT TAIBBI, GRIFTOPIA: BUBBLE MACHINES, VAMPIRE SQUIDS, AND THE LONG CON THAT IS BREAKING AMERICA 122 (Spiegel & Rau 2010) ("The mortgage brokers systematically falsified information on loan applications in order to secure bigger loans and hawked explosive option-ARM mortgages to people who either didn't understand them or, worse, did understand them and simply never intended to pay. The loan originators cranked out massive volumes of loans with plainly doctored applications, not giving a shit about whether or not the borrowers could pay, in a desperate search for short-term rebates and fees. The securitizers used harebrained math to turn crap mortgages into AAA-rated investments; the rating agencies signed off on that harebrained math and handed out AAA ratings in order to keep the fees coming in and the bonuses for their executives high. But even the rating agencies were blindsided by scammers who advertised and sold, openly, help in rigging FICO scores to make broke and busted borrowers look like good credit risks. The corrupt ratings agencies were undone by ratings corrupters!")

[2] *See, e.g.*, Martin Mayer, *Credit Rating Agencies In the Crosshairs*, BROOKINGS.EDU, 2010, http://www.brookings.edu/articles/2010/0831_ratings_agencies_mayer.aspx ("Most of the victims in the villainous story of the 2008 crash can offer some sort of excuse for their behavior, and even find an occasional defender, but there is one player for whom none of the survivors has a kind word. The ratings agencies acted as advertising copywriters and publicists for bad paper, scattering AAA and AA ratings like balloons at a children's party—and after the defaults began they went wild, racing around to pop the balloons in bundles.").

[3] FCIC Report, *supra* note 1, at xxv.

[4] MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 156 (W.W. Norton & Co. 2010).

[5] *Id.* ("The entire [sub-prime] industry had been floated on the backs of the rating agencies, but the people who worked at the rating agencies barely belonged in the industry. If they roamed the halls they might be mistaken, just, for some low-level commercial bankers at Wells Fargo, or flunkies at mortgage lenders, such as Option One: nine-to fivers . . . They weren't players and they didn't know the people who were, either. They got paid to rate the bonds of Lehman and Bear Stearns and Goldman Sachs, but they couldn't tell you the names of, or any of the other important facts about, the guys at Lehman and Bear Stearns and Goldman Sachs who were making a fortune exploiting loopholes in the rating agencies' models. They appeared to know enough to justify their jobs, and nothing more. They seemed timid, fearful, and risk-averse.").

AAA ratings in order to keep the fees coming in and the bonuses for their executives high."[6] In the eyes of their critics, the credit rating agencies were a "colossal failure."[7]

In the lead up to the most recent financial crisis, the agencies overlooked fatal warning signs and fueled demand for risky assets.[8] Most notably, the credit rating agencies awarded high ratings to risky residential mortgage-backed securities (RMBSs) and collaterized debt obligations (CDOs).[9] Economist Joseph Stiglitz likened this behavior to "alchemy," stating that "the banks could not have done what they did without the complicity of the ratings agencies."[10]

Emails that surfaced during SEC investigations demonstrated that some credit rating agency employees were aware of problems in their ratings. One employee at Standard & Poor's Rating Services, Inc. (S&P) noted that the firm's model did not cover "half" of the risk and hypothesized that a security "could be structured by cows and the

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[6] TAIBBI, *supra* note 1, at 122.

[7] In October 2008, in a hearing before the House Committee on Oversight and Government Reform, Committee Chairman Henry Waxman said the following: "The story of the credit rating agencies is a story of colossal failure . . . The credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent, objective assessments. The rating agencies broke this bond of trust, and federal regulators ignored the warning signs and did nothing to protect the public." Gretchen Morgenson, *Credit Rating Agency Heads Grilled by Lawmakers,* NYTIMES.COM, Oct. 22, 2008, http://www.nytimes.com/2008/10/23/business/economy/23rating.html. *See also Approaches to Improving Credit Rating Agency Regulation, Joint hearing before the Subcomm. on Oversight and Investigations and the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services*, 108th Cong. 1 (2009) (statement of Paul E. Kanjorski, Chairman) ("[T]he rating agencies were AA, if not AAA failures. Clearly, they flunked the class on how to act as objective gatekeepers to our capital markets.").

[8] *Id.* at 157.

[9] FCIC Report, *supra* note 1, at xxv ("The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms."); *see* LEWIS, *supra* note 4, at 73 (explaining the repackaging of lower-rated RMBSs into highly-rated CDOs); TAIBBI, *supra* note 1, at 94 ("It's the same homeowners and the same loans, but the wrapping on the box is different.").

[10] Elliot Blair Smith, *Bringing Down Wall Street as Ratings Let Loose Subprime Scourge*, BLOOMBERG.COM, Sep. 24. 2008, http://www.bloomberg.com/apps/news?sid=ah839IWTLP9s&pid=newsarchive.

[agency] would rate it."[11] Another email expressed hope that the employee and his co-workers would be "all wealthy and retired by the time this house of cards falters."[12] As the market for RMBSs and CDOs grew, the rating agencies saw a substantial increase in their profits.[13]

Many have attributed the failures of credit rating agencies to conflicts of interest, especially the conflicts inherent in the issuer-pays model. Under the issuer-pays model, issuers pay credit rating agencies for a rating, creating a perverse incentive to inflate ratings, reduce standards, and otherwise please their customers.[14] This report identifies the conflicts of interest present in the ratings process; summarizes regulatory strategies that seek to improve the transparency, accountability, and the overall informational value of the ratings process; examines recently-finalized Security and Exchange Commission (SEC) regulations relating to credit rating agency conflicts of interest; and suggests other possible regulatory measures. While the report primarily focuses on how the recent financial crisis—and the related market for asset-backed securities—brought attention to these conflicts of interest, the report will also examine how credit ratings—and their limitations—affect a very different type of debt: sovereign debt.

This report focuses on the credit rating agencies unique role as financial gatekeepers, as well as "gate openers." Financial gatekeepers play two complimentary roles: (1) preventing wrongdoing by withholding cooperation or consent and (2) serving

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[11] U.S. SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 12 (2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf [hereinafter U.S. S.E.C. Summary Report].

[12] *Id.* at 12 n.8. The statement was followed by a happy-face emoticon.

[13] *Id.* (stating that Moody's revenues increased from $800 million in 2001 to $2.03 billion in 2006 and that a substantial percentage of the increase was from the structured finance sector).

[14] JOSEPH STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY 92 (W. W. Norton & Company, 2010).

as a reputational intermediary between investors and financial actors.[15] Ratings can not only create a market for particular product, novel or otherwise, but also allow a number of financial actors to take advantage of a bundle of legal rights that accompany an "investment-grade" rating.[16] In this way, credit rating agencies can also serve as "gate openers."[17]

While the recent failures of credit rating agencies may have weakened their reputation in the market, credit rating agencies still greatly influence cost and access to capital.[18] For this reason, it is important to analyze how conflicts of interest influence the credit rating agencies' role as gatekeepers.

Part II discusses background and regulatory history behind credit rating agencies, and Part III analyzes issues across debt markets, including the market for asset-backed securities and sovereign debt. Part IV discusses conflicts of interest and control fraud, including the conflicts inherent in the issuer-pays model, the provision of ancillary services, unsolicited ratings, and large subscriber influence. Part V discusses rating pitfalls, including the theory of regulatory license, complexity and asymmetric information, and rating procedures and practices. Part VI lists regulatory strategies that limit conflicts. Part VII details U.S. statutes and regulation relating to conflicts of interest at credit rating agencies. Part VIII provides an analysis of current law, and Part IX provides recommendations.

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[15] JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 1–2 (Oxford, 2006).
[16] *Id.*
[17] Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers*, FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS?, Yasuyuki Fuchita, Robert E. Litan, eds., Brookings Institution Press and the Nomura Institute of Capital Markets Research, 2006; San Diego Legal Studies Paper No. 07-46, available at SSRN: http://ssrn.com/abstract=900257.
[18] *See, e.g.*, *Downgraded Europe Goes Hat in Hand*, NYTIMES.COM, IHT RENDEZVOUS, Feb. 14, 2012, *available at* http://rendezvous.blogs.nytimes.com/2012/02/14/downgraded-europe-goes-hat-in-hand/?ref=creditratingagencies (explaining how recent downgrades complicate officials' management of the Euro Crisis).

Current U.S. statutes and SEC rules focus on prohibiting smaller, analyst-level conflicts and seek to limit agency-level conflicts through internal governance rules, organizational firewalls, and disclosure rules. Although the rules are definitely a positive step, they may fall short in addressing agency-level conflicts, especially the issuer-pays conflict. For this reason, the report recommends a strong enforcement and oversight policy by the SEC, with a strong eye toward the dangers of new competition in the market; warning signs of fraud; and understandable and usable disclosures. The SEC should avoid a narrow emphasis on procedural regularity and, instead, look to protect investors as much as possible.

Part II: Background & Regulatory History

Credit rating agencies assess the credit-worthiness of issuers and their obligations. The SEC identifies five classes of credit ratings: (1) financial institutions, brokers, or dealers; (2) insurance companies; (3) corporate issuers; (4) issuers of asset-backed securities; and (5) issuers of government securities, municipal securities, or securities issued by a foreign government.[19] The ratings are opinions[20] that communicate the likelihood of default.[21]

The agencies distil complex information into a simple rating scale, "striv[ing] to maintain comparability of ratings across sectors."[22] For long-term investments, the three largest credit rating agencies—Fitch, Inc. (Fitch), Moody's Investor Service (Moody's), and Standard & Poor's Rating Services, Inc. (S&P)—use a rating scale ranging from A to D, sometimes modified with numbers, pluses, or minuses. For example, S&P and Fitch rate a debt issue or issuer with the following long-term ratings: AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, B+, B, B-, and then some ratings in the Cs and Ds.[23] Moody's uses a similar structure, but with numbers instead of pluses and

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[19] U.S. SEC. & EXCH. COMM'N, 2011 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATIONS OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION 4 (2011).

[20] *Cf.* Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., 651 F. Supp. 2d 155, 175–76 (S.D.N.Y. 2009) ("It is well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an 'actual malice' exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern. However, where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection.").

[21] STANDARD & POOR'S, *Understanding Standard & Poor's Rating Definitions* 3, *available at http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3Dunderstanding_ratings_definitions.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1243834063620&blobheadervalue3=UTF-8.*

[22] *Id.*

[23] Ratings: Definitions & FAQs, STANDARDANDPOORS.COM, http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us#def_1; Fitch Ratings – Definitions of

minuses: Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, and so on.[24] Ratings from AAA to AA-[25] and Aaa to Aa3[26] are considered high-grade investments. A triple-A rating suggests the investment is very low-risk, or "money-good."[27] In order to be "investment-grade," as that term is usually defined, a rating must be rated at least BBB-[28] or Baa3. Bonds with ratings lower than BBB- or Baa3 are classified as speculative[29] and are sometimes referred to as "junk" bonds.

In 1975, the SEC coined the term "Nationally Recognized Statistical Rating Organization" (NRSROs).[30] Under the Net Capital Rule, the Commission applied a "lower haircut[31] to securities held by a broker-dealer that were rated investment grade by a credit rating agency of national repute, because those securities typically were more liquid and less volatile in price than securities that were not so highly rated."[32] The SEC deemed credit ratings from NRSROs as reliable and credible for the purposes of the rule.[33]

Ratings and Other Forms of Opinion, FITCHRATINGS.COM, http://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf .

[24] Ratings Symbols & Definitions, MOODYS.COM, http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004, at 4.

[25] Ratings: Definitions and Facts, *supra* note 23.

[26] Ratings Symbols & Definitions, *supra* note 24, at 4.

[27] *See* LEWIS, *supra* note 4, at 157 (referring to the phrase money-good).

[28] Ratings: Definitions and Facts, *supra* note 23.

[29] Ratings Symbols & Definitions, *supra* note 24, at 4.

[30] U.S. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 6 (2003) [hereinafter 2003 SEC Report] ("The Net Capital Rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value of their proprietary securities positions. A primary purpose of these "haircuts" is to provide a margin of safety against losses that might be incurred by broker-dealers as a result of market fluctuations in the prices of, or lack of liquidity in, their proprietary positions.").

[31] *See* Haricut Definition, INVESTOPEDIA.COM, http://www.investopedia.com/terms/h/haircut.asp ("The percentage by which an asset's market value is reduced for the purpose of calculating capital requirement, margin and collateral levels.").

[32] 2003 SEC Report, *supra* note 30, at 6.

[33] *Id.*

After 1975, references to NRSROs in federal and state financial regulation multiplied. A top rating from a NRSRO allowed money market funds to take on certain investments;[34] broker-dealers to take reduced haircuts on commercial paper, nonconvertible debt securities, and nonconvertible preferred stock;[35] and issuers to use simplified registration procedures under the Securities Act.[36] In addition, given a favorable credit rating, SEC rules exempted an issuer of fixed income securities from the Investment Company Act.[37] High NRSRO ratings became a stand-in for the safety and stability of an entity's investment portfolios—whether the entities were pensions, insurance companies, or banks.[38]

For several decades, the SEC named credit rating agencies NRSROs by issuing a no-action letter, "stating that it will not recommend enforcement action to the Commission if ratings from the rating agency are considered by registered broker-dealers to be ratings from an NRSRO for purposes of applying the relevant portions of the Net Capital Rule."[39] The process was notoriously opaque.[40] The SEC staff "initially did not

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[34] 17 C.F.R. § 270.2a-7 (2012).

[35] *See* 17 C.F.R. § 15c3-1(c)(2)(vi)(E) (2012) (haircuts applicable to commercial paper that has been rated in one of the three highest categories by at least two NRSROs); 17 C.F.R. § 15c3-1(c)(2)(vi)(F) (haircuts applicable to nonconvertible debt securities that are rated in one of the four highest rating categories by at least two NRSROs); 17 C.F.R. § 15c3-1(c)(2)(vi)(H) (haircuts applicable to cumulative, nonconvertibfe preferred stock rated in one of the four highest rating categories by at least two NRSROs).

[36] Adoption of Integrated Disclosure System, Securities Act Re1ease No. 6383 (Mar. 16, 1982); Adoption of Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992).

[37] *See generally* U.S. SEC. & EXCH. COMM'N, Concept Release, Release Nos. 33-7085; 34-34616; IC-20508, *available at* http://www.sec.gov/rules/concept/34-34616.pdf , at 4–5 (citing Exclusion from the Definition of Investment Company for Structured Financing, Investment Company Act Release No. 19105 (November 19, 1992), 52 SEC Dkt. 4014).

[38] *See* 2003 SEC Report, *supra* note 30, at 7–8. "In 1951, the National Association of Insurance Commissioners adopted higher capital requirements on lower-rated bonds held by insurers." FCIC Report, *supra* note 1, at 119.

[39] 2003 SEC Report, *supra* note 30, at 10.

[40] *See Review of the Office of Federal Housing Enterprise Oversight and Federal Housing Finance Board: Joint Hearing before the Subcomm. on Oversight and Investigations and the Subcomm. on Capital Markets, Insurance and Government Sponsored Entereprises [sic] of the Committee on Financial Services*, US

adopt specific standards for determining which credit rating agencies were nationally recognized for their services, preferring instead to address the question on a case-by-case basis."[41] However, a 2003 Report by the SEC enumerated some criteria used in the process:

> The single most important factor in the Commission staff's assessment of NRSRO status is whether the rating agency is "nationally recognized" in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The staff also reviews the operational capability and reliability of each rating organization. Included within this assessment are: (1) the organizational structure of the rating organization; (2) the rating organization's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates); (3) the size and quality of the rating organization's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the rating organization's independence from the companies it rates; (5) the organization's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and (6) whether the rating organization has internal procedures to prevent the misuse of nonpublic information and whether those procedures are followed.[42]

The SEC recognized S&P, Moody's, and Fitch as NRSROs in 1976 and issued no-action letters to only four additional credit rating agencies, which were later acquired by the other NRSROs.[43] At the time of the SEC's report in 2003, the SEC only recognized three NRSROs: the big 3—S&P, Moody's, and Fitch.[44] Many noted that the no-action letter process created a Catch-22: to be a NSRSO, you had to be nationally-recognized, and to be nationally-recognized, you had to be a NRSRO.[45]

House of Representatives, 108th Cong. 2 (2004) (statement of Chairman Oxley) ("Registration would replace the opaque recognition process the SEC staff now uses to select rating agencies.").

[41] 2003 SEC Report, *supra* note 30, at 9.

[42] *Id.* at 9–10.

[43] *Id.* at 8–9.

[44] *Id.*

[45] *See* H. David Kotz, U.S. SEC. & EXCH. COMM'N, OFFICE OF INSPECTOR GENERAL: OFFICE OF AUDITS, No. 458, THE SEC'S ROLE REGARDING AND OVERSIGHT OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS (NRSROS) 90 (2009), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2009/Report458.pdf.

Even though the SEC had incorporated references to credit ratings in its financial regulation for decades, the credit rating agencies themselves were not subject to government oversight until 2007.[46] In 2006, Congress enacted the Credit Rating Agency Reform Act.[47] The Act created registration procedures[48] for credit rating agencies that elect to be treated as a NRSRO and mandated NRSROs to adopt procedures to combat conflicts of interest.[49] The SEC could not, however, regulate "the substance of the credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."[50] As of September 2011, SEC has granted NRSRO status to ten credit rating agencies: A.M. Best Company, Inc. ("A.M. Best"); DBRS Inc. ("DBRS"); Egan-Jones Rating Company ("Egan-Jones"); Fitch; Japan Credit Rating Agency, Ltd. ("JCR"); Kroll Bond Rating Agency ("Kroll"); Moody's; Morningstar Credit Ratings, LLC ("Morningstar"); Rating and Investment Information, Inc. ("R&I"); and S&P.[51]

The Dodd–Frank Wall Street Reform and Consumer Protection Act further enhanced the SEC's authority over credit rating agencies.[52] Most notably, the Dodd–Frank Act created the Office of Credit Ratings,[53] a new office within the SEC. The Office will administer SEC rules "to promote accuracy in credit ratings" and ''to ensure

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[46] Credit Rating Agency Reform Act, Pub. L. No. 109-291, 120 Stat. 1327 (2006) (effective in 2007).
[47] *Id.*
[48] 15 U.S.C. § 78o-7(a) (West, Westlaw through 2012 legislation).
[49] 15 U.S.C. § 78o-7(h) (West 2012).
[50] 15 U.S.C. § 780-7(c)(2).
[51] U.S. SEC. & EXCH. COMM'N, 2011 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATIONS OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION 5 (2011), *available at* http://www.sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf.
[52] Dodd–Frank Wall Street Reform and Consumer Protection Act, Subtitle C, Pub. L. No. 111-203, 124 Stat. 1378, 1872–90 (2010) (codified as amended at 15 U.S.C.A. § 78o-7 (West, Westlaw through 2012 legislation)).
[53] *Id.* at 1877.

that such ratings are not unduly influenced by conflicts of interest."[54] Section 939 strikes statutory references to NRSRO ratings,[55] and section 939A directs federal agencies to review its regulatory references to NRSRO ratings and remove them, whenever possible.[56] The Act identifies additional conflicts of interest, in addition to others identified by the Commission in its rules.[57] The Act also removes traditional exceptions for credit rating agencies under Section 15E(m) of the Securities and Exchange Act, subjecting credit rating agencies to the same liability as registered public accounting firms and securities analysis.[58] Lastly, the Act requires a number of reports and public disclosures that will be discussed later in the report.

