

RATINGS REFORM: THE GOOD, THE BAD, AND THE UGLY

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Although dissatisfaction with the performance of the credit rating agencies is universal (particularly with regard to structured finance), reformers divide into two basic camps: (1) those who see the “issuer pays” model of the major credit ratings firms as the fundamental cause of inflated ratings, and (2) those who view the licensing power given to credit ratings agencies by regulatory rules requiring an investment grade rating from an NRSRO rating agency as creating a de facto monopoly that precludes competition. After reviewing the recent empirical literature on how ratings became inflated, this Article agrees with the former school and doubts that serious reform is possible unless the conflicts of interest inherent in the “issuer pays model” can be reduced. Although the licensing power hypothesis can explain the contemporary lack of competition in the ratings industry, increased competition is more likely to aggravate than alleviate the problem of inflated ratings. Still, purging conflicts is no easy matter, both because (1) investors, as well as issuers, have serious conflicts of interest (for example, investors dislike ratings downgrades) and (2) a shift to a “subscriber pays” business model is impeded by the public goods nature of credit ratings. This Article therefore reviews recent policy proposals and considers what steps could most feasibly tame the conflicts of interest problem.

TABLE OF CONTENTS

I. WHAT WENT WRONG? A SUMMARY OF THE CRITICISMS AND THE RECENT EVIDENCE	236
A. <i>The CRAs Ignored Massive and Rapid Deterioration in the Creditworthiness of the Subprime Mortgages and Significantly Inflated Their Ratings after 2000</i>	236
B. <i>How Were Ratings Inflated?: The Role of Discretion in Ratings</i>	242
C. <i>Unique Among Gatekeepers, the CRAs Did Not Verify or Confirm Factual Information Upon Which Their Models Relied</i>	244
II. THE DEBATE OVER POSSIBLE REFORMS: WHAT MIGHT WORK? WHAT WILL NOT	246
A. <i>Developments Over the Last Five Years</i>	246
B. <i>An Overview of the Choices Not Yet Faced</i>	251
III. APPRAISING THE TRADEOFFS	271
IV. CONCLUSION	276

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Few disinterested observers doubt that inflated credit ratings and conflict-ridden rating processes played a significant role in exacerbating the 2008 financial crisis.¹ For a variety of reasons—including the shared oligopoly that the major rating agencies enjoy, their virtual immunity from liability, and the conflicts of interest surrounding their common “issuer pays” business model—the major credit rating agencies (CRAs) simply had too little incentive to “get it right.” Indeed, the margin by which they did not “get it right” now seems extraordinary.² By one estimate, 36% of all collateralized debt obligations (CDOs) that were based on U.S. asset-backed securities had defaulted by July 2008.³

Beyond this recognition that the CRAs failed and that their efforts and performance were compromised by serious conflicts of interest, little consensus exists, particularly among academics, on the desirable shape of reform. Numerous reforms have been proposed by numerous champions, but a fundamental division divides even the most trenchant critics of the CRAs. One school of thought views the CRAs as gatekeepers possessing “reputational capital” that they pledge to generate investors’ confidence in their ratings.⁴ From this reputational capital perspective, conflicts of interest become the principal problem, as the CRAs may willingly (even cynically) sacrifice some reputational capital for enhanced revenues, at least so long as barriers to entry remain high and their legal liability stays low. Indeed, the willingness of gatekeepers to risk and even sacrifice their reputational capital may be the great lesson of the 2008 crisis.

From a different perspective, however, the CRAs are viewed less as informational intermediaries (or “gatekeepers”) and more as holders of regulatory licensing authority that regulatory agencies unwisely delegated to them and that the CRAs have exploited for self-interested purposes.⁵ Some

¹ “The consequent surge in global demand for U.S. subprime securities by banks, hedge and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem.” *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 12 (2008) (statement of Alan Greenspan, former Chairman of the Fed. Reserve Board). Reflecting this consensus, the Group of Twenty (G-20) announced their agreement on the need for “more effective oversight of the activities of Credit Rating Agencies.” Group of Twenty [G-20], *Declaration on Strengthening the Financial System* (Apr. 2, 2009).

² See Joshua D. Coval, Jacob W. Jurek & Erik Stafford, *Economic Catastrophe Bonds*, 99 AMER. ECON. REV. 628, 660 (2009) (finding that ratings on structured finance products were highly inaccurate); Joshua D. Coval, Jacob W. Jurek & Erik Stafford, *The Economics of Structured Finance*, 23 J. ECON. PERSP. 3, 19 (2009); Efraim Benmelech & Jennifer Dlugosz, *The Alchemy of CDO Credit Ratings*, 56 J. OF MONETARY ECON. 617, 630-33 (2009) (criticizing the rating process and practices such as ratings shopping).

³ See John Patrick Hunt, *Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 123 (2009).

⁴ See generally JOHN C. COFFEE, JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* (Oxford Univ. Press 2006) (stating this view and recognizing its limits).

⁵ See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L. W. 619, 711 (1999) (author is a leading proponent of view that ratings-dependent regulation should be dismantled); see also Frank Partnoy,

of these critics even doubt that the market needs credit rating agencies, believing that their role could and should be replaced by alternative mechanisms, including greater reliance on credit default spreads.⁶ Finally, conservatives doubt that any legislative or administrative reforms will work and argue that investors should negotiate by contract for the services that they want.⁷

From these differences in diagnoses of the credit ratings problem follow even sharper divergences in prescriptions. Those who start from the “gatekeeper” perspective tend to favor reforms aimed at reducing conflicts of interest (either by increasing CRA liability or by restricting the issuer’s ability to choose the rating agency). In contrast, those who take the “regulatory license” perspective favor deregulation that would eliminate the need for regulated financial institutions to obtain investment grade ratings before investing. The tension between these two perspectives was evident in the drafting of the United States’ recent financial reform legislation—the Dodd-Frank Act—which largely straddles this gap and pursues both strategies.⁸ Still, if the deregulatory approach is taken, it will lead to a further problem: how should financial institutions (such as money market funds) be regulated once it is acknowledged that in competitive markets these firms may be under pressure to take on excessive risk in order to obtain above-market returns?

The choice is fundamental. Although this Article agrees that investors did place excessive reliance on credit ratings, it is skeptical of the view that the CRAs will naturally wither away or that the Dodd-Frank Act will significantly reduce investors’ reliance on them. Alternatives to credit ratings, such as credit default swap spreads, provide at best only a partial substitute. At the end of the day, for better or worse, the CRAs seem likely to remain a permanent part of the financial infrastructure. Indeed, the future of some industries (such as housing finance) that depend upon asset-backed securitizations probably depends upon ratings that are credible, because “do-it-yourself” financial analysis of opaque debt instruments is no more feasible for most financial institutions than “do-it-yourself” brain surgery.

Overdependence on Credit Ratings Was a Primary Cause of the Crisis 11 (San Diego Legal Studies Paper No. 09-015, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430653.

⁶ These critics believe that better measures of credit quality are available in the form of the spreads on credit default swaps. See Mark J. Flannery, Joel F. Houston & Frank Partnoy, *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085, 2085 (2010). In contrast, although this article accepts that credit default swap spreads can be a useful source of information for investors, it suggests that they are not a feasible substitute, both because of their volatility and their frequent unavailability for structured finance products.

⁷ See Stephen Bainbridge, *Dodd-Frank: Quack Corporate Governance Round II* at 41 (UCLA Sch. of Law Econ. Research Papers No. 10-12, 2010), available at <http://ssrn.com/abstract=1673575>.

⁸ See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Deficient as the CRAs have been, it is also not obvious that governmental agencies can do much better, either at promulgating required standards of creditworthiness or in providing their own credit ratings.

Agreement does, however, exist on one score: all want increased competition among the CRAs. But, as will be seen, the impact of increased competition is problematic; it can encourage ratings arbitrage, as issuers pressure competing rating agencies to relax their standards to obtain business. Moreover, the barriers to entry in this field are likely to remain high. Quite simply, the “Catch-22” for new entrants is that it is nearly impossible to obtain clients unless one has a track record for reliable ratings, yet such a track record is difficult to generate unless one first has clients.⁹ Thus, an easy transition from an “issuer pays” model to a “subscriber pays” model should not be anticipated, and to generate socially useful competition, some governmental intervention seems necessary.

How can public policy structure a more useful competition that does not produce a race to the bottom? Possible options toward this end include: (1) authorizing an independent body to select the rating agency; (2) mandating (and thereby effectively subsidizing) a “subscriber pays” model for ratings; and (3) creating a governmental rating agency to issue ratings (much like the Tennessee Valley Authority (TVA) was created in the United States as a check on the monopoly power of private utilities). But in choosing between these options, a dirty little secret about credit ratings must be recognized: investors have biases of their own, and many want inflated and stable credit ratings that allow them to hold risky securities. Evaluating the policy choices and defining the regulatory objectives in light of the under-recognized fact that all participants in the market suffer from conflicts of interest will be the focus of this Article.

This Article begins with a brief review of the latest empirical evidence on the failure of the CRAs, the evidence of which tends to place their conflicts of interest at center stage. Based on this review, it will argue that the dominant “issuer pays” business model must be modified by reforms that either (1) divorce issuer payment of the CRA from issuer selection of the CRA, or (2) encourage (and implicitly subsidize) an alternative “subscriber pays” market for ratings.

Others may read this same evidence to imply that reliance on credit ratings should be discouraged (or, in the case of “free market” ideologues, that all attempts at their regulation will prove futile). Disagreeing with these more extreme critics, this Article begins from the premise that CRAs do

⁹ Further, even if a new entrant has a superior record for accurate ratings, it is difficult to communicate such a record to investors unless (i) performance statistics are reasonably standardized, and (ii) the Securities and Exchange Commission (“SEC”) establishes a centralized credit rating data repository in order to enable consumers to easily access such data. See Lynn Bai, *The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions*, 7 N.Y.U. J. OF L. & BUS. 47, 103 (2010) (calling for such a centralized repository); see also *infra* Part III.

provide valuable information that strongly influences the cost of capital.¹⁰ Even if credit default spreads (or other market measures) may provide a partial substitute for credit ratings, it is naïve to believe credit ratings will soon be displaced in the foreseeable future. One reason for their likely persistence again involves conflicts of interest. Not only do issuers have them, but so do investors. Because sophisticated institutional investors are often locked in a competitive battle for investor funds, many have a preference for inflated ratings that permit them to hold risky, but high-yielding, securities.¹¹ Also, competition forces many institutional investors to economize on costly research and makes it unlikely that they will internalize securities research—at least absent strong regulatory incentives. Given that some institutional investors, under competitive pressure, will take on excessive risk, deregulatory solutions have the disturbing consequence of permitting virtually anyone to issue credit ratings and virtually anyone to rely on them. The sounder goal in seeking to deemphasize the role of credit ratings should be to deny institutional investors the ability to use ratings as a form of insurance that protects them from the legal consequences of unsound investment decisions. Such defensive use of credit ratings by users in turn encourages the CRAs to inflate ratings and delay before downgrading—in order to please investors as well as issuers. Competition will work only when rating agencies compete based on ratings accuracy, rather than in offering promotional benefits to issuers or legal protections to investors. That will not happen until relative performance statistics for CRAs are made transparently and painfully clear.¹²

Because this Article covers European as well as U.S. developments, it must be emphasized at the outset that “context counts.” The institutional culture and regulatory options available in the United States and Europe differ. The United States characteristically relies more extensively on private enforcement and civil litigation to deter wrongdoing, and the Dodd-Frank Act continues this tradition. Europe is less comfortable with reliance on litigation, and major adaptations would be necessary because the class action and the contingent fee are not generally accepted in Europe. Instead, public enforcement and regulatory negotiation tend to be the preferred levers in Europe. Similarly, Europe has not accorded the credit rating agencies the same de facto regulatory power as the United States has, with the result that downsizing their regulatory role may be a less important objective in Europe.

