Downgrading Rating Agency Reform

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ABSTRACT

The Dodd-Frank Act promised to usher in sweeping changes to overhaul the rating agency industry. But in the years after the Act's passage, hopes have turned into disappointment as the most important questions of how to enhance rating agency competition, accuracy, and accountability remain largely unanswered. The Securities and Exchange Commission ("SEC") has made progress in heightening oversight of the rating agency industry and addressing the most egregious abuses that fueled the financial crisis. But rating agency reforms have fallen far short of their potential due to the Act's competing, if not contradictory, objectives to simultaneously marginalize ratings, expose rating agencies to greater sunlight and private liability exposure, and treat rating agencies as a regulated industry. The most important part of the Act remains the most unresolved: the SEC's mandate to design an alternative for the current conflicts of interest created by debt issuers' selecting and paying their rating agency gatekeepers. Prospects for an independent commission to select rating agencies for structured finance products have foundered due to the challenges of crafting benchmarks for rating agency performance that are necessary for selecting rating agencies and holding them accountable. The danger is that any standard chosen for rating agencies could fuel herding effects, as rating agencies may shape their methodologies to game the system rather than to enhance the accuracy and timeliness of credit risk assessments.

Given the difficulties in resolving this issue, this Article suggests that policymakers should consider alternative ways to enhance competition, such as by using regulatory incentives to break up the leading rating agencies so that smaller rating agencies can more plausibly compete. Additionally, it suggests that expanding the scope of private enforcement opportunities has the potential to leverage the self-interest of issuers to prosecute grossly negligent conduct by rating agencies. This approach would complement the SEC's ongoing efforts to foster greater competition and accountability.

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INTRODUCTION

Rating agency reform was once heralded as "[t]he strongest piece of [the] Dodd-Frank" Act.[1] But the results have fallen short of these high hopes. The questions of how to enhance rating agency competition, accuracy, and accountability remain largely unanswered.[2] Reforms were designed to remedy the systematically lax assessments of credit risk by the three leading rating agencies that legitimized trillions of dollars of asset-backed securities of dubious value.[3] The

1 *See* John Lippert, *Credit Ratings Can't Claim Free Speech in Law Giving New Risks*, BLOOMBERG (Dec. 8, 2010, 12:01 AM), http://www.bloomberg.com/news/2010-12-08/credit-ratings-can-t-claim-free-speech-in-law-bringing-risks-to-companies.html (quoting derivatives expert Frank Partnoy) (internal quotation marks omitted).

2 *See, e.g.*, Andrew Ackerman, *SEC Gives Up on Web Schedules for Dodd-Frank Rules*, WALL ST. J. (Sept. 17, 2012, 4:55 PM), http://blogs.wsj.com/economics/2012/09/17/sec-gives-up-on-web-schedules-for-dodd-frank-rules/ (noting that the SEC has "conced[ed] [that] it has no idea when it will finish the" required Dodd-Frank rulemakings).

3 Writedowns and credit losses from the subprime mortgage crisis alone amounted to

Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[4] promised to remedy rating agencies' shortcomings by simultaneously deemphasizing reliance on ratings as proxies for credit risk, enhancing disclosures and subjecting rating agencies to private liability exposure, and imposing greater public oversight and restrictions on rating agencies.[5]

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upwards of $1 trillion. *Compare* Jody Shenn & David Mildenberg, *Subprime, CDO Bank Losses May Exceed $265 Billion*, BLOOMBERG (Jan. 31, 2008, 3:46 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aeOWjjdmu2pU (noting S&P's estimates that losses will exceed $265 billion), *with* Jody Shenn, *Fed Slashes Subprime, Alt-A Mortgage Payment Shocks, S&P Says*, BLOOMBERG (Mar. 25, 2008, 4:51 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=asN4m0P5mLm4 (noting that losses related to collateralized debt obligations may top $460 billion). *See also* Yalman Onaran, *Banks' Subprime Losses Top $500 Billion on Writedowns*, BLOOMBERG (Aug. 12, 2008, 4:07 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8sW0n1Cs1tY (discussing $500 billion in existing writedowns and credit losses from the subprime crisis and over $1 trillion in likely losses).

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

5 *See, e.g.*, STAFF OF S. COMM. ON HOMELAND SEC. & GOVERNMENTAL AFFAIRS, SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE: MAJORITY AND MINORITY STAFF REPORT 315–16 (2011) [hereinafter WALL STREET AND THE FINANCIAL CRISIS]. Each of these legislative approaches responded to the three main schools of thought on reform. The "abolitionist" camp called for removing government requirements for ratings to marginalize the significance of ratings. *See, e.g.*, Mark J. Flannery, Joel F. Houston & Frank Partnoy, *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085, 2086–89 (2010) (arguing for a shift to reliance on credit default swap spreads to serve as a proxy of creditworthiness); Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10, 21–24 (2006) (arguing that credit ratings provide "no information of value to the investing public"); Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis* 1–2 (Univ. of San Diego Sch. of Law Legal Studies Research Paper Series, Working Paper No. 09-015, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430653 (advocating the abolition of government-mandated requirements for rating because "[a] primary cause of the recent credit market turmoil was overdependence on credit ratings and credit rating agencies"). Conventional "passive" securities advocates sought to strengthen competition and private accountability through greater transparency and disclosure coupled with private causes of action. *See, e.g.*, Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1144–50 (2009) (arguing for greater rating agency disclosures and expanded SEC disciplinary and sanctions power). "Regulated industry" advocates called for greater government intervention in the selection of rating agencies to address market failure combined with more rigorous public oversight and regulation. *See, e.g.*, Lynn Bai, *The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?*, 7 N.Y.U. J.L. & BUS. 47, 97–98 (2010) (arguing for the need for standardization of rating agency performance statistics to facilitate comparability); Jonathan M. Barnett, *Intermediaries Revisited: Is Efficient Certification Consistent with Profit Maximization?*, 37 J. CORP. L. 475, 501–02 (2012) (arguing in favor of greater regulatory oversight as preferable to potentially counter-productive efforts at fostering greater competition); John C. Coffee, Jr., *Ratings Reform: The Good, the Bad, and the Ugly*, 1 HARV. BUS. L. REV. 231, 233–36 (2011) (advocating the abolition of the issuer-pays system and analyzing the merits of the potential alternatives for heightened public regulation); Milosz Gudzowski, Note, *Mortgage Credit Ratings*

The Securities & Exchange Commission ("SEC") has made progress in heightening oversight of the rating agency industry and in addressing the most egregious abuses that fueled the financial crisis.[6] But faith in regulators' potential to overhaul the rating agency industry appears just as inflated as the ratings for asset-backed securities that policymakers have decried. A downgrade of the impact of rating agency reform is overdue. A myriad of legislative and regulatory changes have failed to address the underlying challenges of fostering competition and ensuring timely and accurate assessments of credit risks.[7]

Rating agencies understandably faced a firestorm of blame for their role in fueling the financial crisis. They not only failed to identify credit risks but also legitimized reckless risk taking through inflated ratings.[8] Their failures were on such a large scale and so comprehensive that Congress could not ignore calls for action.[9] But unfortunately, rating agency reform represents a classic case of the Washington way of "addressing" problems. Politicians embraced a hodgepodge of broad and contradictory reforms in the hope that some combination of approaches would solve the problems, or at minimum absolve politicians from blame.[10] In the face of Dodd-Frank's competing objectives, the Act failed to resolve the basic questions of how to

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and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency, 2010 COLUM. BUS. L. REV. 245, 264–71 (advocating a government utility model for ratings); Yair Listokin & Benjamin Taibleson, Essay, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 94–95 (2010) (arguing that mandating that compensating rating agencies with the debt proceeds they rate would create greater incentives for rating accuracy); Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1015–19 (2009) (calling for a user fee on investors to finance the creation of an independent board to select and compensate rating agencies based on a competitive bidding process).

6 *See, e.g.*, *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/dodd-frank.shtml (last modified Dec. 12, 2012).

7 *See, e.g.*, *infra* notes 127–33 and accompanying text.

8 *See, e.g.*, *infra* notes 16–17 and accompanying text.

9 *See, e.g.*, David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 988–91 (2006) (discussing how rating agencies' lax approach fueled abuses in the subprime mortgage market); Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* 34–47 (2007), *available at* http://ssrn.com/abstract=1027475 (discussing the shortcomings of ratings in failing to reflect the risks of subprime debt instruments).

10 *See, e.g.*, DAVID EPSTEIN & SHARYN O'HALLORAN, DELEGATING POWERS: A TRANSACTION COST POLITICS APPROACH TO POLICY MAKING UNDER SEPARATE POWERS 32–33 (1999) (observing that congressional delegation to administrative agencies serves as a blame-shifting device); Peter H. Aranson, Ernest Gellhorn & Glen O. Robinson, *A Theory of Legisla-*

create meaningful competition in an oligopolistic industry and how to incentivize accurate and timely ratings. Congress sidestepped directly addressing these difficult questions, leaving the SEC with the unenviable task of providing some degree of coherence to Congress's spectrum of solutions.[11] After years of regulatory action to implement the Dodd-Frank Act, as many questions as answers remain about the impact of reforms.[12]

The most important part of the Act remains the most unresolved: the SEC's mandate to design an alternative rating industry business model to address the conflicts of interest created by debt issuers' selecting and paying their rating agency gatekeepers.[13] Prospects for the creation of an independent commission to select rating agencies for structured finance products have foundered due to the challenges of crafting benchmarks for rating agency performance that are necessary for selecting rating agencies and holding them accountable.[14] The use of any performance-based standard to select or evaluate rating agencies risks fueling herding effects. Rating agencies may shape their methodologies to game the system rather than to enhance the accuracy and timeliness of credit risk assessments.[15]

Given the intrinsic challenges of establishing performance-based standards for ratings, this Article suggests that policymakers should consider alternative ways to enhance competition, such as the use of regulatory incentives to break up the leading rating agencies or segmenting the rating agency market so that smaller rating agencies can

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tive Delegation, 68 CORNELL L. REV. 1, 57–58 (1982) (arguing that Congress exploits the ability to delegate difficult decisions to administrative agencies to avoid direct accountability).

11 *See infra* Part II.A.

12 The Department of Justice's February 2013 lawsuit against Standard & Poor's offers a glimmer of hope that rating agencies will face some accountability for their roles in the financial crisis. The government's case is based on a rarely used anti-fraud provision of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") that has never been used against rating agencies. The prospects for this novel, yet untested approach remain an open question. *See infra* Part III.B.6; *see also* Jean Eaglesham, Jeanette Neumann & Evan Perez, *U.S. Sues S&P Over Ratings*, WALL ST. J., Feb. 5, 2013, at A1 (discussing how the Department of Justice is making an end-run around traditional barriers to suing rating agencies by applying FIRREA); Aruna Viswanatha & Jonathan Stempel, *S&P Expects U.S. Lawsuit Over Pre-Crisis Credit Ratings*, REUTERS (Feb. 4, 2013, 6:09 PM), http://www.reuters.com/article/2013/02/04/us-mcgrawhill-sandp-civilcharges-idUSBRE9130U120130204 (discussing how the lawsuit concerning S&P's asset-backed security ratings is the first enforcement action against a rating agency related to the financial crisis). .

13 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 939D–939F, 124 Stat. 1376, 1888–90 (2010).

14 *See infra* Part III.A.

15 *See infra* Part III.A.

more plausibly compete. Additionally, policymakers should consider expanding the scope of private enforcement opportunities to leverage the self-interest of issuers to monitor and prosecute grossly negligent conduct by rating agencies. This approach would complement the SEC's ongoing efforts to foster greater competition and accountability in the ratings industry.

I. THE ROLE OF RATING AGENCIES IN THE FINANCIAL CRISIS

A broad consensus exists that rating agencies played a central role in the financial crisis and that remedying the shortcomings of rating agencies is key to preventing future crises.[16] Many actors deserve blame for fueling excessive risk taking through the design of trillions of dollars of structured finance products that intentionally camouflaged substantial risks.[17] But rating agencies merit particular blame because a myriad of federal and state statutes and regulations deputize rating agencies as gatekeepers of credit risk.[18]

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16 Numerous empirical studies documented the failures of rating agencies. *See, e.g.*, ADAM ASHCRAFT, PAUL GOLDSMITH-PINKHAM & JAMES VICKERY, MBS RATINGS AND THE MORTGAGE CREDIT BOOM 23–24 tbl.3 (Fed. Reserve Bank of N.Y., Staff Report No. 449, 2010) (documenting a pattern of stability in high ratings in spite of declines in diligence of and asset quality in mortgage-backed securities from 2001 to 2008); Efraim Benmelech & Jennifer Dlugosz, *The Alchemy of CDO Credit Ratings*, 56 J. MONETARY ECON. 617, 624–28, 632–33 (2009) (criticizing the lax process for credit rating of CDOs and the conflicts of interest created by the hiring of rating agencies by issuers); Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Law and Economic Issues in Subprime Litigation* 16–18, 21, 74 (Harvard John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 612, 2008) (documenting the stability of ratings in spite of marked decline in the extent of diligence into and quality of the underlying mortgages in mortgage-backed securities from 2001 to 2006).

17 Residential Mortgage Backed Securities ("RMBS") and Mortgage-Based Collateralized Debt Obligations ("CDO") are debt obligations based on large pools of mortgage loans whose cash flows derive from principal and interest payments from the underlying mortgages. *See Mortgage-Backed Securities*, U.S. SEC. & EXCH. COMM'N (last modified July 23, 2010), http://www.sec.gov/answers/mortgagesecurities.htm; Maureen Farrell, *Risky Loans Are Back*, CNNMONEY (Sept. 26, 2012, 5:48 AM), http://money.cnn.com/2012/09/26/investing/risky-loans-clo/. Approximately $1.7 trillion in subprime RMBS were issued from 2001 to 2006. *See* ADAM B. ASHCRAFT & TIL SCHUERMANN, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 2 (Fed. Reserve Bank of N.Y., Staff Report No. 318, 2008). The dollar values of subprime CDOs are harder to pinpoint because of less transparency, but JP Morgan has estimated that $500 to $600 billion in subprime CDOs were issued over this period. *See* Jenny Anderson & Heather Timmons, *Why a U.S. Subprime Mortgage Crisis Is Felt Around the World*, N.Y. TIMES, Aug. 31, 2007, at C1; *see also* Michael G. Crouhy, Robert A. Jarrow & Stuart M. Turnbull, *The Subprime Credit Crisis of 07*, at 8–19 (2008), *available at* http://ssrn.com/abstract=1112467 (discussing the array of market participants who have potential culpability for the subprime mortgage crisis).

18 *See, e.g.*, Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, §§ 4, 15E, 120 Stat. 1327, 1329–33 (codified at 15 U.S.C. § 78o-7 (2006)) (laying out the process for rating agencies to be certified as Nationally Recognized Statistical Rating Organizations ("NRSRO")); Reg-

Not only did rating agencies fail to raise red flags about growing risks, but they also legitimized the proliferation of deceptive financial instruments through issuing inflated ratings.[19] Interconnections of interest between rating agencies and their client debt issuers, and an absence of accountability, led rating agencies to abrogate their responsibilities as screeners of credit risk.[20] As a result, rating agencies failed to identify increasing risks or to condition ratings on adequate diligence and disclosures by issuers.[21]

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ulation S-K, 17 C.F.R. § 229.10(c) (2008) (mandating the inclusion of ongoing NRSRO ratings for issuers making filings under the Securities Act of 1933 and the Securities Exchange Act of 1934); *see also* Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, 68 Fed. Reg. 35,258, 35,258 (June 12, 2003) [hereinafter SEC Concept Release] (discussing how since 1975 the SEC "has relied on credit ratings from market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the federal securities laws"); *Selected Principles for the Regulation of Investments by Insurance Companies and Pension Funds*, 75 FIN. MARKET TRENDS 117, 119–20 (2000), http://www.oecd.org/daf/financialmarketsinsuranceandpensions/1923066.pdf (recommending ratings requirements for insurers and pension funds to purchase debt securities).

19 *See, e.g.*, Bethel, Ferrell & Hu, *supra* note 16, at 37–60 (discussing the legal issues surrounding the extensive subprime litigation, such as Rule 10b-5 actions against banks, ERISA litigation, and litigation against rating agencies); *cf.* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1408–09 (2002) (arguing that "the collective failure of the gatekeepers" lay at the heart of the accounting scandals); Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 81 WASH. U. L.Q. 403, 403–08 (2003) (arguing that securities gatekeepers fail the public by not adequately screening for corporate wrongdoing).

20 *See, e.g.*, Frank Partnoy, *The Paradox of Credit Ratings*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65, 74–78 (Richard M. Levich et al. eds., 2002) (emphasizing the government's role in making rating agencies central actors in the securities industry and arguing that rating agencies do not serve as effective gatekeepers of credit risk); Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 342–43 (2003) (attributing the failure of rating agencies as gatekeepers to their reluctance to downgrade their issuer clients because of concerns about the far-reaching effects downgrades can have); Reiss, *supra* note 9, at 988–91, 1022–23 (discussing how rating agencies' lax approach fueled abuses of the subprime mortgage market); Mason & Rosner, *supra* note 9, at 15–19, 34–47 (discussing the shortcomings of ratings in failing to reflect the risks of subprime debt instruments). *But see* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 50–52, 82–93 (2004) (advocating reduced barriers to entry to encourage new entrants into the ratings industry and arguing against greater government oversight of rating agencies); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 12–20 (arguing that additional regulation of rating agencies by the SEC is unnecessary and probably inefficient because it poses risks of political manipulation).

21 *See* Ashcraft & Schuermann, *supra* note 17, at 7, 11–12. A broad literature has explored enlisting private gatekeepers to perform public enforcement functions. *See, e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308–09 (2004) (describing a gatekeeper as a "reputational intermediary" who "receives only a limited payoff from any involvement in misconduct" compared to the primary wrongdoer); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 63 (2003) (defining gatekeepers as parties who "offer a service or sell a product that is necessary for clients wishing

During the financial crisis the quality of credit underpinning structured finance products steadily eroded, yet issuers continued to receive high ratings.[22] Ratings inflation was subtle in that ratings did not go up in general, but the risks rose for the underlying portfolios without resulting in lower initial ratings or downgrades.[23] Opportunistic issuers took advantage of lax ratings to push the envelope in lowering the quality of the underlying portfolios of asset-backed securities, because they could externalize the risks to third-party purchasers.[24] Because rating agencies do not have an affirmative duty to verify the quality of the underlying portfolios, they lacked the incentive to push back when issuers reduced independent due diligence of their portfolios.[25]

Rating agencies also deserve blame for affirmatively creating systematically lax ratings. For example, rating agencies primarily relied on mathematical models that used historical data to estimate the loss distribution and to simulate the cash flows of collateralized debt obligations ("CDO").[26] Rating agencies' methodologies overemphasized

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to enter a particular market or engage in certain activities"); Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1050–54 (1993) (describing gatekeepers as actors who provide "indispensable, or at least extremely useful," services to the targeted wrongdoers, have similar monitoring capacities, and who cannot easily be replaced by wrongdoers); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) (defining gatekeepers as "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers"). This Article understands gatekeepers as private actors whose role as suppliers or consumers of lawful goods or services provides them with the cost-effective ability to detect and potentially prevent wrongdoing.

22 Greed appears to have underpinned the decreased reliance on third-party due diligence. *See* Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, at A1. Review of each underlying mortgage costs about $350, and issuers of CDOs likely did not want to cut into their profit margins and were content to cast a blind eye, while shifting the risk to debt purchasers. *See id.*

23 *See* Benjamin J. Keys et al., *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans*, 125 Q.J. ECON. 307, 330–37 (2010) (pointing to empirical evidence that securitized mortgage portfolios were 20% more likely to default than comparable nonsecuritized portfolios).