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[54] *Id.*
[55] *Id.* at 1885–86 (codified as amended at 12 U.S.C. § 1817; 12 U.S.C. § 1831e; 15 U.S.C. § 78c).
[56] *Id.* at 1886.
[57] *Id.* at 1890 ("It is the sense of Congress that the Securities and Exchange Commission should exercise the rulemaking authority of the Commission under section 15E(h)(2)(B) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7(h)(2)(B)) to prevent improper conflicts of interest arising from employees of nationally recognized statistical rating organizations providing services to issuers of securities that are unrelated to the issuance of credit ratings, including consulting, advisory, and other services.").
[58] *Id.* at 1883.

Part III: Issues across Debt Markets

> *Picture the organizations in the financial markets as animals roaming an open plain. The hedge funds were wolves, hunting in packs, eating what they killed. The investment banks were a now extinct species of predatory cats, saber-toothed tigers, larger and more powerful than the hedge funds. The money center banks were the elephants, big, indestructible, almost a feature of the landscape. And the rating agencies? They were definitely the goats—specifically, the scapegoats. The analogy is almost perfect. From the perspective of the other market players, rating agencies fought over scraps to perform a necessary but lowly task. Just as described in Leviticus, the scapegoats' primary function is to absorb the blame for the sins of the community. They are the animals that everyone loves to hate.*
>
> —Gary Witt, Former Managing Director of Moody's Investor Service[59]

Credit rating agencies occupy myriad roles in different debt markets. However, one factor is consistent: credit rating agencies attract controversy. In some markets, the critics accuse the credit rating agencies for rating too harshly; in others, they are too lax. Under each understanding, credit rating agencies have the potential to exacerbate or precipitate financial crises. They are often late to the game, releasing downgrades suddenly and at inopportune times. When it comes to credit ratings, everyone shoots the proverbial messenger—perhaps because the messenger doesn't always get his story straight.

This report will focus on two debt markets: the market for asset-backed securities (ABS) and sovereign debt markets. This emphasis arises from recent popular interest in credit rating agencies. First, rating agencies incorrectly rated ABSs, such as RMBSs and CDOs, fueling the market for these risky products. Secondly, downgrades of U.S. and European sovereign debt precipitated a discussion on the agencies' influence in debt markets. While the report could undoubtedly focus on issues in corporate debt markets—

[59] Statement of Gary Witt to Financial Crisis Inquiry Commission, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0602-Witt.pdf (2010).

for example failures of Enron and WorldCom, this report will primarily focus on the role of the credit rating agencies in the most recent financial crisis.

ASSET-BACKED SECURITIES

> *[Our financial system] became a Ponzi scheme. Everybody was buying a pig in the poke. But they were buying a pig in the poke with a pretty pink ribbon, and the pink ribbon said, "Triple-A."*
>
> —William K. Black, Interview with Bill Moyers[60]

Securitization, or "structured finance," is one of the largest developments in finance in the last twenty-five years.[61] Securitization allows investors to invest in "bundles, or 'pools,' of income-producing financial assets," such as "mortgages, corporate loans, auto loans, or credit-card receivables."[62] Originators sell these financial assets to an issuer, sometimes referred to as a "special purpose vehicle" (SPV), and the issuer then "issues claims on the pool income to investors."[63] This securitization allows for the separation of origination and risk—a form of "specialization" in financial markets.[64] Financial actors looked to securitization of mortgage pools as a way of controlling interest and pre-payment risk.

There are two types of securitization: pass-through securitization and tranched securitization.[65] In pass-through securitization, popular since the 1970s, the issuer pools the assets and then issues a single type of security, with "each investor hold[ing] a

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[60] *Bill Moyers Journal: Interview with William K. Black* (PBS television broadcast, April 3, 2009), *available at* http://www.pbs.org/moyers/journal/04032009/transcript3.html.
[61] John P. Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV 109, 117 (2009).
[62] *Id.*
[63] *Id.*
[64] Raghuram G. Rajan, *Has Financial Development Made the World Riskier?* Proceedings, Federal Reserve Bank of Kansas City (2005), *available at* http://www.kc.frb.org/publicat/sympos/2005/pdf/Rajan2005.pdf, at 322.
[65] Efraim Benmelech & Jennifer Dlugosz, *The Credit Rating Crisis* (Nat'l Bureau of Econ. Research, Working Paper 15045, 2009), at 3.

proportional claim on the underlying assets."[66] In tranched securitization, issuers can carve out cash flows from the bundle into "tranches," "differing in liquidity, maturity, contingency, and risk," and then market these securities to different clientele, based on their preferences.[67] Cash flows are usually tranched into senior, mezzanine, and junior tiers, "with losses from pool defaults first causing losses in the junior tiers, then in mezzanine tiers once the junior tiers are exhausted, and finally in the senior tiers."[68] Theoretically, the senior tiers have the smallest default risk exposure and thus the highest ratings.[69]

Two types of asset-backed securities[70] (ABS) were particularly relevant to the most recent financial crisis: (1) residential mortgage-backed securities (RMBSs), composed of diversified pools of residential mortgage loans, and (2) collaterized debt obligations (CDOs), composed of RMBSs, other CDOS, or "just about anything that generates yield."[71] Following the failures of Enron and WorldCom in 2002 and 2003,[72] Wall Street largely shifted its focus from CDOs backed by corporate bonds to CDOs backed by RMBSs.[73] Unlike CDOs backed by corporate bonds, CDOs backed by RMBSs contained three—not two—levels of debt.[74] "Instead of . . . using debt to buy the debt of a company, CDOs were using debt to buy the debt from a pool of mortgages, which was itself homeowner's debt."[75]

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[66] *Id.*
[67] *Id.*
[68] Hunt, *supra* note 61, at 118.
[69] *Id.*
[70] *See* Benmelech & Dlugosz, *supra* note 65, at 5 (defining asset-backed securities as a "general term for bonds or notes backed by pools of assets rather than a single corporation or government").
[71] BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS 120 (Penguin 2010).
[72] *Id.* at 121.
[73] *Id.*
[74] *Id.* at 122.
[75] *Id.*

In their book *All the Devils are Here*, Bethany McClean and Joe Nocera note that "CDOs were fraught with risks and conflicts." They describe the large sums of money changing hands, as well as the banks and securities firms' incentives in removing toxic assets off their balance sheet:

> Debt was being used to buy debt. CDO managers were paid a percentage of the money in the CDO, meaning they had an incentive to find stuff to buy—good, bad, or indifferent. Wall Street firms, who usually worked hand in glove with the managers, could earn hefty fees. According to one hedge fund manager who became a big investor in CDOs, as much as 40 to 50 percent of the cash flow generated by the assets in a CDO went to pay the bankers, the CDO manager, the rating agencies, and others who took out fees.
>
> What's more, CDOs could also give banks and Wall Street securities firms both the means and the motive to move their worst assets off their balance sheets and into a CDO instead.[76]

"Securitization is, and always has been, a rating-driven product."[77] The creation of tranches presupposes different exposures to default risk and therefore different ratings. The credit rating agencies were especially important to the market for mortgage-backed securities:

> Issuers needed them to approve the structure of their deals; banks needed their ratings to determine the amount of capital to hold; repo markets needed their ratings to determine loan terms; some investors could buy only securities with a triple-A rating; and the rating agencies' judgment was baked into collateral agreements and other financial contracts.[78]

A triple-A rating was highly desired by investors, so issuers and CDO managers found ways to repackage RMBSs with lower ratings into highly-rated CDOs. Riskier tranches of RMBSs, for example those rated triple-B, were reassembled into tranches of CDOs.

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[76] *Id.* at 121.

[77] Hunt, *supra* note 61, at 176 (quoting Lakhbir Hayre, *A Concise Guide to Mortgage-Backed Securities (MBSs)*, in SALOMON SMITH BARNEY GUIDE TO MORTGAGE-BACKED AND ASSET-BACKED SECURITIES 9, 13 (Lakhbir Hayre ed., 2001)).

[78] FCIC Report, *supra* note 1, at 118.

The credit rating agencies then gave the senior tranches of these CDOs a triple-A rating. Investment banks and credit rating agencies viewed this CDO as "another diversified portfolio of assets"[79] and therefore a safer bet than the individual underlying RMBSs. However, as Michael Lewis notes, the agency model did not change the character of the CDO's underlying bonds:

> The 100 buildings occupied the same floodplain; in the event of a flood, the ground floors of all of them were equally exposed. But never mind: The rating agencies, who were paid fat fees by Goldman Sachs and other Wall Street firms for each deal they rated, pronounced 80 percent of the new tower of debt triple-A. The CDO was, in effect, a credit laundering service for the residents of Lower Middle Class America. For Wall Street it was a machine that turned lead into gold.[80]

Ratings were so important, in fact, that CDO managers began cooking up new types of CDOs to address the marketability of lower tranches of CDOs. CDO managers recycled triple-B tranches of CDOs into "CDO squareds," which in turn had its more senior tranches stamped triple-A.[81] Triple-B tranches of "CDO squared" were reassembled into "CDO cubeds," again with some tranches rated triple-A.[82] CDO managers even created synthetic CDOs, composed of a portfolio of credit default swaps that often referenced CDOs and RMBSs.[83] The demand for these derivative instruments had outpaced the speed by which residential mortgages could be originated.[84]

Despite a lack of transparency regarding the CDOs' underlying assets, investors continued buying the instruments because of the agencies' triple-A ratings.[85] As

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[79] LEWIS, *supra* note 4, at 73.
[80] *Id.*
[81] *Id.* at 123.
[82] *Id.*
[83] *Id.* at .
[84] *Id.*
[85] *See id.* ("One astonishing fact is that CDO managers didn't always have to disclose what the securities contained because those contents could change. Even more astonishing, investors didn't seem to care.").

McClean and Nocera argue, investors "weren't so much buying a security[;] [*t*]*hey were buying a triple-A rating*."[86]

Corporate bonds and asset-backed securities differ substantially in their risk profiles, even though AAA ratings should suggest similar likelihoods of default. "CDOs become much riskier investments than equally rated corporate bonds due to an increased sensitivity to systematic risks, not captured by traditional ratings."[87] For example, the ABS CDOs heavily relied on the perceived safety of real estate.[88] The CDOs no longer represented diverse types of income streams, but rather reflected a belief in the eternal ascendancy of the real estate market.[89] Moody's models assumed an annual increase of 4% in home values.[90]

Furthermore, the agency's models assumed that prices of triple-B RMBSs were not highly correlated.[91] Moody's and S&P's models assumed around 30% correlation, suggesting that a default of one bond would have little impact on the rest of the RMBSs in a given pool.[92] If the CDO's underlying asset pools were lowly correlated, a higher

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[86] *Id.* at 121.

[87] Thomas Mählmann, *Did Investors outsource their risk analysis to rating agencies? Evidence from ABS-CDOs*, J. BANKING & FIN. (2012), at 3.

[88] MCLEAN & NOCERA, *supra* note 71, at 121–22.

[89] *Id.* at 121–22 ("The idea, says one person who was prominent in the CDO business, was that the original rationale for CDOs—loan diversification—had proven to be flawed. But if you bought real estate, he said, "you were golden. You were safe."); FCIC Report, *supra* note 1, at 121 ("Moody's position was that there was not a . . . national housing bubble.");

[90] *Id.* at 120.

[91] MCLEAN & NOCERA, *supra* note 71, at 118; LEWIS, *supra* note 4, at 207; *see* MCLEAN & NOCERA, *supra* note 71, at 118 ("Correlation is essentially a way of describing in numerical terms, the likelihood that if one security defaults, others would default in tandem."); LEWIS, *supra* note 4, at 207–208 ("[A correlation of around 30 percent] did not mean anything like what it sounds. It does not mean, for example, that if one bond goes bad, there is a 30 percent chance that the others will go bad too. It means that if one bond goes bad, the others experience little decline at all."); *see also* Felix Salmon, *Recipe for Disaster: The Formula that Killed Wall Street*, WIRED.COM, Feb. 23, 2009, *available at* http://www.wired.com/techbiz/it/magazine/17-03/wp_quant?currentPage=all ("Using Li's copula approach meant that ratings agencies like Moody's—or anybody wanting to model the risk of a tranche—no longer needed to puzzle over the underlying securities. All they needed was that correlation number, and out would come a rating telling them how safe or risky the tranche was.").

[92] *Id.* at 207.

percentage of the tranches could be labeled triple-A. Credit enhancements by underwriters, such as overcollateralization or excess spreads,[93] could further boost those percentages.[94] For example, 80 percent of the CDO could be named triple-A.[95]

Despite the susceptibility of CDOs and RMBSs to systematic risk, the credit ratings suggested that CDOs could be made safer than corporate bonds. For example, Moody's rated nearly 45,000 mortgage backed securities as triple-A, compared to six private-sector companies that held the rating in 2010.[96] In 2006, Moody's rated 30 mortgage-related securities triple-A *each day*.[97]

As high default rates became more apparent, the credit rating agencies quickly downgraded RMBSs and CDOs. Of the mortgage securities rated triple-A by Moody's in 2006, 83% were ultimately downgraded,[98] and 73% were downgraded to junk.[99] By 2010, over 90% of subprime RMBS securities issued in 2006 and 2007 were "fallen angels," downgraded by Moody's and S&P from triple-A to junk status.[100] Of the 10,000 CDOs rated by S&P, "almost half" were downgraded by the end of 2008.[101] "By the end of 2008, more than 90% of all tranches of CDOs had been downgraded."[102] Curiously, many of the credit rating agencies downgraded CDOs and RMBSs just months after their initial issuance; despite downgrading similar instruments in droves at a similar time, the agencies rated CDOs triple-A in late 2007, only to be later demoted to junk status mere

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[93] STAFF ON S. PERMANENT SUBCOMM. ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (2011), at 251 [hereinafter Levin–Coburn Report].
[94] MCLEAN & NOCERA, *supra* note 71, at 118.
[95] LEWIS, *supra* note 4, at 73.
[96] FCIC Report, *supra* note 1, at *xxvv*.
[97] *Id.*
[98] *Id.*
[99] *Id.* at 122.
[100] Levin–Coburn Report, *supra* note 93, at 267.
[101] Martin Mayer, *supra* note 2.
[102] FCIC Report, *supra* note 1, at 224.

months later.[103] In fact, S&P is currently under investigation by the SEC for its actions related to a CDO called Delphinus.[104]

According to a report released by the National Bureau of Economic Research, "64% of all downgrades in 2007 and 2008 were tied to securities that had home equity loans or first mortgages as collateral."[105] RMBS, ABS, or CDO securities were tied to 95% of all downgrades.[106] "ABS CDOs accounted for 42% of the total write-downs of financial institutions around the world. As of October 2008, Citigroup, AIG, and Merrill Lynch took write-downs totaling $34.1 billion, $33.2 billion, and $26.1 billion, respectively, due to ABS CDO exposure."[107]

SOVEREIGN DEBT

> *There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful.*
>
> –Thomas Friedman[108]

Sovereign debt ratings, just like other credit ratings, communicate the likelihood that a given government borrower will default.[109] "Governments generally seek credit

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[103] *See* Levin–Coburn Report, *supra* note 93, at 266–267 (citing as an example Vertical ABS CDO 2007-1, GSAMP Trust 2007-FM2, and Delphinus CDO 2007-1, Ltd.); *see also* Louise Story, *S.&P. Target of Inquiry in Securities*, NYTIMES.COM, Sep. 26, 2011, http://www.nytimes.com/2011/09/27/business/sec-weighs-action-against-standard-poors.html (describing recent SEC investigation of Delphinus deal with S&P).

[104] *Id.* In this case, S&P proceeded with giving the CDO high ratings, even though the replacement of dummy variables with subprime products would have lowered the rating. Shira Ovide, *Inside S&P: Fears Over an Ill-Fated CDO Deal*, DEAL JOURNAL, WSJ.COM, Sep. 27, 2011, http://blogs.wsj.com/deals/2011/09/27/inside-sp-fears-over-an-ill-fated-cdo-deal/; Joshua Gallu and Zeke Faux, *SEC's Notice to S&P May Signal Enforcement Cases Against Rating Companies*, BLOOMBERG.COM, Sep. 26, 2011, http://www.bloomberg.com/news/2011-09-27/sec-s-notice-to-s-p-may-signal-enforcement-cases-against-raters.html.

[105] Benmelech & Dlugosz, *supra* note 65, at 2.

[106] *Id.* at 10.

[107] *Id.* at 2.