¹⁰ See Adam Ashcraft, Paul Goldsmith-Pinkham & James Vickery, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 449, *MBS RATINGS AND THE MORTGAGE CREDIT BOOM* at 5 (May 2010) (reaching a similar view that credit ratings are informative and affect the cost of capital).

¹¹ See Jess Cornaggia & Kimberly J. Cornaggia, *Does the Bond Market Want Informative Credit Ratings* 2 (Jan. 15, 2011), available at <http://ssrn.com/abstract=1705843> (observing that these institutions prefer stable ratings with few downgrades so that they can continue to hold these risky securities).

¹² Again this brings us back to the need for a centralized data repository and standardized performance statistics. See Bai, *supra* note 9, at 103.

Context also counts in terms of priorities. The failure of the CRAs was largely limited to structured financial products. Similar problems have not characterized the ratings of corporate bonds. Thus, more intrusive reforms can be limited to the lucrative and opaque context of structured finance. As next discussed, the conflicts were stronger and the prospects for ratings arbitrage greater in the case of structured finance.

I. WHAT WENT WRONG?: A SUMMARY OF THE CRITICISMS
AND THE RECENT EVIDENCE

Although the following criticisms overlap, each involves a distinctive aspect of the problem.

A. *The CRAs Ignored Massive and Rapid Deterioration in the Creditworthiness of Subprime Mortgages and Significantly Inflated Their Ratings after 2000*

The rapid deterioration in credit quality associated with subprime mortgages is shown by the following table:¹³

EXHIBIT A:

	Low/No-Doc Share	Debt Payments/Income	Loan/Value	ARM Share	Interest-Only Share
2001	28.5%	39.7%	84.0%	73.8%	0.0%
2002	38.6%	40.1%	84.4%	80.0%	2.3%
2003	42.8%	40.5%	86.1%	80.1%	8.6%
2004	45.2%	41.2%	84.9%	89.4%	27.3%
2005	50.7%	41.8%	83.2%	93.3%	37.8%
2006	50.8%	42.4%	83.4%	91.3%	22.8%

¹³ Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Law and Economic Issues in Subprime Litigation* 74 (Harvard John Olin Center for Law, Econ., and Bus., Discussion Paper No. 612, 2008), available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_et_al_612.pdf. A more recent study by the staff of the Federal Reserve Bank of New York finds that the percentage of “low/no-doc mortgages” in subprime mortgage securitizations rose from 24.8% in 2001 to 46.0% in 2006 and 45.1% in 2007. Similarly, the percentage of “interest-only” mortgages in subprime mortgage deals rose from 0.0% in 2001 to 21.4% in 2006 (and then declined to 16.4% in 2007). This same study found that on “Alt-A deals” (which are slightly more creditworthy than subprime mortgages), “low/no-doc” loans rose from 66.3% in 2001 to 79.3% in 2007, and “interest-only” loans rose dramatically from 0.4% in 2001 to 62.3% in 2007. Adam Ashcraft, Paul Goldsmith-Pinkham & James Vickery, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 449, MBS RATINGS AND THE MORTGAGE CREDIT BOOM, at tbl. 3 (May 2010). Thus, from both sources, the same picture emerges of an extraordinary deterioration in creditworthiness over a brief period.

As it shows, “low document” loans (or “liar’s loans” in the U.S. parlance) almost doubled over a five-year period and came to represent the majority of subprime loans. Moreover, adjustable rate mortgages (or “teaser” loans with initially low interest rates that later steeply climbed) grew to over 91% of all such loans. Interest-only loans (which imply that the borrower could not afford to amortize the principal on the loan) rose to nearly 23% of such loans by 2006. But ratings did not change to reflect these trends.

In overview, the securitization process seems to have led to lax screening by loan originators. One study finds that the highest rates of default occurred on loans sold by the loan originator to an unaffiliated financial firm,¹⁴ and another finds that a loan portfolio that was securitized was 20% more likely to default than a similar portfolio that was not securitized.¹⁵ The implication seems obvious: loan originators dumped their weaker loans on investment banks that were seeking to assemble loan portfolios for securitizations quickly.

These trends, particularly the absence of adequate documentation, should have been evident to the CRAs. Why were they seemingly oblivious to them? Here, three distinctive trends in the structured finance market over the last decade explain their failure and demonstrate the need for regulatory attention.

First, as structured financed issuances overtook corporate debt issuances (by around 2002), the nature of the CRAs’ clientele changed. When the CRAs principally rated corporate bonds, no one client accounted for more than 1% of their business (because even large corporations went to the bond market only intermittently). But as structured finance became the CRAs’ principal profit center, the rating agencies faced a limited number of large investment banks that brought deals to them on a continuing basis (and thus could threaten to take a substantial volume of business elsewhere, if dissatisfied). The high level of concentration in the market for subprime mortgage securitizations is shown by Exhibit B below:

¹⁴ Atif Mian & Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis*, 124 Q. J. ECON. 1449, 1483 (2009).

¹⁵ B. Keys, T. Mukherjee, A. Seru & V. Vig., *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans*, 125 Q. J. ECON. 307, 335 (2010).

EXHIBIT B:
Mortgage Backed Securities Underwriters in 2007:
A Very Concentrated Market

Rank	Book Runner	Number of Offerings	Market Share	Proceed Amount + Overallotment Sold in US (\$mill)
1	Lehman Brothers	120	10.80%	\$100,109
2	Bear Stearns & Co., Inc.	128	9.90%	\$91,696
3	Morgan Stanley	92	8.20%	\$75,627
4	JP Morgan	95	7.90%	\$73,214
5	Credit Suisse	109	7.50%	\$69,503
6	Bank of America Securities LLC	101	6.80%	\$62,776
7	Deutsche Bank AG	85	6.20%	\$57,337
8	Royal Bank of Scotland Group	74	5.80%	\$53,352
9	Merrill Lynch	81	5.20%	\$48,407
10	Goldman Sachs & Co.	60	5.10%	\$47,696
11	Citigroup	95	5.00%	\$46,754
12	UBS	74	4.30%	\$39,832

As this table shows, the top six underwriters controlled over 50% of this market, and the top dozen accounted for over 80%. As a result, they possessed the ability to threaten credibly that they would take their business elsewhere—a threat that the rating agencies had not previously experienced. In recent testimony before a U.S. Senate Committee, a former Managing Director of Moody's with responsibility for supervising their subprime mortgage ratings testified that it was well understood within Moody's that even a small loss of market share would result in a manager's termination.¹⁶

This hypothesis—that the major rating agencies gave inflated ratings to the major underwriters (who were also the issuers in these transactions) because of their high volume of business—has been confirmed by empirical tests. He, Qian, and Strahan compared tranches of mortgage-backed securities sold between 2000 and 2006 by large and small issuers (with issuer size being based on the issuing institution's annual market share) in order to determine if the issuer's size had any observable impact.¹⁷ First, they examined the ex post performance of these two groups by looking at price changes between the date of origination and April 2009. For both AAA-rated and

¹⁶ *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies: Hearing Before the S. Permanent Subcomm. on Investigations*, 111th Cong. 1 (2010) [hereinafter *Hearings*] (statement of Eric Kolchinsky, former Managing Director at Moody's Investors Service).

¹⁷ Jie (Jack) He, Jun 'QJ' Qian & Philip E. Strahan, *Credit Ratings and the Evolution of the Mortgage-Backed Securities Market 2* (Working Paper, Dec. 2010), available at <http://ssrn.com/abstract=1512732>.

non-AAA-rated tranches, they found that those sold by large issuers performed significantly worse than those tranches sold by smaller issuers. They interpret these results to mean that large issuers received relatively inflated ratings, which produced a greater fall when the market crashed.¹⁸ Second, they examined the ex ante credit quality of these two groups by comparing their initial yields. Over the years 2000–2003, they found that large issuers paid a lower yield, but during 2004–2006, this pattern reversed, and larger issuers paid a higher yield.¹⁹ The authors interpret this reversal to reflect the market’s growing recognition of the conflict of interest problem facing rating agencies. As the market perceived the conflict, it began to demand a lower price (and hence a higher yield) on tranches sold by large issuers.²⁰ In short, the implication of these combined tests was that the market was initially fooled but eventually came to be skeptical of the ratings on tranches sold by large issuers. That eventual skepticism came, however, at a painfully high price.

The second major trend in the structured finance market in the decade prior to 2008 that contributed to CRA failure did so by exacerbating this initial conflict of interest problem. Where Moody’s and S&P once shared a de facto dual oligopoly, competition entered this market shortly after 2000 with the rise of Fitch Ratings. With Fitch’s growth into a viable third alternative, the major issuers could credibly threaten to go elsewhere if they did not receive the rating they wanted, and they could engage more easily in the practice of “rating shopping.”

As Becker and Milbourn have shown,²¹ Fitch’s monthly share of U.S. credit ratings between 1998 and 2006 rose from a low of 20% in 2000 to a peak of 45% in 2006:

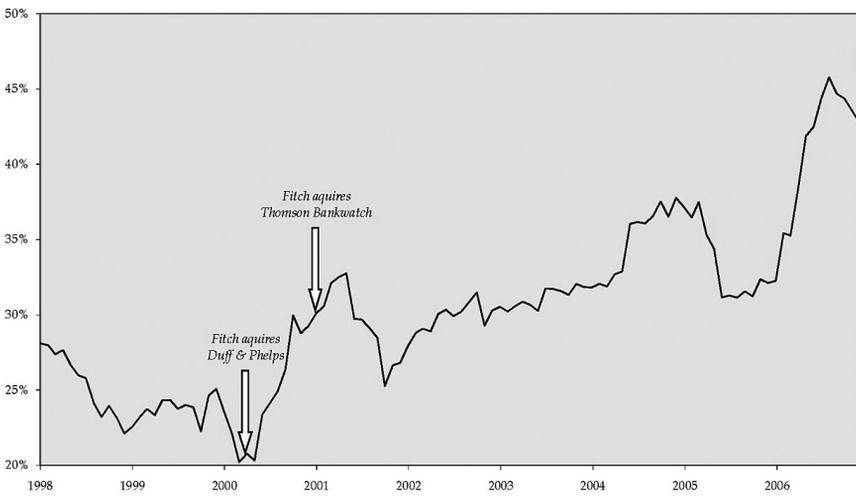
¹⁸ *Id.* at 3.