24 *See id.* at 318; *see, e.g.*, Ashcraft, Goldsmith-Pinkham & Vickery, *supra* note 16, at 52 tbl.3 (documenting how low/no document subprime mortgages rose from 24.8% in 2001 to a height of 46% in 2006, and interest-only subprime mortgage loans rose from 0% in 2001 to 28% in 2005, while the percentage of triple-A mortgages only declined from 90% to 80% during this period); Bethel, Ferrell & Hu, *supra* note 16, at 74 (documenting how the low/no document share of subprime mortgages in mortgage-backed securities rose from 28.5% in 2001 to 50.8% in 2006, and how interest-only mortgages grew from 0% in 2001 to a height of 37.8% in 2005).

25 *See* ASHCRAFT & SCHUERMANN, *supra* note 17, at 11–12; Bajaj & Anderson, *supra* note 22, at A1 (noting that investment banks decreased use of third-party due diligence of the underlying assets of asset-backed securities portfolios, and rating agencies did not push back).

26 *See* ASHCRAFT & SCHUERMANN, *supra* note 17, at 40–43.

initial expectations of loss in estimating the projected lifetime expectations of loss of debt instruments.[27] Flawed and overly optimistic assumptions fueled a system of lax ratings, which failed to anticipate or reflect the housing market downturn.[28] To make matters worse, rating agencies made their models for CDOs transparent, which ironically allowed issuers to game the system by subordinating only the minimum amount of tranches to the senior tranche to still secure AAA ratings.[29] Most troubling, rating agencies made discretionary adjustments from their own models to overstate the degree of cushion of the senior tranches of CDOs in order to guarantee AAA ratings.[30] Rating agencies appeared reluctant to downgrade debt for fear of biting the issuer hands that feed.[31]

The shortcomings of rating agencies raise the question of how their power arose. Historically, rating agencies started off as subscription businesses that bridged an information gap between debt issuers and existing and prospective creditors.[32] Prospective debt purchasers

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27 *See id.* at 56–59.

28 *See id.* at 55–60; *see also* Mark Whitehouse, *Slices of Risk: How a Formula Ignited a Market That Burned Some Big Investors*, WALL ST. J., Sept. 12, 2005, at A1 (discussing how the rating agencies' assumptions concerning risk led to widespread reliance on erroneous ratings for CDOs).

29 *See* PRAGYAN DEB & GARETH MURPHY, LONDON SCH. OF ECON., CREDIT RATING AGENCIES: AN ALTERNATIVE MODEL 9 (2009), http://personal.lse.ac.uk/debp/Papers/Ratings_Regulation.pdf.

30 *See, e.g.*, Ashcraft, Goldsmith-Pinkham & Vickery, *supra* note 16, at 2–5, 52 tbl.3 (analyzing 90% of the mortgage-backed securities issued from 2001 to 2007 and documenting the rapid decline of risk-adjusted subordination from 2005 to 2007 at the height of investor speculation in mortgage-backed securities); John M. Griffin & Dragon Yongjun Tang, *Did Subjectivity Play a Role in CDO Credit Ratings?*, 67 J. FIN. 1293, 1295, 1300, 1309, 1325–26 (2012) (documenting how, in a study of over 900 CDOs from 1997 to 2007, rating agencies systematically made discretionary adjustments, almost 85% of which were upwards and overstated the extent of the AAA tranches); *see also* Richard Stanton & Nancy Wallace, *CMBS Subordination, Ratings Inflation, and the Crisis of 2007–2009*, at 2-3 (Nat'l Bureau of Econ. Research, Working Paper No. 16206, 2010), *available at* http://ssrn.com/abstract=1648006 (documenting how, even though the underlying commercial real estate collateral did not decline, the risk-adjusted subordination declined in the CMBS market until senior tranches had insufficient protection).

31 *See* Andre Güttler, *Lead-Lag Relationships and Rating Convergence Among Credit Rating Agencies* 1–3, 12–15 (European Bus. Sch. Research Paper Series, No. 09-14, 2009), *available at* http://ssrn.com/abstract=1488164 (documenting herding effects among the two leading rating agencies for upgrades but not downgrades).

32 *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1110 (1995) (discussing the role of rating agencies and other securities intermediaries in reducing risk by distilling ambiguous information into clearer signals for markets); *see also* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613–21 (1984) (discussing the gatekeeping roles of securities intermediaries). Currently, only one rating agency, Egan-Jones, functions exclusively as a subscriber-paid rating agency. *See* William D. Cohan, *SEC Sues the One Rating Firm Not on*

paid for rating agencies to assess new debt issues and to provide updates on the creditworthiness of existing debt.[33] The federal government first co-opted ratings as proxies of credit value in the 1930s by requiring banks to hold reserves that met a rating threshold.[34] But the biggest shift in the industry began in the 1970s when a host of treaties, federal statutes, and regulations began to require a broad range of actors—such as money market funds, banks, and regulators—to refer to ratings, effectively making ratings a public good.[35]

United States government requirements for ratings had two significant impacts. First, government requirements for ratings entrenched an oligopoly of rating agencies. The leading rating agencies—Moody's, Standard and Poor's, and to a lesser extent Fitch—had already accounted for the overwhelming majority of the ratings market prior to the 1970s.[36] But the government then reinforced barriers to entry by officially recognizing only the established players as Nationally Recognized Statistical Rating Organizations ("NRSRO").[37] NRSRO status largely served as a virtual tautology of market dominance. The SEC's "single most important criterion" in awarding NRSRO status was "that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings."[38] If the SEC would not recognize an agency as an NRSRO unless it was "widely accepted," in practice only the established leading firms could achieve this status.

Legislation enacted in 2006 partially opened the gates for new entrants by introducing a more open NRSRO certification process, which may foster greater rating agency competition in the long run.[39] But the 2006 legislation did not address the entrenched dominance of the leading rating agencies. The Dodd-Frank Act of 2010 went further by formally abolishing most requirements for ratings in government

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Wall Street's Take, BLOOMBERG (Sept. 30, 2012, 6:33 PM), http://www.bloomberg.com/news/2012-09-30/sec-sues-the-one-rating-firm-not-on-wall-street-s-take.html.

33 *See* Harold Furchtgott-Roth, Robert W. Hahn & Anne Layne-Farrar, *The Law and Economics of Regulating Ratings Firms*, 3 J. COMPETITION L. & ECON. 49, 76–77 (2007) (providing an overview of the historical development of subscription-based rating agencies).

34 *See* Gregory Karp, *The Rise of Standard & Poor's*, CHI. TRIB., Aug. 14, 2011, at 1.

35 *See* SEC Concept Release, *supra* note 18, at 35,259; Karp, *supra* note 34, at 1.

36 *See* Reiss, *supra* note 9, at 1017–21 (discussing the oligopolistic nature of the rating agency market).

37 *See* SEC Concept Release, *supra* note 18, at 35,259.

38 NRSRO status was previously achieved in practice through the SEC's no-action letter process. *See id.* at 35,258, 35,260.

39 *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327–1339 (codified at 15 U.S.C. § 78o-7 (2006)).

statutes and regulations.[40] But by 2010, the damage was arguably done as the market's systematic reliance on rating agencies entrenched their market power.[41] The rating agency industry continues to consist of three giant whales and a handful of minnows of small competitors with marginal market share and modest impact.[42]

The power of the rating agency oligopoly is magnified by the fact that debt issuers routinely seek to have two ratings from among the three leading rating agencies.[43] As a result, little competition exists in the rating agency industry.[44] Because the "big three" are viewed as the "gold standard" for the industry, markets would likely be wary of firms that lack ratings from the leading firms.[45]

Second, the fact that government requirements made ratings a de facto public good facilitated an industry shift from a subscription model to a "user pays" model.[46] Debt issuers had the incentive to select and pay rating agencies to assess their securities in order to en-

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

41 *See* Dave Clarke, *Regulators Propose Credit Rating Alternatives*, REUTERS (Dec. 7, 2011, 2:23 PM), http://www.reuters.com/article/2011/12/07/us-financial-regulation-fdic-idUSTRE7B61IG20111207. For a contrary view that solely emphasizes the significance of regulatory barriers to entry, see Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 681–82 (1999) (arguing that "credit ratings are valuable, not because they contain valuable information but because they grant issuers 'regulatory licenses.' . . . [O]nce regulation is passed that incorporates ratings, rating agencies begin to sell not only information but also the valuable property rights associated with compliance with that regulation.").

42 *See* S. REP. NO. 109-326, at 3–5 (2006). It is important to stress that the modest impact the smaller rating agencies make is still important. For example, Kroll and Morningstar have made progress in gaining market share in rating commercial mortgage-backed securities ("CMBS") in the wake of Standard & Poor's debacle of withdrawing a preliminary rating on a $1.5 billion Goldman Sachs CMBS issue in 2011 and temporarily pulling back from that market. *See* Al Yoon & Jeannette Neumann, *S&P Moves to Revamp Its CMBS Rating System*, WALL. ST. J. (June 4, 2012, 7:11 PM), http://online.wsj.com/article/SB10001424052702303830204577446451858317324.html. Similarly, Egan-Jones, though the smallest rating agency, has played an outsized role in shaping markets and spurring other rating agencies to be more proactive by taking the lead in rating downgrades, such as high-profile downgrades of sovereign debt and the investment firm Jefferies Group. *See* Jean Eaglesham & Jeannette Neumann, *Ratings Firm Is in SEC Sights*, WALL. ST. J. (Apr. 19, 2012, 7:38 PM), http://online.wsj.com/article/SB10001424052702303513404577354023825841812.html. Despite these glimmers of hope, the leading rating agencies continue to enjoy overwhelming dominance. *See* U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 7 (2012) (noting that the three leading rating agencies account for approximately 97% of ratings).

43 *See* Hill, *supra* note 20, at 59–60.

44 *See id.* at 59–61.

45 *See id.* at 59–64 (demonstrating that customers have no incentive to obtain ratings from rating agencies other than Standard & Poor's and Moody's).

46 *See* Manns, *supra* note 5, at 1056–57.

sure access to markets subject to government rating requirements.[47] Government policies inadvertently created a symbiotic relationship between rating agencies and their issuer clients "that may compromise [the] objectivity" of the agencies.[48]

Having a debt issuer select and pay the assessor of its credit risk is akin to having the fox pay the guard of the henhouse. This conflict of interest was particularly problematic in the context of asset-backed securities. Bank issuers used these vehicles to sell off all of their risk exposure in mortgages to third parties,[49] while rating agencies profited handsomely from legitimizing this growing market.[50] At a minimum, this interconnection meant that rating agencies may have incentives to give the companies they are monitoring the benefit of the doubt or to avoid pushing for additional information for fear of jeopardizing their relationship.[51] This concern may have particularly shaped the reluctance of rating agencies to downgrade ratings for fear of harming the financial status of issuers.[52]

Historically, Congress was reluctant to regulate the rating agency industry due to the concern that government regulation would taint the independence of ratings.[53] Instead, policymakers assumed that the reputational concerns of rating agencies would provide strong incentives for their integrity and accuracy and eclipse any short-term gains

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47 *See id.*

48 *Id.* at 1052.

49 *See, e.g.*, Dennis Hevesi, *Residential Real Estate: Looser U.S. Lending Rules Are Protested*, N.Y. TIMES, Apr. 2, 2004, at B8 (discussing the insulating effect of assignee liability for securitization issuers).

50 For example, Moody's earned $884 million in 2006, or approximately 43% of its total revenue, from rating RMBS and CDOs. This number was triple the amount that Moody's earned from these debt instruments only five years earlier, leaving rating agencies with few incentives to scrutinize subprime debt instruments more closely. *See* John Glover, *Regulators May Limit S&P, Moody's Structured Business*, BLOOMBERG (Feb. 6, 2008, 3:46 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akhMWaeEmqvA&refer=home.

51 *See* Roy C. Smith & Ingo Walter, *Rating Agencies: Is There an Agency Issue?*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 292–93 (Richard M. Levich et al. eds., 2002) (discussing the potential for rating agencies to compete by offering more favorable ratings to issuers than other rating agencies); Macey, *supra* note 20, at 342–43.

52 *See* Macey, *supra* note 20, at 342–43 (discussing how applying "nuclear" liability, such as through ratings downgrades, can warp the incentives for securities intermediaries); *see also* Onaran, *supra* note 3 (discussing over $500 billion in writedowns and credit losses from the subprime mortgage crisis).

53 *Cf.* Christopher M. Bruner, *States, Markets, and Gatekeepers: Public-Private Regulatory Regimes in an Era of Economic Globalization*, 30 MICH. J. INT'L L. 125, 143 (2008) (describing how "[b]y characterizing their ratings as opinions rather than investment advice, the agencies preserve potent defenses to civil liability and direct regulation under U.S. law").

from turning a blind eye to client misconduct.[54] Unfortunately, this assumption proved to be incorrect as reputational constraints wane amidst bubble markets and amidst increases in risk-seeking behavior by participants in financial markets.[55]

The weakness of reputational constraints is also partly a product of the nature of ratings. Rating agencies can hide behind their own approaches to assessing risk through a bucket system of categories and can use the opaqueness of ratings both to acknowledge the reality of uncertainties and as a cover for inaccuracy.[56] Rating agencies can also elastically spin their failures as a product of the shortsightedness and knee-jerk reactions of markets,[57] because ratings focus on structural, long-term concerns.[58] Thus, these factors may blunt the force of reputational constraints. Lastly, rating agencies have often succeeded in defending their ratings as journalistic opinions protected by the First Amendment, which raises a significant bar to liability.[59]

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54 *See* Coffee, *supra* note 19, at 1406. This reputational capital argument is frequently used to justify self-regulation of securities intermediaries, such as rating agencies, lawyers, and accountants. *See, e.g.*, Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295, 303 (1988) (arguing that the reputational costs that accountants may face from failing to detect wrongdoing provide them with adequate incentives to monitor their clients).

55 *See* Coffee, *supra* note 19, at 1412–13.

56 The opaqueness of ratings is one reason why some commentators have advocated for the standardization of rating agency performance statistics. *See, e.g.*, Bai, *supra* note 5, at 63–66, 101–04.

57 *See, e.g.*, David Evans, *Moody's Implied Ratings Show MBIA, Ambac Turn to Junk*, BLOOMBERG (May 30, 2008, 2:03 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a0tWb0sTTgu8 (discussing how Moody's has sought to rationalize the gap between market-based indicators of the financial health of bond insurers MBIA and Ambac and its actual ratings).

58 *See* MOODY'S INVESTORS SERV., MEASURING THE PERFORMANCE OF CORPORATE BOND RATINGS 7, 15 (2003) (discussing the emphasis on long-term concerns in determining ratings through the process of "fundamental credit analysis").

59 *See* Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers* 61 (Univ. San Diego Sch. of Law, Research Paper No. 07-46, 2006) (discussing how rating agencies are "largely immune to civil and criminal liability for malfeasance"). Courts have come out on both sides on the question of whether ratings universally enjoy First Amendment protection, but issuers have remarkable difficulty in pinning liability on the shoulders of rating agencies. *See, e.g.*, Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 758–59 & n.5 (1985) (noting in dicta that some forms of rating agencies' "speech" may not require heightened First Amendment protection); Lowe v. SEC, 472 U.S. 181, 210 n.58 (1985) (noting in dicta that "it is difficult to see why the expression of an opinion about a marketable security should not also be protected"); *In re* Fitch, Inc., 330 F.3d 104, 110–11 (2d Cir. 2003) (distinguishing some rating agency functions from those of a journalist for First Amendment purposes); Quinn v. McGraw-Hill Cos., 168 F.3d 331, 336 (7th Cir. 1999) (allowing a claim of negligence and fraudulent misrepresentation against a rating agency to proceed, yet questioning the degree to which it is reasonable to rely on the ratings); Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651

II. THE WASHINGTON WAY: REFORM AS A SUBSTITUTE FOR ACCOUNTABILITY

The enormity of the financial crisis, coupled with the degree of rating agencies' culpability, put rating agencies firmly in Congress's crosshairs.[60] The condemnation of rating agencies was so widespread that the main question in the run-up to the Dodd-Frank Act was not whether reforms were necessary, but what form they would take.[61] Unfortunately, rating agency reforms have followed the classic Washington way of accountability avoidance.[62] Instead of directly addressing the central problems of rating agency accuracy and the absence of competition, Congress chose a broad and conflicting range of solutions.[63] Legislators deferred to the SEC to sort out the problems of implementation (and policy coherence). This way Congress wins with

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F. Supp. 2d 155, 176 (S.D.N.Y. 2009) (denying rating agencies a First Amendment defense for ratings of structured finance products, because the product was only targeted to a small pool of investors); Newby v. Enron Corp., 511 F. Supp. 2d 742, 751, 818, 819 (S.D. Tex. 2005) (holding that ratings enjoyed "qualified" First Amendment protection in a case alleging that the rating agencies failed to exercise reasonable care in changing their ratings because they had rated Enron's debt as investment-grade in December 2000); Compuware Corp. v. Moody's Investors Servs., Inc., 324 F. Supp. 2d 860, 860–61 (E.D. Mich. 2004) (holding that ratings are protected under a state reporter privilege statute); Am. Sav. Bank, FSB v. UBS PaineWebber, Inc., No. M8-85, 2002 U.S. Dist. LEXIS 24102, at *4 (S.D.N.Y. Dec. 16, 2002) (rejecting a rating agency's claims of entitlement to "journalist privilege" protections for its ratings); *In re* Pan Am. Corp., 161 B.R. 577, 581–82, 584 n.6 (S.D.N.Y. 1993) (holding that rating agencies are protected by the First Amendment in spite of their profit motive).

60 Grace Wong, *Rating Agencies in the Hot Seat*, CNNMoney (Sept. 25, 2007, 1:05 PM), http://money.cnn.com/2007/09/25/news/companies/rating_agencies_hearing/ (discussing the lead-up to congressional hearings that scrutinized the role of the credit agencies in the financial crisis); *see, e.g.*, Vikas Bajaj & Mark Landler, *Mortgage Losses Echo in Europe and on Wall Street*, N.Y. TIMES, Aug. 10, 2007, at A1, C7 (discussing the scale of subprime mortgage CDO exposure facing banks and other creditors); Jody Shenn & David Mildenberg, *Subprime, CDO Bank Losses May Exceed $265 Billion*, BLOOMBERG (Jan. 31, 2008, 3:46 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aeOWjjdmu2pU (discussing how almost half the subprime bonds rated by Standard & Poor's in 2006 and early 2007 were cut or placed on review for ratings downgrades in 2008, a fact which suggests rating agencies' lax approach).

61 *See, e.g.*, U.S. SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 1–2 (July 2008) (discussing the shortcomings of rating agencies' policies and procedures, internal audit processes, and surveillance of complex RMBS and CDOs); WALL STREET AND THE FINANCIAL CRISIS, *supra* note 5, at 272 (discussing the "*fact* that the rating agencies issued inaccurate ratings" and the role of "conflicts of interest inherent in the 'issuer-pays' model" in rating agencies' failures).

62 *See, e.g.*, Aranson, Gellhorn & Robinson, *supra* note 10, at 57–58 (arguing that Congress exploits the ability to delegate difficult decisions to administrative agencies to avoid direct accountability).