[108] *The News Hour with Jim Lehrer: Interview with Thomas L. Friedman* (PBS television broadcast, Feb. 13 1996), *available at* http://www.pbs.org/newshour/gergen/friedman.html.

ratings to ease their own access (and the access of other issuers domiciled within their borders) to international capital markets."[110] A credit rating is particularly important given Basel II and Basel III capital requirements, which calculates capital requirements for banks by weighting securities with certain credit ratings.[111]

Research on sovereign debt credit ratings usually focuses on two factors: the determinants of sovereign credit ratings[112]—factors such as GDP growth, levels of economic development, default history, inflation, and per capita income—and ratings' accuracy or ability to predict debt crises. Many studies conclude, using data from crises in the 1980s and 1990s, that "sovereign ratings fail to anticipate banking and currency crises and are instead adjusted ex-post."[113] Several common arguments for this failure include (1) lack of "timely, accurate, and comprehensive information on the borrower's creditworthiness;" (2) a moral-hazard play, where rating agencies "expect implicit guarantees from the international official sectors;" (3) conflicts of interest, as represented by the issuer-pays conflict; and (4) a distinction, stressed by the credit rating agencies, between the relative likelihood of default—represented by credit ratings—and the

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[109] Richard Cantor & Frank Packer, *Determinants and Impact of Sovereign Credit Rating Agencies*, 20 FRBNY ECON. POL'Y REV. (1996), at 38.
[110] *Id.*
[111] BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (Dec. 2010, rev. June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.
[112] *See, e.g.*, Cantor & Packer, *supra* note 109 (studying determinants of sovereign credit ratings); Gautam Setty & Randall Dodd, *Credit Rating Agencies: Their Impact on Capital Flows to Developing Countries* (Financial Policy Forum: Derivatives Study Center, Special Policy Report 6, 2003) (summarizing Moody's & S&P's sovereign debt factors).
[113] Amadou N.R. Sy, *Rating the rating agencies: Anticipating currency crises or debt crises*, 28 J. BANKING & FIN. (2004), at 2845–46.

likelihood of a currency crisis.[114] However, as Amadou N.R. Sy and C.M. Reinhart demonstrate, currency crises are often linked to default rates.[115]

In addition, many researchers note the procyclical nature of credit ratings. In other words, "they claim that ratings increase the magnitudes of the business cycles because sovereigns are upgraded during expansionary periods and downgraded contractionary periods."[116] When ratings are inaccurate or otherwise postdate large financial movements, high ratings during an economic expansion can "speed up" capital, while downgrades during contractionary periods can further worsen the economic cycle.[117] Presumably, ratings that more properly anticipate movements of financial markets can help temper booms and decrease the pain of a bust.[118] Downgrades can be particularly destructive when the rating moves below investment grade, precipitating mass sales of the bonds by institutional investors.[119] The East Asian crisis in 1997 is one of the most commonly cited examples of this phenomenon.[120]

This procyclical analysis often is emphasized with respect to developing countries, especially because sovereign debt ratings can affect private debt markets within developing countries.[121] The credit rating agencies institute a "country ceiling," policy, where firms, especially banks, cannot be rated higher than its home country's

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[114] *Id.* at 2846.
[115] *See generally id.*; Carmen M. Reinhart, *Default, Currency Crises, and Sovereign Debt Ratings* (Nat'l Bureau of Econ. Research, Working Paper No. 8738, 2002).
[116] Gautam Setty & Randall Dodd, *Credit Rating Agencies: Their Impact on Capital Flows to Developing Countries* (Financial Policy Forum: Derivatives Study Center, Special Policy Report 6, 2003), at 12.
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] *Id.* at 13.
[121] *Id.* at 14.

sovereign debt.[122] Moody's appears to make some exceptions, but rarely in developing countries.[123]

Credit rating downgrades in the Euro Zone, as well as public warnings, seem to have a similar effect. For example, after Moody's and Fitch "warned that political efforts to protect the euro had not resolved the immediate dangers of a significant economic downturn in the region and troubles in the banking system," "the yield, or interest rate, on the 10-year Italian government bond—perhaps the most crucial barometer of the euro crisis—rose to 6.5 percent, heading back into a range that could make it hard for Italy to pay off its staggering debts."[124] European politicians later criticized S&P downgrades for "providing no meaningful new information to investors but simply stoking a sense of crisis."[125] In response to these actions, some European politicians have proposed credit rating agency regulations, which if enacted would (1) prohibit unsolicited ratings on sovereign debt; (2) allow member states to opt out of purchasing a credit rating; (3) prohibit statements announcing revision of a given group of countries ("in order to avoid the risk of contagion"); and (4) require credit rating agencies to consider the impact of that rating on financial stability. [126] In addition, the report called for a "fully independent public European Credit Rating Agency" to assess Member States' sovereign debt.[127]

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[122] *Id.*
[123] *Id.*
[124] Liz Alderman & Christine Hauser, *Rating Agency Warnings Bring Down the Markets*, NYTIMES.COM, Dec. 12, 2011, http://www.nytimes.com/2011/12/13/business/rating-agency-warnings-bring-down-the-markets.html?_r=1&scp=7&sq=credit%20rating%20agency%20AND%20euro%20zone&st=cse.
[125] Liz Alderman & Rachel Donadio, *Downgrade of Debt Ratings Underscores Europe's Woes*, NYTIMES.COM, Jan. 13, 2012, http://www.nytimes.com/2012/01/14/business/global/euro-zone-downgrades-expected.html?scp=2&sq=credit%20rating%20agency%20AND%20euro%20zone&st=cse.
[126] Draft Report on the proposal for regulation of the European Parliament and of the Council amending Regulation (EC) No. 1060/2009 on credit rating agencies (Com(2011)0747 – C7-0420/2011 – 2011 1/0361(COD)), 892526EN, *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-480.852&format=PDF&language=EN&secondRef=03.
[127] *Id.*

Part IV: Conflicts & Control Fraud

William K. Black used the term control fraud to characterize actors in the Savings & Loan Crisis.[128] A control fraud "is a company run by a criminal who uses it as a weapon and shield to defraud others and makes it difficult to detect and punish the fraud."[129] While very few actors in the most recent financial crisis have been found guilty of fraud,[130] issuers, arrangers, and credit rating agencies undoubtedly participated in control fraud, perhaps with differing levels of intent and knowledge. In an interview with Bill Moyers, Black acknowledged the existence of control fraud in the most recent financial crisis:

> Now a triple-A rating is supposed to mean there is zero credit risk. So you take something that not only has significant, it has crushing risk. That's why it's toxic. And you create this fiction that it has zero risk. That itself, of course, is a fraudulent exercise.[131]

Just as "[c]ontrol frauds shop for accommodating accountants, appraisers, and attorneys,"[132] issuers and arrangers would shop for a rating that would allow them to market riskier assets. An environment of "deregulation" and "desupervision" in the secondary mortgage market was "criminogenic," in that it encouraged waves of control fraud and embedded systematic risk in thousands of financial products.[133]

The behavior of credit rating agencies was not irrational.[134] Management at credit rating agencies saw immediately attainable high fees and low reputational costs, and

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[128] WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE (Univ. of Tex. Press, 2005).
[129] *Id.* at 1.
[130] *See generally Financial Crisis: Cases and Litigation*, NYTIMES.COM, http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_crisis/litigation/index.html.
[131] *Bill Moyers Journal: Interview with William K. Black*, *supra* note 60.
[132] BLACK, *supra* note 128, at 147.
[133] *See id.* at 4–5 (characterizing the environment of deregulation and desupervision before S&L crisis as "criminogenic").
[134] *Id.* at 4.

"[m]oral hazard arises when gains and losses are asymmetrical."[135] Credit rating agencies succumbed to conflicts of interest that misaligned the gains and losses from overly optimistic, if not grossly incorrect, credit ratings. Concern for market share trumped concern for reputational capital. As Professor John P. Hunt notes, "reputation is unlikely to guarantee high-quality ratings on novel products."[136] Even if a credit rating agency did not know how to issue a quality rating in structured finance or knew that it would issue a poor credit rating, the agency would still enter the market to facilitate the creation of a new market for its rating services, as well as to receive the fees.[137] In this regard, the credit rating agencies do not benefit from delay.[138]

Conflicts of interest at credit rating agencies arise both at the analyst level and the agency level.[139] Conflicts of interest at the analyst level deal with inappropriate contact between the raters and the rated, or an analyst's personal interest in improved performance of the issue. The conflicts include the following: (1) ownership of securities of rated entities;[140] (2) employment position or directorship at a rated entity;[141] (3) business relation beyond ordinary course of business or special purpose relationship;[142] (4) receipt of gifts from rated entities;[143] and (5) the determination of analysts' compensations based on rating fees.[144]

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[135] *Id.* at 6.
[136] Hunt, *supra* note 61, at 174–181.
[137] *Id.*
[138] *Id.*
[139] Lin (Lynn) Bai, *On Regulating Conflict of Interests in the Credit Rating Industry*, 13 N.Y.U. J. LEGIS. & PUB. POL'Y 253, 260–61 (2010).
[140] *Id.* at 260.
[141] *Id.*
[142] *Id.* at 260–61.
[143] *Id.* at 261.
[144] *Id.* at 261.

At the rating agency level, authors have noted five primary conflicts: (1) rating an affiliated underwriter or issuer;[145] (2) providing ancillary services to rated entities;[146] (3) large subscriber influence;[147] (4) the issuer-pays business model;[148] and (5) unsolicited ratings. While this report notes both types of conflicts, this section will only discuss agency-level conflicts.

THE ISSUER-PAYS MODEL

> *"They've become so beholden to their top issuers for revenue they have all developed a kind of Stockholm syndrome which they mistakenly tag as Customer Value creation."*
>
> —Michael Gutierrez, S&P Servicer Evaluation Group[149]

The three largest credit rating agencies, S&P, Moody's, and Fitch, employ an issuer-pays business model. In an issuer-pays model, the issuer—or the entity issuing the debt or debt-like securities—pays the credit rating agency for its rating services. This model is a deviation from the historical trend, popular before the early 1970s, to charge subscribers for access to the agency's ratings.[150] The subscriber-pays model became less popular as the demand for rated securities grew and as it became more difficult for credit rating agencies "to keep their ratings out of the hands of non-subscribers."[151]

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[145] *Id.* (citing 15 U.S.C. § 78o-7(h)(2)(D) (2006)) ("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").
[146] *Id.* at 261–62. ("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.").
[147] *Id.* at 263.
[148] *Id.* at 263–65.
[149] Levin–Coburn Report, *supra* note 93, at 277 (quoting 8/8/2006 email from Michael Gutierrez to Richard Koch, "RE: Loss Severity vs gross/net proceeds," Hearing Exhibit 4/23-14).
[150] Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 239 (2009)
[151] *Id.*

Furthermore, as the business strategies used by issuers grew more complex, "issuing ratings required more resources than could be recovered solely from subscription fees."[152]

With the adoption of the issuer-pays model, credit rating agencies developed business relationships with issuers and exposed themselves to potential conflicts of interest. Adoption of the issuer-pays model did not immediately corrupt the rating process, however. At the beginning of their chapter on Moody's, McLean and Nocera note that "[i]n retrospect, the surprise is not that the rating agencies would eventually be corrupted by their business model, but that it took so long to happen."[153] Rating agencies were sometimes criticized for caring too little about the issuer—for letting the phone ring too long and neglecting to foster business relationships.[154] However, as McLean and Nocera note, the practices of credit rating agencies changed with the rise of structured finance, as well as Moody's spin off from Dun & Bradstreet in 2000.[155] After the spin-off, Moody's became a publicly traded company, which gave many of Moody's executives stock options and a new interest in "generating revenues and profits."[156] Mark Froeba, former senior vice president of US Derivatives at Moody's, described the change in Moody's to investigators:

> When I joined Moody's in late 1997, . . . an analyst's worst fear was that he would contribute to the assignment of a rating that was wrong, damage Moody's reputation for getting the answer right and lose his job as a result. When I left Moody's an analyst's worst fear was that he would do something that would allow him to be singled out for jeopardizing Moody's market share, for impairing Moody's revenue or for damaging Moody's relationships with its clients.[157]

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[152] *Id.*
[153] MCLEAN & NOCERA, *supra* note 71, at 114.
[154] *Id.*
[155] *Id.* at 114–15.
[156] *Id.*
[157] *Id.* at 116.

The new goal of the credit rating agencies was to maximize market share.[158]

The issuer-pays model incentivized agencies to maximize the quantity, and not necessarily the quality, of their ratings. Before re-evaluating their risk models, credit rating agencies would consider how customers would react.[159] Credit rating agencies feared losing a competitive edge if and when they downgraded certain investments.[160] Instead of assigning accurate ratings, the agencies' primary goal was to "maximiz[e] the number of the deals they rated for Wall Street investment banks and the fees the collected from them."[161]

The model also implicated ratings shopping by issuers.[162] Issuers can receive "preliminary" ratings from multiple rating agencies to assess whether or not to purchase a rating from an agency.[163] While ratings shopping "inflate[s] purchased and observed credit ratings," no matter the agency practice,[164] fierce competition in structured finance led to the loosening of rating standards.[165] The issuers did not need ratings from all three agencies, so "issuers could play the agencies off each other."[166] McLean and Nocera illustrate this relationship with comments from Moody's employees:

> "The only way to get market share was to be easier," says Jerome Fons, a longtime Moody's managing director. "It was a race to the bottom." A former

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[158] *See generally* Levin–Coburn Report, *supra* note 93, at 274–278 (discussing the drive for market share among credit rating agencies).
[159] U.S. S.E.C. SUMMARY REPORT, *supra* note 11, at 8.
[160] *Id.* at 25 ("[I]nternal communications appear to expose analytical staff to this conflict of interest by indicating concern or interest in market share when firm employees were discussing whether to make certain changes in ratings methodology. In particular, employees discussed concerns about the firm's market share relative to other rating agencies, or losing deals to other rating agencies.").
[161] LEWIS, *supra* note 4, at 157.
[162] *Id.* at 118.
[163] Jie (Jack) He, Jun 'QJ' Qian, and Philip E. Strahan, *Are All Ratings Created Equal? The Impact of Issuer Size on the Pricing of Mortgage-backed Securities* (Nat'l Bureau of Econ. Research, Working Paper No. 17238, 2011), at 2, 8.
[164] *Id.* at 8.
[165] MCLEAN & NOCERA, *supra* note 71, at 117.
[166] *Id.*

> structured finance executive at Moody's says, "No rating agency could say, 'We're going to change and be more conservative.' You wouldn't be in business for long if you did that. We all understood that."[167]

When Brian Clarkson, manager of the structured finance division at Moody's, gave a "second look" to the agency's models, Moody's market share jumped from 14 percent to 32 percent in the commercial mortgage-backed securities market and 35 percent to 59 percent in the general mortgage-backed securities market.[168]

Because of the importance of arrangers[169] in structured finance, ratings of structured-finance projects such as RMBSs and CDOs particularly implicated conflicts of interest.[170] In a structured-financed deal, the arranger "has more flexibility to adjust the deal structure to obtain a desired credit rating."[171] Secondly, the "arrangers that underwrite RMBS and CDO offerings have substantial influence over the choice of rating agencies hired to rate the deals" and often have a longstanding business relationship with the credit rating agencies. In an analysis of RMBS and CDO deals, the SEC noted that the same twelve to thirteen arrangers were responsible for the vast majority of rating business in the structured-finance arena.[172] Researchers have noted that mortgage-backed securities issued by larger issuers received better ratings than those issued by smaller

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[167] *Id.* at 119.

[168] *Id.* at 117. This report will often focus on the activities of Moody's in rating RMBSs and CDOs. The FCIC report, as well as other important works on the financial crisis, focus on the actions of Moody's. While the abuses at S&P appear to be just as prevalent, the substantial culture changes at Moody's often provide a compelling narrative. Brian Clarkson was a particularly colorful character. His management style was infamous, and many analysts from his department at Moody's later testified to describe the department's shortcomings. *See generally id.* at 110–124 (quoting many co-workers at Moody's).

[169] An arranger is "a bank or other financial institution responsible for originating and syndicating a transaction" and often is the "primary designer" of a structured-finance deal. *Id.* at 33; Syndicated Loan: A Glossary, http://www.loan-market-assoc.com/uploads/files/Syndicated_Loan_glossary.pdf.

[170] U.S. S.E.C. SUMMARY REPORT, *supra* note 11, at 33.

[171] *Id.*

[172] *Id.* at 34 (noting that in an analysis of the three largest credit rating agency deals, 12 arrangers accounted for 80% of the subprime RMBS deals in both number and value and 11 arrangers accounted for 92% of the deals and 80% of the value for CDO deals).

issuers, especially during boom years; the securities were "structured more aggressively" so that a greater fraction of the funds were rated triple-A.[173]

For the credit rating agencies, each deal—and there were thousands—could bring substantial fees.[174] S&P charged issuers from $40,000 to $135,000 to rate tranches of an RMBS and from $30,000 to $750,000 for tranches of a CDO.[175] Surveillance fees—imposed either annually or at the time of the initial rating—ranged from $5,000 to $50,000 for RMBSs.[176] Structured finance accounted for 43% of Moody's revenues from 2001 to 2006[177] and 49% of S&P's revenues in 2007,[178] up from 36% in 2002. The impact on the companies' revenues was substantial:

> Moody's gross revenues from RMBS and CDO ratings more than tripled in five years, from over $61 million in 2002, to over $260 million in 2006. S&P's revenue increased even more. In 2002, S&P's gross revenue for RMBS and mortgage related CDO ratings was over $64 million and increased to over $265 million in 2006. In that same period, revenues from S&P's structured finance group tripled from about $184 million in 2002 to over $561 million in 2007. . . . In addition, from 2000 to 2007, operating margins at the CRAs averaged 53%. Altogether, revenues from the three leading credit rating agencies more than doubled from nearly $3 billion in 2002 to over $6 billion in 2007.[179]

The companies' share prices increased substantially, "outpac[ing]" the major investment banks on Wall Street.[180] The companies paid their CEOs and managers handsomely.[181]

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[173] He, Qian, & Strahan, *supra* note 163, at 27.
[174] *See* FCIC Report, *supra* note 1, at 121 (analyzing a sample deal in which Moody's was paid $208,000 and S&P $135,000).
[175] Levin–Coburn Report, *supra* note 93, at 256.
[176] *Id.*
[177] *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agency: Hearings Before the U.S. Comm. on Banking, Housing and Urban Affairs* (testimony of Professor John C. Coffee) (2008), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=94ccc2ab-8401-4e4c-a1b2-71f36a9fd25b.
[178] Levin–Coburn Report, *supra* note 93, at 257.
[179] *Id.* at 256–57.
[180] *Id.* at 257–58.
[181] "Top CRA executives received millions of dollars each year in compensation. Moody's CEO, Raymond McDaniel, for example, earned more than $8 million in total compensation in 2006. Brian Clarkson, the head of Moody's structured finance group, received $3.8 million in total compensation in the same year.

ANCILLARY SERVICES

Most credit rating agencies offer ancillary services, such as debt restructuring or risk management consulting, in addition to their core business of rating debt.[182] Credit rating agencies can generate substantial income through ancillary services. For example, Moody earned $550 million from ancillary services in 2008—approximately 30% of the total revenue earned by the agency.[183] "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."[184] While credit rating agencies maintain that they have established firewalls between rating and ancillary services divisions of the agency, buy-side participants have noted instances in which analysts from a credit rating agencies have marketed advisory services to their firm.[185]

Furthermore, credit rating agencies may issue more favorable ratings to issuers who purchase additional services, thus punishing issuers who do not purchase such services.[186] Hannover Re, a large reinsurance company, claimed that Moody's downgraded the company in retaliation for not using its ancillary services. In this popular example, Hannover Re hired S&P and A.M. Best Company for its rating services in 1998 and thereafter declined a subscription with Moody's.[187] Moody's then rated Hannover Re on an unsolicited basis, "with an initial rating of Aa2, one notch below that

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Upper and middle managers also did well. Moody's managing directors made between $385,000 to about $460,000 in compensation in 2007, beforestock options. Including stock options, their total compensation ranged from almost $700,000 to over $930,000. S&P managers received similar compensation." *Id.* at 258–259.

[182] Bai, *supra* note 139, at 261.

[183] *Id.* at 269.

[184] *Id.* at 261.

[185] *Id.* at 262 (citing 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.)).