¹⁹ *Id.* at 4.

²⁰ *Id.* at 3-4.

²¹ Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?* 36 (Harvard Bus. Sch., Working Paper No. 09-051, 2010), available at <http://ssrn.com/abstract=1685891>.

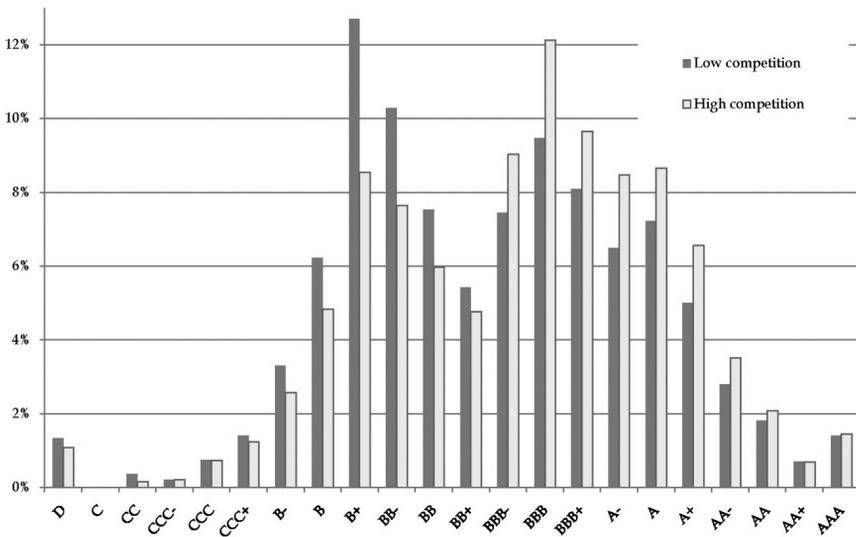
FIGURE 1:
 FITCH MONTHLY MARKET SHARE OF CREDIT RATINGS (U.S. ISSUERS)
 12 MONTH MOVING AVERAGE 1998–2006



This sharp rise was the consequence of a series of acquisitions of smaller rating agencies (such as Duff & Phelps and Thomson Bankwatch) that Fitch's new parent undertook in 2000 as part of a strategy to build up Fitch's market share.

For many commentators, competition is exactly the reform that the market for credit ratings most needs. But Becker and Milbourn find that its appearance in fact led to a significant inflation in ratings. As the following diagram shows, the percentage of investment grade ratings went up with greater competition, and the percentage of non-investment ratings went down—in both cases for every rating:

FIGURE 2:
FIRM CREDIT RATINGS DISTRIBUTION: HIGH AND LOW
COMPETITION IN THE CREDIT RATING INDUSTRY



By no means does this data truly prove that competition cannot work, but the shift from a duopoly to a three-way oligopoly in a market where the CRAs compete for the issuer’s business appears to have influenced both Moody’s and S&P, making them more generous in their ratings. A recent congressional hearing featured former employees of the CRAs who testified that their firms’ culture changed around 2000, and the loss of even a small percentage of market share produced pressure from within the firms to relax rating standards.²²

The third secular change that adversely affected CRA performance was the sharp reduction after 2000 in factual verification and due diligence by CRAs. Although the CRAs themselves never engaged in significant verification efforts, other agents did. Nonetheless, factual verification of the creditworthiness of securitized mortgages largely disappeared after 2000, as investment banks and deal arrangers ceased to pay for such activities, and the CRAs did not insist on their continuation. Although this development will be discussed in more detail later, it appears to have been driven less by the desire to economize on expenses than by a desire to suppress the “red flags” that factual investigations would uncover about the deterioration in credit quality in the subprime mortgage field.

²² *Hearings, supra* note 16, at 2 (statement of Eric Kolchinsky).

B. *How Were Ratings Inflated?: The Role of Discretion in Ratings*

The foregoing discussion has emphasized the significance of conflicts of interest in the rating process. But how did these conflicts actually impact the rating process? Here, the real question is: why were risky subprime mortgages able to be rated investment grade (and, more specifically, AAA) when they were collected into portfolios? The initial answer, of course, involves tranching and elaborate subordination. In theory, collateralized debt obligations (CDOs) received AAA ratings because rating agencies concluded that sufficient debt obligations had been subordinated to the senior tranche to justify rating that senior tranche AAA. In light of their subsequent failure, however, the question becomes: was the level of subordination sufficient? Here, a recent 2010 study by Griffin and Tang of 916 CDOs issued between January 1997 and December 2007 finds that the CRAs did not follow a consistent policy or valuation model with respect to subordination, but rather regularly made “adjustments” on subjective grounds.²³ Although these adjustments could be either positive or negative, 84% of these adjustments were in fact positive, and these adjustments increased the size of the top-rated AAA tranche by “an additional 12.1% of the AAA at the time of issue.”²⁴ These discretionary adjustments, they find, “explain why ‘AAA’ CDO tranches are large and similar in size despite varying CDO structures.”²⁵ Less surprisingly, they further find that the amount of the adjustment was positively correlated with future downgrades.²⁶ In short, the evidence shows not that the CRAs’ valuation models were wrong, but that they were systematically overridden by discretionary adjustments in a manner that increased the size of AAA tranches.

The degree to which CRAs overrode their own models to increase the size of the senior tranche that could now be rated AAA appears both extraordinary and largely based on discretionary upward adjustments. Griffin and Tang report that “only 1.3% of AAA CDOs closed between January 1997 and March 2007 met the rating agency’s reported AAA default standard,” with the rest falling short.²⁷ Ultimately, they conclude that if CRAs followed their own models, AAA tranches should have been rated “as approximately BBB” and that if the AAA tranches in their sample of 916 CDOs were so downgraded to BBB, the total overvaluation “cumulates to \$86.2 billion in cost to investors.”²⁸

²³ See John M. Griffin & Dragon Yongjun Tang, *Did Subjectivity Play A Role in CDO Credit Ratings?* 17 (McCombs Research Paper Series, Paper No. FIN-04-10 2010), available at <http://ssrn.com/abstract=1364933>.

²⁴ *Id.* at 3.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.* at 4. They add: “The rest fell short. In 92.4% of cases, the AAA-rated tranche only met the AA default standard.” *Id.*

²⁸ *Id.* at 4–5.

In making these discretionary adjustments, the CRAs appear to have been acquiescing to the desires of the investment banks that engineered these securitizations. By increasing the size of the AAA tranche, the rating agencies made the CDO both more valuable and, at least as important, easier to sell (as lower rated tranches could only be sold to a much smaller audience). Hull estimates that often as much as “\$90 of AAA-rated securities [were] ultimately created from each \$100 of subprime mortgages.”²⁹ Because subprime borrowers are by definition poor credit risks, he estimates that the typical subprime borrower “would at best be rated BBB” and thus, he finds, it was highly unlikely that any financial alchemy could generate \$90 of AAA-rated instruments from \$100 of BBB-rated mortgages.³⁰

The conclusions reached by Griffin and Tang have recently been expressly confirmed by an even larger study by the staff of the New York Federal Reserve Bank.³¹ Using a uniquely large data set that covered 60,000 Mortgage Backed Securities (MBS) issued between 2001-2007, or “nearly 90% of the deals issued during this period,”³² they find that risk-adjusted subordination declined “significantly between the start of 2005 and 2007”;³³ as a result, a greater percentage of the total offering was rated AAA. Their most striking finding is that “deals with a high share of low- and no-documentation loans (low doc) perform disproportionately poorly, even relative to other types of risky deals”—implying to them that these loans were not rated conservatively enough on an *ex ante* basis.³⁴ Unlike other studies, they do not find a steady decline from 2001 to 2007, but rather a sudden decline in 2005 to 2007 (at the peak of the boom), when a record number of deals came to market and when (in their view) the reputational costs of error became modest in relation to the expected profits to the rating agency.

Although the senior tranches in CDOs were supposed to be supported by a foundation of subordinated junior tranches, the actual level of subordination was always thin. In the case of subprime deals, the topmost AAA tranche constituted on average 82.4% of all the securities in the portfolio over the period from 2001 to 2007 (and some years was over 90%). In “Alt-A deals” (which involve slightly less risky mortgages), the AAA-rated

²⁹ John Hull, *Credit Ratings and the Securitization of Subprime Mortgages* 4 (Fed. Reserve Bank of Atlanta 2010 Fin. Mkts. Conference, “Up from the Ashes: The Financial System After the Crisis,” May 11, 2010), available at http://www.frbatlanta.org/documents/news/conferences/10fmc_hull.pdf.

³⁰ *Id.* In fact, on the typical “Alt-A deal,” the earlier noted Federal Reserve Bank study finds that, over the period from 2001 to 2007, \$100 of “Alt-A” mortgages generated on average approximately \$93.1 of AAA-rated CDO debt securities. Ashcraft et al., *supra* note 10, at Tbl. 3.

³¹ See Ashcraft et al., *supra* note 10, at 31.

³² *Id.* at 2.

³³ *Id.* at 3.

³⁴ *Id.* at 4.

tranche represented over 93% of the securities in the CDO pool over the same period.³⁵

This willingness of the rating agencies to tolerate “thin” subordination and award AAA ratings to top-heavy securitization structures was not limited to the special context of subprime mortgages. In the related field of commercial mortgage-backed securitizations (CMBS), relatively little changed in the underlying market. That is, there was no general decline in the quality of the collateral (as there was in the case of residential mortgages), and the rate of default on such loans did not increase appreciably. Thus, ratings should have remained relatively reliable. Still, studying a comprehensive sample of CMBS transactions from 1996 to 2008, Stanton and Wallace find that the CMBS market collapsed during the 2008–2009 financial crisis because rating agencies permitted subordination levels to be reduced by issuers until they provided insufficient protection for the supposedly safe senior tranches.³⁶ This finding undercuts the argument of the rating agencies that they were blindsided by sudden changes in the subprime mortgage arena. To the contrary, the rating agencies appear to have tolerated thin subordination across a variety of contexts, as issuers and underwriters pressured them to compete.

C. Unique Among Gatekeepers, the CRAs Did Not Verify or Confirm Factual Information Upon Which Their Models Relied

Unlike auditors, securities analysts, attorneys, investment banks and other financial gatekeepers, CRAs have never conducted factual verification with respect to the information on which their valuation models rely.³⁷ While accountants are quite literally “bean counters” and security analysts contact a variety of sources of information (customers, suppliers, rivals) to obtain information about an issuer, CRAs simply disclose that they are relying on information supplied to them by others. The problem, of course, is that no valuation model, however well designed, can outperform its informational inputs; hence, use of unverified data results in the well-known “GIGO Effect”—Garbage In, Garbage Out.