63 *See* John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1050, 1066 (2012).

public opinion by showing it made a far-reaching effort to address the widely acknowledged problems with rating agencies. But Congress has a convenient scapegoat in the SEC if reforms in practice fail to address the industry's problems.[64]

A. *The Three Competing Reform Schools of Thought*

Part of Congress's shortcomings is understandable, because legislators faced immense pressure to address the causes of the financial crisis and to come up with a solution in a hurry.[65] Legislators' need for speed led them to cherry-pick a hodgepodge of conflicting approaches from each of the leading camps of rating agency reform. The three major schools of thought were "regulated industry" advocates who called for greater government intervention in the selection of rating agencies to address market failure in combination with more rigorous public oversight and regulation;[66] conventional "passive" securities regulators who sought to strengthen competition and private accountability through greater transparency and disclosure coupled with private causes of action;[67] and the "abolitionist" camp who called for marginalizing rating agencies by removing government requirements for ratings.[68] Adopting any one of these three reform approaches could have provided a coherent blueprint for reform. But embracing all three at once has led to conflicting visions of reform that may lead to predictable failure.

"Regulated industry" proponents called for greater government intervention to resolve inherent conflicts of interest in the issuer-pays system and to sustain more invasive oversight of rating agencies.[69] Their premise is that rating agencies are needed to assess credit risk, but that conflicts of interest created by the issuer-pays system compromised the industry's independence and integrity.[70] The fact that debt issuers chose and paid for rating agencies meant that rating agencies

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64 *See* EPSTEIN & O'HALLORAN, *supra* note 10, at 32–33 (observing that congressional delegation to administrative agencies serves as a blame-shifting device).

65 *See* Coffee, *supra* note 63, at 1050 (discussing how inconsistent or poorly designed reforms are inevitable because Congress engages in rapid fire reform due to time and interest group pressures).

66 *See, e.g.*, Bai, *supra* note 5, at 47, 97–98; Barnett, *supra* note 5, at 501–02; Coffee, *supra* note 5, at 233–36; Gudzowski, *supra* note 5, at 264–71; Listokin & Talbelson, *supra* note 5, at 94–95; Manns, *supra* note 5, at 1015–19.

67 *See, e.g.*, Dennis, *supra* note 5, at 1144–50.

68 *See, e.g.*, Flannery, Houston, & Partnoy, *supra* note 5, at 2086–88; Macey, *supra* note 5, at 21–24; Partnoy, *supra* note 5, at 1–2.

69 *See, e.g.*, Coffee, *supra* note 5, at 254–61.

70 *See id.* at 232–35.

had structural incentives to inflate ratings and to delay downgrades to avoid biting the hands that feed them. This market failure required extraordinary government intervention in the selection and compensation of rating agencies, as well as an expanded government role in holding rating agencies accountable. The Franken Amendment to the Dodd-Frank Act embraced this perspective, by calling for the creation of an independent commission to select rating agencies for asset-backed securities or for the SEC to choose an alternative approach that addresses this conflict of interest.[71]

"Passive" securities regulation advocates believed the shortcomings of rating agencies are a product of an absence of market-based competition and private accountability.[72] This view's premise is that shedding greater light on ratings would facilitate the testing of rating agencies' reputations and enhance market-based competition by creating a more level playing field for smaller players and new entrants.[73] Enhanced transparency and disclosure would increase competition and private oversight and, coupled with the creation or strengthening of private causes of action, allow market actors to hold rating agencies accountable. This view is at the heart of most securities reforms over the past generation.[74] Proponents of this view have faith that private competition and accountability will succeed if the government sets rules to the game that foster competitive markets and private oversight.

The "abolitionist" camp believes government requirements for ratings created a misguided reliance on ratings.[75] From their perspective, ratings are ineffective proxies of credit risk at best, and the power

71 The Franken Amendment proposal called for an independent commission to select and compensate rating agencies for structured finance products using a lottery or random assignment with an eventual transition to performance-based selection. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939F, 124 Stat. 1376, 1889–90 (2010); *see also* Coffee, *supra* note 5, at 232–35 (noting that the Franken Amendment "sever[s] the connection between issuer payment and issuer selection of the [credit rating agency]").

72 *See, e.g.*, Dennis, *supra* note 5, at 1142–44.

73 *See, e.g.*, *id.* at 1144–47.

74 *See, e.g.*, *Capital Markets Regulatory Reform: Strengthening Investor Protection, Enhancing Oversight of Private Pools of Capital, and Creating a National Insurance Office: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 30 (2009) (statement of Comm'r Denise Crawford, Texas Securities Commission) (noting that inclusion of a private right of action in the securities reform legislation at issue in the hearing was "extremely important" due to limits on the resources of regulators to pursue all violations of the securities laws).

75 *See, e.g.*, Flannery, Houston & Partnoy, *supra* note 5, at 2086–88 (arguing that credit default swap spreads offer a more accurate proxy of credit quality than ratings); Partnoy, *supra* note 41, at 682 (arguing that "rating agencies sell[ ] regulatory licenses under oligopolistic (or even monopolistic) conditions").

of credit ratings turned solely on government mandates.[76] This view offers a sharp contrast to both the regulated industry and conventional securities regulation approaches. Instead of trying to improve the quality or independence of ratings, abolitionists believe marginalizing rating agencies will foster the development of better alternatives for measuring credit risk. Therefore, they advocated abolishing government requirements for credit ratings and mandating that government agencies develop alternative benchmarks for credit risk to better address the problem of poor risk management.[77]

Each of these perspectives offers strikingly different conceptions of the problems facing the rating agency industry. Incorporating reforms based on all three of these discordant views was a remarkable exercise of legislative indecision. This all-of-the-above approach meant rating agency reform was a missed opportunity for delineating a clear, consistent vision for how to overhaul the industry. While reforms addressed the most egregious excesses of rating agencies in the run-up to the crisis, the extent to which the SEC can craft a coherent framework for overseeing rating agencies amidst the Act's disparate objectives remains to be seen.

B. *The Evolution of Conflicting Regulatory Strategies*

The Dodd-Frank Act's approach to rating agency reform was striking, because it was a marked departure from the traditional reliance on reputational constraints. Although government requirements had made ratings virtually indispensable for debt issuers, policymakers had deemed the independence of rating agencies from government

76 Macey, *supra* note 5, at 21–24 (2006) (arguing that credit ratings provide "no information of value to the investing public"); Partnoy, *supra* note 20, at 65–67 (arguing that the only value added by ratings is the "regulatory license" they provide to issuers by checking the box of regulatory requirements).

77 *See, e.g.*, Partnoy, *supra* note 20, at 80–81. Even before the Dodd-Frank Act, the SEC anticipated this approach by proposing new rules that would scale back requirements for issuers to secure ratings in order to "reduce undue reliance on credit ratings." *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,088, 40,088 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 240, 242, 249) (proposing the removal of some formal rule and form requirements for NRSRO ratings under the Securities Act of 1933 and the Exchange Act); References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,124, 40,124–25 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 270, 275) (proposing the removal of some formal requirements for NRSRO ratings under rules pursuant to the Investment Company Act of 1940 and Investment Advisers Act of 1940); Security Ratings, 73 Fed. Reg. 40,106, 40,106, 40,109–10, 40,118 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 229, 230, 239, 240) (proposing to change rating requirements for money markets and investment companies, as well as for registered asset-backed securities).

as key to their legitimacy.[78] Policymakers believed that rating agencies would not compromise their integrity by issuing inflated ratings for short-term gain due to the fear of losing their credibility in the long run.[79] This logic shaped the SEC's policy of recognizing rating agencies as NRSROs. As discussed previously, until 2006 the criteria for recognizing rating agencies was that they were "widely accepted" as "credible and reliable . . . by the predominant users of securities ratings."[80] This approach simply laureled the existing dominant firms, yet came without meaningful strings attached to ensure public or private accountability.[81]

The first attempt at reforming rating agencies initiated a modest shift toward greater public oversight, but primarily relied on passive regulation by mandating greater transparency and disclosure.[82] The Credit Rating Agency Reform Act of 2006[83] opened the door for new entrants into the rating agency industry by creating a more clear process and criteria for the SEC to recognize NRSROs.[84] The Act also mandated greater disclosure from rating agencies of ratings methodologies and conflicts of interest.[85] Although a handful of rating agencies took advantage of the relaxed NRSRO standards to enter the industry, the presence of new small entrants did little to change the market power that the dominant rating agencies enjoyed.[86] The 2006 legislation also failed to create any meaningful public or private means of holding rating agencies accountable. Regulators continued to rely on

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78 *See* Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 228 (2009) (discussing how rating agencies have historically faced a lack of oversight due to deference to self-regulation).

79 *See* Richard Cantor & Frank Packer, *The Credit Rating Industry*, 19 FED. RES. BANK N.Y. Q. REV. 1, 4 (1994) (arguing "[w]hile the current payment structure may appear to encourage agencies to assign higher ratings to satisfy issuers, the agencies have an overriding incentive to maintain a reputation for high-quality, accurate ratings"); Schwarcz, *supra* note 20, at 14 (arguing that reputational constraints will sufficiently restrain rating agencies).

80 *See* SEC Concept Release, *supra* note 18, at 35,260.

81 *See* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1674 (2008); *cf.* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327–39 (codified at 15 U.S.C. § 78o-7 (2006)) (creating greater accountability standards for NRSROs).

82 *See* Credit Rating Agency Reform Act, 120 Stat. at 1327, 1332–34.

83 Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327–39 (codified at 15 U.S.C. § 78o-7 (2006)).

84 *See id.* at 1329–32.

85 *See id.* at 1332–34.

86 *See* Kettering, *supra* note 81, at 1674, 1701 n.491 (discussing how the 2006 rating agency legislation had at best marginal effects in increasing regulatory oversight and fostering competition).

the reputational fallout from rating agency disclosures or errors to keep rating agencies in line.[87]

1. *The Marginal Impact of Rolling Back Requirements for Ratings*

With the onset of the financial crisis, Congress shifted from all but ignoring the various schools of thought on rating agency reform to embracing each of them at once. The most significant paradox of Dodd-Frank's rating agency reform was that Congress sought to marginalize rating agencies while simultaneously subjecting them to a range of regulatory oversight that underscored rating agencies' importance.

The central theme of marginalization efforts was to roll back the myriad federal requirements for ratings in statutes, rules, and regulations.[88] The logic was that the government had legitimized the widespread reliance on ratings, and abolishing these requirements would end the public endorsement of private assessments of credit risk.[89] The Act replaced requirements for ratings with language requiring investors to consider the creditworthiness of securities, implicitly suggesting that investors should not focus solely on ratings.[90] Dodd-Frank required regulatory bodies to review and remove most references to rating agencies and to develop their own broader standards of creditworthiness to supplant the role of ratings.[91] The Act also stripped rating agencies of their Regulation FD exception, which had allowed them to access nonpublic information about issuers.[92]

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87 *Cf. id.* at 1700–01 (noting that the 2006 Act did not mandate any changes to the dominant rating agency business model).

88 This approach built on earlier SEC proposals to scale back requirements for issuers to secure ratings. *See supra* note 77. The premise of these changes is to make clear that investors should not "place undue reliance on the NRSRO ratings." *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,088, 40,088–89, 40,100 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 240, 242, 249). The emphasis is on the word "undue," because regardless of whether these proposed rules are implemented the problem of rating agency accountability will still exist. Entrenched market practices of soliciting and relying upon ratings are likely to sustain the importance of ratings.

89 *Cf.* References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. at 40,089 ("[T]here is a risk that investors interpret the use of the term [NRSRO] in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to place undue reliance on the credit ratings issued by these entities.").

90 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939, 124 Stat. 1376, 1885–86 (2010).

91 *See id.* § 939A, 124 Stat. at 1887.

92 *See id.* § 939B, 124 Stat. at 1887–88; Removal from Regulation FD of the Exemption for

The message to the market was that rating agencies no longer enjoyed a government imprimatur of legitimacy. In light of the failures of rating agencies, encouraging public and private parties not to rely blindly on ratings was sensible. But the question remains whether removing requirements for ratings was necessary to convey this message or counterproductive in denying the reality of ratings' continued relevance in the market. The shortcomings of rating agencies and the resulting financial fallout during the crisis clearly conveyed a cautionary message about reliance on ratings far more powerfully than a shift in government policy.

The dilemma is that the government is seeking to diminish reliance on ratings at a time of significant financial uncertainty. In spite of the Dodd-Frank Act's efforts to reduce reliance on ratings, markets and many government agencies have indicated that they will continue to rely on ratings as proxies for credit risk for the foreseeable future.[93] The problem is that no viable alternative proxy for credit risk exists. The closest alternative, credit default swap spreads, provides at best short-term snapshots of market sentiment of risk.[94] Instead, the Dodd-Frank Act is based on blind faith that the mandate for public agencies to create alternative proxies for risk will lead to the creation of viable substitutes.[95] That may be wishful thinking as it fails to reflect the realities of the current public and private ability to gauge risk in the turbulent wake of the financial crisis.

The closest alternative to ratings, credit default swaps, serve as an equivalent of insurance against default events as holders of debt pay a "premium" to another party in exchange for compensation if a default event occurs.[96] The virtue of credit default swaps is that they allow creditors to hedge against loss, and both the initial sale and resale

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Credit Rating Agencies, Exchange Act Release No. 9146, 99 SEC Docket 1550 (Oct. 4, 2010), https://www.sec.gov/rules/final/2010/33-9146.pdf.

93 *See, e.g.*, FED. DEPOSIT INS. CO., REFERENCES TO CREDIT RATINGS IN FDIC REGULATIONS 3–4 (2011), http://www.fdic.gov/regulations/reform/LA11-NI0117.pdf (discussing how efforts to come up with alternatives for reliance on credit ratings is a work in progress because "[i]dentifying alternatives to credit ratings that are suitable for regulatory capital determinations is challenging and involves policy tradeoffs").

94 *But see* Flannery, Houston & Partnoy, *supra* note 5, at 2086–89.

95 *See, e.g.*, Stuart Minor Benjamin & Arti K. Rai, *Fixing Innovation Policy: A Structural Perspective*, 77 GEO. WASH. L. REV. 1, 2–5 (2008) (analyzing the past shortcomings of government mandates for innovation).

96 *See* Flannery, Houston & Partnoy, *supra* note 5, at 2087–88. The differences between credit default swaps and ratings are similar to what distinguish police officers from building inspectors, respectively. Both have an eye on identifying risks and preempting wrongdoing, but the building inspectors focus on structural issues, such as long-term risks, rather than present infractions. *Cf.* MOODY'S INVESTORS SERV., *supra* note 58, at 25.

prices for these swaps serve as proxies for risk.[97] Credit default swaps themselves, however, have become speculative instruments as part of a multi-trillion-dollar industry.[98] The speculative element of these instruments means that credit default swap holders may seek to distort the actual risks of the marketplace and foster a false sense of security or panic to serve their short-term ends.[99] Credit default spreads also tend to reflect market overreactions and thus lead to a very high rate of reversals of risk assessments.[100] By contrast, ratings seek to approximate the long-term creditworthiness of issuers, which despite the shortcomings of ratings, is the time frame of most concern to regulators and investors.[101]

The absence of credible alternatives to ratings means that regulatory bodies may potentially embrace less accurate proxies of credit risk. Congress may have faith in government entities' ability to anticipate market risks. But this faith stands in contrast to a long track record of government actors' sluggishness in understanding and addressing emerging risks in complex financial markets.[102] When failure happens, the temptation always is to have change for change's sake in the hope that a better result will occur.[103] But rolling the dice and betting that public agencies will suddenly understand risks better is a

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97 *See* Flannery, Houston & Partnoy, *supra* note 5, at 2088–89.

98 *See Reform of the Over-the-Counter Derivative Market: Limiting Risk and Ensuring Fairness: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 147–48 (2009) (statement of Henry T. C. Hu, Director of the Division of Risk, Strategy, and Financial Innovation, U.S. Securities and Exchange Commission) (discussing how "[t]he derivatives market has grown enormously since the late 1990s to approximately $450 trillion of outstanding notional amount in June 2009").

99 *See* Gillian Wee, *Credit Swaps Show Fear, Not Reality, Executives Say*, BLOOMBERG (Oct. 3, 2008, 12:02 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a.o1tHR Joe.k&refer=bondheads (arguing that widening credit default swaps have exposed a disconnect between the actual balance sheets of companies and the fears of panicked investors); Edmund L. Andrews, *Treasury's Plan Would Give Fed Wide New Power*, N.Y. TIMES, Mar. 29, 2008, at A1 (noting that proposed reforms to overhaul the Federal Reserve's power would not address the distortions speculation has caused in credit default swaps markets).

100 *See* MOODY'S INVESTORS SERV., *supra* note 58, at 27.

101 *See id.* at 15, 27.

102 The more complex the activity, the more private actors may enjoy advantages over their public regulator counterparts who are often several steps behind the markets. *See* Donald C. Langevoort, *Technological Evolution and the Devolution of Corporate Financial Reporting*, 46 WM. & MARY L. REV. 1, 17–18 (2004); Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 2–11, 18–20 (discussing how "the increasingly widespread problem of complexity" makes it difficult for public enforcers to regulate and oversee "virtually all securitization and derivatives deals and other forms of structured-financing transactions").

103 *See, e.g.*, Jeffrey Manns, Legislation Comment, *Reorganization as a Substitute for Reform: The Abolition of the INS*, 112 YALE L.J. 145, 146 (2002) (discussing how policymakers

significant gamble in itself. The move away from relative uniformity of risk assessments to a world in which each agency designs its own risk standards only increases the likelihood that government actors will miss, or even intentionally deemphasize, risk issues in order to fuel growth in a particular area of regulation. While the independence of rating agencies has come under question by critics of the issuer-pays system, government regulators may prove even more vulnerable to industry capture.

Removing requirements for ratings also potentially handicaps the ability of the SEC to regulate rating agencies. If the government had the sole objective of stripping rating agencies of their influence, then removing requirements makes sense. The problem is that other parts of the Dodd-Frank Act treat rating agencies as regulated industries subject to significant oversight and regulatory constraints.[104] If treaties, statutes, and rules require ratings by NRSROs, then every rating agency has a strong incentive to continue to be certified as an NRSRO with its attendant SEC-imposed regulatory framework and conditions. However, rolling back requirements for ratings opens up the possibility that the leading rating agencies will simply opt out of NRSRO status to avoid the regulatory burdens.

Abolishing requirements for ratings has not had the impact of marginalizing ratings that proponents had hoped would occur. Ratings continue to be a de facto requirement for most debt issues.[105] This fact does not entirely dismiss the view that rating agencies' value came in part from regulatory requirements. But decades of government requirements for ratings made ratings a virtual necessity, and market practices are now so deeply entrenched that the removal of government mandates has had little impact.[106] It is also important to note, however, that ratings featured prominently in the financial landscape before government requirements for ratings began in the 1970s.[107] The combined impact of the historical practice of enlisting

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routinely pursue reorganizations for no other reason than the hope that shaking up the agency would lead to positive change).

104 *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1872–83 (2010).

105 *See* David S. Hilzenrath, *SEC Poses Plan to Curb Reliance on Credit Ratings, but Regulators Cite Difficulties*, WASH. POST (Apr. 27, 2011), http://www.washingtonpost.com/business/economy/sec-poses-plan-to-curb-reliance-on-credit-ratings-but-regulators-cite-difficulties/2011/04/27/AFv2yp0E_story.html.

106 *See id.*

107 *See generally* RICHARD SYLLA, A HISTORICAL PRIMER ON THE BUSINESS OF CREDIT RATINGS 21–24 (2001), http://www1.worldbank.org/finance/assets/images/Historical_Primer.pdf.

rating agencies, coupled with decades of government requirements, has entrenched rating agencies for the foreseeable future.