[186] *Id.*

[187] *Id.*

given by Standard & Poor's, and subsequent ratings of Aa3 (in January 2001) and A2 (in November 2001), and Baa1 (in March 2003)."[188] The ratings were lower than those given by S&P and A.M. Best—a full two to four notches.[189] The final downgrade to Baa1 caused a ten percent drop in the company's stock price "and surprised many analysts, because there was no new public information to justify" the downgrade.[190] Hannover management characterized the downgrades as "pure blackmail."[191] They alleged that "they were told on many occasions that their rating would be impacted positively if they subscribed to Moody's service."[192]

UNSOLICITED RATINGS

Credit rating agencies may engage in similar retaliatory behavior by issuing unsolicited ratings, or "hostile" ratings.[193] Moody's appears to freely engage in unsolicited ratings,[194] while other agencies tend to limit the practice to sovereign debt ratings, large public corporate debt, and developing markets. For example, S&P "'assign[s] and publish[es] ratings for all public corporate debt issues over $100 million—with or without a request from an issuer,'"[195] and in the 1990s, S&P released 150 unsolicited ratings before becoming a contender in the Japanese credit market.[196] The agencies insist that these unsolicited ratings meet a demand for information in

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[188] *Id.*
[189] *Id.*
[190] *Id.*
[191] *Id.*
[192] *Id.* (citing 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)).
[193] Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 709 (1999).
[194] *See id.* at 652 n.154 ("Although S&P commits not to publish a rating the issuer doesn't want, Moody's alone insists on its right to issue even unsolicited ratings.").
[195] Bai, *supra* note 139, at 264 (quoting STANDARD & POOR'S, CORPORATE RATINGS CRITERIA 16 (2008), *available at* http://www.nafoa.org/pdf/CorprateCriteriaBook-2008.pdf).
[196] *Id.* at 264–65.

financial markets[197] or enhance the agencies' credibility.[198] However, smaller credit rating agencies often argue that unsolicited ratings serve to strong-arm investors into buying rating services from large issuers:

> Fitch Investors Service has stated that Moody's uses the threat of an unsolicited rating to scare reluctant customers into requesting a rating, and a managing director from Duff & Phelps Credit Rating Co. has stated that "[u]nsolicited ratings are tantamount to blackmail."[199]

In fact, the Department of Justice investigated Moody's for anti-competitive practices, including the use of unsolicited ratings. Unsolicited ratings are usually lower than solicited ratings[200] and may impose significant costs on the issuer.[201]

In October 1995, Jefferson County School District in Colorado sued Moody's for publishing an unsolicited rating.[202] In 1993, the school district decided to refinance its bonded indebtedness by issuing refunding bonds.[203] The district elected to hire two rating agencies, S&P and Fitch, despite having had a previous relationship with Moody's.[204] Although the bonds initially sold well, the demand for the bonds fell after Moody's stated that bonds had a negative outlook in an electronically distributed information service.[205] The Dow Jones Capital Reports republished Moody's opinion.[206]

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[197] *Id.* at 264; Partnoy, *supra* note 193, at 652 n.154.
[198] *Id.*
[199] *Id.*
[200] Bai, *supra* note 139, at 265; *see id.* ("Rating agencies explain this phenomenon by pointing out that issuers are often uncooperative in providing information when rating agencies attempt to issue unsolicited ratings.").
[201] *See* Partnoy, *supra* note 193, at 653 ("Issuers may consider the expected costs of receiving a negative unsolicited rating.").
[202] *Id.* at 709 n.46; Jefferson Cnty. School Dist. No. R-1 v. Moody's Investor Services, Inc., 175 F.3d 848 (10th Cir. 1999) (explaining how Moody's published an article regarding the bonds' "negative outlook" after the district hired Fitch and S&P); *see also id.* at 709 n.45 (describing how Moody's issued an unsolicited rating for Egyptian sovereign debt).
[203] *Jefferson Cnty School Dist. No. R-1*, 175 F.3d at 850.
[204] *Id.*
[205] *Id.*
[206] *Id.*

In response, the school sued the rating agency for intentional interference with contractual relations, intentional interference with prospective contractual relations, and publication of an injurious falsehood:

> According to the School District, Moody's published the article in order to retaliate against it for deciding to use other credit rating agencies, and the article had a significant effect on the marketing of the bonds: purchase orders ceased, several buyers canceled prior orders, and the School District was forced to reprice the bonds at a higher interest rate in order to complete the sale, thereby causing it to suffer a net loss of $769,000.[207]

The Tenth Circuit concluded that because the statement did not contain or imply a provably false factual assertion, the rating was protected by the First Amendment.[208] As will be discussed later on in the paper, First Amendment protections often interfere with plaintiffs' attempts to hold credit rating agencies liable.

LARGE SUBSCRIBER INFLUENCE

Since the credit rating agencies with the largest market shares utilize an issuer-pays system, large subscriber influence is an often overlooked conflict. However, since some commentators argue for a return to a subscriber-pays system, or some alteration thereof, the conflict is important. "This conflict involves credit rating agencies being paid by subscribers for access to credit rating agencies where the value of the security holdings or the status of regulatory compliance of the subscribers depends on the ratings of the securities."[209] For example, a broker-dealer subscriber may have an interest in having his securities rated investment-grade to benefit from lower haircuts when computing its net capital.[210] "For fear of losing subscription revenue, rating agencies

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[207] *Id.*
[208] *Id.* at 860.
[209] Bai, *supra* note 139, at 263.
[210] *Id.*

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."[211]

[211] *Id.*

Part V: Rating Pitfalls

According to the credit rating agencies and their proponents, credit rating is a competitive business, in which "reputation for objectivity and accuracy" is an agency's most important asset.[212] This viewpoint, often referred to as the "reputational capital" view, suggests that businesses have an incentive—outside of regulation, liability, or any other similar force—to behave well and preserve its reputational capital; in other words, the pursuit of reputational capital sustains a "self-policing society."[213]

Under this framework, credit ratings address the information asymmetry[214] between debt issuers and investors.[215] Because "prices in a market with information asymmetry will reflect the average quality of a product," sellers "have an incentive to disclose the superior nature of their product so they can receive the highest price."[216] If sellers assure buyers of the issues' credit quality, moral hazard problems arise; sellers may "exaggerate" their credit quality and give buyers inaccurate information.[217] Thus, credit rating agencies serve as a third-party information intermediary between debt issuers and investors, helping the market determine the appropriate price for the issue, given its credit quality. By "specializing in the gathering, analysis, examination, and dissemination" of information regarding the creditworthiness of an issuer or instrument, credit rating agencies "eliminate the duplicative and wasteful (i.e., inefficient) efforts of individuals engaging in such activities."[218]

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[212] Partnoy, *supra* note 193, at 630–31.
[213] *See id.* at 628 ("Economists since Adam Smith have noted the value of reputational capital in sustaining a self-policing society.").
[214] *Id.* at 632 ("Information asymmetry exists in markets where seller have superior information to buyers about product quality, yet cannot costlessly convey this information to buyers.").
[215] *Id.*
[216] *Id.*
[217] *Id.* at 632, 632 n.58.
[218] *Id.* at 630–31.

According to this model, outside investors will only find the credit rating agency—the "certifying agent" in this fact pattern—credible under the following circumstances:

> First, the certifying agent must have reputational capital at stake in the certification activity. In other words, the certifying agent would suffer a loss of future relationships because of reduced trustworthiness if it suggested a fair market value in excess of the offering price. Second, the loss in reputational capital must exceed the gain possible from false certification. Third, the agent's services must be costly and the cost must be related to the asymmetric information associated with the issuing firm.[219]

While many scholars, especially in recent years, have explained why credit rating agencies do not meet these factors, the reputational capital view of credit rating agencies often assumes these criteria are met.[220]

At a certain intuitive level, the reputational capital view makes sense. Since rating agencies depend on others valuing their opinion,[221] they should avoid appearing untrustworthy or lax, even if they may charge issuers for their services.[222] Indeed, credit ratings are often good predictors of default, making many conclude that "reputation incentives dominate."[223] However, history has shown that credit rating agencies have failed to recognize risk that, in retrospect, seems clearly apparent.[224] "Hot markets and

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[219] *Id.* at 633.
[220] *Id.*
[221] *See generally* Caleb Deats, Note, *Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agencies' Faulty Methodologies from Regulation?,* 110 COLUM. L. REV. 1818 (2010) (discussing First Amendment protection of rating opinions).
[222] *See* Partnoy, *supra* note 218, at 630 ("Credit ratings are closely related to reputational capital for a second, derivative, reason: the success and function of a credit rating agency also depends on trust and credibility. Each credit rating agency depends for its livelihood on its reputation for objectivity and accuracy.").
[223] *See, e.g.*, Daniel M. Covitz & Paul Harrison, FED. RESERVE BD., *Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate* (2003) (concluding that despite conflicts of interest, rating agencies appear to be motivated primarily by reputation-related incentives).
[224] *See* LEWIS, *supra* note 4, at 157 (explaining that many rating agencies made unrealistic assumptions concerning home prices and default rates).

large profits" significantly increase the benefits of inaccurate, hastily determined ratings.[225]

When credit rating agencies fail in communicating risk to investors and investors largely depend on those ratings, the financial system is fragile; the system "produces overestimates of creditworthiness and underpricing of risk."[226] For example, investors in ABS CDO tranches often relied exclusively on ratings when pricing deals at origination.[227] This "overdependence" may result from the regulatory, rather than informational, value of credit ratings; a cost-to-benefit consideration, where complexity of securities increases the cost of due diligence and thus deters investors from performing their own independent investigation; and insufficient information about collateral pools.[228] This section will discuss these common pitfalls: (1) regulatory license and (2) complexity and asymmetric information. These factors interfere with reputational incentives and encourage reliance on ratings, despite the credit rating agencies' previous failures in communicating risk. These failures often derive from weaknesses in the ratings process, as represented by agency models, the ratings committee, and general management practices—another "rating pitfall" discussed in this section.

REGULATORY LICENSE

Because credit ratings should be, and in many instances were, good shorthand for the relative riskiness of a debt instrument, financial regulation often incorporated references to credit ratings. Most notably, the SEC named some credit rating agencies

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[225] Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1150 (2009).
[226] Jan Kregel, *Minsky's "Cushions of Safety," Systematic Risk and the Crisis in the US Subprime Mortgage Market*, *available at* http://www.levyinstitute.org/pubs/ppb_93.pdf.
[227] Thomas Mählmann, *Did Investors outsource their risk analysis to rating agencies? Evidence from ABS-CDOs*, J. BANKING & FIN. XXX (2012).
[228] *Id.*

Nationally Recognized Statistical Rating Organizations (NRSROs). This classification was useful in a variety of financial regulations.[229] Under the Basel II and Basel III Agreements of the Basel Committee on Banking Supervision, banks can use ratings from certain credit rating agencies to determine their net capital reserve[230]—a system adopted by most countries.[231] In the U.S., a top rating from a NRSRO allowed money market funds to take on certain investments;[232] broker-dealers to take reduced haircuts on commercial paper, nonconvertible debt securities, and nonconvertible preferred stock;[233] banks to hold less capital;[234] and issuers to use simplified registration procedures under the Securities Act.[235] In addition, given a favorable credit rating, SEC rules exempted an issuer of fixed income securities from the Investment Company Act.[236] And perhaps most importantly for the mortgage market, "the Secondary Mortgage Market Enhancement Act of 1984 permitted federal- and state-chartered financial institutions to

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[229] *See generally* U.S. SEC. & EXCH. COMM'N, Concept Release, Release Nos. 33-7085; 34-34616; IC-20508, *available at* http://www.sec.gov/rules/concept/34-34616.pdf (summarizing S.E.C. rules that reference NRSROs).

[230] 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; BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (Dec. 2010, rev. June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.

[231] Bai, *supra* note 139, at 255.

[232] 17 C.F.R. § 270.2a-7 (2012).

[233] *See* 17 C.F.R. § 15c3-1(c)(2)(vi)(E) (haircuts applicable to commercial paper that has been rated in one of the three highest categories by at least two NRSROs); 17 C.F.R. § 15c3-1(c)(2)(vi)(F) (haircuts applicable to nonconvertible debt securities that are rated in one of the four highest rating categories by at least two NRSROs); 17 C.F.R. § 15c3-1(c)(2)(vi)(H) (haircuts applicable to cumulative, nonconvertible preferred stock rated in one of the four highest rating categories by at least two NRSROs).

[234] FCIC Report, *supra* note 1, at 119 (referring to the Recourse Rule); 12 C.F.R. § 567.6(b)(3).

[235] Adoption of Integrated Disclosure System, Securities Act Re1ease No. 6383 (Mar. 16, 1982); Adoption of Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992).

[236] S.E.C. Concept Release, *supra* note 229, at 4–5 (citing Exclusion from the Definition of Investment Company for Structured Financing, Investment Company Act Release No. 19105 (November 19, 1992), 52 SEC Dkt. 4014).

invest in mortgage-related securities if the securities had high ratings from at least one rating agency."[237]

In other words, ratings became "valuable, not because they [were] accurate and credible, but because they [were] the key to reducing costs associated with regulation."[238] In this environment, "rating agencies [began] to sell not only information but also the valuable property rights associated with compliance with that regulation."[239] Furthermore, by recognizing the opinions of only a certain rating agencies (i.e. NRSROs), the largest NRSROs acquired substantial market shares.[240] The regulatory importance of credit ratings fueled demand for high credit-ratings and led many institutional investors—from financial firms to insurance companies—to invest in instruments that were highly rated by credit rating agencies.

COMPLEXITY & ASYMMETRIC INFORMATION

Securitized products are undoubtedly more complex than the average debt instrument. They contain layers of risk, with some information unavailable to the investor. For example, RMBSs offer little information about the composition and characteristics of the loan collateral to investors, with loan-by-loan data generally unavailable. [241] Complexity and asymmetric information contributes to overdependence on credit ratings by investors. As the FCIC report notes, "[m]any investors, such as some pension funds and university endowments, relied on credit ratings because they had neither access to the same data as the rating agencies nor the capacity or analytical ability to assess the securities they were purchasing." [242]

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[237] FCIC Report, *supra* note 1, at 119.
[238] Partnoy, *supra* note 193, at 681–82.
[239] *Id.*
[240] *Id.*
[241] FCIC Report, *supra* note 1, at 119 (quoting Moody's former managing director Jereme Fons).
[242] *Id.*

Furthermore, complexity may obfuscate fraudulent behavior and poor underwriting practices,[243] allowing gross underestimations of risk. While it was clear in published reports and internal emails that many credit rating agencies were aware of mortgage fraud problems, the agencies failed to account for the possibility of fraud in its rating process.[244] In late 2007, Fitch completed a report explaining the underperformance of RMBSs.[245] The report concluded that the quality of the mortgages underlying RMBSs had been impaired by (1) occupancy misrepresentation, (2) unreliable or fabricated FICO scores, and (3) incorrect calculation of debt-to-income ratios, among other fraudulent or poor underwriting practices.[246] The agency noted that the results of its analysis were "disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file."[247] As Matt Taibbi summarized, "[t]he corrupt ratings agencies were undone by ratings corrupters!"[248]

Complexity may also contribute to ratings shopping.[249] Whereas credit rating agencies usually issue similar forecasts and ratings for simple assets, asset complexity causes variation in ratings, incentivizing ratings shopping and more complex structured-finance products.[250]

> For complex assets, ratings may differ, creating an incentive to shop for the best rating. There is a threshold level of asset complexity such that once this threshold is crossed, shopping becomes optimal and ratings inflation emerges. Furthermore, the link between asset complexity and ratings shopping can work in both

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[243] M. Diane Pedley, Glenn Costello, & Mary Kelsch, *The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance*, US Residential Mortgage Special Report, FITCH RATINGS (November 28, 2007) [hereinafter Fitch Fraud Report].
[244] Levin–Coburn Report, *supra* note 93, at 311.
[245] Fitch Fraud Report, *supra* note 243, at 2
[246] *Id.*
[247] *Id.* at 4.
[248] TAIBBI, *supra* note 1, at 122 (referring to companies rigging FICO scores).
[249] Vasiliki Skreta & Laura Veldkamp, *Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation* (NAT'L BUREAU OF ECON. RESEARCH, Working Paper No. 14761, 2009), at 2.
[250] *Id.*

directions. An issuer who shops for ratings might want to issue an even more complex asset, to get a broader menu of ratings to choose from. This, in turn, makes shopping even more valuable.[251]

THE RATINGS PROCESS: AGENCY MODELS, THE RATINGS COMMITTEE, & STAFFING

"These errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both."

—Moody's managing director, anonymous internal management survey[252]

Arrangers adopted structures which perpetuated and exacerbated problems with agency models. "Once an arranger devised a structure that received the desired ratings, others may have followed, so that any deficiencies in the rating agency methodology were able to spread."[253] As mentioned previously, agency models, for all their sophistication, often incorporated fatal assumptions in their model—assumption concerning levels of correlation among the RMBSs backing CDOs; the nature of real estate prices; homebuyers' ability to pay mortgages; and occupancy rates among the homes purchased.

Rating agencies have used several different models to rate tranches of mortgage-backed securities. Moody's has used at least three models since the mid-1990s: (1) the first model used to rate residential mortgage-backed securities, developed in 1996; (2) M_3 Prime, used to rate prime, jumbo, and Alt-A deals, developed in 2003; and (3) M_3 Subprime, used to rate subprime deals, developed in fall of 2006.[254] S&P used a model called the Loan Evaluation and Estimate of Loss System (LEVELS).[255] "The models incorporated firm- and security-specific factors, market factors, regulatory and legal

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[251] *Id.*
[252] Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping?*, NYTIMES.COM, Dec. 6, 2008, http://www.nytimes.com/2008/12/07/business/07rating.html?pagewanted=all.
[253] Hunt, *supra* note 61, at 124.
[254] FCIC Report, *supra* note 1, at 120.
[255] Levin–Coburn Report, *supra* note 93, at 252.

factors, and macroeconomic trends."[256] An arranger would submit the pool information, proposed capital structure,[257] and proposed credit enhancements[258] to the credit rating agency, and then an analyst would use the model to rate the issuance.[259] In using the RMBS models, the analyst typically fed a loan tape—a "spreadsheet provided by the arranger with details on each loan"—into the credit rating model.[260]

The M_3 Prime model was a large development because it "let Moody's automate more of the process."[261] The company used loan-level information from the issuer—"loan-to-value ratios, borrower credit scores, originator quality, and loan terms and other information"—to simulate "the performance of the loans in 1,250 scenarios, including variations in interest rates and state-level unemployment as well as home price changes."[262] Although the model incorporated a wide range of data, the model did not incorporate the possible decline of real estate prices. By and large, the models assumed a continuous increase:

> On average, across the scenarios, home prices trended upward at approximately 4% per year. The model put little weight on the possibility prices would fall sharply nationwide . . . Even as housing prices rose to unprecedented levels, Moody's never adjusted the scenarios to put greater weight on the possibility of decline.[263]

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[256] FCIC Report, *supra* note 1, at 120.
[257] *See* Levin–Coburn Report, *supra* note 93, at 251 (stating that the proposed capital structure would include "how many tranches would be created, how the revenues being paid into the RMBS or CDO would be divided up among those tranches, and how many of the tranches were designed to receive investment grade ratings"—"financial cushion[s] that would protect the designated investment grade tranches from expected losses").
[258] *See id.* at 251 (summarizing credit enhancements, including excess spreads, over-collateralization, and subordination).
[259] *Id.* at 252.
[260] *Id.* at 252.
[261] FCIC Report, *supra* note 1, at 120.
[262] *Id.* at 120.
[263] *Id.* at 120–21.