In the past, some due diligence was undertaken in the rating process. Prior to 2000, the rating agencies generally could rely on an independent third party for information about the quality of the collateral in securitization pools. During this period, investment banks outsourced the task of due dili-

³⁵ *Id.* at Tbl. 3.

³⁶ See Richard Stanton & Nancy Wallace, *CMBS Subordination, Ratings Inflation and the Crisis of 2007-2009* at 3 (Nat'l Bureau of Econ. Research, Working Paper No. 16206, 2010), available at <http://ssrn.com/abstract=1648006>.

³⁷ See SECS. EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION'S STAFF'S EXAMINATION OF SELECT CREDIT RATING AGENCIES 18 (2008) (noting that CRAs “did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated.”).

gence on asset-backed securitizations to specialized “due diligence” firms. These firms (of which Clayton Holdings, Inc. was probably the best known) would send squads of loan reviewers to sample the loans in a portfolio to be purchased from a financial institution or loan originator, checking credit scores and documentation. Although this sampling fell well short of an audit, it could identify the likely percentage of “problem” loans in the portfolio. But the intensity of this due diligence review declined after 2000. *The Los Angeles Times* quotes the CEO of Clayton Holdings to the effect that:

“Early in the decade, a securities firm might have asked Clayton to review 25% to 40% of the sub-prime loans in a pool, compared with typically 10% in 2006”³⁸

The President of a leading rival due diligence firm, The Bohan Group, Inc., made an even more revealing comparison:

“By contrast, loan buyers who kept the mortgages as an investment instead of packaging them into securities would have 50% to 100% of the loans examined, Bohan President Mark Hughes said.”³⁹

In short, lenders who retained the loans checked the borrowers reasonably carefully, but the investment banks decreased their investment in due diligence, making only an increasingly cursory effort as the bubble inflated. This evidence is consistent with the earlier finding that loans in a securitized portfolio defaulted at a significantly higher rate.⁴⁰

The actual “due diligence” personnel employed by these firms also told the above-quoted *Los Angeles Times* reporter that supervisors in these firms would often change documentation in order to avoid “red-flagging mortgages.” These employees also report regularly encountering inflated documentation and “liar’s loans,” but, even when they rejected loans, “loan buyers often bought the rejected mortgages anyway.”⁴¹ In short, even when the watchdog barked, no one at the investment banks truly paid attention, and no one told the rating agencies.

All these elements converge to support a classic “moral hazard” story: those who did not expect to hold these loans for long invested increasingly less in investigating the loans’ creditworthiness and may have repressed adverse information so that it did not reach others by ceasing to conduct due diligence. Concomitantly, issuers reduced the amount of subordination used to support the senior tranche and thereby increased the size of the more valuable senior tranche. The bottom line appears to be that an “originate and

³⁸ See E. Scott Reckard, *Sub-Prime Mortgage Watchdogs Kept on Leash; Loan Checkers Say their Warnings of Risk Were Met with Indifference*, L.A. TIMES, Mar. 17, 2008, at C1.

³⁹ *Id.*

⁴⁰ See text and notes, *supra* note 15, at 334–35.

⁴¹ See Reckard, *supra* note 38.

distribute” business model did lead to lax screening and deceptively below average loan portfolios.

Other detailed critiques of the CRAs have persuasively argued that: (1) they were slow to revise their ratings or downgrade securities; (2) they tend to “herd” or converge over time on a common rating (probably because a common error does not result in unique reputational damage);⁴² and (3) they did not adequately disclose their valuation models. Again, such behavior may have reflected the biases of investors as much as those of issuers, because investors did not want rating downgrades that applied to securities they already held in their portfolios. Thus, the problem of conflicts extends beyond the issuer.

II. THE DEBATE OVER POSSIBLE REFORMS: WHAT MIGHT WORK? WHAT WILL NOT?

CRA failure must be recognized as a factor that enhances systemic risk. Unless a reliable watchdog monitors the creditworthiness of CDOs and other asset-backed securitizations, these securities will either remain unmarketable or will endure highly volatile “boom and bust” cycles. Still, reformers mainly divide between (1) those who want to subject CRAs to closer regulation to purge the rating process of conflicts of interest, and (2) those who believe that the answer is deregulation through downsizing the role of credit ratings. This section will briefly review recent developments and then survey the range of reforms that have been proposed.

A. *Developments Over the Last Five Years*

1. *The United States*

In both the United States and Europe, credit rating agencies were not directly regulated for most of their existence. On the statutory level, this changed only in 2006 in the United States,⁴³ and prospective changes were only proposed in 2009 and 2010 in Europe. However, although the CRAs were not regulated, many institutional investors were. In the United States, banking and financial regulators have long required institutional investors and broker dealers to obtain ratings for debt securities they wished to hold in their portfolios in order to enable prudential-based regulation to distinguish

⁴² See Andre Gutler, *Lead-Lag Relationships and Rating Convergence Among Credit Rating Agencies* 14 (European Bus. Sch. Research Paper No. 09-14, 2009), available at <http://ssrn.com/abstract=1488164> (finding that Moody’s closely tracks S&P upgrades, but not its downgrades). Such “upside” herding only cannot be attributed to a quantitative model, but appears discretionary.

⁴³ In 2006, Congress passed the Credit Rating Agency Reform Act of 2006, which added Section 15E (“Registration of Nationally Recognized Statistical Rating Organizations”) to the Securities Exchange Act of 1934. 15 U.S.C. § 780-7.

safe investments from speculative ones. Beginning in 1975, the SEC required that such ratings be issued by “nationally recognized statistical rating organizations” (NRSROs).⁴⁴ Effectively, this NRSRO requirement meant that rating agencies not so designated by the SEC could not issue ratings on which institutions and broker-dealers could rely for these regulatory purposes. CRAs excluded from the “NRSRO” club were thus prejudiced because their ratings carried a lesser value.

Curiously, the SEC never officially defined the term “NRSRO,” nor did it establish formal criteria governing admission to the NRSRO club. Instead, the SEC’s staff used a vaguer and ultimately question-begging test that looked to whether an applicant was “nationally recognized by the professional users of ratings in the United States as an issuer of credible and reliable ratings.”⁴⁵ Between 1975 and 2006, the SEC generally refused to confer the NRSRO designation on most credit rating applicants, apparently because it feared that new and “fly-by-night” rating agencies would be more generous in awarding investment grade ratings and thereby lead a race to the bottom.

The SEC’s conservatism in approving new NRSROs drew criticism (particularly from excluded firms). Equally important, in the wake of the Enron, WorldCom, and related corporate scandals in the 2001–2002 period, the existing NRSROs became politically vulnerable because they had clearly failed to detect approaching financial disasters (the often-cited illustration being that none of the NRSROs downgraded Enron until four days before its bankruptcy).⁴⁶ Following a series of critical hearings, Congress enacted the Credit Rating Agency Reform Act of 2006, which created an objective registration framework that sought to both facilitate entry by new agencies into the NRSRO market and to mandate greater accountability by existing NRSROs. Although the 2006 Act did authorize broad rule-making by the SEC to restrict conflicts of interest, it also expressly denied the SEC the power to “regulate the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings.”⁴⁷ This compromise, under which the SEC can restrict conflicts of interest, require disclosure, and monitor performance, but not regulate the methodologies or models by which ratings are determined, reflected a congressional view that the SEC lacked the expertise to prescribe models to the CRAs, but could evaluate the consistency of application by each CRA. This compromise was not disturbed by the Dodd-Frank Act.

Pursuant to the powers granted it by the 2006 Act, the SEC promulgated a series of rules to (1) govern the registration procedure, (2) provide detailed disclosure as to the experience with the ratings issued by each NR-

⁴⁴ For a fuller background, see Coffee, *supra* note 4, at 294–96.

⁴⁵ See SECS. EXCH. COMM’N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 9 (2003).

⁴⁶ See Coffee, *supra* note 4, at 34–35.

⁴⁷ Section 15E(c)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-7(c)(2).

SRO rating agency, (3) regulate conflicts of interest, and (4) encourage competition. Probably the most noteworthy of these rules is Rule 17g-5, which expressly prohibits some seven types of conflicts of interest.⁴⁸ Even more importantly, Rule 17g-5 was amended in 2009 to create an “equal access” obligation. Under it, an NRSRO hired by an issuer or other arranger to determine an initial credit rating for a structured finance product must make available the information it receives from the issuer or arranger to other NRSROs (but not to the public generally) in order to enable them to issue their own ratings.⁴⁹ The intent of this “equal access” rule is to encourage competition by allowing potential competitors to obtain the same information given by the issuer to the CRA that it hires. In short, although this rule is based on the SEC’s power to regulate conflicts of interest, its primary intent is to foster competition.

The 2006 Act required the SEC to admit any NRSRO applicant that could make an adequate showing of competence, and the SEC has in fact expanded the number of NRSROs to ten (with other applications still pending). Nonetheless, “the Big Three” (Moody’s, Standard & Poor’s and Fitch Ratings) have remained dominant, with the new CRAs largely focusing on specialized market niches, such as insurance companies, or rating foreign firms based in their own jurisdiction. This continuity suggests that the Big Three’s dominance cannot be adequately explained by the regulatory powers the SEC allocated to them under its NRSRO system, as their market power both preexisted and survived the period in which they alone had licensing power. Indeed, even during the 1975-2006 period, a few new entrants were admitted by the SEC to the NRSRO club, but they were unable to compete successfully (and were ultimately acquired by the Big Three). Uniquely, Fitch Ratings did become competitive with Moody’s and S&P, but it had specialized in structured finance and thereby had acquired a competitive head start over its rivals (Moody’s was in fact slow to enter the structured finance field). Overall, this pattern suggests that there are important “first mover” advantages because reputational capital is hard to acquire and goes to the first firms in the field. If licensing power alone could explain the dominance of the Big Three, then the newer members of the SEC’s NRSRO club should be sharing in a collective oligopoly.

2. *Europe*

In comparison to the United States, Europe has not traditionally regulated CRAs. Following the Enron scandal in 2001, the Committee of European Securities Regulators (CESR) conducted a study for the European

⁴⁸ These seven prohibited conflicts (all set forth in Rule 17g-5(c)) are ably discussed in Lynn Bai, *On Regulating Conflict of Interests in the Credit Rating Industry*, 13 N.Y.U. J. LEGIS. & PUB. POL’Y 253 (2010). See also 17 C.F.R. Section 240.17g-5(c).

⁴⁹ See Securities Exchange Act Release No. 34-61050 2009 SEC LEXIS 3798 (Nov. 23, 2009).

Union Commission (the Commission) that ultimately concluded that legislation was not necessary to regulate the CRAs. Instead, the Commission relied on a Code of Conduct developed by the International Organization of Securities Commissions (IOSCO) to ensure the accountability of the CRAs. The Commission designated to CESR the responsibility of monitoring compliance with this Code and instructed CESR to report to the Commission annually. In 2006, after the first such report from CESR, the Commission again concluded that, although it saw problems with the performance of the CRAs, these problems were not sufficient to require legislation.⁵⁰

Under the IOSCO Code of Conduct approach, each CRA adopted a voluntary code, typically using the IOSCO Code as its model. CRAs could deviate from the IOSCO Code if they chose, but they had to disclose any departures pursuant to the EU's traditional "comply or explain" system of self-regulation.