Opponents of ratings may correctly note that over the long haul the absence of requirements for ratings will erode the influence of rating agencies if other credible benchmarks of gauging risk emerge. But the reality is that the removal of requirements for ratings has failed to have a significant impact in the short run.[108] Instead, this aspect of reform makes the SEC's job more difficult. The ongoing influence of the leading rating agencies underscores the fact that markets continue to value their opinions.

The elimination of the Regulation FD exception for access to nonpublic information also appears to have had no meaningful impact. In theory this move is significant in signaling that rating agencies do not receive special government protection and that a level playing field of market information exists. But in practice rating agencies have used nondisclosure agreements to secure access to nonpublic information, which achieves through contract law the same access previously granted under Regulation FD.[109]

2. *The Potential for Transparency and Private Enforcement*

While the Dodd-Frank Act moved partially in the direction of making rating agencies into a regulated industry, the Act simultaneously moved in the direction of relying on conventional private accountability tools. This passive securities regulation approach sought to use transparency and disclosure requirements to facilitate private monitoring and to enlist private plaintiffs to police rating agencies.

The Act requires greater disclosure of the qualitative and quantitative content of credit ratings and of third-party due diligence.[110] While the SEC is expressly barred from shaping the methodologies of rating agencies,[111] the Act imposes procedural requirements designed to heighten rating transparency.[112] The board of directors for each rating agency must approve the qualitative and quantitative ap-

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108 *See* Hilzenrath, *supra* note 105.

109 *See* Gerd D. Thomsen, *Frequently Asked Questions About Regulation FD*, MORRISON & FOERSTER, http://www.mofo.com/files/Uploads/Documents/FAQs-Regulation-FD.pdf (last visited Feb. 26, 2013).

110 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1872–83 (2010).

111 *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, sec. 4, § 15E(c)(2), 120 Stat. 1327, 1332 (codified at 15 U.S.C. § 78o-7 (2006)).

112 *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act § 938, 124 Stat. at 1885–87.

proaches used in rating methodologies.[113] Rating agencies must publicly disclose the qualitative and quantitative methods for each rating, consistently apply changes to methodologies and procedures, and disclose methodological changes as well as significant errors.[114] Rating agencies must have procedures in place for determining the likelihood of defaults.[115] The Dodd-Frank Act also calls for rating agencies to "clearly define and disclose the meaning of [ratings] symbol[s]" and to apply these symbols "consistent[ly] for all types of securities . . . for which the symbol is used."[116]

Rating agencies must add standardized disclosures with each rating that detail the qualitative and quantitative methodology used, the assumptions that underpin the analysis, the extent of third-party due diligence, and caveats about the limits of ratings.[117] The legislation also requires disclosure of the revolving door between rating agencies and clients, so that investors and other private monitors can have a better understanding of the degree of potential conflicts of interest that arise from former raters going to work for issuers, underwriters, or sponsors.[118]

The Act also details specific disclosure requirements to make it easier for ratings users to gauge the performance of ratings as well as to understand the nature and limits of ratings. Rating agencies must disclose the initial ratings and changes in ratings for each rated security to facilitate comparisons across rating agencies.[119] In addition, rating agencies must periodically disclose information that indicates the degree of accuracy of past ratings.[120] This change appears to heighten incentives for rating agency accuracy, but the devil is in the details as no clear standard exists as to what defines rating accuracy. In cases of sudden credit deterioration or titanic defaults, rating agencies may potentially be caught red-handed with inaccurate ratings. But in most cases rating agencies can continue to assert that ratings were accurate at the time of issue.

The virtue of greater disclosure requirements from the government's perspective is that they facilitate greater private oversight while minimizing direct government expenditures. Greater trans-

113 *See id.* § 932, 124 Stat. at 1882–83.
114 *See id.* § 932, 124 Stat. at 1879.
115 *See id.* § 932, 124 Stat. at 1881.
116 *Id.* § 938, 124 Stat. at 1885–87.
117 *See id.* § 932, 124 Stat. at 1879–80.
118 *See id.* § 932, 124 Stat. at 1875–76.
119 *See id.* § 932, 124 Stat. at 1878.
120 *See id.*

parency may enable both public and private parties to more easily detect abuses or deviations from rating agencies' methodologies. But the degree to which "sunlight" provisions lead to greater rating agency accountability or restraint is an open question. Sunshine may make it harder for the most egregious excesses of rating agencies to rear their ugly head in the future. But this approach does not deal with rating agencies' deeper problems caused by the absence of competition and accountability.[121]

3. *The Rating Agencies' Successful Rebellion*

The Dodd-Frank Act tried to give teeth to private oversight by creating private causes of action,[122] but the Act's attempts to foster private accountability faltered in practice. Private causes of action were designed to complement transparency and disclosure by providing incentives for a broad pool of actors to monitor and prosecute deceptive ratings.[123] The enlistment of private monitors could have been a viable strategy by itself. But the SEC caved in the face of rating agencies' defiance to expert liability exposure, which allowed rating agencies to sidestep the most significant private enforcement tool created by the Act.

The attempt to impose expert liability on rating agencies was one of the most ambitious components, and the most visible failure, of rating agency reform. Prior to the Dodd-Frank Act, government regulations required the inclusion of ratings in the registration statement for asset-backed securities.[124] However, SEC Rule 436(g) expressly exempted rating agencies from expert liability.[125] The rule shielded rating agencies from private liability for fraud in registration statements under section 11 of the Securities Exchange Act of 1934.[126]

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121 *Cf.* Mark Fenster, *The Opacity of Transparency*, 91 IOWA L. REV. 885, 902–10 (2006) (discussing the limits of transparency).

122 *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act § 933, 124 Stat. at 1883–84.

123 Private monitors may have incentives to innovate new ways to uncover gatekeeper violations or to prosecute gatekeepers because they personally internalize the monitoring costs and monetary rewards in ways that public monitors do not. *See, e.g.*, Michael Selmi, *Public vs. Private Enforcement of Civil Rights: The Case of Housing and Employment*, 45 UCLA L. REV. 1401, 1438–49 (1998) (discussing how private litigants have pursued the most challenging and significant discrimination cases); Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 112–13 (2005) (suggesting how private litigants may employ novel strategies and approaches to expand enforcement potential).

124 *See* 17 C.F.R. § 229.1120 (2005).

125 *See id.* § 230.436(g)(1) (2011).

126 *See id.* While the SEC had considered revoking this special protection for rating agen-

The Dodd-Frank Act, however, attempted to subject rating agencies to the same expert liability as accountants face under section 11,[127] authorizing investors to sue rating agencies for knowingly or recklessly issuing materially misleading ratings.[128] This change would have meant that rating agencies would face the burden of showing they had reasonable grounds to believe and actually believed their ratings were accurate.[129]

But immediately after the Dodd-Frank Act came into effect the leading rating agencies refused to allow the inclusion of their ratings in registration statements for asset-backed securities in order to avoid liability exposure.[130] This move was a high-stakes game of chicken between the leading rating agencies and the SEC that threatened to freeze asset-backed securities markets, which expressly required inclusion of ratings in registration statements.[131] The SEC blinked first and immediately suspended this part of the legislation, first for six months and then for the indefinite future.[132] This showdown demonstrated unequivocally the power of rating agencies and their ability to push back on government regulation. It also left a gaping hole in terms of private accountability.[133] While investors had access to greater disclosures from rating agencies, they lacked access to enforcement tools to hold rating agencies accountable.

The other private enforcement dimension of the Act lowered the pleading standards for Rule 10b-5 antifraud liability.[134] While significant in theory, in practice the expanded pleading opportunities are unlikely to increase private litigation in any significant way because

cies in 2009, it declined to do so presumably due in part to the fear of a backlash from rating agencies. *See* Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, 74 Fed. Reg. 53,114, 53,114–15 (Oct. 15, 2009) [hereinafter SEC 436(g) Concept Release]; *cf.* Gretchen Morgenson, *Hey, S.E.C, That Escape Hatch Is Still Open*, N.Y. TIMES, Mar. 6, 2011, at BU1 (describing the rating agencies' reaction to the possible imposition of expert liability).

127 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 939G, 124 Stat. at 1890; SEC 436(g) Concept Release, *supra* note 126.

128 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 933, 124 Stat. at 1883–84.

129 *See id.*

130 *See* Morgenson, *supra* note 126, at BU1.

131 *See id.*

132 *See id.*

133 The fact that a House committee voted to reinstate the Rule 436(g) exception for rating agencies provides additional evidence of the agencies' influence and power. *See* H.R. 1539, 112th Cong. (as voted on by H. Comm. on Fin. Servs., July 20, 2011).

134 *Compare* 15 U.S.C. § 78j-1 (2006), *and* 17 C.F.R. § 240.10b-5 (2008), *with* Dodd-Frank Wall Street Reform and Consumer Protection Act § 933, 124 Stat. at 1883–84.

rating agencies effectively have a safe harbor of due diligence compliance.[135] Investors could always allege that rating agencies committed Rule 10b-5 fraud, which serves as the prophylactic antifraud provision for securities. This provision was toothless in practice, however, because meeting the high pleading standard of alleging particular facts that established a strong inference that rating agencies knew of or recklessly made a material misstatement or omission was virtually impossible.[136]

The Dodd-Frank Act lowered the pleading standard, so that plaintiffs need only allege particular facts that create a strong inference that rating agencies knowingly or recklessly failed to conduct reasonable investigation of the factual elements underpinning the portfolios.[137] The Rule 10b-5 pleading changes in turn effectively create a safe harbor from antifraud liability if rating agencies engage in due diligence, such as by obtaining reasonable verification of the information from independent third parties.[138] This provision complements other parts of the Act, which call for third-party due diligence providers to certify that they have conducted a thorough review of the underlying debt of asset-backed securities and to disclose their due diligence reports to the public.[139] Ultimately, the Rule 10b-5 changes create incentives for large paper trails of due diligence documentation, which will address the pre-financial crisis abuse of rating asset-backed securities with no or little diligence.

The shortcoming of the changes to the Rule 10b-5 pleading standards is their narrow scope. First, the relaxed pleading standards focus only on due diligence and do not provide an effective outlet for addressing other forms of potential ratings deception.[140] Second, the Rule 10b-5 pleading standards only allow a narrow window for private oversight as private parties will only rarely uncover facts from which

135 *See* 15 U.S.C. § 77k(b)(3)(C).

136 *See id.* § 78u-4(b)(2) (establishing pleading standard); *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 321 (2007) (discussing the difficult burden plaintiffs face in pleading scienter in these cases).

137 Dodd-Frank Wall Street Reform and Consumer Protection Act § 933, 124 Stat. at 1883–84.

138 *See id.* The Dodd-Frank Act called for rating agencies not to rely solely on issuers for information on debt issues, and instead required them to consider outside information that is "credible and potentially significant" to ratings decisions. *See id.* § 935, 124 Stat. at 1884. The changes to Rule 10b-5 provided the incentives behind this nebulous mandate.

139 *See id.* § 932, 124 Stat. at 1881–82.

140 For example, establishing a paper trail of due diligence documentation may do little to address the issue of inflated or lax ratings. Instead, it may ironically give rating agencies a better defense against charges that their ratings are baseless.

one can strongly infer the absence of a reasonable investigation. This approach is likely rooted in the concern that private liability could swiftly bankrupt rating agencies. But it comes at the cost of marginalizing private oversight, especially given the abandonment of expert liability exposure.

4. *The Attempt to Transform Rating Agencies into a Regulated Industry*

In spite of efforts to rescind ratings requirements and rely on disclosures and private enforcement, the Dodd-Frank Act's primary impact was to move the rating agency industry closer to becoming a regulated industry by attaching more strings to NRSRO status. The Act imposed a broad range of governance, internal controls, and conflict of interest compliance requirements[141] designed to address the worst excesses of rating agencies during the CDO boom.[142] The Act also centralized oversight authority in the SEC's Office of Credit Ratings, which is tasked with conducting annual examinations, monitoring internal controls, issuing inspection reports, and imposing penalties on wayward rating agencies.[143]

Governance and internal control reforms emphasized independent oversight and internal risk management, which significantly built on the Sarbanes-Oxley Act's[144] emphasis on director independence and oversight.[145] Faith in director independence has become a virtual gospel of good corporate governance since the Sarbanes-Oxley Act, and the Dodd-Frank Act significantly expands on this combination of

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141 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 932, 124 Stat. at 1872–83.

142 *See id.* § 931, 124 Stat. at 1872 (finding that "[i]n the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.").

143 *See id.* § 932, 124 Stat. at 1877–78.

144 Sarbanes Oxley Act of 2002, 18 U.S.C. § 1514A (2006).

145 *See* William B. Chandler III, *On the Instructiveness of Insiders, Independents, and Institutional Investors*, 67 U. CIN. L. REV. 1083, 1084–85 (1999) (discussing the "conventional wisdom" of the virtues of independent directors to address the shortcomings of corporate governance); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 452–58 (2008) (discussing how reforms, including Sarbanes-Oxley, frequently "trumpet" greater director independence as the panacea for failures in corporate governance); E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. PA. L. REV. 2179, 2183–84 (2001) (discussing how regulators vest discretion in independent directors because of faith that independent directors are best positioned to police corporate conduct).

internal oversight and external accountability.[146] At least half of the members of boards of directors of rating agencies must consist of independent directors, and investors must have representation on the boards.[147] The legislation calls for the boards of directors of rating agencies to exercise specific oversight roles in examining methodologies and models, accuracy, internal controls, and conflict of interest compliance.[148] Each rating agency must have an independent chief compliance officer who submits an annual report on compliance with regulatory obligations to the rating agency and the SEC.[149] Rating agencies must also enforce internal controls to ensure compliance with their rating methodologies and submit annual reports on their compliance to the SEC.[150] These explicit director oversight roles and reporting requirements to the SEC make rating agencies increasingly resemble a regulated industry. But it remains to be seen whether this approach will enhance rating agency accountability. It is unclear how effective independent directors and internal controls will be in addressing the problems of rating agencies.[151]

The Dodd-Frank Act also imposed conflict of interest restrictions and due diligence requirements. The SEC is tasked with enacting rules to ensure that rating agencies avoid having their efforts to solicit business affect ratings.[152] To that end, rating agencies must expressly affirm that each rating was not affected by its "business activities" and instead is based solely on its independent evaluation of the risks and

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146 *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921 (1999) (observing that "[m]ost commentators applaud the trend toward greater board independence"); Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1864 (2007) (observing a "near consensus" that greater director independence is key to effective corporate governance).

147 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 932, 124 Stat. at 1882.

148 *See id.* § 932, 124 Stat. at 1882–83.

149 *See* PRICEWATERHOUSECOOPERS LLP, A CLOSER LOOK: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: IMPACT ON CREDIT RATING AGENCIES 3 (2010).

150 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 932(a), 124 Stat. at 1873.

151 *See, e.g.*, Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 131–32 (2010) (arguing that "the independent director's value has been vastly overstated"); Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. 1375, 1378–79 (2006) (questioning the efficacy of relying on independent directors to police corporate conduct because of the lack of SEC actions against independent directors).

152 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 932, 124 Stat. at 1878–79.

merits of the debt issue.[153] Rating agencies must publicly disclose when employees involved in the ratings process leave to join an issuer, underwriter, or sponsor and review the past year of ratings for the companies involved to uncover the impact of any conflicts of interest.[154] The emphasis on internal controls and conflict of interest compliance deal with the worst excesses prior to the financial crisis in which due diligence was cast to the wayside and conflicts of interest appear significant.[155] The problem is that these reforms only skirt the deeper issues of rating agencies' incentives and ability to gauge risks in a timely and accurate way.

5. *The Potential and Limits of the Office of Credit Ratings*

The Dodd-Frank Act mandated the creation of the SEC's Office of Credit Ratings to fulfill the new oversight roles by monitoring the activities of NRSROs.[156] The virtue of the Office of Credit Ratings is that it establishes a locus of accountability. The uncertainty is whether the Office is adequately equipped to oversee rating agencies or whether it will prove to be a toothless tiger. The success of the Office will turn on the enforcement tools at its disposal and the political will to fulfill its duties of enforcing statutes and rules governing rating agencies' conduct, protecting users of ratings, promoting rating accuracy and greater disclosure, and ensuring that conflicts of interest do not unduly affect ratings.[157]

The Office's monitoring role is primarily oriented toward identifying potential problems for future rulemaking. The Office is charged with conducting annual, risk-based examinations of rating agencies and assessing rating agencies' compliance with their own standards.[158] The Office will issue reports to Congress and the SEC Commissioners about rating agency compliance and can make recommendations for future rules.[159]

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153 *See id.* Rating agencies must also subject employees engaged in ratings to qualification standards, which indirectly serves to further the separation of the business solicitation and ratings' sides of the business. *See id.* § 936, 124 Stat. at 1884–85.

154 *See id.* § 932, 124 Stat. at 1875.

155 *See, e.g.*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON RISK RETENTION 13–15 & n.13, 42, 89 (2010).

156 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 932, 124 Stat. at 1877–78.

157 *See About the Office of Credit Ratings*, U.S. SEC. & EXCH. COMM'N (last modified July 31, 2012), http://www.sec.gov/about/offices/ocr/ocr-about.shtml.

158 *See id.*

159 *See id.*

Troubleshooting emerging problems is important, and an area where the SEC has room for substantial improvement.[160] But the key to the Office of Credit Ratings' success will turn on the scope of its enforcement powers and the degree to which those powers are exercised. Federal law expressly recognizes that the SEC cannot regulate the substance of rating agency methodologies,[161] but the SEC may nonetheless subject rating agencies to procedural requirements and liability for fraud.[162] For example, rating agencies are required to file their registration applications and annual reports with the SEC, and those reports may serve as a basis for actions for false or misleading statements.[163] Rating agencies face potential liability for failure to supervise their employees who engage in fraudulent conduct.[164] Additionally, rating agencies are obligated to act as whistleblowers to regulators if they receive credible information that issuers have committed or are committing material legal violations.[165]

Rating agencies can address their supervisory and whistleblowing roles by strengthening internal controls. Enacting and implementing internal controls will give rating agencies a prophylactic defense that they have taken reasonable measures to detect issuer or internal fraud. But it is far from clear that expanding the SEC's antifraud powers will do much to enhance the quality of ratings beyond creating incentives for rating agencies to take internal steps to avoid blatant abuses.

One potential wild card of Dodd-Frank is that the Act vests the SEC with the power to suspend or revoke NRSRO registration if it determines that the rating agency lacks the financial or managerial resources to produce credible ratings.[166] The odd dichotomy is that the SEC has done little to pursue the leading rating agencies for their failures in the run-up to the financial crisis,[167] while its most prominent

160 *See, e.g.*, John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 735–37 (2009) (criticizing the SEC's inaction in the run-up to the financial crisis).

161 *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1332 (codified at 15 U.S.C. § 78o-7 (2006)).

162 *See id.*, 120 Stat. at 1336–37.

163 *See id.*, 120 Stat. at 1329, 1331–34.

164 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1873–74 (2010).

165 *See id.* § 934, 124 Stat. at 1884.

166 *See id.* § 932, 124 Stat. at 1874.

167 The SEC has presumably given support for the Department of Justice's February 2013 lawsuit against Standard & Poor's for asset-backed security ratings in the run-up to the financial crisis, a significant case which will be discussed shortly. *See infra* Part II.B.6. It is telling, how-

enforcement action has been against the smallest, most independent rating agency, Egan-Jones.[168]

The SEC has taken modest steps toward scrutinizing rating agency conduct during the run-up to the crisis.[169] But it has considered pursuing actions against rating agencies for fraud in only a handful of cases, in spite of the widespread consensus that lax ratings were a significant factor in the crisis.[170] This inaction raises the concern that the Office of Credit Ratings will primarily serve to identify problems and make recommendations for rulemaking, rather than to heighten enforcement or address the shortcomings of rating agencies in real time.