The M3 Subprime Model, developed in the fall of 2006, operated similarly, again simulating the loans in 1,250 scenarios. Analysts noted that they "manually calibrated" this model, adding additional weight to the most stressful scenarios and added deterioration by using the "single worst case."[264] As the FCIC Report notes, however, Moody's did not "sufficiently account for the deteriorating quality of the loans being securitized." The report referred to one committee member who noted that the Structured Credit Committee "talked about everything but, you know, the elephant sitting on the table."[265]

For CDOs, Moody's simulated performance through a system called CDOROM.[266] S&P used a system called "CDO Evaluator" for CDOs, later updated to "Evaluator 3" or "E3."[267] "[U]nlike RMBS statistical models that used past performance data to predict RMBS default and loss rates, the CDO models relied primarily on the underlying ratings of the assets as well as on a set of assumptions, such as asset correlation, and ran multiple simulations to predict how the CDO pool would perform."[268] Neither model reanalyzed the underlying RMBSs or other bonds in a CDO;[269] "both models simply relied on the credit rating already assigned to those securities."[270] In fact, the composition of CDOs often changed, while still maintaining their rating.[271]

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[264] *Id.* at 121.
[265] *Id.* at 121.
[266] *Id.* at 253.
[267] *Id.*
[268] Levin–Coburn Report, *supra* note 93, at 253.
[269] *Id.*
[270] *Id.* at 254.
[271] *See* MCLEAN & NOCERA, *supra* note 71, at 121 ("CDO managers didn't always have to disclose what the securities contained because those contents could change.").

The final rating is usually determined by a ratings committee, composed of analysts and managers.[272] The quantitative analysis involved in the agency models is only a starting point.[273]

> [Methodology] ordains neither the recommended opinion presented by the lead analyst, nor the individual opinion of any committee member, nor the resulting [agency] opinion. Rather, the lead analyst and each other voting member is expected to use only her own judgment in forming her opinion and to vote this same opinion.[274]

At the committee stage, credit rating agencies often increased the percentage of a tranche that could be labeled triple-A according to their models.[275] The credit rating agencies "did not follow a consistent policy or valuation model with respect to subordination, but rather regularly made 'adjustments' on subjective grounds."[276] Eighty-five percent of these adjustments were positive, increasing the size of the top-rated triple-A tranche on average by 12.1 percent at the time of issue.[277] CDO tranches that were adjusted in this manner were more likely to be downgraded.[278]

Analysts often noted that their objections would fall on deaf ears in committee meetings. In Moody's committee meetings, analysts noted managers' preferences for higher ratings, deriding and intimidating analysts for their objections:[279]

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[272] FCIC Report, *supra* note 1, 121.
[273] William J. Harrington, Comment on SEC Proposed Rules for National Recognized Statistical Rating Organizations, File No. S7-18-11 (2011), *available at* http://www.sec.gov/comments/s7-18-11/s71811-33.pdf [hereinafter Harrington Comment], at 13
[274] *Id.*
[275] John C. Coffee, *Ratings Reform: The Good, The Bad, and The Ugly* (September 2010). Columbia Law and Economics Working Paper No. 375; ECGI - Law Working Paper No. 162/2010. Available at SSRN: http://ssrn.com/abstract=1650802, at 13–14.
[276] *Id.* at 12 (citing John M. Griffin and Dragon Yongjun Tang, *Did Subjectivity Play a Role in CDO Credit Ratings?* (2009))
[277] *Id.*
[278] *Id.* at 13.
[279] *Id.* at 6.

> Intimidation could be blatant, with managers belittling opposing views, interrupting while others speak, making evident that they didn't consider the committee memo to be relevant or engaging in non-committee activities such as communicating on an electronic device until ready to speak themselves. Managers might also adopt a strictly formulaic approach and seek to have aspects of others' opinions deemed "irrelevant" to the opinion at hand or challenge a member with a possible ramification of her opinion along the lines of "with your view, you should be suggesting that the entire methodology be up for grabs and we're not here to do that."[280]

In other words, "management maneuvered for a prescribed result . . . ."[281] Brian Clarkson, the manager of Moody's structured finance division, was notorious in this regard; employees characterized his management style as "fear and intimidation."[282] Above all else, Clarkson emphasized Moody's market share:

> Soon after Clarkson took charge, Moody's began making a point of informing its analysts of the company's market share in various structured products . . . . If Moody's missed out on a deal, the credit analyst would be asked to explain why. ("Please . . . advise the reason for any rating discrepancy vis-à-vis our competitors," read one e-mail.) . . . .
>
> . . . . Clarkson used to tell people, "we're in business and we have to pay attention to market share. If you ignore market share, I'll fire you."[283]

Explaining Moody's increase in market share in the mortgage-backed securities market from 2000 to 2001—a move from 35 percent to 59 percent, Clarkson noted that some analysts had been "reshuffl[ed]." However, these analysts were not reshuffled; "[t]hey were fired."[284]

Moody's also witnessed a significant staffing change. Moody's and S&P hired less qualified staff to keep costs down—"a move away from hiring people with backgrounds in credit and toward hiring recent business school graduates or foreigners

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[280] *Id.* at 14–15.
[281] *Id.* at 14.
[282] MCLEAN & NOCERA, *supra* note 71, at 115.
[283] *Id.* at 116.
[284] *Id.* at 117.

with green cards to keep costs down."[285] As one former Moody's analyst stated in a comment to SEC proposed rules,

> During the heyday of CDO issuance from 2005 to 2006, management also stopped hiring senior analysts and instead hired junior analysts who, while possessing the raw talent to grow into competent analysts, were too inexperienced to perform the tasks to which they were assigned. Critically, a junior analyst asked to lead the rating of a CDO could not possibly possess sufficient confidence, tactical sense or gravitas to challenge a banker, collateral manager or Moody's manager intent on pumping out another debauched CDO. Nor would the junior analyst have known that she could recommend in committee a lower rating than that indicated solely by modeling, to offset, for instance, the poor quality of RMBS opinions embedded in a CDO of ABS.[286]

Furthermore, outsiders often perceived agency employees as less intelligent than their Wall Street counterparts—a market reality arising from vastly different compensation rates.[287] Michael Lewis details these criticisms, describing agency employees as aloof, timid, and underpaid.[288] "Collectively they had more power than anyone in the bond markets, but individually they were nobodies."[289] The smartest employees, purportedly, left to higher paid jobs, "so they could manipulate the companies they used to work for."[290] Congress recognized this talent gap in enacting the Dodd–Frank Act, requiring SEC to issue rules governing minimum competency, training, knowledge, and experience of NRSRO employees.[291]

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[285] *Id.* at 123.
[286] Harrington Comment, *supra* note 273, at 17.
[287] *See* MCLEAN & NOCERA, *supra* note 71, at 123 ("[Credit rating agency employees] made a fraction of the pay of even a junior investment banker.").
[288] *See* LEWIS, *supra* note 4, at 156–57 (discussing Steve Eisman, Danny, and Vinny's trip to a subprime conference in Las Vegas and their encounters with credit rating agency employees).
[289] *Id.* at 156.
[290] *Id.*
[291] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 936, Pub. L. No. 111-203, 124 Stat. 1378, 1884 (2010) (codified as amended at 15 U.S.C.A. § 78o-7 (West, Westlaw through 2012 legislation)).

Agency staff members were also infamously overworked, working twelve to fifteen hours a day.[292] Management requested the analysts rate a large volume of issues, compromising initial rating activities as well as other activities such as surveillance.[293] Moody's management refused to hire additional staff, presumably because they anticipated a decline in RMBSs and related CDOs when housing prices stopped increasing.[294] Analysts felt that they had inadequate resources to properly understand each issuance.[295]

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[292] MCLEAN & NOCERA, *supra* note 71, at 123.
[293] Levin–Coburn Report, *supra* note 93, at 304–310.
[294] MCLEAN & NOCERA, *supra* note 71, at 123 ("[According to a former Moody's structured finance executive] Moody's top brass . . . thought the mania would end with home prices flattening out, and as a result they wouldn't add staff because they didn't want to be stuck with the cost of employees if the revenues slowed down.").
[295] Levin–Coburn Report, *supra* note 93, at 305–06.

Part VI: Regulatory Strategies that Limit Conflicts

> *The regulation of economic activity is without doubt the most inelegant and unrewarding of public endeavors. Almost everyone is opposed to it in principle; its justification always relies on the unprepossessing case for the lesser evil.*
>
> –John Kenneth Galbraith, *The Great Crash, 1929*[296]

OUTRIGHT PROHIBITION

One regulatory strategy is to define certain conflicts of interest and prohibit a credit rating agency from engaging in these conflicts. The current SEC rules adopt this strategy. Rule 17g-5 has two types of conflicts: prohibited conflicts and conflicts that are only prohibited if the credit rating agency fails to make proper disclosures and adopt internal control mechanisms.[297] Because the agency-level conflicts, especially the issuer-pays system, are so embedded in the current operations of the credit ratings, regulators appear to only prohibit smaller, analyst-level conflicts outright.

For example, regulation may prevent an analyst from occupying marketing, sales, and structuring roles, in addition to performing rating services on the same issue. Similarly, the analyst may not receive gifts from the issuer, issue a rating on securities the analyst owns, or issue a rating on an entity of which the analyst is an officer or director. While these rules may be a positive development, they often ignore larger agency-level conflicts of interest.

ORGANIZATIONAL FIREWALLS

Another approach to regulating conflicts of interest is to isolate the rating functions of the agency from the sales and marketing divisions, as well as structuring services. By establishing strict organizational firewalls, analysts and management may

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[296] JOHN KENNETH GALBRAITH, THE GREAT CRASH, 1929 26 (Houghton Mifflin Harcourt Publishing Co., 2009) (1954).
[297] 17 C.F.R. § 240.17g-5 (2012).

find that market-share and profit considerations are less of a factor. For example, the Dodd–Frank Act authorizes the SEC "to issue rules to prevent the sales and marketing considerations of a [NRSRO] from influencing the production of ratings by the [NRSRO]."[298] The SEC also requires NRSROs to adopt their own internal governance measures to control conflicts of interest; these rules often incorporate some type of organizational firewall.

LIABILITY

Because the First Amendment protects some credit rating opinions, plaintiffs often had a difficult time holding credit rating agencies liable for the damages caused by their credit ratings. When the credit rating agencies subject their opinions to general publication and address "matters of public concern," courts afford credit ratings First Amendment protection.[299] In this context, credit rating agencies are more like journalists than financial fiduciaries; in order to be held liable, the plaintiff must show "actual malice"[300]—that the "defendant made the statement with knowledge of its falsity or with reckless disregard of its truth."[301] However, if a credit rating is released to a select group of investors, such as in targeted offering materials, the actual-malice standard does not apply.[302]

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[298] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 932, Pub. L. No. 111-203, 124 Stat. 1376, 1874.

[299] *See* Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., 651 F. Supp. 2d 155, 175–76 (S.D.N.Y. 2009) ("It is well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an 'actual malice' exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern.").

[300] *See* Anschutz Corp. v. Merrill Lynch & Co. Inc., 785 F. Supp. 2d 799, 831–32 (N.D. Cal. 2011) (showing that courts apply actual malice standard for matters of public concern—opinions subject to general publication and opinions dealing with public figures—not those opinions only accessible to a select group of investors).

[301] Compuware Corp. v. Moody's Investors Services, Inc., 499 F.3d 520, 526 (6th Cir. 2007) (citing New York Times, 376 U.S. 254, 279–80 (1964)).

[302] *See* Abu Dhabi, 651 F. Supp. 2d at 175–76 ("[W]here a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same [First

Traditionally, credit rating agencies were exempt from "expert liability," as imposed by Section 11 of the 1933 Securities Act.[303] Section 11 allows investors to sue certain experts when a registration statement "contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[304] The experts subject to liability include

> every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.[305]

SEC Rule 436 specifies that, for the purposes of Section 11, if a registration quotes or summarizes an expert's report, those experts must file an exhibit to the registration statement consenting to the use of their reports or opinions.[306] Subsection (g) of the rule exempted credit rating agencies from Section 11 liability by stating that a security rating was not considered "part of the registration statement;" credit rating agencies neither had to file a consent, nor find themselves subject to Section 11 liability for an untrue statement of material fact or a misleading omission. The Dodd–Frank Act declared that Rule 436(g) would no longer have "force and effect,"[307] lifting the exemption and requiring credit agencies to file a consent with registration statements citing a given credit rating.

Amendment] protection."); Genesee County Employees' Ret. Sys. v. Thornburg Mortg. Sec. Trust 2006-3 (D.N.M. Nov. 12, 2011) ("The credit ratings at issue in this case are not entitled to First Amendment protection . . .These credit ratings impacted only the limited group of investors who received the offering documents, the Thornburg Trusts, and the companies involved with those Thornburg Trusts as opposed to the public at large." (citing Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 761 (1985)).

[303] Consents required in Special Cases, 17 C.F.R. § 230.436(g) (2012).

[304] Securities Act of 1933, § 11(a); 15 U.S.C. § 77k(a) (2006).

[305] Securities Act of 1933, § 11(a)(4); 15 U.S.C. § 77k(a)(4).

[306] Consents required in Special Cases, 17 C.F.R. § 230.436(a)–(b).

[307] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 936G, Pub. L. No. 111-203, 124 Stat. 1378, 1890 (2010).

Dodd–Frank also loosened pleading requirements for actions involving a credit rating agency.[308] For actions under Section 11,[309] Rule 10b-5,[310] and Section 18,[311] the plaintiff no longer needs to show that the credit rating agency believed its ratings to be false or misleading in its complaint. Instead, Dodd–Frank requires the following:

> In the case of an action for money damages brought against a credit rating agency or a controlling person under this title, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed—
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> (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or
>
> (ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.[312]

Under the previous standard for Rule 10b-5 liability, the complaint had to "state with particularity facts giving rise to a strong inference"[313] that the "defendant knowingly or recklessly made a material misstatement or omission."[314] Plaintiffs were often unable to meet this burden for actions against credit rating agencies.[315] "In the context of credit

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[308] 15 U.S.C.A. § 78u-4(b)(1) (West, Westlaw through 2012 legislation).
[309] 15 U.S.C.A. § 77k.
[310] 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5 (2012) ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.").
[311] 15 U.S.C.A. § 77www.
[312] Dodd–Frank Act, § 933(b), 124 Stat. at 1833 (codified as amended at 15 U.S.C.A. § 78u-4(b)(2)(B)).
[313] 15 U.S.C.A. § 78u-4(b)(2)(A).
[314] Gregory A. Fernicola & Joshua B. Goldstein, *Credit Rating Agencies*, SKADDEN COMMENTARY ON THE DODD–FRANK ACT, (Skadden, D.C.), July 9, 2010, at 3, *available at* http://www.skadden.com/newsletters/FSR_Credit_Rating_Agencies.pdf.
[315] *Id.*

ratings, courts required plaintiffs to plead that the rating agency did not genuinely believe its opinions regarding credit quality or that the opinions lacked basis in fact."[316]

Credit agencies responded to the changes to expert liability by refusing to consent to their ratings being included in registration statements for asset-backed securities. Because Regulation AB[317] requires registration statements associated with asset-backed securities to "disclose whether the issuance or sale of any class of offered securities is conditioned on the assignment of a rating by one or more rating agencies,"[318] the credit rating agencies' refusal caused the market for asset-backed securities to freeze.[319] Shortly after the Dodd–Frank Act took effect, the SEC "quickly issued a 'no action' letter, indicating that it would not bring enforcement actions against issuers that did not disclose ratings in prospectuses."[320] With the removal of the expert-liability threat for the ratings agencies, the market began operating again.[321] On January 24, 2011, the SEC extended its nonenforcement stance indefinitely.[322]

REGULATORY PENALTIES

In order to enforce its rules on credit rating agencies, the governmental agency should have a means of punishing the agency for non-compliance. Currently, the SEC

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[316] *Id.* (citing In re IBM Corp. Sec. Litig., 163 F.3d 102 (2d Cir. 1998)); *compare* Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., 651 F. Supp. 2d 155, 176 (S.D.N.Y. 2009) ("[P]laintiffs have sufficiently pled that the Rating Agencies did not genuinely or reasonably believe that the ratings they assigned to the Rated Notes were accurate and had a basis in fact. As a result, the Rating Agencies' ratings were not mere opinions but rather actionable misrepresentations."), *with* Order Denying Defendants' Special Motion to Strike, California Public Employees' Retirement System v. Moody's Corp. (Cal. Superior 2012) (No. 490241), 2012 WL 98548 ("Plaintiff produced sufficient evidence that each defendant made representations to plaintiff regarding past or existing material facts in connection with its ratings of the subject investment vehicles without reasonable grounds to believe that the representations were true.").
[317] Asset-backed Securities (Regulation AB), 17 C.F.R. § 229 (2012).
[318] 17 C.F.R. § 229.1120.
[319] Gretchen Morgenson, *Hey, S.E.C., That Escape Hatch Is Still Open*, NYTIMES.COM, Mar. 5, 2011, http://www.nytimes.com/2011/03/06/business/06gret.html.
[320] *Id.*
[321] *Id.*
[322] *Id.*

can "censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration" of any NRSRO and take similar actions for a person affiliated with a NRSRO.[323] The SEC can undertake these actions if it "finds, on the record after notice and opportunity for hearing," that the action is "necessary for the protection of investors and in the public interest."[324] Furthermore, the NRSRO or the person affiliated with the NRSRO (1) must have committed acts enumerated in 15 U.S.C.A. § 78(o)(b)(4)—relating to false or misleading facts in a report filed with a Commission by a broker-dealer or their associates—; (2) violated certain financial laws; (3) failed to file certifications; (4) "failed to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity"; or (5) failed reasonably to supervise, with a view to preventing a violation of the securities laws, an individual who commits such a violation, if the individual is subject to the supervision of that person."[325]

The SEC may also

> temporarily suspend or permanently revoke the registration of a [NRSRO] respect to a particular class or subclass of securities, if the Commission finds, on the record after notice and opportunity for hearing, that the [NRSRO] does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.[326]

SEC has authority to issue fines and penalties by rule,[327] but current rules make no provision for a monetary penalty.

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[323] 15 U.S.C.A. § 78o-7(d)(1).
[324] 15 U.S.C.A. § 78o-7(d)(1).
[325] 15 U.S.C.A. § 78o-7(d)(1)(A)–(F).
[326] 15 U.S.C.A. § 78o-7(d)(2).
[327] 15 U.S.C.A. § 78o-7(p)(4).