Well established as the "comply or explain" model was in Europe, the 2008 financial crisis induced Europe to abandon it in the case of the CRAs in favor of a mandatory system of registration and administrative supervision. The process began in 2009, when the European Parliament adopted a "Proposal by the European Commission for a Regulation on Credit Rating Agencies."⁵¹ This initial regulation introduced the principle of mandatory registration for credit rating agencies operating in Europe, but it was not then clear who would supervise the CRAs. Then, on June 2, 2010, the European Commission proposed a revision to this regulation to create a pan-European body—the European Security Markets Authority (or ESMA)—that would be given exclusive supervisory authority over credit rating agencies registered in Europe.⁵² Backstopping this supervision would be new powers given to the ESMA to investigate, impose fines, and suspend or terminate a CRA's license. The proposal requires approval by the European Parliament and member governments, but it would represent the first pan-European body with day-to-day regulatory authority over the securities markets.

In some important respects, the EU Regulation resembles the SEC's approach, both in the requirement of registration and in a common "equal access" rule intended to promote competition.⁵³ The ESMA, however, would

⁵⁰ Stephane Rousseau, *Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road Toward Accountability*, 19–20 (Capital Mkts. Institute Research Paper, July 23, 2009), available at <http://ssrn.com/abstract=1456708>.

⁵¹ See Regulation 1060/2009, 2009 OJ (L 302), 1.

⁵² For overviews of this proposal, see James Kanter, *EU Seeks Oversight of Rating Agencies*, INT'L HERALD TRIB., June 3, 2010, at 15; *EC Waves Big Stick, Rival at Rating Agencies*, AUSTRALIAN, June 4, 2010, at 28. European thinking on credit rating agencies continues to evolve, and the latest step is a "public consultation" issued by the European Commission in late 2010, which stresses conflicts of interest and the issue of overreliance on credit ratings. See Huw Jones, *EU Plans for Financial Services in 2011*, HEDGEWORLD DAILY NEWS, Jan. 10, 2011. This is, however, the same tension between goals that exists in the United States.

⁵³ The SEC has, however, exempted foreign issuers for the time being from its "equal access" rule, while Europe has not. See *SEC, EU Take Divergent Approach to Ratings*, EUROWEEK, Nov. 26, 2010.

have marginally greater authority than the SEC, because it would be empowered to evaluate the methodologies and procedures used by the CRA to rate securities. Under the proposed EU Regulation, CRAs must periodically review their methodologies, adopt reasonable measures to assure the reliability of the information relied upon by their models, and ensure that their employees are adequately trained and have appropriate knowledge and experience. In general, the EU Regulation is framed in broad and non-specific terms and at this stage focuses more on establishing a framework for supervision than on mandating specific prophylactic rules.

3. *The New Convergence*

As a result of the EU Regulation, recent amendments to the IOSCO Code of Conduct, and the SEC's rules, the United States and Europe seem to be converging. Both SEC Rule 17g-5 and the IOSCO Code seek to reduce conflicts of interest by (1) barring an NRSRO or similar European CRA from issuing a rating with respect to an obligor or security where it has advised or consulted on the design or structuring of the security,⁵⁴ and (2) prohibiting an analyst who participates in the rating determination from negotiating the fee that the issuer or arranger pays for it.⁵⁵ The first prohibition is designed to discourage the provision of consulting services to issuers by rating agencies, and seems modeled on similar prohibitions in the Sarbanes-Oxley Act that precluded auditing firms from providing defined consulting services to audit clients for fear that the provision of such services would exacerbate conflicts of interest.⁵⁶ The second prohibition on analyst involvement in fee negotiations similarly seeks to protect the professional independence of the analyst (much as the "global settlement" reached by U.S. regulators in 2002 with the major investment banks sought to distance securities analysts from any involvement in marketing activities).⁵⁷ Building on

⁵⁴ SEC Rule 17g-5(c)(5) bars an NRSRO issuer from issuing or maintaining a rating where it (or any associated person) "made recommendations about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security." 17 C.F.R. § 240.17g-5(c)(5) (2009).

⁵⁵ SEC Rule 17g-5(c)(6) prohibits an NRSRO from issuing or maintaining a credit rating "where the fee paid for the rating was negotiated, discussed or arranged by a person within the NRSRO who has responsibility for participating in, determining or approving credit ratings" 17 C.F.R. § 240.17g-5(c)(6) (2009).

⁵⁶ Section 201 of the Sarbanes-Oxley Act of 2002 added a new Section 10A(g) to the Securities Exchange Act of 1934, which specifies a list of prohibited activities and services that an auditor of a public company cannot perform for that client because of the conflicts of interest that would result. This list ended with: "(9) any other service that the [Public Company Accounting Oversight Board] determines, by regulation, is impermissible." Section 10A(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j-1(g).

⁵⁷ The securities analysts scandal broke in 2002 when then New York State Attorney General Eliot Spitzer charged that research analysts at investment banks were issuing baseless and inflated stock recommendations to satisfy their employers and their corporate clients. Eventually, a global settlement involving the SEC, the NASD, and state regulators established prophylactic rules for the major investment banks that sought to insulate research analysts from pressure from investment bankers by limiting contacts between them and restricting the in-

the IOSCO Code of Conduct, the EU Regulation would similarly bar a rating agency from providing consulting or advisory services to a client whose securities it is rating.

Convergence is also evident in the common requirements under the SEC rules and the EU Regulation that CRAs disclose their methodologies, models, and key rating assumptions. Similarly, recent revisions to the IOSCO Code follow the SEC in endorsing a form of an “equal access” rule under which issuers are encouraged to publicly disclose all information provided by an issuer that is used by a CRA in rating an asset-backed security. If established, ESMA would presumably make this norm mandatory.

Given this relatively high level of convergence (albeit with fewer mandatory rules or enforcement mechanisms in Europe), the important questions become: (1) What important topics have not yet been addressed?; and (2) Are there areas in which Europe and the U.S. do not agree? One obvious example of the latter is the reported plan of the European Commission to establish a regional European rating agency to compete with the Big Three.⁵⁸ No similar idea has been proposed in the United States. At least in part, this proposal may be a reaction to the fact that Moody’s and S&P are American firms and, perhaps even more, to the action of the Big Three in recently downgrading European sovereign debt (most notably that of Greece) in a manner that was perceived to have exacerbated the recent European financial crisis in 2010.⁵⁹

More importantly, although some conflicts of interest have been addressed, neither the SEC nor the EU Commission has yet addressed the “issuer pays” business model of the CRAs or the highly concentrated character of the CRA market. These issues dwarf those on which the European Union and the United States appear to have converged.

B. An Overview of the Choices Not Yet Faced

In some areas, the United States and Europe still diverge; in other areas (such as the promotion of competition and the control of conflicts of interest), neither has yet fully resolved how to implement its goals.

volvement of analysts in IPO marketing activities. For a review of this episode and the resulting reforms, see generally Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 58 ALA. L. REV. 1083 (2007).

⁵⁸ See generally Kanter, *supra* note 52; Jones, *supra* note 52.

⁵⁹ European commentators have viewed the recent E.U. decision to tighten supervision of credit rating agencies and to seek to reduce the dominance of the Big Three as having been motivated in part by the Big Three’s common decision to downgrade (or place on ratings watch) the sovereign debt of Greece, Ireland, and Portugal in 2010. See Sarah Collins, *Credit Rating Agencies: ECON Votes to Bring Agencies Under New Markets Watchdog*, EURO POLITICS, Nov. 24, 2010 (noting that rating agencies were “blamed for inflating market tensions” by downgrading those countries’ sovereign debt). Of course, this may be a case of “blaming the messenger” with the debt of those countries deserving downgrades from investment grade status.

1. *Litigation and Remedies: Should the Goal Be Compensation or Deterrence?*

Although the U.S. House of Representatives initially passed legislation that would have subjected the CRAs to liability for gross negligence,⁶⁰ the Dodd-Frank Act stopped well short of adopting the House's negligence standard and instead opted for a more traditional fraud-based standard that was contained in the later passed Senate bill. That Senate bill (whose liability provision was initially drafted by this author and is later discussed in more detail) used a more traditional scienter-based test. Essentially, the Senate bill coupled a fraud-based standard with a safe harbor that becomes applicable when the CRA conducts or obtains factual verification of the key elements in its ratings model. Thus, the Senate bill's goal was more focused on encouraging due diligence than on maximizing the potential for liability.

Although if the Dodd-Frank Act does enhance the liability of the CRAs, a constitutional question mark still hangs over this area that could nullify this new liability provision. Some judicial decisions in the United States have viewed credit ratings as expressions of opinion protected by the First Amendment.⁶¹ The case law in the United States is currently divided on this question,⁶² and no authoritative answer is possible until the Supreme Court addresses the issue.

From a policy perspective, however, the issue should be faced candidly: does negligence-based liability make sense? Although the case for enhanced liability may be strong, three distinct policy reasons suggest that a liberalized negligence standard would be ill-advised. First, a negligence standard could easily bankrupt the CRAs, as a single case could produce a billion dollar (or greater) judgment. Second, the threat of a negligence standard could lead the CRAs to withdraw from rating risky structured finance products (and similarly chill new entrants from entering this field). Indeed, if the CRAs were to cease to rate structured finance products because of this standard, housing finance in the United States might remain paralyzed, as many investors might feel unable to make judgments on their own about opaque structured finance products. Third, and most importantly, the appropriate

⁶⁰ See H.R. 4173 § 6003(c), 111th Cong. (1st Sess. 2009). This provision would have subjected the CRAs to liability if a credit rating was "(1) grossly negligent at the time it was issued, and (2) a substantial factor in the economic loss suffered by the investor." *Id.*

⁶¹ For such holdings, see *Jefferson C. Sch. Dist. No. R-1 v. Moody's Investor's Serv., Inc.*, 175 F.3d 848, 852–56 (10th Cir. 1999); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 511 F. Supp. 2d 742, 809–27 (S.D. Tex. 2005). For a recent skeptical review of the CRAs' claim to a First Amendment defense, see generally Caleb Deats, *Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agencies' Faulty Methodologies From Regulation?*, 110 COLUM. L. REV. 1818 (2010).

⁶² Some recent decisions have refused to find the First Amendment applicable to ratings on structured finance products, because in the view of these courts no issue of public concern that merited First Amendment protection arises in the rating of the debt of a "special purpose entity" that was to be sold only to a limited group of institutional investors. See *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 651 F. Supp. 2d 155, 176 (S.D.N.Y. 2009).

legislative goal should be deterrence, not compensation. Given that trillions of dollars in structured finance products have been marketed globally, there is no realistic possibility that the credit rating agencies could fund meaningful compensation to most of their victims. Their pockets are simply not deep enough to cover even a small percentage of the losses associated with structured finance.