The SEC's most significant enforcement action has been the attempt to suspend the smallest rating agency, Egan-Jones.[171] Sean Egan, co-founder of Egan-Jones, has been one of the most vocal critics of the SEC for its inaction in the face of lax ratings that understated market risks.[172] The SEC has forcefully struck back in alleging that Egan-Jones made material misstatements about its experience and internal controls in its 2008 NRSRO application to rate government and asset-backed securities.[173] Not only may this case have a chilling effect on future industry reformers and potential entrants, but it also raises questions about the SEC's earnestness in enacting reforms.[174]

Another challenge the Office of Credit Ratings faces is manpower and resource constraints. The SEC's chronic funding problems

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ever, that the SEC chose to prioritize prosecuting the smallest rating agency, Egan-Jones, rather than to take the lead in trying to hold Standard & Poor's accountable.

168 *See* Cohan, *supra* note 32.

169 *See* Jean Eaglesham & Jeannette Neumann, *Raters Drawing SEC Scrutiny*, WALL ST. J., June 17, 2011, at C1 (discussing an ongoing SEC investigation focused on whether Standard & Poor's and Moody's committed fraud in failing to do sufficient research about the mortgage-backed securities they were rating).

170 *See id.*; WALL STREET AND THE FINANCIAL CRISIS, *supra* note 5, at 5–7.

171 *See* Jesse Eisinger, *Taking on the Little Guy, but Missing the Bigger Ones*, N.Y. TIMES DEALBOOK (MAY 2, 2012, 12:00 PM), http://dealbook.nytimes.com/2012/05/02/taking-on-the-little-guy-but-missing-the-bigger-ones/; *see also* Günter Strobl & Han Xia, *The Issuer-Pays Rating Model and Ratings Inflation: Evidence From Corporate Credit Ratings* (Feb. 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2002186 (laying out empirical evidence that Standard & Poor's had inflated ratings compared to Egan-Jones for corporate bond issues).

172 *See* Eisinger, *supra* note 171.

173 *See* Jeannette Neumann, *SEC Charges Egan-Jones, Says Firm Exaggerated Its Expertise*, WALL ST. J. (Apr. 24, 2012, 7:28 PM), http://online.wsj.com/article/SB10001424052702303592404577364132973207216.html.

174 *See* Eisinger, *supra* note 171 (critiquing the SEC's action against Egan-Jones as potential retaliation for Sean Egan's criticism of the SEC and the issuer-pays system).

mean it is outmanned and outgunned in almost every financial area under its jurisdiction.[175] Allocating a staff of approximately twenty-five people to oversee the rating agency industry ensures that the Office of Credit Ratings will be chronically overstretched.[176] Even to the extent the Office seeks to initiate enforcement actions proactively, its reach will be necessarily limited. The independence and ability of the Office to fulfill its mandate is also an open question, because the first nominee to head the Office is a Wall Street insider who may have little interest in truly shaking up the rating agency industry.[177] It also remains to be seen whether the rank-and-file members of the Office possess both the independence and sufficient industry understanding to fulfill their oversight roles.

6. *The Department of Justice's Novel Legal Strategy*

Ironically, the Department of Justice ("DOJ"), rather than the SEC, has brought the first (and to date only) lawsuit against a rating agency for its role in the financial crisis. In February 2013, the DOJ filed suit against S&P alleging fraud in asset-backed securities ratings based on a rarely used anti-fraud provision of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA").[178] Applying a banking law statute to the securities context of rating agencies is a novel and untested approach, which seeks to bypass traditional barriers to suing rating agencies.[179] FIRREA empowers the DOJ to prosecute any one of fourteen categories of civil fraud (including bank, mail, and wire fraud and making false statements) if

175 For example, at the time the financial crisis spun out of control in 2007 the SEC had a staff of approximately 3,600 who "are responsible for overseeing over 10,000 publicly traded companies; over 10,000 investment advisers who manage over $37 trillion in assets; nearly 1,000 fund complexes; 6,000 broker-dealers with 172,000 branches; and the $44 trillion worth of trading that's conducted each year on America's stock and options exchanges." *See Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission: Hearing Before the H. Comm. of Fin. Servs.*, 110th Cong. 10 (2007) (statement of Christopher Cox, Chairman, United States Securities and Exchange Commission).

176 *See* Jeanette Neumann, *Rating-Firm Oversight Rises*, WALL ST. J., June 19, 2012, at C6.

177 *See* Jeanette Neumann, *SEC: Former Brokerage Executive to Oversee Credit-Rating Firms*, WALL ST. J. (June 15, 2012, 6:12 PM), http://online.wsj.com/article/SB10001424052702303410404577468461139923658.html.

178 *See* Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183 (1989); Alejandro Lazo & Andrew Tangel, *U.S. Sues S&P Over Mortgage Ratings*, L.A. TIMES, Feb. 4, 2013, at A1 (discussing the potential implications of the lawsuit against S&P); Viswanatha & Stempel, *supra* note 12 (discussing how the lawsuit against S&P is the first enforcement action against a rating agency for its role in the financial crisis). .

179 *See* Eaglesham, Neumann & Perez, *supra* note 12, at A1 (discussing how DOJ is making an end-run around traditional barriers to suing rating agencies by applying FIRREA).

the fraud "affect[s] a federally insured financial institution."[180] FIRREA is a potentially potent weapon because the act allows the DOJ to use many of the enforcement powers it enjoys in the criminal context to uncover evidence and prosecute fraud in financial civil suits. For example, FIRREA empowers the DOJ lawyers to directly subpoena documents and take depositions for a civil investigation of fraud, which constitutes an extraordinary grant of pre-suit civil discovery.[181] FIRREA also gives the DOJ a long reach with a ten year statute of limitations and a big stick to induce settlements due to the threat of large potential liabilities.[182]

In spite of FIRREA's appeal to prosecutors, it is far from clear that this creative application of FIRREA will succeed in holding rating agencies accountable. Prosecutors have not yet tested the contours of what potentially "affect[s] a federally insured financial institution."[183] More importantly, the challenge is that DOJ must establish the predicate fact that S&P knowingly committed fraud. This task will prove difficult given the nature of ratings as opinions that raters openly condition with caveats, assumptions, and admissions of the imprecision of a bucket system focused on long-term structural

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180 *See* Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA"), Pub. L. No. 101-73, § 951(c), 103 Stat. 183, 498 (1989) (codified at 12 U.S.C. § 1833a(c) (2006)).

181 *See id.* § 951(f), 103 Stat. at 498–99 (codified at 12 U.S.C. § 1833a(g)). Additionally, FIRREA allows criminal grand jury material to be passed on for use in DOJ civil suits without a court order. This means that the DOJ can potentially use any material developed in the pursuit of a failed criminal investigation to have a second bite at the apple in a civil proceeding. *See* 18 U.S.C. § 3322(a) (2006).

182 Violators face penalties of up to $1.1 million per violation (or $5.1 million per continuing violation) or up to the amount of the gain to the perpetrator or loss to the victim in cases of monetary gain, a figure which could be dramatically large given the scope of the financial crisis. FIRREA § 951(b)(1)–(3), 103 Stat. at 498 (codified at 12 U.S.C. § 1833a(b)(1)–(3)); *see also* 28 C.F.R. § 85.3(a)(6)–(7) (2012) (adjusting penalties for inflation).

183 FIRREA § 951(c), 103 Stat. at 498 (codified at 12 U.S.C. § 1883a(c)). Since 2009 the DOJ has filed a number of suits against financial institutions based on FIRREA, but these suits have largely led to settlements or are still pending, which means there is little precedent concerning the Act's scope. *See, e.g.*, United States v. Bank of Am. Corp., No. 1:12-cv-00361 (D.D.C. filed Mar. 22, 2012); United States v. Bank of N.Y. Mellon Corp., No. 1:11-cv-06969 (S.D.N.Y. filed Oct 4, 2011). Related language of "affects a financial institution" has been used in the context of sentence enhancements for mail and wire fraud, see for example18 U.S.C. §§ 1341, 1343, 3293, and the definition of what constitutes a "continuing financial crimes enterprise." *See, e.g.*, 18 U.S.C. § 225. Precedents from these collateral contexts suggest that the notion of what "affect[s] a federally insured institution" under FERRIA may be broad and satisfied by actions that merely entail "increased risk of loss." *See* United States v. Serpico, 320 F.3d. 691, 694–695 (7th Cir. 2003); *see also* United States v. Pelullo, 964 F.2d 193, 215–216 (3d Cir. 1992) (holding that the language "affects a financial institution" applies to acts in which the bank is not the "object" or target of the fraud).

concerns.[184] While it is positive that the government has signaled its intent to hold S&P accountable,[185] DOJ faces an uphill fight to prove that the company and senior management knowingly committed fraud.[186] For example, although the complaint highlights the inherent conflicts of interest in the issuer-pays system, it seeks to substantiate claims of fraud with colorful e-mails by S&P underlings to make up for the absence of any smoking guns establishing fraudulent corporate policy.[187] At best, the government's evidence of internal debates and policy paralysis at S&P about how to deal with the financial crisis merely mirrored the inaction and indecision of regulators.[188]

S&P will still face incentives to settle the case to resolve this blight on its business and minimize the reputational fallout.[189] But a monetary penalty will do little to address the industry's ills, and S&P can be expected to resist any settlement that includes an admission of wrongdoing that could expose it to private liability.[190] While the DOJ's creative lawyering is notable, the impact and implications of this approach for the rating agency industry remain open questions,

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184 *See, e.g.*, MOODY'S INVESTORS SERV., *supra* note 58, at 7, 15 (discussing raters' focus on long-term concerns in determining ratings); Bai, *supra* note 5, at 63–66, 101–04 (discussing the opaqueness of ratings).

185 For example, Moody's may also be the target of a FIRREA action as DOJ and the SEC have ongoing probes concerning Moody's role in the financial crisis. *See* Jeannette Neumann, *Two Firms, One Trail in Probes of Ratings*, WALL ST. J., Feb. 11, 2013, at C1.

186 *See* Jeffrey Manns, *Break Up the Ratings Oligopoly!*, BLOOMBERG (Feb. 18, 2013, 6:30 PM), http://www.bloomberg.com/news/2013-02-18/let-s-downgrade-s-p-moody-s-ratings-oligopoloy.html.

187 *See generally* Complaint, United States v. McGraw-Hill Co., No. 13-cv-00779 (C.D. Cal. filed Feb. 4, 2013) (cataloging e-mails sent to and from S&P employees). *See also, e.g.*, Andrew Tangel, Alejandro Lazo & Jim Puzzanghera, *Suits Reveal Details on Standard & Poor's Views*, L.A. TIMES, Feb. 6, 2013, at B1 (discussing the laundry list of embarrassing e-mails from S&P underlings that were included in the complaint, disclosures that were partly designed to subject S&P to the court of public opinion).

188 *See* Manns, *supra* note 186; *S&P Calls Government Suit Meritless*, N.Y. TIMES DEALBOOK (Feb. 5, 2013, 11:49 AM), http://dealbook.nytimes.com/2013/02/05/s-p-calls-governments-suit-meritless/ (laying out S&P's defense that it engaged in "spirited debate" about how to respond to seismic shifts in debt markets during the financial crisis).

189 *See, e.g.*, Tangel, Lazo & Puzzanghera, *supra* note 187, at B1 (discussing S&P's incentives to settle the case).

190 If there is no admission of wrongdoing, a settlement may not help the state attorneys general and other private litigants that have sought to piggyback off of the governments' claims because they face higher pleading burdens. *See, e.g.*, Jeannette Neumann, *S&P Seeks to Merge State Suits Into One*, Wall St. J., Mar. 28, 2013, at C1 (discussing the lawsuits state attorneys general have brought under state fraud law that seek to leverage the allegations laid out in the government's FIRREA suit).

and reform efforts continue to focus on overhauling the issuer-pays system.[191]

III. Replacing the Issuer-Pays System

The Dodd-Frank Act's most significant reform rests on the most uncertain foundation: the SEC's mandate to address the conflict of interest created by issuers' selecting and paying their rating agency gatekeepers. The Franken Amendment literally sought to transform rating agencies fully into a regulated industry by calling for the creation of an independent commission to select rating agencies for structured finance products using a lottery or random assignment system with an eventual transition to performance-based selection.[192] The SEC has the option of adopting the Franken Amendment or developing its own alternative to address the conflicts of interest arising from the issuer-pays system.[193]

The underlying logic of the Franken Amendment was that ratings are necessary for assessing credit risk, but that market failure and barriers to entry require the extraordinary regulatory restrictions and oversight typical of a regulated industry.[194] The positive dimension of this open-ended reform process is that it is intended to create a system that would insulate rating agencies from issuer influence and create a more open market for rating agency competition.[195] This approach places the government squarely in the middle of the question of how to facilitate greater competition that enhances rating accuracy, a topic explored in greater depth later in this Article.[196]

Rating agency opposition led to a watering down of the proposal in the final legislation into a mandate that the Government Accountability Office ("GAO") and the SEC conduct a series of studies over two years to consider the Franken Amendment and other alternatives

191 *See* Jia Lynn Yang & Dina ElBoghdady, *Overhaul of Rating Agencies Bogs Down Four Years After Financial Crisis*, Wash. Post (Feb. 6, 2013), http://articles.washingtonpost.com/2013-02-06/business/36950343_1_jeffrey-manns-agencies-financial-crisis (discussing how the lawsuit against S&P has masked the SEC's failures to address the underlying challenges of rating agency reform).

192 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939F, 124 Stat. 1376, 1889–90 (2010) (codified at 15 U.S.C. § 78o-9 (Supp. IV 2011)).

193 *See id.* §§ 939D, 939F, 124 Stat. at 1888–90.

194 *See* David Indiviglio, *Franken Amendment Would Bring Real Rating Agency Reform*, Atlantic (May 6, 2010, 5:56 PM), http://www.theatlantic.com/business/archive/2010/05/franken-amendmentwould-bring-real-rating-agency-reform/56346.

195 *See id.*

196 *See infra* Part III.A; *see also* David M. Herszenhorn, *Senate Amends Financial Overhaul Bill*, N.Y. Times, May 14, 2010, at B2.

for the current issuer-pays system.[197] The SEC must implement the Franken Amendment's proposal "unless the Commission determines that an alternative system would better serve the public interest and the protection of investors."[198] This language vests the SEC with sweeping discretion, as it is a virtual tautology that any decision the SEC makes is designed to further the public interest and protect investors.

It remains to be seen whether the SEC will embrace the Franken Amendment's framework or forge an alternative framework. The GAO published two reports identifying a range of potential alternatives.[199] But the GAO's reports shy away from any concrete recommendations and instead counsel the SEC to conduct further study on the viability of these potential alternatives.[200] This recommendation implicitly suggests the concern that the existing reform proposals are underdeveloped and that it may be premature to implement such a significant overhaul of the rating agency industry.

The SEC's December 2012 report was equally noncommittal about whether and in what form the Franken Amendment or another alternative approach would be implemented.[201] While the study acknowledged conflicts of interest exist under the current issuer-pays system,[202] it mimicked the GAO reports in discussing the pros and cons of the potential alternatives to the issuer-pays system, rather than recommending concrete action.[203] The SEC concluded that there was a need for further study on the viability of the potential alternatives for selecting and compensating rating agencies and proposed convening a roundtable of experts to debate the issues.[204] In other words the

197 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 939(D), 124 Stat. at 1888.

198 *Id.* § 939F, 124 Stat. at 1890.

199 *See* U.S. Gov't Accountability Office, GAO-12-240, Credit Rating Agencies: Alternative Compensation Models for Nationally Recognized Statistical Rating Organizations 8–14 (2012), *available at* http://www.gao.gov/products/GAO-12-240 [hereinafter GAO-12-240]; U.S. Gov't Accountability Office, GAO-10-782, Securities and Exchange Commission: Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures 79–93 (2010), *available at* http://www.gao.gov/products/GAO-10-782 [hereinafter GAO-10-782].

200 *See* GAO-12-240, *supra* note 199, at 25–28.

201 *See* Sec. & Exch. Comm'n, Report to Congress on Assigned Credit Ratings 72–82 (2012), *available at* http://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf.

202 *Id.* at 12–16.

203 *Id.* at 72–82.

204 *Id.* at 73.

SEC kicked the can down the road and postponed making difficult decisions about the contours of reform.[205]

Both a public and behind-the-scenes clash continues to take place between rating agencies and the federal government over the future of rating agency regulation. For example, although Senator Franken has made abolition of the issuer-pays system one of his signature issues and has publicly called on the SEC to follow through on implementing an alternative framework for selecting rating agencies,[206] the underlying politics may be more subtle. The high-profile downgrade of the federal government's credit rating in August 2011[207] was arguably one example of the larger struggle between rating agencies and the federal government.

Standard & Poor's downgraded the federal government, and all three of the leading rating agencies engaged in muscle flexing by openly criticizing the federal government's fiscal policies during the summer of 2011.[208] The increased scrutiny of the federal government's credit rating can be interpreted as a shot over the bow that underscored the ability of rating agencies to affect the United States and world markets. The brilliance of this strategy is that no one could fault rating agencies for being more proactive and timely in their ratings, as that was an objective of the Dodd-Frank Act.[209] It remains to be seen whether the possible threat of further downgrades of the United States may cause the SEC to exercise restraint and either not follow through on implementing an alternative to the issuer-pays system or embrace a watered-down solution.

As importantly, the SEC may be overstretched and overwhelmed in implementing its sweeping mandate under the Dodd-Frank Act.[210]

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205 *See* David Dayen, *Financial Reform's Triple F Rating*, AM. PROSPECT (Feb. 21, 2013), http://prospect.org/article/standard-poors-poor-standards.

206 *See, e.g.*, Al Franken, *Wall Street Rating Agencies' Corrupt System*, CNN (Aug. 19, 2011), http://articles.cnn.com/2011-08-19/opinion/franken.rating.reform_1_jeffrey-manns-credit-rating-rating-agencies?_s=PM:OPINION.

207 *See* Damian Paletta & Matt Phillips, *S&P Strips U.S. of Top Credit Rating*, WALL ST. J. (Aug. 6, 2011), http://online.wsj.com/article/SB10001424053111903366504576490841235575386.html.

208 *See, e.g.*, Damian Paletta, *Rating Agencies Inch Closer to Historic Downgrade of U.S. Debt*, WALL ST. J. (July 14, 2011, 9:02 PM), http://blogs.wsj.com/washwire/2011/07/14/rating-agencies-inch-closer-to-historic-downgrade-of-u-s-debt/.

209 *See* Jeffrey Manns, *The Revenge of the Rating Agencies*, N.Y. TIMES, Aug. 10, 2011, at A23.

210 The SEC was so overstretched that it initially struggled to find the funds just to create the Office of Credit Ratings with a staff of twenty. *See* Ben Protess, *S.E.C. Removes Credit Ratings from Regulations*, N.Y. TIMES DEALBOOK (July 26, 2011, 12:28 PM), http://dealbook.nytimes.com/2011/07/26/s-e-c-removes-credit-ratings-from-regulations/.

The SEC may be reluctant to enact dramatic changes for the rating agency industry since so many other parts of the Dodd-Frank Act are works in progress.[211] At a time of continued economic uncertainty, there may be a lack of political will to follow through on an overhaul of the rating agency industry. For these reasons the SEC may find more modest changes sufficient to enhance the quality of credit ratings.