REMOVING REGULATORY AND STATUTORY REFERENCES

If references to NRSROs in legislation distort the informational quality of credit ratings or interfere with the self-regulating nature of reputational capital, then regulators should seek to eliminate these distortive effects by removing or otherwise minimizing references to NRSROs in financial regulation. As Professor John C. Coffee notes, this idea is "popular in academia" because it is "simple, sweeping, and requires no understanding of the institutional or regulatory context."[328] However, once implemented, regulators have to decide (1) which NRSRO references to delete and (2) how to replace the references.

The Dodd–Frank Act removed a number of statutory references to NRSROs.[329] The statute replaced the phrase "not of investment grade" with the phrase "standards of credit-worthiness" in a number of statutes, allowing the regulatory agencies to determine what standard is appropriate.[330] Furthermore, all regulatory agencies must "remove any reference to or requirement of reliance on credit ratings" and substitute an appropriate "standard of credit-worthiness."[331] In practice, the actual implementation of these policies will be a "slow and confused process."[332] Credit rating agencies have been such a large force in financial markets that reducing reliance on NRSRO ratings may be painful at first. While these "standards of creditworthiness" will largely be factor-based, they may incentivize investors to request more information about these instruments, and not just blindly accept a NRSRO opinion.

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[328] *See* Coffee, *supra* note 275, at 43.
[329] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 939, Pub. L. No. 111-203, 124 Stat. 1376, 1885 (2010).
[330] *Id.*
[331] § 939A(b), 124 Stat. at 1887.
[332] *See* Coffee, *supra* note 275, at 43–44 (discussing the credit rating agencies' refusal to consent to the use of its credit ratings in registration statements of asset-backed securitization after removal of the traditional exemption to credit-rating agency liability).

In accordance with the Dodd–Frank Act,[333] the SEC has also proposed rules to remove references to NRSROs in its regulation.[334] The proposed rules suggest alternative methods of assessing creditworthiness. For example, a broker-dealer could consider the following factors in determining a proper haircut: "(1) credit spreads; (2) securities-related research; (3) internal or external credit risk assessments; (4) default statistics; (5) inclusion on an index; (6) priorities and enhancements; (7) price, yield and/or volume; and (8) asset class-specific factors."[335] Professor Frank Partnoy has a strong preference for credit default swaps spreads.[336] A preliminary look at these numbers suggests that spreads (1) are revisited more frequently than credit ratings and (2) reflect risk and market knowledge about bonds and securities more accurately.[337]

DISCLOSURE

Performance Disclosures

In principle, disclosure requirements (1) "enhance the reputational cost to rating agencies that engage in inappropriate rating actions" and (2) "help break the entry barrier for smaller rating agencies with strong performance records in a market that is dominated by certain established names," such as Moody's, Standard & Poor's, and Fitch.[338]

The current SEC rules emphasize performance disclosures. Professor Lynn Bai examines data recently released by credit rating agencies to assess whether debt issuers

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[333] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 939A, Pub. L. No. 111-203, 124 Stat. 1376, 1887 (2010).
[334] SEC Proposes Rule Amendments to Remove Credit Rating References in Exchange Act Rules, SEC.GOV, http://www.sec.gov/news/press/2011/2011-100.htm.
[335] *Id.*
[336] *See generally* Mark J. Flannery, Joel F. Houston, & Frank Partnoy, *Credit Default Swap Spreads As Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085 (2010).
[337] *Id.* at 2113. *But see* LEWIS, *supra* note 4, at 74–78 (explaining how Michael Burry paid a relatively-low 250 basis points to own credit default swaps on the "very crappiest triple-B bonds").
[338] Lynn Bai, *The Performance Disclosures of Credit Rating Agencies: Are they Effective Reputational Sanctions?*, 7 N.Y.U. J. L. & Bus. 47 (2010).

and the investment community use the disclosures in selecting agencies for their debt ratings.[339] The rating agencies report data differently, complicating the comparability of the data. After analyzing performance data, Bai concludes that there is "no evidence debt issuers have considered rating agencies' historical performances before making their selections" and suggests that debt issuers are "brand conscious," with a "tendency of selecting ratings agencies based on latter's pre-existing market positions and name recognitions."[340] In this regard, the government may be able to parse performance disclosures better than the average investor by "rating" the rating agencies. For example, a report by the Subcommittee of Investigations recommended that rank NRSROs in term of their performance, especially in regards to accuracy.[341]

Disclosure Accompanying Credit Ratings

Under the Dodd–Frank Act, the SEC may create rules requiring disclosures that accompany ratings, including the following information: (1) "information that can be used by investors and other users of credit ratings to better understand credit ratings in each class of credit rating issued by the nationally recognized statistical rating organization";[342] (2) "the assumptions underlying the credit rating procedures and methodologies";[343] (3) the data that was relied on to determine the credit rating;[344] and (4) "if applicable, how the nationally recognized statistical rating organization used servicer or remittance reports, and with what frequency, to conduct surveillance of the credit rating."[345] The disclosure must also note certain enumerated quantitative[346] and

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[339] *Id.* at 51.
[340] *Id.*
[341] Levin–Coburn Report, *supra* note 93, at 316.
[342] 15 U.S.C.A. § 78-o7(s)(1)(B) (West, Westlaw through 2012 legislation).
[343] 15 U.S.C.A. § 78-o7(s)(1)(A)(i).
[344] 15 U.S.C.A. § 78o-7(s)(1)(B)(ii).
[345] 15 U.S.C.A. § 78o-7(s)(1)(A)(iii).

qualitative factors,[347] including the conditions in which the credit rating could change, the main assumptions underlying methodologies and inputs, and the quality of underlying data.

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[346] "Each nationally recognized statistical rating organization shall disclose on the form developed under this subsection—
(i) an explanation or measure of the potential volatility of the credit rating, including—
(I) any factors that might lead to a change in the credit ratings; and
(II) the magnitude of the change that a user can expect under different market conditions;
(ii) information on the content of the rating, including—
(I) the historical performance of the rating; and
(II) the expected probability of default and the expected loss in the event of default;
(iii) information on the sensitivity of the rating to assumptions made by the nationally recognized statistical rating organization, including—
(I) 5 assumptions made in the ratings process that, without accounting for any other factor, would have the greatest impact on a rating if the assumptions were proven false or inaccurate; and
(II) an analysis, using specific examples, of how each of the 5 assumptions identified under subclause (I) impacts a rating;
(iv) such additional information as may be required by the Commission."

15 U.S.C.A. § 78-07(s)(3)(B).

[347] "Each nationally recognized statistical rating organization shall disclose on the form developed under paragraph (1)—
(i) the credit ratings produced by the nationally recognized statistical rating organization;
(ii) the main assumptions and principles used in constructing procedures and methodologies, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating structured products;
(iii) the potential limitations of the credit ratings, and the types of risks excluded from the credit ratings that the nationally recognized statistical rating organization does not comment on, including liquidity, market, and other risks;
(iv) information on the uncertainty of the credit rating, including—
(I) information on the reliability, accuracy, and quality of the data relied on in determining the credit rating; and
(II) a statement relating to the extent to which data essential to the determination of the credit rating were reliable or limited, including—
(aa) any limits on the scope of historical data; and
(bb) any limits in accessibility to certain documents or other types of information that would have better informed the credit rating;
(v) whether and to what extent third party due diligence services have been used by the nationally recognized statistical rating organization, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third party;(vi) a description of the data about any obligor, issuer, security, or money market instrument that were relied upon for the purpose of determining the credit rating;
(vii) a statement containing an overall assessment of the quality of information available and considered in producing a rating for an obligor, security, or money market instrument, in relation to the quality of information available to the nationally recognized statistical rating organization in rating similar issuances;

Furthermore, rule 17g-7 requires credit rating agencies to explain in reports accompanying ABS ratings (1) "the representations, warranties and enforcement mechanisms available to investors" and (2) "how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities."[348]

Disclose or Disgorge

Professor Hunt proposes a "disclose or disgorge" policy. Because reputational capital incentives do not function correctly for new or novel products, "[a]gencies should be required to disgorge profits derived from issuing ratings on particular types of new products if the ratings turn out to fall below a specified level of quality, unless the agency discloses in advance that the ratings are of low quality."[349] As Professor Hunt argues, the proposal

> removes the incentive to issue undisclosed low-quality ratings, permits investors to decide for themselves whether to use low-quality ratings (investors who are not good at judging risk for themselves might find such ratings useful), and avoids unnecessary, error-prone, and irrelevant inquiries into the agency's "intent to deceive" and the ex ante "reasonableness" of its determinations that would be required under fraud or negligence rules. It also does not rely on administrative foresight to the same extent as a pending proposal apparently intended to require agencies to get SEC approval before issuing ratings on novel instruments.[350]

ISSUER CAPS

As was discovered in the conflicted ratings process for CDOs and RMBSs, an issuer-paid credit rating agency may have clients who contribute a significant percentage

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(viii) information relating to conflicts of interest of the nationally recognized statistical rating organization; and
(ix) such additional information as the Commission may require."

15 U.S.C.A. § 78o-7(s)(3)(A).
[348] 17 C.F.R. § 240.17g-7 (2012).
[349] Hunt, *supra* note 61, at 182.
[350] *Id.* at 182.

of the agency's total revenue. With these profitable business relationships at risk, the agency may hesitate to downgrade an issue or lose the issuer's business by awarding low ratings. For these purposes, the SEC has defined a high threshold: a NRSRO may not issue a credit rating "solicited by a person that, in the most recently ended fiscal year, provided the [NRSRO] with net revenue . . . equaling or exceeding 10% of the total net revenue of the [NRSRO] for that fiscal year."[351]

DUE DILIGENCE

"Rating agencies are unique among financial gatekeepers in not conducting factual verification."[352] As the FCIC notes, "Moody's did not sample or review individual loans" when employing its M_3 model to rate various mortgage-related securities, but rather relied on loan-level information from the issuers.[353] Agencies did not perform due diligence review of RMBS loan tape or require the issuer to certify its accuracy.[354] Prior to 2000, rating agencies often required "factual investigation by independent experts of the critical facts on which their models rely," relying on "due diligence" firms such as Clayton Holdings and the Bohan Group employed by the investment banks.[355] "However, as the housing bubble grew, investment banks cut off this flow of information, possibly because it might alert rating agencies to problems."[356] Frank Raiter, former head of S&P's RMBS division, noted that employees "were discouraged even to use the term 'due diligence' as it was believed to expose S&P to liability."[357]

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[351] 15 C.F.R. § 240.17g-5(c)(1).
[352] Coffee, *supra* note 275, at 45.
[353] FCIC report, *supra* note 1, at 120.
[354] Levin–Coburn Report, *supra* note 93, at 311.
[355] Coffee, *supra* note 275, at 45.
[356] *Id.* at 46.
[357] Levin–Coburn Report, *supra* note 93, at 311.

Professor Coffee notes that Dodd–Frank's altered pleading standard encourages credit rating agencies to engage in due diligence or hire an independent firm to engage in factual verification.[358] If credit rating agencies fail to engage in these forms of factual verification, the credit rating agencies' motion to dismiss will not be granted.[359] Furthermore, under Dodd–Frank, the SEC must require credit agencies to issue a form with credit ratings, disclosing, among other things, "whether and to what extent third party due diligence services have been used by the nationally recognized statistical rating organization, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third party."[360] While the provision does not mandate factual verification, Coffee notes that the provision "creates an embarrassment cost if due diligence services are not used."[361] Furthermore, with respect to asset-backed securities, "[t]he issuer or underwriter of any asset-backed security shall make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter."[362]

INCREASING COMPETITION

As of 2011, S&P, Moody's, and Fitch issued 97% of all outstanding ratings,[363] and issuer-paid NRSROs issued approximately 99% of the total currently outstanding NRSRO credit ratings.[364] "[T]he regulatory use of ratings, economies of scale, high fixed

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[358] Coffee, *supra* note 275, at 47.
[359] *Id.*; *see* Dodd–Frank Wall Street Reform and Consumer Protection Act, § 933(b), 124 Stat. at 1833 (codified as amended at 15 U.S.C. § 78u-4(b)(2)(B)) (defining state-of-mind requirement for pleadings).
[360] Dodd–Frank Act, § 932(s)(3)(A)(v), 124 Stat. at 1880.
[361] Coffee, *supra* note 275, at 46.
[362] 124 Stat. at 1881.
[363] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-240, CREDIT RATING AGENCIES: ALTERNATIVE COMPENSATION MODELS FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 7 (2012).
[364] *Id.*

costs, and network effects (the value or utility of products or services increasing with the number of users) . . . have created barriers to entry and [have] led to concentration in the credit rating industry."[365]

Before SEC began its formalized NRSRO registration process in 2006, many attributed the failures of the credit rating agencies to lack of competition. Fitch, Moody's, and S&P were largely the only competitors in the market because SEC had bestowed on NRSRO status only on a few credit rating agencies. Many believed that NRSROs failed because their NRSRO status gave them unfair market power in the credit rating agency business, allowing an oligopolistic environment. Creating a formal NRSRO registration process would not only increase transparency, but also improve the overall functioning of the market.

This understanding has been popular in Europe as well. After several prominent downgrades of sovereign debt at sensitive times, many European Parliament members lamented the influence of credit rating agencies and hoped for a strong European alternative.[366] In February of 2012, Leonardo Domenici proposed an amendment in a draft report that would "enhance competition" by imposing a market-share cap; under the amendment, no credit rating agency would be able to hold more than 25% market share,

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[365] *Id.*

[366] *See* Stephen Castle, *Europe Seeks to Reduce Debt Ratings' Influence*, NYTIMES.COM, Feb. 28, 2010, http://www.nytimes.com/2012/02/29/business/global/european-parliament-proposes-sweeping-european-powers-over-credit-ratings.html?_r=1&scp=3&sq=credit%20rating%20agencies&st=cse ("Even before France and other countries lost their top credit ratings in January, European leaders had blamed the agencies for worsening the debt crisis."); Huw Jones, *Euro MP seeks credit rating agency market share caps*, REUTERS.COM (February 28, 2012), http://www.reuters.com/article/2012/02/28/eu-ratingagencies-idUSL5E8DS55620120228 ("EU politicians have accused the ratings agencies of contributing to the financial crisis, and making it harder to rescue euro zone countries like Greece because of rating downgrades at sensitive moments.").

"in a notional amount," in each asset class—banking, insurance, corporate, and structured finance .[367]

However, given the profit incentives in an issuer-pays system, competition may not improve ratings quality. As Moody's chief executive, Raymond McDaniel, told the board in 2007:

> "It turns out ratings quality has surprisingly few friends . . . Ideally, competition would be primarily on the basis of ratings quality, with a second component of price and a third component of service. Unfortunately, of the three competitive factors, ratings quality is proving the least powerful . . . In some sectors, it actually penalizes quality by awarding ratings mandates based on the lowest credit enhancement needed for the highest rating."[368]

A study by Bo Becker and Todd Milbourn came to a similar conclusion.[369] Analyzing data from Fitch's entry into the market, Becker and Milbourn conclude that competition has a negative effect on ratings quality. They note that although competition can reduce the level of rents in rating agencies and increase the additional information provided to financial markets, "increasing competition in the ratings industry involves the risk of impairing the reputational mechanism that seemingly underlies the provision of good quality ratings."[370]

STALENESS REFORMS

Credit ratings may have low informational value because they are not often updated to reflect new information and changing market conditions. "One reason for this is economic: there is today little, if any, revenue in downgrading a client's rating and

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[367] Draft Report on the proposal for regulation of the European Parliament and of the Council amending Regulation (EC) No. 1060/2009 on credit rating agencies (Com(2011)0747 – C7-0420/2011 – 2011 1/0361(COD)), 892526EN, at 8.
[368] MCLEAN & NOCERA, *supra* note 71, at 119.
[369] Bo Becker & Todd Milbourn, *How did increased competition affect credit ratings?* (NAT'L BUREAU OF ECON. RESEARCH,Working Paper No. 16404, 2010), at 4.
[370] *Id.* at 10.

some risk of a loss of future business."[371] In response to this problem, regulators may require the issuer to enter a "multi-year contract with the rating agency to monitor the issuer's rating for a defined period after a rating's issuance."[372] While issuer-paid credit rating agencies may still be slow to downgrade,[373] this mandated relationship may reduce the destructive influence of sudden, large downgrades.

INTERNAL GOVERNANCE

Professor Coffee notes that regulating internal corporate governance is an "obvious (and politically irresistible) approach toward reform of the credit rating agencies."[374] However, the impact of these regulatory reforms will probably be minimal, given the failures of codes and compliance officers at preventing the abuses of the credit rating agencies during the most recent financial crisis.

For example, shortly after the failures of Enron and WorldCom, Moody's adopted a code of conduct. This move may have been an attempt to stem calls for regulatory oversight. The code acknowledged outside concern for the integrity of the credit rating process given the existence of the issuer pays model. The code stated that "[t]he credit rating Moody's assigns . . . will not be affected by the existence of, or potential for, a business relationship between Moody's and the issuer."[375]

In 2006, Congress asked more from credit rating agencies, while showing a preference for internal management of conflicts. The Credit Rating Agency Reform Act required the credit rating agencies to create specific policies and procedures that would address conflicts of interest. NRSROs must

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[371] Coffee, *supra* note 275, at 49.
[372] *Id.* at 50.
[373] *Id.*
[374] *Id.* at 50.
[375] MCLEAN & NOCERA, *supra* note 71, at 119.

> 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.[376]

The Dodd-Frank Act further enhanced the required internal controls. Under these provisions, each NRSRO

> shall establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe, by rule.[377]

In addition, the NRSRO should submit an annual internal controls report[378] and appoint a compliance officer,[379] limiting that individual from engaging in other operations of the agency, such as rating debt, marketing or sales activities, and developing methodologies.[380]

However, credit rating agencies have had compliance officers long enough for employees to see their failures. One former Moody's analyst noted that the policies issued by the compliance department, although seemingly complex and thorough, "serve the sole purpose of constructing a virtual Potemkin village for regulators to admire."[381] Furthermore, McLean and Nocera note that shortly after Moody's released its code of conduct, Moody's fired experienced compliance officers in favor of perceivably laxer ones, previously employed at the structured finance department.[382] One compliance

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[376] Credit Rating Agency Reform Act, §15E(h)(1), Pub. L. No. 109–291, 120 Stat. 1327, 1334 (2010) (codified as amended at 15 U.S.C.A. § 78o-7(h)(1) (West, Westlaw through 2012 legislation)).
[377] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 932(a)(3)(A), Pub. L. No. 111-203, 124 Stat. 1376, 1873 (2010) (codified as amended at 15 U.S.C.A. 78o-7(c)(3)(A) (West, Westlaw through 2012 legislation)).
[378] 15 U.S.C.A. § 78o-7(c)(3).
[379] 15 U.S.C.A. § 78o-7(j)(1).
[380] 15 U.S.C.A. § 78o-7(j)(2).
[381] Harrington Comment, *supra* note 273, at 9.
[382] MCLEAN & NOCERA, *supra* note 71, at 120.

officer noted that his guidance "was routinely ignored if that guidance meant making less money."[383]

Mandating internal management of conflicts may not be effective, given the failure of similar policies at investment banks and current policies at credit rating agencies.[384] However, as Professor Coffee notes, the reforms "may sometimes provide valuable information to experienced regulators."[385]

ADMINISTRATIVE REGISTRATION

Both the United States and Europe now require credit rating agencies to be registered with a regulatory agency. While governmental oversight is necessary, regulatory oversight, in isolation, may not reduce conflicts and enhance the informational quality of credit ratings. Regulators may focus on "procedural regularity"—on such questions such as whether the agency kept full and complete records or had a compliance officer—rather than on significant actions that would reduce conflicts of interest.[386] However, some requirements may keep agencies aware of continuing problems—for example, reports required when a final credit rating materially deviates from the rating implied by the NRSRO quantitative models;[387] reports regarding an issuer's material violations of the law;[388] or reports regarding employment transitions.[389]

ALTERNATIVE BUSINESS MODELS

Because the issuer-pays system is by far the most significant agency-level conflict of interest, critics of the system have proposed alternative business models. In

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[383] *Id.*
[384] Coffee, *supra* note 275, at 51.
[385] *Id*.
[386] Coffee, *supra* note 275, at 52.
[387] *Id.* (citing 17 C.F.R. § 240.17g-5(2) (2012)).
[388] 15 U.S.C.A. § 78o-7(u) (West, Westlaw through 2012 legislation).
[389] 15 U.S.C.A. § 78o-7(h)(5).

accordance with section 939F of The Dodd–Frank Act, the GAO recently completed a report on alternative compensation models for structured finance products. This section will mirror their discussion of each model in the report.