If so, the realistic objective should be to focus deterrence on the CRAs so that in the future they conduct adequate due diligence and update their financial models to reflect new developments. On this premise, any cause of action against the CRAs should logically be coupled with a ceiling on liability to ensure that the deterrent threat does not lead to the financial destruction of an arguably necessary financial intermediary. Indeed, this danger is especially acute in the case of a CRA, because its mistakes are typically interlinked and involve multiple securities issuances. That is, an error in its valuation model or any shortcoming in its verification procedures may produce inflated ratings in the case of dozens (or even hundreds) of issuers (with billions of dollars in damages thereby resulting). In contrast, any single error by an auditor will likely produce only inaccurate financial statements in the case of one issuer. Put differently, because a misjudgment by a CRA may enable a far greater dollar volume of securities to be sold, the need for deterrence is strong, but the case for a ceiling on its liability may be even stronger.

2. *Manager Compensation As a Policy Lever*

In principle, the accuracy of a credit rating is only demonstrated over the long-run, but the payment for it is made in the short-run. This mismatch can create agency problems, as the managers who determine the rating may not expect (or intend) to be around at the end of the ratings cycle. In effect, they may hope to obtain incentive compensation in the short-run reflecting their firm's increased ratings revenue, even though their mispricing of risk has created a much greater long-term liability for their employer. To deal with this mismatch, some have proposed compensation constraints. For example, at the entity level, the fee to the CRA could conceivably be placed in escrow until the bond was paid off; alternatively, the law could entitle investors to "clawback" the fee if the rating proved inaccurate (i.e., in the event of a default, downgrade, or some other "credit event"). At the manager level, salaries or other compensation could be similarly clawed back by the rating agency. Alternatively—and perhaps more feasibly—the manager could become entitled to bonuses or other incentive compensation at the conclusion of the ratings cycle if the rating proved accurate.

Although logical in theory, these compensation-based proposals encounter overwhelming practical difficulties. Rating fees cannot easily be placed in escrow for the life of the bond without creating severe liquidity problems for the ratings agency. Equally important, if the rating proves in-

flated, the issuer who paid the CRA for that rating should not receive a seeming windfall profit by allowing it to recapture its excessive fee. Only the injured investor deserves any repayment, and it wants restitution of its loss, not a mere clawback of the rating agency's fees. Clawbacks directed at employees and former employees may also be difficult to enforce—particularly years after the inaccurate rating was issued. Nor is it clear that the CRA should be entitled to a clawback from its own analysts. Indeed, if the inflated rating was the result of pressure by the rating agency on its employee (backed up by the implicit threat of dismissal if the employee lost “market share”), then arming the employer with a right to clawback the employee's compensation rewards the principal culprit. In any event, employees who are motivated to inflate ratings by fear of demotion or dismissal are unlikely to find the distant threat of a clawback in future years sufficient to offset fully the shorter-term pressure.

Subtler variations on compensation formulas can be imagined. Listokin and Talbleson have suggested that rating fees should be paid to the CRA in the rated securities so that the cost of the overvaluation of the rate securities would fall on the rating agency.⁶³ Clever as this idea may be in principle, it would not work if the CRA could immediately sell the debt securities before their misrating was discovered. If sales were restricted, then the CRA would have to hold a sizable portfolio of securities with resulting liquidity and legal problems.⁶⁴ Also, if the rating fee was a basis point (or less) of the deal size, such a fee system would issue relatively small amounts of debt securities (and in odd denominations) to the rating agency. It is inefficient to hold or trade small quantities of a large number of illiquid debt securities (as the CRA would incur disproportionate brokerage fees). To sum up, clawbacks and long-term compensation restrictions seem impractical.

3. *Curbing Conflicts of Interest and the “Issuer Pays” Business Model*

The most obvious conflict of interest that potentially undercuts the credit rating agency's independence and objectivity is the simple fact that the issuer pays the rating agency's fee. At some point in the mid-1970s, the credit rating agencies shifted to this business model after finding that they could be no more than marginally profitable operating on a subscription basis under which investors paid for their ratings.⁶⁵

⁶³ See generally Yair Listokin & Benjamin Talbleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91 (2010).

⁶⁴ For example, the CRA might become an “inadvertent” investment company under the Investment Company Act of 1940 if this securities portfolio constituted the majority of its assets. This could happen because CRAs do not own sizable fixed assets.

⁶⁵ See Coffee, *supra* note 4, at 295–96.

Obvious as the conflict in an “issuer pays” model is, three points must be immediately made about the realism of seeking to eliminate it: (1) Most financial gatekeepers—auditors, law firms, investment banks—operate under a similar model under which the issuer pays their fees; (2) Investors also have biases that can create conflicts for rating agencies; and (3) A “subscriber pays” model may be doomed to failure by the “public goods” nature of ratings. Because the rating agency cannot effectively prevent the communication of its ratings to non-paying investors once it discloses its ratings to its clients, it cannot capture the full value of the financial information that it creates. For example, a subscriber may leak the rating information to another institutional investor, possibly in return for some reciprocal favor (including disclosure of the rating issued by some other rating agency). As a result, free riders will inevitably acquire and use the information without compensating the creator—in effect, instantiating the standard “non-excludability” criterion that defines a public good. Indeed, some have argued that the principal CRAs encountered this free riding problem in the early 1970s, which led them to shift to the “issuer pays” model.⁶⁶

But if a pure “subscriber pays” system is not feasible, a close approximation may be more realistic. Regulators could encourage the issuer to pay for the rating, but deny it the ability to select the rater. Issuers should be willing to pay for an independent rating because unrated securities would not be marketable. This strategy would also respond to the independent problem of “rating shopping,” under which issuers seek preliminary ratings and then choose the agency giving it the highest preliminary rating to issue the final rating.⁶⁷

From this starting point, the next step is to consider the alternative means by which the rating agency might be chosen. Three obvious alternatives are apparent, but each could be further refined in a variety of ways:

⁶⁶ Professor Lawrence White has suggested that this shift was attributable to the rating agencies’ inability to keep their ratings secret—in effect, their ratings became “public goods.” By the 1970s, information technology—the xerox, the fax machine, etc.—made it impossible for rating agencies to keep their ratings confidential, as the initial subscriber could easily disseminate this information to colleagues that were non-subscribers. For a similar account that also relies on the rating agencies’ inability to keep their ratings secret, see Milosz Gudowski, *Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency*, 10 COLUM. BUS. L. REV. 245, 254-55 (2010).

⁶⁷ The topic of “ratings shopping”—the practice whereby issuers seek out the most lenient rating agency or the agency least likely to downgrade an already rated issue—has been much discussed, and some former agency employees have testified that it was common. See Jesse Eisenger, *Lessons on Bond Ratings Not Learned After Crisis; Window on Wall Street*, INT’L HERALD TRIB., Jan. 6, 2011, at 17 (discussing testimony of Eric Kolchinsky, a former Moody’s executive). For more general discussions of ratings shopping, see Benmelech & Dlugosz, *supra* note 2, at 630–33; Efraim Benmelech & Jennifer Dlugosz, *The Credit Rating Crisis*, in 24 NBER MACROECONOMICS ANNUAL 2009, at 161–207 (Daron Acemoglu et al. eds., 2009).

a. *The Government As Hiring Agent*

The selection of the rating agency could be given to an independent governmental agency. In 2010, the U.S. Senate voted in favor of this option, approving by a large majority an amendment offered by Senator Al Franken (D-MN) to the then pending Dodd-Frank Act. The Franken Amendment would have created a “Credit Agency Review Board” (the Board), which would choose the initial rater for all “structured financial products.” The issuer would remain free to (1) secure no rating at all, or (2) hire additional rating agencies if it wished. As proposed, the Board would be established under the SEC and subject to its oversight. Although the Board would not determine the fee to be paid by the issuer to the rating agency, the SEC was instructed by the legislation to place a “reasonable” ceiling on the fee, both to prevent overcharging by the rating agency and implicit bribery by the issuer.

Ultimately, the Franken Amendment was watered down in the final revisions of the Dodd-Frank Act so that its proposed Board is contingent upon SEC approval. As finally passed, the Dodd-Frank Act requires the SEC to conduct a study of the feasibility of this approach. Following that study (which must be conducted within two years of the Act’s passage), the SEC is authorized to adopt the equivalent of, or a variation on, the Franken Amendment.⁶⁸ In short, this proposal remains very much on the table for discussion and modification.

b. *Encouraging a “Subscriber Pays” Model*

Another possible approach that avoids issuer domination of the rating determination would be to require institutional investors to obtain their own ratings from a rating agency not retained by the issuer or underwriters before they could purchase the debt securities. The issuer would also remain free to hire its own rating agency, but each institutional investor would need to obtain its own independent rating. The goal of this approach is to spur the growth of a “subscriber pays” market. Its key premise is that a “subscriber pays” market will not develop on its own (as it clearly has not to date) so long as investors are free to rely on an “issuer paid” rating. Some reformers would go even further and seek to mandate or encourage the formation of investor-owned rating agencies on the premise that such collectives would be bias free.⁶⁹

At least two serious objections make this approach problematic: (1) it may not be feasible (as institutions will resist paying any fee), and (2) it may simply substitute the investor’s bias for the issuer’s bias. The belief that insti-

⁶⁸ See Dodd-Frank Act § 939F.

⁶⁹ For such a proposal, see generally Joseph Grundfest & Evgeniya E. Hochenberg, *Investor Owned and Controlled Rating Agencies: A Summary Introduction* (Rock Ctr. for Corporate Governance Working Paper No. 66, 2009), available at <http://ssrn.com/abstract=1494527>.

tutional investors will form their own ratings agencies probably posits a stronger investor interest in ratings reform than it is realistic to assume exists. Mutual funds in particular need to economize on costs in order to compete for investor funds. Conceivably, even if individual institutions will resist expending funds on ratings, groups of institutions might economize on their fees under a mandatory “subscriber pays” system by jointly hiring an independent rating agency at a discounted “wholesale” price.

But this still leaves the second problem: institutions have their own conflicts of interest. They may prefer inflated ratings because it permits them to hold higher risk securities and thus earn higher yields without appearing to violate their “prudent man” responsibilities to their own investors.⁷⁰ To be sure, not all institutions behave in this fashion and probably only a minority do, but a problem with a wholly individualized “subscriber pays” model is that it might encourage high risk-taking by some institutions.

c. The Government Utility Model

A last alternative is a government-created and managed rating agency, and the E.U. is currently considering such an approach on a regional basis. This “Governmental Utility Model” could be designed to be a check on the private market—much as the TVA was created in the U.S. during the New Deal era as a check and yardstick by which to measure the performance of privately owned public utilities.⁷¹ That is, it would not be an exclusive rater, but investors would compare the Moody’s or S&P rating against the governmental rating.

d. A Policy Evaluation

Each approach has its own advantages and disadvantages. Using the government (or its proxy, such as a stock exchange) as the neutral party who selects the initial rating agency is simple and direct and should assure the independence of the chosen rater. That the issuer could then select its own rating agency for a second opinion also ensures that there will be a diversity of views. More uncertain, however, is both whether the rating agency so chosen would have credibility and whether it would have the proper incentives. Conceivably, a governmental board could degenerate into a means for distributing patronage and political payoffs. How do we ensure that political loyalties and contributions do not influence the selection of the initial, government-appointed rating agency? The Franken Amendment provided that independent commissioners chosen by the SEC would perform this function, and it also permits its CRARB to use either a lottery or a rotating assignment

⁷⁰ For this view, see Cornaggia & Cornaggia, *supra* note 11, at 2.