If the SEC does implement an alternative system for selecting rating agencies, however, the rating agency industry could face a sea change. The devil is in the details though in considering the extent to which alternative proposals would facilitate competition by smaller rating agencies and new entrants. The related concern is whether and to what degree alternative selection approaches would foster rating agency accuracy. Selecting rating agencies based on performance is enticing rhetoric, but the challenge is determining whether performance standards may perversely distort ratings or accentuate herding effects.

A. *The Potential Models for Replacing the Issuer-Pays System*

Because the biggest question facing rating agency reform is how to replace the issuer-pays system, it is important to understand the strengths and weaknesses of each of the major proposals. The GAO identified a range of potential alternatives to the issuer-pays system which fall into three camps: (1) rating agencies independently choosing which issues to rate with a variety of funding mechanisms; (2) a mandate for ratings from new government- or investor-owned rating agencies; and (3) government intermediation in selecting rating agencies.[212] While the proposals vary in terms of whether issuers or investors would pay for ratings, a common theme is that the conflict of interest problem arises from the influence that debt issuers may exercise by selecting rating agencies, not necessarily from the fact that debt issuers pay for ratings.[213] Ratings could plausibly either be financed by a user fee imposed on debt issuers or a transaction fee from the sales of bonds paid by debt purchasers.[214]

The independent rating agency approach would empower rating agencies to choose which debt issues to rate and comprise an alternative to issuer funding (to mitigate issuers' influence derived from foot-

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211 *See, e.g.*, *id.*

212 *See* GAO-12-240, *supra* note 199, at 8–14.

213 *See, e.g.*, *id.* at 14.

214 *See id.* at 12.

ing the bills). Under a stand-alone model for funding, a transaction fee for initial issuance and secondary trading would fund rating agencies and would be distributed by a third-party intermediary.[215] Alternatively, under a designation model, securities holders or users could direct ratings fees to the rating agencies they deem most accurate.[216]

The problem with both a stand-alone and designation funding approach is that no clear method exists for increasing incentives for rating agency accuracy. Both approaches would free rating agencies from ties to issuers, but they would only succeed to the extent that rating agencies focus on building their reputations for accuracy and integrity—the traditional constraint that failed in the run-up to the crisis.[217] Having end users choose which rating agencies to fund creates the potential for private accountability. But in practice, it appears unlikely that most investors would have the information, ability, or incentives to take on this role. The problem of risk dispersion looms large because if every end user has to chip in a small amount, then there may not be any financial incentive to invest greater resources in monitoring rating agencies and directing funds to the perceived best performers.[218] Ironically, uncertainties about compensation may drive smaller rating agencies out of the market and entrench the leading rating agencies.

The government- or investor-owned rating agency camp calls for a mandate for ratings from a new form of rating agency to offer competition to the existing rating agencies.[219] Their shared premise is that the leading rating agencies are so entrenched that the only way to foster viable competition is to create it out of whole cloth.[220] In the

215 *See id.* at 10.

216 *See id.* at 10–11. The implicit basis for this approach would be a revival of subscription-based ratings. *See* Hill, *supra* note 20, at 50–52 (discussing the development of, and shift away from, subscription-based ratings).

217 *See* Peter B. Oh, *Gatekeeping*, 29 J. CORP. L. 735, 752 (2004) (arguing that "in the long-run, reputational intermediaries will commit fraud if the risk is acceptable either for the firm or its agents"); Lawrence J. White, *Markets: The Credit Rating Agencies*, 24 J. ECON. PERSP. 211, 220–21 (2010) (discussing how reputational concerns failed to constrain overly optimistic ratings in the lead-up to the financial crisis).

218 *See* Steven L. Schwarcz, Keynote Address, *Understanding the Subprime Financial Crisis*, 18 J. BANKR. L. & PRAC. 5, 10–11 (2009) (discussing how a high degree of risk dispersion can create a collective action problem as no party may have sufficient risk exposure to incentivize them to engage in due diligence or risk monitoring).

219 *See* Joseph A. Grundfest & Evgeniya E. Hochenberg, *Investor Owned and Controlled Rating Agencies: A Summary Introduction* 5–6 (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper Series, No. 66, Stanford Law Sch. Law & Econ. Olin, Working Paper Series No. 391, 2009), *available at* http://www.ssrn.com/abstract=1494527.

220 *See id.* at 4–6.

wake of sovereign debt downgrades, European Union politicians explored the possibility of creating a government-funded rating agency to offer a rival to the American-based rating agencies.[221] A government-owned rating agency would be independent from issuers,[222] but the "solution" would simply replace one conflict of interest with another. Markets would likely not trust ratings issued by a government-linked entity for fear that it would inflate the ratings of companies who enjoy the government's favor.[223]

In contrast, the advocates of an investor-owned rating agency argue that a mandate for a rating from an investor-owned rating agency would induce investors to create rating agencies with independence from issuers.[224] The challenge facing this approach is that institutional investors are the most likely candidates to form a rating agency.[225] But they are also the least likely to want to share informational advantages with the market, because leveraging these advantages is literally how they make money.[226] Investor-owned rating agencies would also bring their own biases which would open up temptations to inflate ratings of assets that the investors own or to downplay ratings in areas of potential future acquisitions.[227] For these reasons, it may make more sense to produce incentives for greater competition among existing rating agencies or to encourage new entrants who do not simply bring new types of conflicts of interest to the table.

The various government intermediation proposals share a common core with the Franken Amendment in calling for an independent commission or board to select rating agencies. The key question for these approaches is what mechanism a government body should use to select rating agencies and how effectively these approaches would enhance rating agency accuracy and timeliness. Four alternative selection mechanisms have been proposed: an independent commission

221 *See Dearth of Investors: Plan to Set Up European Rating Agency Under Threat*, SPIEGEL ONLINE (Apr. 16, 2012, 5:42 PM), http://www.spiegel.de/international/europe/plan-to-set-up-european-rating-agency-is-failing-according-to-newspaper-a-827876.html [hereinafter *Dearth of Investors*]. Fitch is technically based in both New York and London, but its roots are in the United States. *See About Us*, FITCH RATINGS, http://www.fitchratings.com/web/en/dynamic/about-us/about-us.jsp (last visited Sept. 14, 2012).

222 *See Dearth of Investors*, *supra* note 221.

223 *See* Grundfest & Hochenberg, *supra* note 219, at 6, 8.

224 *See id.* at 5–6.

225 *See id.* at 6, 8.

226 *See* Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 314–17 (2002) (discussing the informational advantages that investors may legally enjoy).

227 *See, e.g.*, Coffee, *supra* note 5, at 258–59 (arguing that, in many cases, institutional investors prefer inflated ratings).

could select rating agencies randomly, employ a rotating assignment of rating agencies, base rating agency assignment on past performance, or oversee a bidding system for the right to rate.[228]

While a random assignment or rotation approach would eliminate the problem of issuers selecting rating agencies, neither approach would do anything to create incentives for rating agency accuracy. In the name of fostering the growth of smaller rating agencies, it could potentially create an entitlement system for private rating agencies who would receive assignments and funding solely due to their NRSRO status. These two approaches would undermine competition and potentially erode incentives for timely and accurate ratings. For this reason, random assignment or a rotation approach could serve at best as temporary, makeshift steps toward creating a more permanent selection process that facilitates competition.

The two main alternatives are to design a system in which rating agencies compete and are compensated based on their performance or to create a bidding process in which past performance is one of a set of factors weighed in determining which rating agencies are chosen for future debt issuances. The challenge of both of these approaches is that no clear consensus exists on what performance-based standards to use to assess rating agencies.[229] Proposals have suggested creating peer comparison models to examine whether rating agencies' percentage of predicted default of debt instruments deviated from that of their peers and whether annual yields of identically rated debt securities from different asset classes varied in a significant way.[230] The dilemma of either of these performance-based metrics is that they may accentuate herding effects. Rating agencies would have greater incentives to engage in conscious parallelism to avoid liability, which could undercut the objectives of greater accuracy and accountability. Herding effects are already an issue in an oligopolistic industry,[231] and the

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228 *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939F, 124 Stat. 1376, 1889–90 (2010) (calling for an independent body to select and compensate rating agencies for determining the ratings of structured finance products); Coffee, *supra* note 5, at 233–36, 257–58 (analyzing the merits of potential alternatives for replacements to the issuer-pays system); Manns, *supra* note 5, at 1017–18, 1066–69 (calling for a user fee on investors to finance the creation of an independent board to select and compensate rating agencies based on a competitive bidding process).

229 *See* Coffee, *supra* note 5, at 258 (arguing that "[a] reliable track record for accuracy might take a decade or more to develop").

230 *See* Onnig H. Dombalagian, *Regulating Informational Intermediation*, 1 AM. U. BUS. L. REV. 59, 78–79, 89 (2012).

231 *See, e.g.*, Thomas A. Piraino, Jr., *Regulating Oligopoly Conduct Under the Antitrust Laws*, 89 MINN. L. REV. 9, 10–11 (2004) (discussing the pervasiveness of conscious parallelism in

solution could exacerbate the problem. An additional concern is that the benchmark would swiftly become the centerpiece of rating agencies' methodologies, regardless of whether the standards incentivize accuracy and timeliness.

Another concern in pegging selection to past performance is that the standard caveat of every investment advertisement may apply[232]—past performance may not be indicative of future results. For example, the historical performance of rating agencies may have looked reasonably good up until the financial crisis. In fact, arguably, inflated ratings for mortgage-backed securities matched the inflated expectations about the housing market as a broad range of actors were caught up in unrealistic expectations.[233] A performance standard may not capture red flags until it is too late, and rating agencies will have failed once again to highlight growing credit risks.

A related issue is the impact of standardization of ratings, which is a likely corollary to efforts to create performance-based benchmarks. In theory, standardizing ratings will help facilitate comparability and creating performance-based tests will foster accountability.[234] But the danger exists that these approaches may undercut rating agencies' incentives to create their own distinctive tests of risk. Ratings may potentially add more value when rating agencies are applying different tests of risk. The evolution of multiple alternative standards may lead to identification of some emerging risks that a single-performance standard would miss. Market-based incentives are also needed for rating agencies to innovate. If a single lesson emerged from the financial crisis, it is the government's inability to anticipate the impact of financial innovation,[235] and the combination of standardization of ratings and performance-based evaluations could have perverse effects.

The SEC may also lack the wherewithal to implement meaningful change. The SEC's capitulation on expert liability for rating agencies was a telling lesson.[236] Regulators quickly came to the conclusion that the danger of disruption to credit markets was too great to hold the line on demanding the inclusion of ratings in asset-backed security re-

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oligopolistic industries because the small number of players facilitates coordination without express communication).

232 *See, e.g.*, WISDOMTREE, http://www.wisdomtree.com/ (last visited Oct. 21, 2012).

233 *See* WALL STREET AND THE FINANCIAL CRISIS, *supra* note 5, at 6.

234 *See, e.g.*, Bai, *supra* note 5, at 47, 97–98 (arguing for the need for standardization of rating agency performance statistics to facilitate comparability).

235 *See, e.g.*, WALL STREET AND THE FINANCIAL CRISIS, *supra* note 5, at 17.

236 *See* Morgenson, *supra* note 126, at BU1.

gistration statements with its attendant expert liability exposure.[237] If the SEC suspended this more modest reform, then it appears much more unlikely that the SEC will embrace comprehensive reform of the issuer-pays system.

B. *The Accountability Challenge*

These concerns about the fate of the Franken Amendment highlight an important fact: the Dodd-Frank Act leaves unresolved the difficult question of how to define the benchmark for assessing rating agency performance. One of the remarkable features of the rating agency industry is that markets have historically valued ratings even though no clear benchmark for accuracy exists.[238] The past reputation of rating agencies alone legitimized the role of ratings as a proxy for creditworthiness in the eyes of the market.[239] In turn, well-established reputations were sufficient for rating agencies to serve as NRSROs.[240] The legitimacy logic was circular as a rating agency needed a well-established track record to achieve NRSRO status, which meant new entrants could not viably compete. While 2006 legislation eased access for new entrants,[241] the fact that market participants and regulators did not fully comprehend the nature and limits of ratings exacerbated the moral hazard. The absence of any standard for accountability also created a recipe for abuse by issuers and rating agencies, as it made it easier to bend the rules during market frenzies.[242]

The Dodd-Frank Act recognizes that rating agencies' inconsistent applications of their own standards is a clear red flag that requires regulators' attention, and it tasks the Office of Credit Ratings with overseeing this mandate.[243] Identifying rating agencies' inconsistent application of their methodologies represents a step of progress in

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237 *See id.*

238 *Examining the Role of Credit Rating Agencies in the Capital Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 69 (2005) (statement of Stephen Joynt, President and CEO, Fitch Ratings) [hereinafter *Examining the Role of Credit Rating Agencies*].

239 *See* White, *supra* note 217, at 215 (arguing that rating agencies' reputational concerns historically mitigated the impact of conflicts of interest).

240 *See* SEC Concept Release, *supra* note 18, at 35,260.

241 *See supra* notes 82–84 and accompanying text.

242 *Cf. Credit Rating Agencies and the Next Financial Crisis: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 111th Cong. 63 (2009) (statement of Ilya Kolchinsky, Former Managing Director, Moody's Investors Service) (noting that, because most "standards come from the rating agency itself," rating agencies are "judge, jury, and executioner of their own standards").

243 *See About the Office of Credit Ratings*, *supra* note 157.

making it more difficult for rating agencies to weigh the rating scale in favor of issuers. But this approach alone only addresses one dimension of potential conflicts of interest. Rating agencies may be completely consistent in applying their methodologies and produce consistently inaccurate and untimely ratings that mislead investors. But designing a benchmark for rating agency performance may prove very difficult, as no consensus has developed on how to gauge rating agency performance.[244] Any proposed benchmark may perversely accentuate herding effects among rating agencies. They may cluster ratings around the benchmark, regardless of whether striving to meet the standard fosters greater accuracy.

Part of the problem is that there is a degree to which ratings are intentionally ambiguous. Rating agencies provide gauges of the long-term, structural creditworthiness of issuers, rather than a moment-by-moment picture of market reactions to risk.[245] Ratings are designed to reflect a balanced tradeoff between accuracy and stability that incorporate quantitative and qualitative analysis.[246] They offer proximate measures of risk designed to indicate buckets of relative risk.[247] It is possible to find that a rating agency is inconsistent when it offers similar ratings to financial products that end up having very different results. But even in that case hindsight bias may lead to the conclusion that rating agencies erred, when in fact plausible quantitative and qualitative grounds could have existed for granting similar ratings to debt that ultimately has different outcomes. It may be difficult to grade ratings based off of snapshots in time, because ratings cover broad-based categories of risk and rest in part on necessarily speculative long-term assessments of financial wherewithal.[248]

The intentional ambiguity of ratings provides a liability shield for rating agencies and plays into their argument that they are offering opinions that should merit First Amendment protection.[249] Practically speaking, perhaps only in cases of gross negligence or fraud is the shroud of ambiguity so thin that it can be readily dismissed.

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244 *See supra* note 242.

245 *See* MOODY'S INVESTORS SERV., *supra* note 58, at 15.

246 *See* STANDARD & POOR'S, GUIDE TO CREDIT RATING ESSENTIALS 11–12 (2011), http://img.en25.com/Web/StandardandPoors/SP_CreditRatingsGuide.pdf.

247 *See id.* at 3.

248 *See id.* at 12 (noting that "[t]he length and effects of business cycles can vary greatly . . . making their impact on credit quality difficult to predict with precision").

249 *See* Kettering, *supra* note 81, at 1689–91 (discussing the First Amendment protection that ratings have traditionally enjoyed).

Even if policymakers decided on a set of standards for assessing rating agency accuracy, rating agencies would have perverse incentives to converge their ratings on whatever standard is set, especially if the standard was tied to compensation or their eligibility for future ratings. Any benchmark for rating agency accuracy will be only as effective as the underlying criteria. Because no clear criteria for rating agency efficacy exist, any standard is likely to be incomplete and suffer from under- or over-inclusiveness. Even to the extent that a commission could devise effective benchmarks for accuracy at a given time, the standards might lag behind emerging risks since regulators may not recognize market changes until it is too late. Rating agencies would have incentives to embrace these outdated performance standards as the definitive verdict of accuracy regardless of whether the criteria are directly correlated with rating accuracy.

Standards for assessing rating agency performance would ironically accentuate already strong herding effects among rating agencies, which is one of the basic problems plaguing the industry.[250] Commentators have documented that the leading rating agencies often mimic each other's ratings, especially in terms of rating downgrades.[251] A standard for benchmarking rating agency accuracy may give rating agencies even greater incentives to walk in lockstep with one another. This approach would be logical for rating agencies, because they would benefit from operating in tandem, as each individual rating agency would be shielded from criticism for industry-wide mistakes. Rating agencies would not have incentives to stick their necks out and make ratings that stand out from the rest of the industry. The downside risk of wrongly deviating from the herd would likely outweigh the potential benefits from being right.

Assessing the timeliness of rating changes is even more difficult. Rating agencies have repeatedly received heaps of scorn for downgrading ratings too slowly.[252] Perhaps the most egregious case is Enron, which each of the major credit rating agencies rated as investment grade until four days before its collapse.[253] But policymakers may open up a Pandora's box of self-fulfilling downgrades to the extent that rating agencies are assessed on or their compensation tied

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250 *See* Coffee, *supra* note 5, at 259.

251 *See* Güttler, *supra* note 31, at 1–3, 12–15 (documenting herding effects among the two leading rating agencies for upgrades but not downgrades).

252 *See, e.g.*, Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping?*, N.Y. TIMES, Dec. 7, 2008, at A1.

253 *See* STAFF TO THE S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC & PRIVATE-SECTOR WATCHDOGS 73, 115 (Comm. Print 2002).

to the timeliness of ratings. Rating agencies may have incentives to issue steep downgrades at earlier times, potentially fueling panics that help to foster the outcomes rating agencies predict.

A related concern is that if rating agencies are judged by how quickly they pull the trigger to assess the impact of changes in risk, such criteria may destabilize markets by incentivizing rapid upgrades or downgrades of securities. Rapid changes may result in increased trading volatility and magnify the impact of false positive or negative ratings. Alternatively, if changes become too frequent markets may paradoxically begin to block out ratings changes due to information overload and therefore be less sensitive to emerging risks.[254] For these reasons policymakers need to grapple carefully with the dangers of unintended consequences from designing benchmarks for rating agency performance.

Given these significant concerns, it may be prudent for policymakers to recognize that performance standards are at best years away and that benchmarks may create as many problems as they "solve." Regulators should consider potential strategies for enhancing competition and private policing of rating agency conduct, rather than focusing on pinning down benchmarks for rating agency accuracy. Fostering greater competition is critical to unraveling two key interconnected problems: the entrenchment of a rating agency oligopoly and herding effects that stifle rating agency accuracy. In addition, expanding the scope of private causes of action will enlist investors in a complementary role to public enforcement efforts to hold rating agencies accountable.

C. *The Potential and Limits of Competition*

Efforts to foster competition need to address two related issues: the role of oligopolistic industry dominance in stifling competition and the impact of herding effects in reducing rating agency accuracy.[255] Oligopolies present a double curse in both thwarting competition and

254 *See* Richard Craswell, *Interpreting Deceptive Advertising*, 65 B.U. L. REV. 657, 689–90 (1985) (discussing how information overload effect can result in blocking out all information, potentially fostering poor decisionmaking).