Random Selection Model

In the random selection model, a "ratings clearinghouse randomly would select NRSROs to rate a new issuance."[390] The clearinghouse "could be a nonprofit, a governmental agency such as SEC, or a private-public partnership that would design the criteria by which new entrants could qualify as a credit rating agency."[391] Upon being randomly selected, the NRSRO could refuse or accept to complete the rating, and the issuer would pay its fee—covering both rating and clearinghouse costs—to the clearinghouse.[392] Once the credit rating released its initial and maintenance ratings, the clearinghouse would pay the credit rating agency—an amount established by the clearinghouse based on the type of security.[393]

The model also incorporates "a peer comparison review to create an incentive for NRSROs to produce quality ratings."[394] If the agency's performed poorly in relation to its peers, the rating agency may lose a percentage of business or rating fees.[395] The review would compose of two tests. First, "if the default percentage of debt instruments rated by a given NRSRO differed from the default percentage of its peers by a set parameter, then the NRSRO would be subject to sanctions such as losing a percentage of

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[390] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-240, CREDIT RATING AGENCIES: ALTERNATIVE COMPENSATION MODELS FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 8 (2012), *available at* http://www.gao.gov/assets/590/587832.pdf.
[391] *Id.*
[392] *Id.*
[393] *Id.*
[394] *Id.*
[395] *Id.* at 9.

business or rating fees."[396] Second, another test would "compare annual yields of identically rated debt securities from different asset classes" and examine whether "[s]ecurities in different asset classes . . . . [that are] rated similarly . . . have the same yield. An NRSRO would be subject to sanctions if the yields of identically rated securities differed by a certain threshold."[397]

Investor-Owned Credit Rating Agency Model

Under the investor-owned credit rating agency model, select institutional investors would create and operate a NRSRO.[398] The investors would have to qualify as "highly sophisticated institutional purchasers," demonstrating that it "was large and sophisticated, managed billions of dollars in assets, and could be relied upon to represent the buy-side interest in accurately rating debt market instruments."[399]

> Issuers would have to obtain two ratings—one from the investor-owned NRSRO and the second from their choice of NRSRO. More specifically, an NRSRO could not publicly release a rating for which an issuer or sponsor paid unless the NRSRO received written notification that the issuer had paid an investor-owned NRSRO to publicly release its rating. The investor-owned NRSRO would publish its rating on or before the date on which the solicited NRSRO published its rating.[400]

According to proponents, the model change incentive structures, add new competition, and balance investors' and issuers' interests.[401] However, an NRSRO composed of institutional investors would have conflicts of interest similar to the "large subscriber" conflict discussed earlier on in the paper. Large institutional investors have an interest in inflated ratings, as well.

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[396] *Id.*
[397] *Id.*
[398] *Id.*
[399] *Id.*
[400] *Id.*
[401] *Id.* at 9–10.

Stand-Alone Model

Under the stand-alone model, NRSROs could not charge for ancillary services.[402] NRSROs would not charge for their services, but would rather be compensated through transaction fees in the primary and secondary market. Over the life of the security, issuers, secondary-market sellers, and investors in the primary and secondary market would pay portions of the transaction fees.[403] The public would be able to access all ratings.[404]

Designation Model

Under the designation model, issuers would pay fees to a third-party administrator, which would then direct fees to the NRSRO based on investor preferences. All interested NRSROs would receive the information necessary to rate the issuance, and investors who purchased the issuance would then select one or several NRSROs to receive fees, according to the quality of their research. "After the initial rating, the issuer would continue to pay maintenance rating fees to the third-party administrator. A final rating fee would be paid in conjunction with the retirement (or repurchase) of the security."[405] "While the letter rating would be free to the public," "the research underlying it would be distributed to security holders and (at the discretion of the relevant NRSROs) to potential security holders."[406]

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[402] *Id.* at 10.
[403] *Id.*
[404] *Id.*
[405] *Id.* at 10–11.
[406] *Id.* at 11.

User-Pays Model

Under the user-pays model, all rating "users" would pay the NRSRO "for each period in which it booked the related asset or liability."[407] A "user" is "any entity that included a rated security, loan, or contract as an element of its assets or liabilities as recorded in an audited financial statement."[408] This definition would include "holders of long or short positions in a fixed-income instrument, parties that refer to a credit rating in contractual commitments (that is, as parties to a lease), or parties to derivative products that rely on rated securities or entities."[409] With the cooperation of the Public Company Auditing Oversight Board, third-party auditors would ensure that users paid NRSROs for use of the ratings.[410] While more "cumbersome" than the subscriber-pays model, the user-pays model attempts to "capture 'free riders.'"[411]

Alternative User-Pays Model

Under the alternative user-pays model, "a government agency or independent board would administer a user-fee system financed by debt purchasers, which would fund a competitive bidding process for the selection of rating agencies."[412] NRSROs would bid on rating an issuance, and the agency or board would pay for the rating with the pooled resources of many creditors.[413]

Furthermore, "[u]sers of ratings would be given enforceable rights and would require NRSROs to assume certification and mandatory reporting duties to creditors."[414]

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[407] *Id.*
[408] *Id.*
[409] *Id.*
[410] *Id.*
[411] *Id.*
[412] *Id.* at 12.
[413] *Id.*
[414] *Id.*

The system would also establish creditor committees, which would monitor credit ratings and serve as designated representatives of creditors in actions against NRSROs.[415]

Issuer and Investor-Pays Model

Under the issuer and investor-pays model, "[p]ayments for ratings would come from a fee levied on issuers of new debt issues and investors as parties of secondary market trades." [416] A dedicated fund, similar to the Municipal Securities Rulemaking Board (MSRB), would hold the fees.[417] The fund would then assign two to three NRSROs to rate new issuances. The frequency at which the NRSRO would be selected would be dependent on the NRSRO's performance:

> Initially, all NRSROs would be placed in a continuous queue and would receive rating assignments when their respective numbers came up, unless they were unable or unwilling to rate a particular issue. In the future, ratings would be assigned based on the performances of the NRSROs, with those agencies that produced superior performance receiving more assignments.[418]

The ratings would be available to the public.[419]

PUBLIC CREDIT RATING AGENCY

Some have considered creating a public alternative to credit rating agencies.[420] Although the public agency would be subject to regulatory capture and its own conflicts of interest, the agency may provide investors with more peace-of-mind, given the difficulty of limiting the issuer-pays model. However, as the lack of SEC intervention

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[415] *Id.*
[416] *Id.* at 13.
[417] *Id.*
[418] *Id.*
[419] *Id.*
[420] *See, e.g.*, M. Ahmed Diomande, James Heintz, & Robert Pollin, *Why U.S. Financial Markets Need a Public Credit Ratings Agency*, *available at* http://www.wallstreetwatch.org/working_papers/Public_Credit_Ratings_Agency.pdf

before the financial crisis demonstrates, "the government does not have a great history of keeping abreast of financial innovations—a role that is critical for rating agencies."[421]

Furthermore, the political ramifications of some rating decisions may deter the public credit rating agency from downgrading certain debts and may discourage diversity of opinion. As Professor Coffee notes,

> [T]he creation of a governmental rating agency presents special dangers. Not only might such an agency be conflicted, but there is a more ominous danger that if private CRAs [credit rating agencies] disagree with its rating analysis, the regulator might take their disagreement as evidence of a deficiency in the procedures or methodologies of the non-governmental CRAs. As anger against the CRAs mounts, the prospect of retaliation for politically incorrect ratings lurks in the background. Ironically, while the CRAs have been justly criticized in the U.S. for inflated ratings, they may face even greater hostility in Europe for downgrades that are perceived as excessive or premature.[422]

In fact, a draft report released recently proposes the creation of a public European Credit Rating Agency responsible for rating member' states' sovereign debt.[423] This suggestion was largely in response to recent downgrades that arguably worsened the Euro Crisis.

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[421] Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 102–03 (2010).
[422] Coffee, *supra* note 275, at 55.
[423] Draft Report on the proposal for regulation of the European Parliament and of the Council amending Regulation (EC) No. 1060/2009 on credit rating agencies (Com(2011)0747 – C7-0420/2011 – 2011 1/0361(COD)), 892526EN, *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-480.852&format=PDF&language=EN&secondRef=03.

Part VII: Statutes and Regulation Relating to Conflicts of Interest at NRSROs

Current law relating to conflicts of interest at credit rating agencies focuses on analyst-level conflicts and internal management of conflicts of interest. In accordance with enabling legislation, SEC rules regulate only conflicts of interest arising at NRSROs.[424]

Outright and Conditional Prohibition

Rule 17g-5[425] mentions two sets of regulated conflicts: (1) prohibited conflicts[426] and (2) conflicts of interest[427] that are only prohibited[428] if the NRSRO does not take certain measures[429] to disclose and address the conflict. If the NRSRO adopts an issuer-pays fee structure with regard to certain securities or money-market instruments "issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction," the NRSRO must disclose that conflict on their Form NRSRO;[430] establish, maintain, and enforce written policies and procedures to address and manage conflicts of interest; and maintain a password-protected website chronicling ratings for the security or money-market instrument,[431] to which other NRSROs with proper certification have access.[432]

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[424] Instead of issuing "no-action" letters, the SEC now has a clear certification process for NRSROs. *See generally Small Entity Compliance November 2009 Amendments to the Rules Relating to the Oversight of Nationally Recognized Statistical Rating Organizations*http://www.sec.gov/rules/final/2009/34-61050-secg-nrsro.htm
[425] Conflicts of Interest, 17 C.F.R. § 240.17g-5 (2012).
[426] § 240.17g-5(c).
[427] § 240.17g-5(b).
[428] § 240.17g-5(a).
[429] § 240.17g-5(a)(1)–(3).
[430] § 240.17g-5(a)(1).
[431] § 240.17g-5(a)(3)(i).
[432] § 240.17g-5(a)(3)(ii); § 240.17g-5(e).

The list of outright prohibited conflicts is particularly interesting. NRSROs may not issue or maintain a credit rating

> (1) solicited by a person that, in the most recently ended fiscal year, provided the [NRSRO] with net revenue . . . equaling or exceeding 10% of the total net revenue of the [NRSRO] for that fiscal year;[433]
>
> (2) with respect to a person . . . where the [NRSRO], a credit analyst that participated in determining the credit rating, or a person responsible for approving the credit rating, directly owns the securities of, or has any other direct ownership interest in, the person [434] or is an officer or director of the person that is subject to the credit rating;[435]
>
> (3) with respect to a person associated with the [NRSRO];[436]
>
> (4) 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;[437]
>
> (5) 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 credit ratings or for developing or approving procedures or methodologies used for determining credit ratings, including qualitative and quantitative models;[438] or
>
> (6) 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.[439]

On May 18, 2011, SEC proposed an addition to this list. If the rules are adopted, NRSROs may not issue or maintain a credit rating

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[433] § 240.17g-5(c)(1).
[434] § 240.17g-5(c)(2).
[435] § 240.17g-5(c)(4)
[436] § 240.17g-5(c)(3).
[437] § 240.17g-5(c)(5).
[438] § 240.17g-5(c)(6).
[439] § 240.17g-5(c)(7).

> where a person within [NRSRO] who participates in sales or marketing of a product or service of the [NRSRO] or a product or service of a person associated with the [NRSRO] also participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative or quantitative models.[440]

A later subsection would exempt smaller NRSROs from this requirement.[441] In addition, the proposed rules require the Commission to "suspend or revoke the registration of a [NRSRO] if the Commission finds in a proceeding that the [NRSRO] has violated a rule [under the section] . . ., that the violation affected a rating, and that suspension or revocation is necessary for the protection of investors and in the public interest."[442]

Furthermore, the SEC prohibits practices determined to be "unfair, coercive, or abusive," including abusive practices relating to the provision of ancillary services and associated conflicts.[443] These practices include (1) "conditioning or threatening to condition the issuance of a credit rating" on the purchase of the NRSRO's other services and products, "including pre-credit rating assessment products"; (2) issuing, modifying, or threatening to issue or modify a credit rating that is not determined in accordance with the NRSRO's "established procedures and methodologies for determining credit ratings" based on whether the issuer will purchase the credit rating; and (3) engaging in similar "anti-competitive behaviors" with regard to asset-backed securities, where the credit rating agency would insist rating the whole pool rather than portions of the pool.[444]

While the rules do not prohibit use of the issuer-pays model, the rule imposes more restrictions on NRSROs that adopt the fee structure by requiring more disclosures.

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[440] SEC. & EXCH. COMM'N, Proposed Rules (2011), Release No. 34-64514, at 457, *available at* http://www.sec.gov/rules/proposed/2011/34-64514.pdf.
[441] *Id.* at 458.
[442] *Id.*
[443] 17 C.F.R. § 240.17g-6 (2012).
[444] *Id.*; 15 U.S.C.A. § 78o-7(i)(1).

NRSROS must decline business from customers who are responsible for large proportion of their profits and adopt organizational firewalls. Those responsible for negotiating fees cannot be the same people responsible for ratings. Furthermore, NRSROs cannot both rate for an issuer and serve as a financial advisor.[445]

Internal Governance

> NRSROs must also adopt certain internal governance measures. NRSROs must
>
> establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such [NRSRO] and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business.[446]

The Dodd–Frank Act also suggests additional internal governance measures. Each NRSRO shall have a board of directors,[447] at least one-half of which are independent[448] of the NRSRO.[449] The board shall oversee the following:

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[445] Given that NRSROs did occupy these dual roles before regulation, this rule is a positive step. However, it is unclear how this provision will be effectively enforced. "The problem comes in distinguishing between when an NRSRO is explaining its reasoning for giving a bond a particular rating and when an NRSRO is actually making a recommendation to an issuer about how the bond should be structured." *See* A. Brooke Murphy, *Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies Led to the Subprime Credit Crisis and the Need for Greater Accountability*, 62 OKLA. L. REV. 735, 763 (2010). Since the SEC values transparency in the ratings process, NRSROs may circumvent the rules' prohibitions by disguising the recommendations as explanations about the models employed by the NRSRO.

[446] Credit Rating Agency Reform Act, §15E(h)(1), Pub. L. No. 109–291, 120 Stat. 1327, 1334 (2010) (codified as amended at 15 U.S.C.A. § 78o-7(h)(1) (West, Westlaw through 2012 legislation)).

[447] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 932(t)(1), Pub. L. No. 111-203, 124 Stat. 1378, 1882 (codified as amended at 15 U.S.C.A. § 78o-7(t)(1) (West, Westlaw through 2012 legislation).

[448] In order to be independent, a member

> (i) may not, other than in his or her capacity as a member of the board of directors or any committee thereof—
>
> > (I) accept any consulting, advisory, or other compensatory fee from the nationally recognized statistical rating organization; or
> >
> > (II) be a person associated with the nationally recognized statistical rating organization or with any affiliated company thereof; and
>
> (ii) shall be disqualified from any deliberation involving a specific rating in which the independent board member has a financial interest in the outcome of the rating.

15 U.S.C.A. § 78o-7(t)(2)(B).

> (A) the establishment, maintenance, and enforcement of policies and procedures for determining credit ratings;
>
> (B) the establishment, maintenance, and enforcement of policies and procedures to address, manage, and disclose any conflicts of interest;
>
> (C) the effectiveness of the internal control system with respect to policies and procedures for determining credit ratings; and
>
> (D) the compensation and promotion policies and practices of the nationally recognized statistical rating organization.[450]

The compensation for independent members would be independent of the business performance of the NRSRO.[451] However, a portion of the independent members shall include users of the NRSRO's ratings.[452]

Second, credit rating agencies have to track employment transitions of their analysts. The statute requires credit rating agencies to perform a look-back review: If an employee of the NRSRO was an "employee of a person subject to a credit rating of the [NRSRO] or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating" and determined credit ratings for that person, the NRSRO must assess whether conflicts of interest compromised the rating and adjust the rating appropriately.[453] In addition, NRSROs must report when certain employees—senior officers, those involved in the determination of credit ratings, and those in supervising the latter—obtain "employment with any obligor, issuer, underwriter, or sponsor of a security or money market instrument for which the organization issued a credit rating during the

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[449] 15 U.S.C.A. § 78o-7(t)(2)(A) (at least one-half of the board—but not less than two members).
[450] 15 U.S.C.A. § 78o-7(t)(3).
[451] 15 U.S.C.A. § 78o-7(t)(2)(C).
[452] 15 U.S.C.A. § 78o-7(t)(2)(A).
[453] 15 U.S.C.A. § 78o-7(h)(4).

12-month period prior to such employment."[454] Furthermore, employees of NRSROs now have whistleblower protections under 18 U.S.C. § 1514A(a).[455]

[454] 15 U.S.C.A. § 78o-7(h)(5).
[455] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 922, 124 Stat. at 1888.

Part VIII: Analysis of Current Rules

The current SEC rules have several limitations. First, while the SEC rules subject credit rating agencies with an issuer-pays system to more scrutiny, the rules do not alter the bottom-line. Credit rating agencies with an issuer-pays model arguably have higher regulatory costs, but the rules do not adequately deter the use of this model or substantially change the benefits to hastily assigned and inflated ratings.