⁷¹ For a strong endorsement of such a governmental utility model, see Milosz Gudowski, *Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency*, 10 COLUM. BUS. L. REV. 245, 264–71 (2010).

system. The sheer volume of initial ratings may compel such a mechanical approach because the Board may find it infeasible to make individualized decisions in every case.

Although random or rotation assignments should protect against political favoritism and probably would encourage new entrants to apply to become NRSROs in order to obtain initial rating assignments, the problem with such a system is that it creates little incentive for rating agencies to compete based on the quality of their ratings. If assured a market, the rating agencies do not need to win the favor of investors to obtain revenues. In addition, the rating agency so chosen might charge inflated fees because, once selected by the Board, it can use this leverage to compel the issuer to pay an above-market fee. Further, if we are concerned about encouraging factual verification and due diligence, the participants under this system would have little incentive to invest in costly research or to conduct factual verification. Effectively, they might behave much like civil servants or tenured academics, placidly enjoying the quiet life.

Of course, the Board might instead choose the initial rating agency based on each CRA's prior record for accuracy. But this is easier said than done. A reliable track record for accuracy might take a decade or more to develop. New entrants would also have little prior experience upon which to rest any claim to demonstrated accuracy, and thus they would be prejudiced. In theory, the debt securities would have to be repaid or redeemed before the full rating cycle was completed and the accuracy of the rating could be accurately judged. If the Board were to prefer established raters with a demonstrated history of rating accuracy, this would largely perpetuate the existing oligopoly of the Big Three and might subject the Board to criticism for failing to encourage greater competition. Hence, political pressures and congressional expectations seem likely to compel the Board to favor either rotating assignments or some other technique that gave a substantial share of initial rating assignments to firms outside the Big Three.

Another problem might be the response of the Big Three to such a system. If the Big Three rating agencies elected to operate only as "issuer paid" rating agencies and thus did not seek initial ratings from this Board, most of the initial raters would be relatively unknown raters whose opinions might not command much respect in the market. In short, there are risks that the initial raters would be both under-motivated and ignored, unless a more demanding selection criterion gave them greater credibility.

The second alternative—i.e., requiring institutions to obtain a credit rating from the rating agency of their choice (provided that it was not also paid by the issuer)—has the key advantage of encouraging greater competition. New rating firms would enter this market to compete for this business (probably on the accurate assumption that Moody's and S&P would remain committed to an "issuer pays" business model). Under such a "subscriber pays" system, the free rider problem would also diminish in its significance, because each substantial institutional investor would be required to hire a rat-

ing agency for advice.⁷² A market would thus be assured. Reputational capital would now count for something, and the rating agency might deliver a fuller report, not simply a two- or three-letter rating. Candidly, however, it must be recognized that investors are likely to resist having to pay themselves for a rating. Securities analysts have similarly found investors resistant to paying for investment advice. Although a “subscriber pays” model could be legally mandated, investors are likely to constitute a powerful political lobby against such a reform—at least so long as its costs fall on them.

A further danger in this model might be that some institutional investors would opt for the cheapest rating agency, which agency might in turn economize on its own efforts by simply conforming to the ratings provided by the “issuer paid” rating agency. Such “herding” is already common among both securities analysts and rating agencies.⁷³

Finally, there is the even more sinister danger that many institutions (in particular, money market funds) wanted inflated ratings so that they could earn the higher returns from riskier securities. To hold such higher yielding securities, it was necessary for them to be able to rely on the stability of the rating and the unlikelihood of a post-issuance rating downgrade.⁷⁴

In response to these objections, several possible design revisions can be imagined. One response to the unwillingness of investors to pay for research would be to allow institutions to pass on the cost of ratings by seeking reimbursement of their rating fees from the issuer or deal arranger. At this point, the conflict of interest problem now re-enters through the back door (as underwriters might find ways to influence the choice of rating agency in return for agreeing to reimburse those costs). Reimbursement of the rating fee need not be prohibited, but its permissibility should be clearly conditioned on the investor having an unfettered right to choose its own rating agency.

Another bolder alternative, proposed by Grundfest and Hochenberg, envisions that any issuer who purchases an NRSRO rating must also pay for a second rating from an “Investor Owned and Controlled Rating Agency” (IOCRA).⁷⁵ Again, this seeks to subsidize a “subscriber-based” market. Still, the incentive of investors to form such subsidiaries or collectives seems modest, in part because institutional investors are often in active competition with each other and thus do not share information freely.

Absent the unlikely formation of such investor-owned rating agencies, the simpler and more comprehensive approach would be to require issuers to

⁷² A significant legal difficulty arises, however, with proposals to mandate behavior by investors. In general, the SEC and other securities regulators have no delegated power over investors as a group (but only selected institutions, such as mutual funds). Nor would it be politically easy to pass legislation requiring investors (or even institutional investors) to bear specified costs (such as the cost of a rating agency’s rating).

⁷³ See generally Gutler, *supra* note 42.

⁷⁴ See generally Cornaggia & Cornaggia, *supra* note 11 (arguing that the slowness of Moody’s and S&P to downgrade ratings was motivated by the desire of institutions to hold risky, but higher yielding, securities).

⁷⁵ See generally Grundfest & Hochenberg, *supra* note 69.

pay for one or more ratings from an investor-chosen rating agency. But here the critical complication involves how investors are to choose such a second (or even third) rating agency, as the issuer cannot reasonably be expected to pay for the choice of each individual investor when this might require it to retain numerous rating agencies. One feasible answer to this problem would be to instruct the governmental Board that selects the rater (under the Franken Amendment approach discussed above) to poll institutional investors and select the rater preferred by the most institutions (possibly excluding any rating agency already retained by the issuer). In effect, the Board would defer to the investors' choice. This would not permit every institution its individual choice, but it would still induce rating agencies to compete for the investors' favor. So long as the issuer is not choosing the rating agency, there is little harm in its paying the rating agency's fee, and under this variation, rating agencies would still be incentivized to cater their services to investors.

To be sure, the danger remains that some investors may prefer a rating agency that gave inflated ratings in order to enable them to purchase risky securities with higher yields. But an advantage of this last approach of an investor vote or poll is that it mitigates the danger that "fly-by-night" rating agencies would be chosen to deliver inflated ratings. Such a desire is plausible in individual cases because an "investment grade" rating from an NR-SRO agency gives legal protection to the board and officers of a risk-preferring institutional investor in the event that a breach of fiduciary duty claim is raised against them following a costly default. Yet, if some investors will act in this fashion, it seems unlikely that most will. Thus, a rating agency collectively chosen by a vote or poll of the institutions reduces this danger if we assume that the majority of institutions are prudent and only the minority are apt to behave as risk-preferrers.⁷⁶

The third option of the governmental rating agency raises the clearest dangers, for two distinct reasons. First, governmental agencies cannot pay the same salaries or incentive compensation to their employers as firms in the private sector can, and this implies that a "public" rating agency might have to rely on inferior personnel or less research. Second and more importantly, serious doubt exists that a "public" rating agency could give a negative (or "junk") rating to an important or politically-favored local firm. Consider whether over the last decade a U.S. "public" rating agency would have dared to rate the bonds of General Motors (G.M.) as "junk" (or non-investment grade). To be sure, the debt market might well have known that General Motors deserved such a low rating, but political outrage would have been predictably triggered if such a negative rating prevented a debt offering

⁷⁶ Institutional investors vary greatly in their styles and preferences. Although it is certainly imaginable that some money market funds would want inflated ratings so that they could take higher risk and receive higher returns, it is less plausible that pension funds would do so. Hence, the majority's preference would likely favor accuracy over deliberate inflation.

(or embarrassed public pension funds so that they declined to buy in G.M.'s debt offering). Congress could threaten to withhold further appropriations to such an agency unless its pessimism about the lowly-rated favored firm were corrected.

This U.S. example is probably mirrored by equivalent European examples (e.g., could a German "public" ratings agency easily downgrade Deutsche Bank or Volkswagen?). Indeed, the European Commission's interest in a European credit rating agency may have been triggered in part by the political outrage at the Big Three for downgrading of Greece's sovereign debt. Some non-European editorialists have already recognized this episode as a classic case of "blaming the messenger."⁷⁷ The sad but simple truth is that politically accountable public bodies may find it more difficult to resist political pressure.

Nonetheless, even if a "Government Utility" rating agency is not a preferred option, little harm would follow from the addition of such an agency to the mix of opinions (if either the first or second option discussed above were selected). Also, a regional credit rating agency that was not subject to the control of any one country might be relatively less vulnerable to political pressure (although the example of downgrading Greece's debt suggests otherwise).

The one advantage of a Government Utility Approach is also the major disadvantage of the "subscriber pays" model: those who do *not* pay are left in the dark by a "subscriber pays" model. Transparency might be lost if all major institutional investors were relying on "subscriber paid" ratings, which smaller investors could not access. Still, the validity of this concern probably depends on whether issuers and deal arrangers would continue to hire Moody's and S&P to deliver "issuer paid" ratings that were publicly disclosed. If they would, then the public would still have at least one publicly disclosed rating (which would likely be more accurate than today because of the competition from "private" ratings). In effect, no one is worse off under this system. Moreover, the need for public disclosure of ratings may depend on the extent of retail investor participation in the market, and generally retail investors simply do not participate in the market for structured finance products.

4. *Reducing the Regulatory Power of Rating Agencies*

Some believe that the basic error made by regulators was to grant ratings agencies a de facto regulatory role. In truth, this decision, which dates back to the 1930s in the United States, was the product of the inability of financial regulators to define excessive risk themselves. Needing to prevent, first, banks, and, later, mutual funds, investment banks, pension funds, and

⁷⁷ See Peter Hosking, *Brussels Busy Shooting the Messenger*, AUSTRALIAN, June 4, 2010, at 28.

other collective investment vehicles from overinvesting in risky securities, U.S. financial regulators either: (1) required these institutions to limit their debt investments to securities having an “investment grade” credit rating (or at least to keep the majority of their portfolio in such securities); or (2) applied a stern “haircut” (or writedown) to financial investments not having such a rating, thereby requiring investment and commercial banks to retain greater capital for regulatory purposes. Then, realizing that financial institutions could outflank these rules by turning to new “fly-by-night” credit rating agencies, the SEC adopted rules in the mid-1970s that created a small, select club of NRSROs.⁷⁸ Because only the ratings issued by these NRSRO agencies were to be considered by regulators in determining the “investment grade” status of debt securities, this last step gave the Big Three de facto regulatory power.