255 A broad consensus exists that broadening competition in the rating agency industry is a significant policy objective. *See, e.g.*, Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 422 (2004) (observing that "regulators should devise strategies to encourage more market competition"); Hill, *supra* note 20, at 45 (arguing that rating agency "[r]egulatory reform should do what it can to encourage a less concentrated market structure").

facilitating herding by making it easier for each leading firm to observe and mimic the others' approaches.[256]

As discussed earlier, the challenge is that three leading rating agencies dominate the industry, and significant barriers to entry make it difficult for new or smaller entrants to pose plausible alternatives.[257] The traditional standard for SEC recognition of a rating agency as an NRSRO was having an established track record of rating debt,[258] which created a chicken-and-egg problem. Only the dominant, established players—Moody's, Standard & Poor's, and Fitch—had the experience and reputation to secure significant business.[259] Every other potential competitor was so small as to be virtually insignificant. New entrants could not gain enough market share to secure recognition by the SEC or, more importantly, to gain legitimacy in the market.[260]

The 2006 reforms opened the door a bit wider by creating the *appearance* of greater competition, but did not create the substance.[261] Eased requirements for recognition as an NRSRO led to a modest increase in the number of rating agencies, but it did little to nothing to level the playing field for new entrants.[262] Even if the law did not require substantial experience for recognition as an NRSRO, the market demanded experience that small and new rating agencies simply did not have.[263]

In 2009 the SEC went a step further in seeking to level the playing field for new entrants by creating an "equal access" requirement under Rule 17g-5.[264] Under this equal access rule, rating agencies must reveal any information acquired from issuers of structured fi-

256 *See, e.g.*, Jonathan Macey, *The Demise of the Reputational Model in Capital Markets: The Problem of the "Last Period Parasites,"* 60 SYRACUSE L. REV. 427, 434 (2010) (discussing how market concentration in securities markets leads "over time . . . [to an] undeniable diminution in the quality of the services").

257 *See supra* notes 37–45 and accompanying text.

258 *See supra* notes 36–38 and accompanying text.

259 *See supra* notes 36–38 and accompanying text.

260 *See, e.g.*, Bai, *supra* note 5, at 91.

261 *See supra* notes 39–42 and accompanying text.

262 *See supra* notes 39–42 and accompanying text.

263 *See* Bethany McLean, *Moody's Junkies*, SLATE (Aug. 2, 2011, 11:07 AM), http://www.slate.com/articles/business/moneybox/2011/08/moodys_junkies.html ("After the crisis, in 2010, Jules Kroll . . . formed Kroll Bond Ratings in order to provide investors with an alternative. But Kroll noted in his [congressional] testimony that investors often *require* before they'll buy a security that it have not just a rating, but a rating from Moody's, Standard & Poor's, and/or Fitch.").

264 *See* 17 C.F.R. §§ 240.17g-5(a)(3), (b)(9) (2010).

nance products to other NRSROs.[265] This rule sought to prevent the leading rating agencies from leveraging their power to cut smaller players off from the information flows they need to develop and enhance their competing rating models.[266] While this reform was a positive step in aiding smaller competitors, leveling the playing field of information flows has not proven sufficient to erode the leading rating agencies' market positions.[267] This fact raises the question of whether heightened competition is even possible without more invasive action to open up opportunities for smaller firms and to reduce the market share of the leading firms.

As noted earlier, the Franken Amendment's ultimate goal is to expand opportunities for competition by abolishing the issuer-pays system.[268] The challenge is the degree to which a performance-based selection process will heighten competition or, alternatively, foster herding effects. The herding effect problem is intertwined with the challenge of increasing competition in an oligopolistic industry. Market concentration arguably facilitates herding effects, both in inflated initial ratings and market downgrades. Just as gas stations across the street from each other can easily see one another's prices and raise or lower their own prices accordingly in fully legal conscious parallelism, the leading rating agencies can easily mimic each other's ratings to minimize the risk of being singled out as overly aggressive or passive in initial ratings, downgrades, or upgrades.[269]

Proponents of greater competition generally believe that the presence of more participants will break down this herd mentality. New entrants would have incentives to distinguish themselves based on the timeliness and accuracy of their ratings.[270] The problem is that greater competition alone may not necessarily diminish herding incentives. As discussed previously, if benchmarks for rating accuracy are used either to evaluate rating agencies or to select and compensate

265 *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 63,832, 63,834 (Dec. 4, 2009).

266 *See* Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 Fed. Reg. 28,265, 28,275–76 (May 16, 2011).

267 *See* Mahesh Kotecha, Roy Weinberger & Sharon Ryan, *The Future of Structured Finance Ratings*, 16 J. STRUCTURED FIN. 28, 28–30 (2011).

268 *See supra* notes 192–93 and accompanying text.

269 *See, e.g.*, Piraino, *supra* note 231, at 10–11, 38 (discussing the pervasiveness of conscious parallelism in oligopolistic industries because the small number of players facilitates coordination without express communication).

270 *See, e.g.*, *Examining the Role of Credit Rating Agencies in the Capital Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 6–8 (2005) (statement of Sean Egan, Managing Director, Egan-Jones Rating Company).

rating agencies, then herding effects may be magnified for all participants. The risk of being outside the herd may prove too much in that the downside of exposure as an outlier may be far higher than the upside of being a standout for accuracy. In other words the negative risk to the bread and butter of a rating agency's business may outweigh the benefits of taking risks in asserting independence from the herd. So the irony is strategies that regulators may use to increase competition may actually incentivize greater convergence and mimicry. For this reason, regulators need to consider carefully how to facilitate competition in a way that does not inadvertently thwart the objectives of rating agency reform.

The challenge facing rating agency reform is that it is far from clear both how to promote competition in an oligopolistic industry and whether competition in itself will produce incentives for greater ratings accuracy. Four approaches to increasing competition are worth considering. First, some commentators have argued that rating agencies may be the financial equivalent of natural monopolies (which could be more accurately framed as "natural oligopolies"). Therefore, the introduction of more than a handful of participants may create destructive competition and fuel rating inflation.[271] Second, others have put their faith in the abolition of the issuer-pays system and argued that a government board could provide a more level playing field in selecting rating agencies.[272] Third, other proponents advocate for a mandate for investor-owned rating agencies to create incentives for the creation of new forms of rating agencies or for the government to create its own rating agency.[273] This Article suggests a fourth approach: the breakup of the leading rating agencies in order to produce a critical mass of successors who share in the reputational legitimacy of their predecessors.

"Natural oligopoly" proponents argue that the financial crisis occurred due to too much competition. Their concern is that increased competition may allow issuers to play one rating agency off another to secure inflated ratings.[274] It may seem more than ironic to argue that

271 *See* Barnett, *supra* note 5, at 501–52 (arguing that greater competition among rating agencies may reduce the supra-competitive rents they receive and decrease the quality of ratings); Coffee, *supra* note 5, at 240–41.

272 *See supra* notes 192–200 and accompanying text.

273 *See supra* note 224 and accompanying text.

274 *See* Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?* 3–4, 10 (Harvard Bus. Sch., Working Paper No. 09-051, 2010), http://www.hbs.edu/research/pdf/09-051.pdf (arguing that the predictive accuracy of Moody's and Standard & Poor's ratings declined in the 1990s in ratings contexts in which Fitch's market share grew).

too much competition exists in a world of three leading rating agencies. But the advocates of this view argue that rating agency independence may only be possible when issuers are forced to deal with a limited number of rating agencies and cannot shop for this gatekeeping service.[275]

Issuers routinely secure two ratings,[276] and therefore if Standard & Poor's and Moody's had continued to serve exclusively as the gold standard, then issuers would have little choice but to accept ratings from these companies. Natural oligopoly proponents argue that Fitch's evolution starting in 2000 from the junior partner of the leading raters into a virtual equal drove ratings inflation.[277] Because issuers had a viable third rating agency to choose, they could and did engage in ratings shopping which led to a race to the bottom among rating agencies.[278] The opportunity for ratings shopping occurred at a time of increasing concentration of asset-backed securities markets, giving issuers even more leverage in demanding lax ratings in exchange for business.[279]

While it is true that the rise of Fitch's business is correlated with inflated ratings in asset-backed securities, it is far from clear that the problem stemmed from increased competition.[280] The financial crisis was not the first time that rating agencies erred on a large scale, as rating agency performance arguably has a cyclical nature.[281] The crisis

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275 *See* Vasiliki Skreta & Laura Veldkamp, *Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation*, 56 J. MONETARY ECON. 678, 686–88, 691 (2009) (arguing that the increasing complexity of structured finance products created opportunities for issuers to pit rating agencies against each other in shopping for the best ratings).

276 *See* Hill, *supra* note 20, at 59–60.

277 *See* Coffee, *supra* note 5, at 239–40 (noting how Fitch's growth occurred in part through mergers with smaller rating agencies Duff & Phelps in 2000 and Thomson Bankwatch in 2001).

278 *See* Becker & Milbourn, *supra* note 274, at 9 (finding that Standard & Poor's and Moody's bond ratings are slightly lower for bonds that have a Fitch rating, which is "consistent with firms seeking out Fitch when their ratings appear low relative to other measures of credit quality").

279 *See* Coffee, *supra* note 5, at 238–39 (pointing out that the top six issuers controlled over fifty percent of the mortgage-backed securities market in 2007 and the top dozen issuers accounted for over eighty percent of the market); Jie He, Jun Qian & Philip E. Strahan, *Credit Ratings and the Evolution of the Mortgage-Backed Securities Market*, 101 AM. ECON. REV. 131, 135 (2011) (documenting that large issuers' mortgage-backed securities from 2000 to 2009 performed significantly worse than equally rated comparable mortgage-backed securities from smaller issuers).

280 *See* Coffee, *supra* note 5, at 241 (observing that Fitch's rise as a third leading rating agency was correlated with an increase in investment grade ratings, yet conceding that "[b]y no means does this data truly prove that competition cannot work").

281 *See* Partnoy, *supra* note 5, at 4 (discussing credit rating agencies' role in the bond market crisis of 1994–1995 and in the collapse of Enron).

was notable for the degree of egregiousness in ratings inflation, not for the fact that ratings were lax, which has been a systematic problem. An equally consistent explanation of the events leading to the financial crisis is that rating agencies were caught up in the herding effects of the roaring 2000s, resulting in financial envelope pushing, if not fraud.[282] That in turn begs the question of how or whether greater competition could dampen the herding effects and lead to more accurate and timely ratings.

As discussed earlier, the creation of a government-controlled or investor-owned rating agency would produce immediate competition.[283] But a government-controlled rating agency would face a significant legitimacy problem due to perceptions that it would favor government-connected companies.[284] A mandate for investor-owned rating agencies to provide ratings would foster the emergence of new competitors.[285] But these rating agencies would also suffer a potential legitimacy problem due to concerns that institutional investors would bring their own biases to the table.[286]

D. *The Case for Breaking up the Leading Rating Agencies*

The government-board approach is the standing option for increasing competition, because it is the default for reforming the issuer-pays system laid out in the Franken Amendment.[287] The ultimate outlines of rating agency reform are still a work in progress as the SEC grapples with its mandate to determine whether an alternative selection method for ratings of asset-backed securities is feasible.[288] While the SEC may possibly use this opportunity to radically reform the rating agency industry, numerous questions about the contours and impact of an alternative selection approach may thwart the potential for reform.

It is possible that even if the SEC embraces the Franken Amendment in its entirety that the landscape of rating agencies will remain

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282 *See* Mehrsa Baradaran, *Reconsidering the Separation of Banking and Commerce*, 80 Geo. Wash. L. Rev. 385, 411 (2012) (discussing the role of herding effects in fueling the financial crisis).

283 *See supra* notes 219–26 and accompanying text.

284 *See supra* note 223 and accompanying text.

285 *See supra* notes 224–26 and accompanying text.

286 *See supra* note 223 and accompanying text.

287 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939F, 124 Stat. 1376, 1889-90 (2010).

288 *See, e.g.*, Jeannette Neumann, *Franken Credit-Rating Rule at Key Juncture*, Wall St. J. (July 20, 2012, 3:47 PM), http://online.wsj.com/article/SB10000872396390444873204577539230872194166.html.

surprisingly unchanged. In theory a selection process that opened up opportunities for smaller rating agencies to receive rating opportunities could help to level the playing field. Over time smaller rating agencies could distinguish themselves based on the accuracy and timeliness of their ratings. In the short term the selection process would implicitly be a subsidy program that provides smaller rating agencies with more work and, therefore, greater market share.

Unfortunately, an alternative selection approach may not work out as well as envisioned. If the regulators design a system with restrictions that are too onerous, the established rating agencies may opt out of the selection system or opt out of NRSRO status entirely. The leading rating agencies could continue to prosper by offering market-recognized ratings outside of any system the SEC constructs, because the leading agencies' imprimatur of legitimacy may continue to be essential for most debt issues. Smaller rating agencies may receive a windfall from their selection to rate asset-backed securities, but may not necessarily receive the reputational benefit that comes with rating a greater number of securities, at least not in the foreseeable future. The SEC may be left with a tremendous amount of investment in efforts to foster competition and little to show for it.

If such efforts to foster competition will likely fall far short of their goals, the SEC needs to consider other options. One alternative approach the SEC should consider is breaking up the leading rating agencies. This divestiture approach has a simple logic. Government requirements for ratings were integral to entrenching the leading rating agencies and creating an oligopoly.[289] Breaking up the leading rating agencies would undo what government statutes and rules helped to create.[290] Removing requirements for ratings was insufficient to enhance competition because the damage was already done due to decades of market expectations for ratings from the leading rating agencies.[291] While the Franken Amendment and other proposals are bold, even an independent selection process may not prove sufficient to legitimize smaller rating agencies and to make them viable competitors to the leading rating agencies.

289 *See supra* notes 36–38 and accompanying text.

290 *See* Abraham Bell & Gideon Parchomovsky, *Givings*, 111 YALE L.J. 547, 549–54 (2001) (making the case for givings—the mirror image of takings—in mandating compensation to the state for government action that confers discrete benefits on a small group of beneficiaries).

291 *See, e.g.*, FED. DEPOSIT INS. CO., *supra* note 93, at 3 (discussing how efforts to come up with alternatives for reliance on credit ratings is a work in progress because "[i]dentifying alternatives to credit ratings that are suitable for regulatory capital determinations is challenging and involves policy tradeoffs").

For this reason, to undo the damage of previous government requirements, policymakers should consider a divestiture approach. Breaking up the leading rating agencies would create smaller entities that would share in the reputational umbrella of their larger predecessors. In this way, policymakers could fast-track the creation of a competitive pool of smaller rating agencies that enjoy market credibility. This approach would also open up the possibility for smaller rating agencies to more plausibly compete, because a set of industry monoliths would not crowd out their competitors.[292]

The challenge is that while the existence of a rating agency oligopoly has anticompetitive effects, it is far from clear that antitrust law provides an existing basis to justify mandating divestitures among rating agencies. Antitrust regulators do not possess the authority to target anticompetitive oligopolies with the exception of cases in which oligopolists engage in price-fixing agreements or other forms of express collusion.[293] At best, antitrust regulators can only indirectly affect oligopolists by preventing acquisitions or mergers that will result in greater market concentration or conditioning merger approvals on divestitures.[294]

The difficulty with potential antitrust enforcement against rating agencies is that the leading rating agencies have no need for a meeting of the minds. Their market power is deeply entrenched, and express collusion is unnecessary because rating agencies can leverage the fact that most ratings are public information. Viewing the other leading agencies' publicly available disclosures about methodologies and ratings decisions provides all the information they need for their strategies to converge.

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292 The expanded market share in CMBS that Kroll and Morningstar accrued after Standard & Poor's high-profile mistake and temporary pull back from the CMBS market suggests how small rating agencies could benefit if the leading rating agencies cast smaller shadows. *See* Yoon & Neumann, *supra* note 42.

293 *See* John E. Lopatka & William H. Page, *Economic Authority and the Limits of Expertise in Antitrust Cases*, 90 CORNELL L. REV. 617, 673–75 (2005) (discussing how antitrust regulation cannot address conscious parallelism by oligopolies in the absence of express collusion); Donald F. Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655, 671 (1962) (observing that conscious parallelism without express coordination among the parties cannot trigger antitrust liability).

294 *See* Herbert Hovenkamp, *Post-Chicago Antitrust: A Review and Critique*, 2001 COLUM. BUS. L. REV. 257, 334–35 (discussing the conventional application of the Herfindahl-Hirschman market concentration index to review mergers in highly concentrated markets); U.S. DEP'T OF JUST., ANTITRUST DIV., ANTITRUST DIVISION POLICY GUIDE TO MERGER REMEDIES 6–12 (2011) (discussing the use of divestitures as "structural remedies" to "remedy the competitive harm that otherwise would result from the merger").

Broadening antitrust laws to regulate oligopolies is one potential solution to this problem, but one that is far beyond the scope of this Article. Instead, the distinctive nature of rating agencies may give regulators some unique tools to incentivize divestitures by the leading rating agencies. The SEC could leverage requirements that rating agencies register as NRSROs to incentivize divestitures by the leading rating companies.[295]

This objective could be achieved indirectly by creating separate certifications for rating categories of debt, such as government and corporate bonds, and barring raters from issuing evaluations for more than one asset category. Leading rating companies would then have a choice of vacating segments of the market or spinning off parts of their business into freestanding companies. For example, if raters of asset-backed securities had to be independent from rating agencies for other types of debt issues, then raters would have a single-minded focus on determining the risks of this asset class that played such a prominent role in triggering the financial crisis.[296] This approach would remove the potential for rating agencies to give deferential ratings to asset-backed securities in exchange for kickbacks of retaining or securing other aspects of an issuers' business.

A requirement that independent, non-affiliated rating agencies rate only one category of debt could be phased in over a period of years to give rating agencies sufficient time to divest. A phase-in period would also give smaller rating agencies or new entrants time to focus on a particular ratings sector. This approach would create incentives for leading rating agencies to break up their business into multiple entities to maximize shareholder value. Standard & Poor's parent company, McGraw Hill, has already spun off its education division from Standard & Poor's.[297] This fact suggests that Standard & Poor's itself could be plausibly broken into separate entities to focus on different sectors of the ratings' market. Fitch grew in part through a series of acquisitions of smaller rating agencies during the 2000s.[298] Although antitrust regulators did not proactively identify threats from greater market concentration,[299] this special designation of asset-backed securities NRSROs would create incentives to undo some of

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295 *See* Manns, *supra* note 186.

296 *See supra* note 3 and accompanying text.

297 *See* Azam Ahmed & Michael J. de la Merced, *To Lift Stock, McGraw-Hill Will Split in Two*, N.Y. TIMES DEALBOOK (Sept. 12, 2011, 6:50 AM), http://dealbook.nytimes.com/2011/09/12/mcgraw-hill-to-break-into-two/.

298 *See supra* note 277 and accompanying text.

299 *See* Thomas J. Fitzpatrick, IV & Chris Sagers, *Faith-Based Financial Regulation: A Pri-*

the damage caused by authorizing Fitch's growth through acquisitions.[300]

This approach is feasible in part because of the scale of the structured finance industry. Although asset-backed securities have not risen back to the heights of the market boom, they have long served as one of the most lucrative and largest niches of rating agencies' portfolios.[301] A potential critique of this approach would be that it could create separate oligopolies between structured finance rating agencies and nonstructured finance rating agencies or alternatively between corporate debt and government debt raters. But the smaller scale would give competitors greater ability to focus on sectors of debt in which they could build experience and legitimacy and more plausibly compete over time.[302] If the number of viable competitors multiplied, the SEC could consider transitioning back toward a system in which NRSROs were allowed to compete for all types of ratings.[303]

Another strategy for decreasing market concentration would be to leverage the Franken Amendment's proposal for an alternative means to select rating agencies for structured finance products. If the SEC embraces some version of an independent selection process, it could condition rating agencies' eligibility for the program on only rating asset-backed securities. This approach would have similar results as attempting to tie divestments by the leading rating agencies to NRSRO certification.