Rule 17g-5 largely focuses on analyst-level conflicts. The rules only seek to remediate agency-level conflicts, if at all, through internal governance measures, reporting requirements, organizational firewalls, and disclosure. While these analyst-level conflicts are common-sense limitations, the regulation may not change the culture of intimidation and excessive focus on market share that predated the financial crisis. Despite intricate internal rules, management may still refrain from hiring senior analysts, seek to pressure analysts in committee meetings to issue higher ratings, and otherwise contribute to an environment ripe for control fraud. While the SEC can suspend registration for credit rating agencies with inadequate resources, enforcement may only occur in the most abusive situations. While it may be difficult to eliminate the unquantifiable human factors that lead to this most recent financial crisis—such as general chumminess with customers, errors in judgment, or "bad bosses"—disclosures and internal management may be largely inadequate if (1) the SEC refrains from enforcement ensuring compliance with their rules and (2) the disclosures are unwieldy and difficult to parse.

Given the widespread and longstanding use of the issuer-pays model, it would be difficult to ban the issuer-pays model without a direct Congressional mandate. Sections 939D, 939E, and 939F require the Government Accountability Office to perform studies

on alternative business models, the creation of an independent professional analyst organization, and "establishing a system in which a public or private utility or a self-regulatory organization assigns [NRSROs] to determine the credit ratings of structured finance products."[456] While the GAO's most recent report on alternative compensation models was useful, the report stresses the preliminary nature of its findings, suggesting that the SEC contact the authors of the alternative models in the creation of their individual report.[457] The report seems to hint at an inevitable dead-end.

Furthermore, the rules are generalized "thou-shalt-not" provisions; the rules do not fill in the gray areas. Most notably, credit ratings agencies may find it easy to circumvent organizational firewalls by characterizing their activities as something fostering general transparency concerning their rating practices—not fee negotiation or advisory services. To address these questions, the SEC can develop guidance regarding its rules or undertake more enforcement actions under its current rules; these activities may limit border-line conflicts of interest or other forms of circumvention.

Finally, the SEC conflict rules only affect NRSROs.[458] Given current registrations, this limitation is not a problem; the three largest credit rating agencies—S&P, Moody's, and Fitch—are all NRSROs. However, given the Dodd–Frank Act's simultaneous push to regulate NRSROs and remove the references to NRSRO ratings in financial regulation, some firms may forego NRSRO certification in the future to avoid disclosure requirements and to engage freely in prohibited conflicts.[459] While NRSRO

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[456] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 939F, Pub. L. No. 111-203, 124 Stat. 1378, 1889.
[457] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-240, CREDIT RATING AGENCIES: ALTERNATIVE COMPENSATION MODELS FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 28 (2012).
[458] *See* 15 U.S.C. § 78o-7(h)(2) (enabling provision for SEC rules, limiting the SEC to NRSROs).
[459] *See* Coffee, *supra* note 275, at 43.

classifications remain important in a number of other federal and state[460] regulations, regulators at all levels of government are reconsidering references to NRSRO ratings.[461] Credit rating agencies may find themselves in an environment in which NRSRO status is not as valuable as it used to be and forego certification.[462] Under the current statutory and regulatory context, the SEC cannot suspend or place limitations on non-NRSRO agencies.

On a more positive note, the rules highlight the importance of due diligence and transparent, consistent rating processes. Changes to pleading standards encourage credit rating agencies to perform reasonable verification and investigation on data underlying their models. Furthermore, in asset-backed or mortgage-backed securities transactions in which the NRSRO used a quantitative model, credit rating agencies must maintain records of "material differences between the credit rating implied by the model and the final credit rating issued."[463] This sort of record-keeping, while subject to fraud, may highlight instances in which the issuer-pays conflict compromises ratings quality. Disclosures accompanying ratings—along with the removal of references to NRSROs in financial regulation and statutes—may reduce overdependence on ratings and place ratings within context.

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[460] *See, e.g.*, U.S. S.E.C. SUMMARY REPORT, *supra* note 11, at 11 n.21 (providing California insurance regulation as an example).
[461] *See,e.g.*, Rating Agency Working Group, National Association of Insurance Commissioners, http://www.naic.org/committees_e_rating_agency.htm.
[462] *See id.* ("Accordingly, when the burdens outweigh the benefits, it makes sense for them to abandon NRSRO status—if they can.").
[463] 15 C.F.R. § 17g-2(a)(2).

Part IX: Recommendations

There's a funny thing about credit rating agencies: commentators, journalists, and Congressmen may excoriate their failings, but they cannot imagine a world without them. Surely, they were colossal—or perhaps, more colorfully, triple-A—failures in accurately rating CDOs and RMBSs, but after 30 years, a world without the imprimatur of NRSRO credit ratings seems a little too fast and loose. What "standards of creditworthiness" will replace references to NRSRO ratings? If not "investment-grade," then what? Will the stability of our financial system become dependent on elusive, factors-based standards—on the reasoned judgment of the same financial actors that served as arrangers in these dastardly RMBS and CDO deals?

From the regulator's point of view, references to NRSRO ratings may have given the agencies too much power and subjected the system to uncontrolled, systematic risk, but at least the "investment-grade" designation was concrete and easily applicable. Now, agencies must develop "standards of creditworthiness" through the notice and comment process—a process dominated by, however justifiably, industry members. These new standards—such as Partnoy's suggestion for use of spreads in credit default swaps[464]—are not immune to their own distortions; the standards may create another type of regulatory license—incentivize actors to adjust spreads on credit default swaps to finagle their way into lower capital requirements, for example. And of course, they do not alter human naiveté about the economic worth of instruments; Michael Burry and Cornwall Capital, actors in the *Big Short*, were shocked at the low premiums associated with credit default swaps—for what was for them, a very sure bet.[465]

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[464] *See supra* text accompanying notes 336–337 (explaining Partnoy's preference for credit default swap yield spreads).

[465] *See, e.g.*, LEWIS, *supra* note 4, at 51 ("It was as if you could buy flood insurance on the house in the valley for the same price as flood insurance on the house on the mountaintop.").

The SEC is slowly implementing the statutory provisions of Dodd–Frank with regard to the credit rating agencies. In its most recent annual examination report, the SEC noted notable strides in improving conflict of interest management, even though most agencies reported deviations from their models and procedures at some point in the year.[466] However, as of this writing, the SEC has not established the Office of Credit Ratings, nor has it lifted its nonenforcement stance with regard to issuers under Regulation AB.

FOCUS ON THE MOST CONFLICT-RIDDEN, CRIMINOGENIC TRANSACTIONS

In establishing its priorities, the SEC should focus on the transactions in which the issuer-pays conflict compromises the ratings process the most. The issuer-pays conflict is most detrimental when deals are profitable, numerous, and implicate a continuing business relationship with a particular arranger or issuer.[467] For these reasons, the SEC should seriously consider models such as the random selection model and the alternative user-pays model for structured finance ratings. These models remove the issuer-pays conflict, while rewarding agencies who rate issuances more accurately. The Office of Credit Ratings, or a nonprofit professional organization in partnership with the office, may be able to serve the model's clearinghouse or random assignment functions. The transition will be a slow and confused process, which may reduce the demand for, or otherwise slow the market for, asset-backed securities. However, in the long run, elimination of the conflicts in the securitization process may reduce the most "criminogenic" ratings transactions.[468]

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[466] U.S. SEC. & EXCH. COMM'N, 2011 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATIONS OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION (2010).
[467] *See supra* text accompanying notes 169–173 (explaining this influence of a few arrangers in RMBS and CDO deals).
[468] *See supra* text accompanying note 133 (discussing William Black's theory on "criminogenic" environments for financial fraud).

Furthermore, as William J. Black may argue, the SEC should scrutinize the so-called "high fliers."[469] The credit rating agencies became immensely profitable—with huge operating margins—in the lead-up to the financial crisis. As Black notes, no one—especially regulators—likes to scrutinize the wildly successful, the perceived business genius. However, as later became apparent, Brian Clarkson of Moody's wasn't operating an honest, profitable division, or later, company; he was overworking his employees, intimidating them into bad ratings, and then touting the company's profitability as quality customer service.[470] The SEC did not have regulatory authority over the credit rating agencies until 2007—fairly late in the game. If the SEC had time to act sooner with respect to credit rating agencies—and it should be noted that it missed a good number of red flags over which it did have full authority[471]—the inordinate profitability of these credit rating agencies, as well as huge increases in profitability, would have been a reason to scrutinize the agencies' records and internal governance practices a little more.

The SEC should also remember that competition is not a panacea, but may actually exacerbate ratings shopping problems.[472] Surely, the formal registration process for NRSROs, in comparison to the notoriously opaque "no action" letter designation,[473] is a positive development. However, as agencies have shown in the past, new competitors may lead to a race to the bottom.

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[469] *See, e.g.*, BLACK, *supra* note 128, at xvi ("Every S&L high flier failed. They were all control frauds.").

[470] Brian Clarkson served as the head of the structured finance division at Moody's during the height of subprime securitization and was promoted to President and Chief Operating Officer of Moody's Investor Service. *See supra* text accompanying notes 168, 282–284 (describing Clarkson's focus on market share, as well as his management style of "fear and intimidation").

[471] *See* FCIC Report, *supra* note 1, at xviii ("We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves.").

[472] *See* supra text accompanying notes 368–370 (explaining competition's effect on credit ratings quality).

[473] *See supra* text accompanying notes 39–45 (explaining the no-action letter designation for NRSROs pre-dating the 2006 Credit Agency Reform Act).

REMOVE BARRIERS TO AGENCY LIABILITY

In addition, the SEC should lift the nonenforcement stance on issuers selling asset-backed securities, which in effect reinstates the "expert liability" exemption for credit rating agencies. As Martha Coakley, Attorney General of Massachusetts, wrote in a report to the SEC, "Regulation AB forms the centerpiece of the SEC's investor protection regime for the asset-backed securitization markets."[474] In contravention of black-letter law, issuers are releasing asset-backed securities without necessary ratings disclosures, and the credit rating agencies—worried about "crushing liability" from Section 11—have refused to consent. Of course, the SEC had a difficult choice to make when the larger credit rating agencies' refusal brought the market to a grinding halt, but an indefinite nonenforcement stance goes too far. In this regard, competition can be a positive force, discouraging this sort of recalcitrance among the larger rating agencies. Smaller NRSROs may find an increase in market share as worth the extra risk.

Under 15 U.S.C. § 78o-7(p)(4), the SEC can establish, by rule, penalties and fines applicable to NRSROs. Penalties are more versatile than other enforcement tools—less severe than suspension or revocation of registration—and can deter analysts and agencies from engaging in prohibited conflicts of interest. However, as of this writing, the SEC has not created any penalties or fines relating to its rules on NRSROs. To improve the deterrent effect of its rules, the SEC should create a fine or penalty that can be levied against NRSROs for noncompliance. For example, the SEC may want to levy penalties against a NRSRO that has engaged in prohibited conflicts.

Furthermore, the credit rating agencies should be held liable for fraud, when applicable. Although the SEC cannot regulate ratings substance, procedures, and

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[474] Letter from Martha Coakley, Attorney General of Massachusetts, to Mary Schapiro, Chairman of the SEC, *available at* http://www.mass.gov/ago/docs/press/2011/2011-03-07-sec-letter-attachment1.pdf.

methodologies, SEC can examine these areas in antifraud actions.[475] In one notable example, SEC is investigating S&P for its actions rating the Delphinus CDO 2007-1.[476] While S&P has some strong legal defenses,[477] the SEC is still pursuing the investigation, at least six months after announcing the initial inquiry.[478] To ensure effective investigations and enforcement, Congress should fully fund the SEC. The Dodd–Frank Act gave the SEC many new responsibilities, and the SEC must have an adequate staff and budget to create new regulations and to undertake enforcement actions.[479]

IMPROVE RATINGS & DISCLOSURES

The SEC should try to parse disclosures to make them as easily understandable and useful as possible. Focusing on the detail of, rather than the digestibility of, these disclosures may flood investors with too much information and dampen their effectiveness. For example, the Levin–Coburn Report, released by the Permanent Subcommittee of Investigations, suggested that the SEC rank rating agencies based on their accuracy for each type of debt issuance.[480] Given Professor Bai's observations on performance disclosures,[481] investors may benefit from this sort of simplification.

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[475] *See* 15 U.S.C.A. § 78o-7(c)(2) (West, Westlaw through 2012 legislation) (stating that language limiting the SEC's authority to regulate substance, procedures, and methodologies should not be used as a defense in an antifraud action); *see also* § 78o-7(o)(2) (allowing States to investigate and bring enforcement actions against credit rating agencies for fraud and deceit).

[476] *See supra* note 103–104 (describing Delphinus 2007-1 CDO deal).

[477] *See U.S. SEC concedes challenges in credit-rating probes*, REUTERS.COM, Sep. 29, 2012, http://www.reuters.com/article/2011/09/29/sec-raters-idUSS1E78S1GJ20110929 (listing the agencies' legal shields, including the effective date of the 2006 Credit Rating Agency Reform Act, First Amendment concerns, and previous ambiguities surrounding regulation of agency procedures and methodologies).

[478] Jeanette Neumann & Thomas Catanus, *U.S. Steps Up S&P Inquiry: Former Analysts Questioned Again On Mortgage-Bond Ratings*, WSJ.COM, Jan. 17, 2012, http://online.wsj.com/article/SB10001424052970203721704577156963813900028.html.

[479] *See* Charles Riley, *SEC starved for reform funds*, CNN.COM, Jan. 11, 2011, http://money.cnn.com/2011/01/11/news/economy/SEC_funding/index.htm ("The longer [the SEC] operate[s] under significant budgetary restrictions, the greater the impact.").

[480] Levin–Coburn Report, *supra* note 93, at 316.

[481] *See supra* text accompanying notes 338–340 (explaining how performance disclosures have not altered market choices, due to brand allegiance and difficulty in comparing data sets across agencies).

Currently, "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 [NRSRO] determines credit ratings."[482] Because of this limitation, the SEC can only improve the informational value of credit ratings through roundabout regulatory measures. In this statutory environment, therefore, it is up to the credit rating agencies to improve its ratings and their ability to communicate risk.[483]

The credit rating agencies should consider changes to the rating scale, subjecting structured securities to a different rating scale than corporate bonds or altering the current uniform rating system with extra notations describing the instrument's susceptibility to systematic risk.[484] For example, the extra notation may denote how debt will be repaid—whether creditworthiness "rests mainly on the expected capacity to resell its encumbered asset at a higher price" or on "normal economic activities."[485] In these scenarios, entities could be highly rated, but have an additional notation based on the method of repayment: AAA_L, for liquidation, or AAA_I rating, for income.[486] This extra notation, as well as the relative balance between AAA_I and AAA_L ratings, could alert regulators to increasing instability in financial markets—what economist Hyman Minsky calls "Ponzi finance."[487]

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[482] 15 U.S.C.A. § 78o-7(c)(2) (West, Westlaw through 2012 legislation).

[483] By law, NRSROs should state their most crucial assumptions, especially those concerning continuing market conditions, and alert regulators to circumstances in which issued ratings substantially differ from those suggested by their quantitative models.

[484] Eric Tymoigne, *A Critical Assessment of Seven Reports on Financial Reforms: A Minskian Perspective* (Levy Economics Institute, Working Paper No. 574.4, 2009), at 59.

[485] *Id.* at 59.

[486] *Id.*

[487] *Id.*; *see generally* Hyman P. Minsky, The Financial Instability Hypothesis (Levy Economics Institute, Working Paper No. 74, 1992), *available at* http://www.levyinstitute.org/pubs/wp74.pdf, at 7 ("For Ponzi units, the cash flows from operations are not sufficient to fulfill either the repayment of principle or the interest due on outstanding debts by their cash flows from operations. Such units can sell assets or borrow . . . A unit that Ponzi finances lowers the margin of safety that it offers the holders of its debts.").

Furthermore, the credit rating agencies should adopt staleness reforms, providing for frequent and regular reassessments of ratings in boilerplate ratings contracts.

If credit ratings do not adequately improve rating processes, Congress should consider expanding the SEC's power to regulate ratings substance, procedures, and methodologies. Provisions in the Dodd–Frank Act have alluded to possible statutory developments in this area. For example, the Act requests a study from the SEC examining standardization of credit ratings terminology across asset classes and credit rating agencies.[488] In response to this study, Congress may give the SEC more flexibility in regulating ratings processes.

Foray into regulation of substance, procedures, and methodologies has its own legal challenges, however. These statutes would particularly implicate First Amendment concerns, casting a "chilling effect" on speech or otherwise reducing the diversity of financial opinions. For example, while standardization may help make ratings more understandable and digestible, such regulation may reduce the overall information available to the investor. Although this regulation may help investors understand the agencies' most crucial assumptions, a ratings system that tests creditworthiness on a standardized set of market stress conditions[489] may obscure systematic risk.

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[488] Under the Dodd–Frank Act,

> Commission shall undertake a study on the feasability and desirability of—
>
> (A) standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms;
> (B) standardizing the market stress conditions under which ratings are evaluated;
> (C) requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and
> (D) standardizing credit rating terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.

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

[489] § 939(h)(B), 124 Stat. at 1887.

Part X: Conclusions

Credit ratings are not always accurate or helpful, but they undoubtedly can have a tremendous economic impact. If anything is clear, it is that credit ratings can make or break markets. A triple-A rating is tremendously valuable, while "fallen angels" can release financial chaos.

Sometimes, the quest for market share and profit clearly leads the rating agencies astray, compromising quality and due diligence efforts. Other times, the credit rating agencies may simply adopt too narrow of an analytic approach, or incorporate assumptions that, while based on some recent trends, betray long-term historical patterns. And surely, the credit rating agencies can fall subject to human error and foolish optimism. The previously imponderable can become a reality; economic expertise and mathematical sophistication can obfuscate impending financial doom.

Unfortunately, however, markets do not come to a "permanently high plateau."[490] As this most recent crisis makes clear, they fluctuate, fail, and flounder. Financial stability breeds instability.[491] Fraud occurs in waves, creating the potential for widespread destruction.[492]

The credit rating agencies undoubtedly serve an important function in the market, but reputational capital incentives may not always deter fraud and laxity. Unfortunately, the issuer-pays conflict persists, despite recent proscription of its symptoms. With new oversight over the credit rating agencies, the SEC should be sensitive to these conflicts, with an eye towards prevention and not just procedural regularity. The focus on disclosures, internal governance, and organizational firewalls has an underlying purpose:

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[490] GALBRAITH, *supra* note 296, at 70 ("Stock prices have reached what looks like a permanently high plateau." (quoting Irving Fisher's famous observation shortly before the 1929 stock market crash)).
[491] Kregel, *supra* note 226.
[492] BLACK, *supra* note 128, at xv.

the protection of the overall financial system. As the Dodd–Frank Act states, "the activities and performances of credit rating agencies . . . are matters of national public interest." Credit rating agencies are "central to capital formation, investor confidence, and the efficient performance of the United States economy."[493]

[493] Dodd–Frank Wall Street Reform and Consumer Protection Act, § 931(a), Pub. L. No. 111-203, 124 Stat.1376, 1872 (2010).

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