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mer on Oversight of Credit Rating Organizations, 61 ADMIN. L. REV. 557, 602 (2009) (discussing antitrust regulators' deference to Fitch's acquisitions of other rating organizations).

300 *See supra* notes 277–78 and accompanying text.

301 *See* Joshua Coval, Jakub Jurek & Erik Stafford, *The Economics of Structured Finance*, 23 J. ECON. PERSP. 3, 4–5 (2009) (discussing the high degree of profitability rating agencies have enjoyed from rating structured finance products).

302 *See* Gretchen Morgenson, *Wanted: Credit Ratings. Objective Ones, Please.*, N.Y. TIMES, Feb. 6, 2005, at BU1 (discussing how Egan-Jones adopted a strategy of targeting particular market sectors and building its business through subscription sales prior to its recognition as an NRSRO rating agency); *see also* Julie Creswell & Vikas Bajaj, *Bond Raters in Effort to Repair Credibility*, N.Y. TIMES (Feb. 8, 2008), http://www.nytimes.com/2008/02/08/business/08ratings.html.

303 This approach could leverage the Herfindahl-Hirschman Index ("HHI") of market concentration (a widely used tool in the antitrust merger context) to determine when sufficient competition has arisen to justify reverting back to a system in which NRSROs could register to cover all debt issues. While the HHI focuses on the relative impact of mergers on market concentration, its baseline for "highly concentrated" markets could serve as a proxy to assess both the degree to which rating agency market segmentation succeeds in decreasing market concentration and when to consider reopening competition across all sectors. *See* U.S. DEP'T OF JUST. & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 18–19 (2010); Statement Accompanying Release of Revised Merger Guidelines, 49 Fed. Reg. 26,823, 26,830–31 (June 29, 1984).

Alternatively, a rating agency selection commission could stack the deck in favor of divestment by making market share one of the considerations for allocating ratings business and systematically favoring smaller rating agencies. This approach may implicitly create incentives for the leading rating agencies to divest this part of the business, in order to remain competitive. The government routinely gives preferences to small businesses in government contracting.[304] Therefore, there would be clear precedent for offsetting the advantages larger firms enjoy and incentivizing divestments. At a minimum this approach would open up greater opportunities for smaller rating agencies to prove themselves as viable competitors.

The downside of this strategy is that the leading rating agencies may choose to opt out of NRSRO status or decline to participate in the alternative selection process for asset-backed securities. The leading rating agencies may feel confident that the market will continue to demand their services because of their longstanding reputations and that any threat to their market share is distant at best. Additionally, the fact that the Dodd-Frank Act stripped so many requirements for ratings from government statutes and regulations means that NRSRO status is less valuable than it was before.[305] In other words, stripping away requirements for ratings ironically took away some of the leverage that the SEC has to tie restrictions to NRSRO status. For now NRSRO status is voluntary.[306] But if leading rating agencies seek to opt out of this status, policymakers should consider making it obligatory for issuing ratings to give regulators greater leverage to regulate the industry and foster competition.

E. Expanding Oversight by Investors

1. Acknowledging the Conflicts of Interest Among Stakeholders

Enhancing rating agency competition should be the priority of policymakers. But a related concern is the shortcoming of existing tools to hold rating agencies accountable. The danger is that policymakers will rely too much on public oversight and place excessive faith in regulators. Instead, policymakers should consider creating a

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304 *See, e.g.*, Andrew George Sakallaris, *Questioning the Sacred Cow: Reexamining the Justifications for Small Business Set Asides*, 36 PUB. CONT. L.J. 685, 685–86 (2007) (discussing the merits of "small business set asides" in government contracting).

305 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939, 124 Stat. 1376, 1885–87 (2010).

306 Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564, 33,568 (June 18, 2007) (to be codified at 17 C.F.R. pts. 240, 249b).

broader role for oversight and enforcement by investors as a complement to government monitoring of rating agencies. Expanding the role for investor enforcement is especially important, because the suspension of rating agencies' expert liability exposure took away much of the scope of private enforcement.[307]

The case for expanding private oversight depends on how much stakeholders want reform to succeed fully. Having accurate and timely ratings is the professed objective for reforms, and all stakeholders, including rating agencies themselves, publicly affirm that goal.[308] But a clear tension exists between this objective and the conflicting interests and priorities of regulators, issuers, and investors.[309] The unspoken truth about rating agency reform is that it is unclear the degree to which any party wants to move toward a world of accurate and timely ratings.

The intrinsic conflict of interest that arises when issuers choose their rating agency gatekeeper has received most of the attention from commentators.[310] Issuers understandably want inflated ratings and slow downgrades because these affect their bottom line.[311] But if ratings are too inflated, it will threaten the credibility of both issuers and rating agencies. For example, issuers were stung by the fallout from the financial crisis as the excesses of inflated ratings temporarily dried up demand for asset-backed securities.[312] The saying "pigs get fat, hogs get slaughtered" applies. Although issuers have every interest in staying fat with inflated ratings and delayed downgrades, self-preservation demands that issuers will likely want to avoid a repetition of the most egregious excesses of ratings during the run-up to the crisis.

This same logic applies to rating agencies as well. Rating agencies proactively addressed some of the worst excesses that led to the subprime mortgage crisis.[313] By engaging in a degree of self-regulation and restraint, rating agencies hope to avoid more invasive regula-

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307 *See* Morgenson, *supra* note 126, at BU1.

308 *See, e.g.*, *Examining the Role of Credit Rating Agencies*, *supra* note 238, at 69 (arguing that excessive regulation interferes with the ability of rating agencies to produce "objective and timely ratings").

309 *See, e.g.*, *supra* notes 224–27 and accompanying text.

310 *See, e.g.*, Coffee, *supra* note 5, at 232, 234 (discussing the inherent conflicts of interest of the issuer-pays system).

311 *See, e.g.*, *supra* notes 224–27 and accompanying text.

312 *See, e.g.*, Adam Ashcraft, Allan Malz & Zoltan Pozsar, *The Federal Reserve's Term Asset-Backed Securities Loan Facility*, FRBNY Economic Policy Review (forthcoming), at 1, http://www.newyorkfed.org/research/epr/forthcoming/1207ashc.pdf.

313 *See, e.g.*, Floyd Norris, *Moody's Official Concedes Failures in Some Ratings*, N.Y. Times, Jan. 26, 2008, at C3.

tion and to dampen any reputational fallout from the crisis.[314] That is progress, but progress akin to monopolists engaging in limit pricing, which occurs when a monopolist charges less than the monopoly price as a way to forestall regulatory pressure or new entrants by diverting attention away from its monopoly power.[315] Similarly, in the wake of the financial crisis rating agencies have incentives to scrutinize new offerings more closely and to downgrade more proactively. But these self-preservation steps do not change the leading rating agencies' underlying incentives to largely maintain the status quo in which ratings are deferential to issuers and slow to change.

The federal government may also lack the incentive to sustain a system of accurate and timely ratings, which casts doubt on relying primarily on a regulated industry approach. The concern is that, if rating agencies were truly timely and accurate, they may expose how deep a hole the federal government and broader economy is in. The controversy about the downgrade of the credit rating of the United States underscores the paradox the government faces. Standard & Poor's took the lead in taking reformers at their word that they wanted timely downgrades by issuing a downgrade of the United States itself, and each of the other rating agencies signaled that the United States was under scrutiny.[316] This downgrade in itself was more of a reputational shock than a financial one, but it signaled the ability of the rating agencies to push back.[317] The federal government's debt financing challenges will only loom larger in the future,[318] which may dampen the political impetus for rating agency accountability.

SEC regulators also indirectly experience the political headwinds against timely and accurate ratings. Regulators may want to appear to heighten rating agency accountability, but also fear the self-fulfilling prophecy potential for lower ratings to lead to ratings downgrades.

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314 *See generally* Gary Shorter & Michael V. Seitzinger, Cong. Research Serv., R40613, Credit Rating Agencies and Their Regulation 11 (2009) (documenting changes that the leading rating agencies imposed on themselves, including enhancements to the review of issuers' due diligence processes, greater disclosures, analyst rotations, and use of an ombudsman to review conflicts of interest).

315 *See* Aaron S. Edlin, Essay, *Stopping Above-Cost Predatory Pricing*, 111 Yale L.J. 941, 944, 975–76 (2002) (discussing limit pricing strategies).

316 *See* Manns, *supra* note 209, at A23.

317 *See* Binyamin Appelbaum, *Lowering Nation's Credit Rating May Have Little Effect, Economists Suggest*, N.Y. Times, July 30, 2011, at A14.

318 *See, e.g.*, Scott Hamilton & Sara Eisen, *U.S. Fiscal Cliff Threatens Growth, IMF's Cottarelli Says*, Bloomberg (Oct. 9, 2012), http://www.businessweek.com/news/2012-10-09/u-dot-s-dot-fiscal-cliff-threatens-growth-imf-s-cottarelli-says.

Greater accuracy of ratings may reveal the weaknesses of the financial system that the SEC oversees and ultimately exacerbate other problems that are papered over by generous ratings.

That leaves investors as the strongest potential constituency for accurate and timely ratings. But there is a danger of overstating the degree of their commitment to holding rating agencies accountable. Investors have a clear interest in rating accuracy at the time they purchase a security, because it provides a proxy of credit risk as well as insulates money managers from criticism if the investment goes awry.[319] Systematically lower ratings would enhance credit quality and value for investors. But investors' interest in timely upgrades or downgrades is not as clear once they own the security, because rapid increases or decreases in ratings, however timely, would disrupt their business.[320]

In fact, sophisticated investors may have little interest even in accurate ratings ex ante. Perpetuating a system of inflated ratings may allow institutional investors to leverage their informational advantages over the broader market. Institutional investors' internal research may put them in a better position to cherry-pick higher quality assets with the same ratings as lower quality assets.[321] This point is particularly problematic when considering that institutional investors are presumed to be the actors with the greatest ability and incentive to monitor rating agencies.[322]

In spite of this concern, investors, including institutional investors, have the strongest interest among these stakeholders in increasing the degree of accuracy and timeliness of ratings. They may bring their own conflicts of interest to the table (though to a lesser degree than other actors), but investors serve as the one plausible tool to increase private oversight and accountability of rating agencies. The fact that investors' interests are fractured may actually empower them to be more effective monitors, because some investors at any given time will have a strong interest in monitoring ratings. Regulators cannot and should not "go it alone" in leading the overhaul of rating agencies. There is a need to bring investors more actively into the process of creating sustainable means for overseeing rating agencies, fostering competition, and enhancing ratings' accuracy.

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319 *See* Becker & Milbourn, *supra* note 274, at 1, 11, 13.

320 *See* Moody's Investors Serv., *supra* note 58, at 25.

321 *See* Ayres & Choi, *supra* note 226, at 314–17.

322 *See supra* notes 224–26 and accompanying text.

2. *The Case for Expanded Policing of Rating Agency Conduct with Capped Damages*

The abandonment of expert liability exposure for rating agencies means that the primary recourse for private enforcement is through Rule 10b-5 actions. For this reason it is worthwhile to consider the potential for expanding private oversight tools more broadly. A combination of capped damages and a gross negligence standard for rating agency liability exposure could provide a balanced way to incentivize private policing of a broader spectrum of rating agency misconduct, while keeping both rating agency duties and potential sanctions manageable.

The reluctance to expand the scope of private monitoring and enforcement likely rests on the concern of exposing rating agencies to potentially ruinous liability, even in the case of a single breach.[323] Rating agencies lack the means to make investors whole for their reliance on erroneous ratings.[324] Rating fees are nominal compared to the dollar amount of debt issues they assess. For this reason imposing full liability for investors' losses would pose significant risks of overdeterrence, because rating agencies only receive a small amount of the rewards that issuers receive from a deceptive rating.[325]

Exposing rating agencies to modest sanctions in private suits could have substantial incentive effects, yet not over-deter. Policymakers could mitigate liability concerns by capping the liability exposure of rating agencies to a multiple of their annual fees for any given security. This way a single suit or series of suits would not raise the risk of bankrupting rating agencies. Rating agencies could be required to carry insurance or to meet self-insurance requirements of capital reserves to guard against this risk.[326] This requirement could be linked to NRSRO certification, so that investors would know that

323 In response to this argument, a number of academics have made the case for a modified strict liability standard on auditors because of their essential role in safeguarding the financial stability of corporations in spite of analogous risks. *See, e.g.*, Coffee, *supra* note 21, at 350–52; Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 540–46 (2001).

324 *See* Coffee, *supra* note 21, at 306 (discussing how gatekeepers simply lack the financial ability to provide significant compensation to investors through victim suits).

325 *See* Hamdani, *supra* note 21, at 115–16 (discussing the dangers of overdeterrence from holding gatekeepers liable for all injuries that flows from their failed screening).

326 *Cf.* Coffee, *supra* note 21, at 350–51 (calling for auditors to take out insurance that is a multiple of their revenue stream); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39, 41–42 (2002) (calling for issuers to purchase insurance for their financial statements).

rating agencies face a degree of liability if it turns out that ratings were deceptive.

This approach would balance incentives for greater private monitoring and enforcement with a limited financial deterrent for rating agencies.[327] A system of caps on liability exposure could also allow for the imposition of a higher multiple of annual fees in the case of repeated or willful breaches of duty, creating a bounded punitive damage exception consistent with a deterrence strategy. Caps on liability exposure would also facilitate the ability of rating agencies to secure insurance coverage for their potential liability. While this approach would require the creation of a new insurance niche, insurance markets cover an ever-increasing set of risks, and the cap approach would make rating agency exposure a more measurable risk.[328] Alternatively, rating agencies could bypass the need for formal insurance if their capital levels and diversification of risks are high enough that they are effectively self-insured.[329] This approach would raise costs for rating agencies, but likely not in a way that would risk driving them out of the market.

The use of capped damages would allow policymakers to enlist the plaintiff's bar to police a broader range of rating agency conduct. For example, both the original House Dodd-Frank bill and recent European Union legislation called for the imposition of gross negligence liability on rating agencies.[330] The virtue of this approach is that it is very difficult to prove outright fraud by rating agencies, and policing of fraud only covers a small subset of rating agency misconduct.[331] Rating agencies have specialized skills and employ methods and ratings that incorporate a degree of ambiguity.[332] This fact may allow rating agencies to obfuscate the degree of issuer risk exposure, in-

327 *Cf.* Macey, *supra* note 20, at 342–43 (2003) (discussing how applying "nuclear" liability can warp the incentives for securities intermediaries).

328 *See, e.g.*, Jeffrey Manns, Note, *Insuring Against Terror?*, 112 YALE L.J. 2509, 2509–11, 2516–20 (2003) (documenting the emergence of private terrorism insurance and other catastrophic loss insurance in spite of far greater uncertainties of liability exposure).

329 *See* Rory A. Goode, *Self-Insurance as Insurance in Liability Policy "Other Insurance" Provisions*, 56 WASH. & LEE L. REV. 1245, 1251–55 (1999) (discussing self-insurance as a substitute for commercial policies).

330 *See* H.R. 4173, 111th Cong. § 6003(c) (1st Sess. 2009) (subjecting a rating agency to liability if it was "grossly negligent at the time [a rating] was issued" and if the rating was "a substantial factor" in investors' losses).

331 *See, e.g.*, David A. Maas, Comment, *Policing the Ratings Agencies: The Case for Stronger Criminal Disincentives in the Credit Rating Market*, 101 J. CRIM. L. & CRIMINOLOGY 1005, 1006–10 (2011).

332 *See* Triantis & Daniels, *supra* note 32, at 1110.

creasing the difficulty of delineating a clear standard of conduct or accuracy.[333] Short of a smoking gun of complicity or an absence of due diligence, it will be difficult to show the required rating agency recklessness to establish outright fraud.

Instead, the larger enforcement concern is the degree of rating agency negligence, which can undermine the reliability of ratings. The nature of rating agencies' screening role is that their wrongdoing will be subtle and instead fall within or near the boundaries of negligent or grossly negligent conduct, i.e., a gross deviation from reasonable standards of care.[334] The adoption of negligence-based liability could open the floodgates to litigation about the contours of reasonable care in the ratings context. But the lighter touch of applying a gross negligence approach may offer a better balance of incentives for gatekeeper compliance and private monitoring. There may be concerns that rating agencies may still be overly cautious if they face significant uncertainty concerning what constitutes compliance with a gross negligence standard.[335] But having rating agencies err on the side of defensible ratings and additional diligence is not a bad problem to have given rating agencies' recent failures. Caps on liability may dampen incentives for private monitoring and suits. Coupling limited liability exposure with a gross negligence standard, however, would provide incentives for a balance of greater oversight and plausible liability burdens.

CONCLUSION

Reforms have addressed the most egregious shortcomings of rating agencies that fueled the financial crisis. But in many ways the process of reform is still in its inception phase. The most important

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333 *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 790 (2001).

334 There are numerous definitions of gross negligence, which appear to coalesce around the concept of the failure to exercise even slight care or diligence. For example, Delaware courts apply a standard of gross negligence to determine whether corporate directors have sufficiently informed themselves to receive deference under the business judgment rule, and they have defined gross negligence as "reckless indifference to or a deliberate disregard of the whole body of stockholders." Tomczak v. Morton Thiokol, Inc., Fed. Sec. L. Rep. (CCH) ¶ 95,327, at 96,585 (Del. Ch. Apr. 5, 1990) (quoting Allaun v. Consol. Oil Co., 147 A. 257, 261 (Del. Ch. 1929)). Black's Law Dictionary defines gross negligence as "watchfulness and circumspection" that "falls short of being such reckless disregard of probable consequences as is equivalent to a wilful and intentional wrong." BLACK'S LAW DICTIONARY 1033 (6th ed. 1990).

335 *See* Louis Kaplow & Steven Shavell, *Accuracy in the Determination of Liability*, 37 J.L. & ECON. 1, 10–14 & n.33 (1994) (discussing how varying judicial interpretations of what constitutes good faith compliance may lead to excessive caution by potential defendants).

challenges of how to foster competition and enhance rating agency accuracy and accountability remain open questions. Part of the problem is Dodd-Frank's conflicting strategies that simultaneously promise to marginalize rating agencies, to expose rating agencies to disclosure requirements and private suits, and to entrench rating agencies as a regulated industry. Pursuing all of these objectives at once has been counter-productive and has made the SEC's already daunting task of rating agency oversight all the more unmanageable.

The crucial challenge facing policymakers is designing a replacement for the issuer-pays system. Policymakers face significant dilemmas in crafting benchmarks for rating agency performance. For example, tying the selection or compensation of rating agencies to meeting benchmarks could potentially undermine the goals of greater competition by accentuating herding effects and the tailoring of ratings to meet the benchmark. Given the challenges of establishing performance-based standards, policymakers should consider alternative ways to enhance competition such as by using regulatory incentives to break up the leading rating agencies to create a larger pool of credible rating agencies. Additionally, policymakers should consider expanding the scope of private enforcement opportunities to leverage the self-interest of investors to monitor and prosecute grossly negligent conduct by rating agencies. This approach would enhance efforts to foster greater competition and accountability and would complement the SEC's ongoing efforts to overhaul the rating agency industry.