In hindsight, the now ironic premise behind the SEC’s reluctance to expand the number of NRSROs was that the Big Three were beyond capture. Until 2006, the SEC closely guarded its NRSRO designation and deliberately excluded most applicants seeking it (and those granted admission to the NRSRO club were often acquired by Moody’s or S&P). Eventually, the passage of the Credit Rating Agency Reform Act in 2006 opened the doors of this club to new entrants. Although the economic barriers to entry remain high, there are today at least ten NRSROs, up significantly from the three firms that long dominated the field. But most of the new entrants occupy only specialized “niche” markets, and few, if any, rate structured finance products (for reasons discussed below).

Critics assert that the NRSRO designation (and similar requirements for investment grade ratings adopted as early as the mid-1930s by the Comptroller of the Currency) gave the credit rating agencies de facto licensing power and thereby compelled investors to rely upon them for regulatory permission. Clearly, this outcome was not intended, as federal regulators were simply following the path of least resistance. For regulators, the drafting of comprehensive standards of creditworthiness (as the obvious alternative to reliance on credit ratings) would have been a burdensome challenge (which is only now being faced). But even if the intent was benign, the effect was unfortunate, and these critics make a plausible case that regulatory licensing power became the principal barrier to entry that excluded new entrants. Still, while plausible, this case is ultimately less than fully convincing for several reasons: first, the Big Three also dominate European ratings where they enjoy no similar licensing power. Second, because Moody’s and S&P dominated the field since early in the 20th century, well before the creation of NRSROs and similar regulatory rules, the claim that their licensing power explains their market dominance cannot explain their market power before the time that they received any licensing power. Third, experience since 2006 shows that expanding the NRSRO club to ten firms has not eroded the

⁷⁸ For a concise overview of these developments, see Coffee, *supra* note 4, at 283–91.

dominance of the Big Three.⁷⁹ Their supremacy thus seems more based on “first mover” advantages and the difficulty of entering the field without a proven track record. If, as widely assumed, economies of scale characterize the production of financial information, the first entrant can operate more efficiently and exclude later entrants.

In this light, two more plausible hypotheses exist for the Big Three’s dominance. First, it is arguable that many sophisticated institutional investors relied on Moody’s and S&P because there was no one better to rely upon, even though they knew the conflicts latent in the “issuer pays” model.⁸⁰ Second, regulatory arbitrage can also explain the dominance of the Big Three. If Moody’s and S&P tend to do what critics suspect (i.e., to inflate their ratings, to only belatedly downgrade risky securities, and to ignore factual verification), the deeper problem is that these tendencies may have pleased issuers and many institutional investors alike because such a policy allowed the former to market risky products as safe (and thereby sell at a higher price) and the latter to hold risky securities with higher yields (which more accurate ratings would have prevented).⁸¹ In this light, the Big Three were selling a flawed product that both the “sell” and “buy” sides of the market wanted because of their own biases.

Whatever its accuracy, the “licensing power” argument has convinced many, and reformers in the U.S. have insisted on reducing the de facto regulatory power accorded NRSRO rating agencies. As a result, the Dodd-Frank Act requires all federal agencies to delete references to credit ratings (or requirements for the reliance on specified such ratings) from their regulations.⁸² Instead, the Act instructs financial regulators to adopt their own “standards of credit-worthiness.”⁸³

What will be the impact of such deletions? In all likelihood, they will have only marginal impact on the market position of the Big Three credit rating agencies, because many institutional investors will still want ratings for legal defensive purposes if they are sued. Only a small subset of institutional investors have the “in-house” capacity to undertake a serious analysis

⁷⁹ Based on an empirical study, Professor Bai finds that “brand name” has been more effective than relative performance and that the firms with the largest market share have had the poorer performance record for accuracy. See Bai, *supra* note 9, at 87–89.

⁸⁰ Economists have in fact developed such a model that assumes that some investors are “naïve” and others sophisticated. Under it, naïve investors take the ratings at face value, while sophisticated investors realize they are unable to determine the accuracy of the rating. They conclude that the reputational cost may be low in an oligopolistic market where all the major actors inflate their ratings. See Patrick Bolton, Xavier Friexas & Joel Shapiro, *The Credit Rating Game* (NBER Working Paper No. 14712, 2009), available at <http://www.nber.org/papers/w14712>.

⁸¹ For a concise summary of this position, see generally Cornaggia & Cornaggia, *supra* note 11.

⁸² See Dodd-Frank Act § 939A (“Review of Reliance on Ratings”). This section requires each federal agency to review its regulations and “remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.” *Id.*

⁸³ *Id.* Again, this may prove easier said than done.

of the creditworthiness of debt securities, while many funds compete by economizing on such expenses. Nonetheless, one strategic move might be made by the Big Three that would destabilize the status quo: they could decide to surrender their NRSRO status, and thereby avoid the more demanding provisions of the Dodd-Frank Act, which only apply to NRSROs. Indeed, the combined impact of the Franken Amendment and the deletion of references to credit ratings in SEC rules may make NRSRO status more of a burden than a benefit for the Big Three. If the Franken Amendment were implemented by the SEC, the cost of abandoning their NRSRO status for the Big Three would be that they would lose the ability to give the initial ratings to most “structured finance” issuers. Yet, logically they might prefer to market themselves to issuers as the providers of second opinions. With SEC rules no longer referring to credit ratings, the Big Three will necessarily lose some of their so-called licensing power, and to this extent NRSRO status is less valuable. Accordingly, when the burdens outweigh the benefits, it makes sense for them to abandon NRSRO status—if they can.⁸⁴

The idea that reducing the regulatory power of the ratings agencies is the key to regulatory reform is simple, sweeping, and requires little understanding of the institutional or regulatory context; thus, it is popular in academia. In reality, however, reducing the role of the rating agencies will likely be a slow and confused process, and thus, at least for the interim, oversight remains essential. The difficulties that a policy of downsizing the rating agencies will encounter has been shown by the early experience under the Dodd-Frank Act. The Act expressly overruled a long-standing SEC rule (Rule 436(g)) that gave rating agencies an exemption from the liability that a statutory expert faces under Section 11 of the Securities Act of 1933.⁸⁵ Under Section 11, an “expert” whose opinion is cited in a registration statement used in connection with a public offering of securities has presumptive liability for any material misstatement that it makes. Thus, if the issuer’s stock price declines after the offering, the expert can be held liable for this price decline, unless it can prove that it was not negligent (with the burden of proof on the expert). Because the language of Section 11 clearly covers rating agencies, it followed that if the registration statement referenced their ratings, the rating agencies faced Section 11 liability. Still, for many years, the SEC had effectively exempted rating agencies from Section 11 liability pursuant to Rule 436(g), which allowed a rating agency to avoid consenting to becoming a statutory “expert.” Dissatisfied with the rating agencies’ per-

⁸⁴ A complicated legal issue surrounds whether existing NRSROs can deregister and in effect abandon their NRSRO license (now that it has reduced value). That issue is beyond the scope of this paper and will likely depend on future SEC regulations.

⁸⁵ See 17 C.F.R. § 230.436(g) (2009). Technically, this rule permitted the rating agency not to file a consent to the use of its rating in the prospectus. The significance of this failure to file a consent was that an expert is liable under Section 11 only if it consents to be named as an expert in the registration statement.

formance, Congress ended this exemption in the Dodd-Frank Act and expressly overrode Rule 436(g).⁸⁶

What happened next? Predictably, the rating agencies refused to consent and thus blocked their ratings from being referenced in registration statements (as they were entitled to do). At this point, issuers discovered that, in the case of asset-backed securitizations, the SEC's rules required disclosure of the rating in the registration statement; thus, they could not comply without the rating agency's consent. As a result, for a brief time, the public debt markets froze, and offerings were delayed.⁸⁷ In response, the SEC declared a six month moratorium on its rule requiring the disclosure of ratings in the registration statement in the hope that a compromise could be negotiated.⁸⁸ The probability is that the SEC will accede to a compromise under which ratings can be disclosed without the rating agency becoming an "expert" or facing Section 11 liability.⁸⁹

The message here is that feasible reform needs to be incremental, because ratings are too deeply embedded in the debt offering process to be simply eliminated by the stroke of a pen. Whether the rating agencies would continue their "strike" if it would cost them issuer business is uncertain, but negligence-based liability could conceivably cause them to withdraw from some markets. Similar problems will arise if money market funds are told that they may not rely on NRSRO "investment grade" ratings. Worried that they may face personal liability for an investment that goes sour, the boards of such funds have already fiercely resisted any deregulation that would deny them the ability to rely on investment grade ratings, and politically they are a potent force. This does not mean that de-emphasis of credit ratings is wrong, but only that it will involve bruising political fights and some unforeseen consequences.

Before bruising battles are fought, public policy needs to define more clearly what it is seeking most. The key problem is less that rating agencies were given licensing power, and more that they sought to compete on bases other than ratings accuracy. Over time, they found they could please both

⁸⁶ See Dodd-Frank Act § 939G (providing that Rule 436(g) "shall have no force or effect"). As a result, if a rating agency's rating is to be cited in a registration statement, the rating agency must consent and thereby face Section 11 liability.

⁸⁷ See Anusha Shrivastava & Fawn Johnson, *SEC Breaks Impasse With Rating Firms*, WALL ST. J., July 23, 2010, at C-1; Dennis Berman, *Note to Credit Raters: Evolve or Die*, WALL ST. J., July 27, 2010, at C-1.

⁸⁸ See Meredith Cross, *Statement by the SEC Staff: Statement Regarding the Registered Asset-Backed Securities Market* (July 22, 2010) available at <http://www.sec.gov/news/speech/2010/spch072210mc.htm> (announcing a six-month moratorium during which ratings need not be disclosed in the registration statement).

⁸⁹ One "solution" in the eyes of the Bar would be to allow disclosure of the rating in a "free writing prospectus" which does not carry Section 11 liability. The term "free writing prospectus" is defined in SEC Rule 405 and its use is governed by SEC Rule 433. See 17 C.F.R. §§ 230.405, 230.433 (2009). Arguably, such a compromise frustrates Congress's intent by allowing rating agencies to escape Section 11 liability, but the likely alternative might induce investment banks to issue CDOs only in private placements (to which Section 11 does not apply).

issuers and many institutional investors through practices such as inflated ratings, discretionary adjustments based on subjective decision-making, and stable (and thus stale) ratings, which were only downgraded on the brink of insolvency.⁹⁰ This business model dominated the attempts of the few new entrants into their market who sought to rely on more accurate and quantitative criteria,⁹¹ because more accurate and timely ratings did not confer the same protection from liability. In this light, eliminating the “licensing power” of ratings agencies will change little, because protective and inflated ratings will still be desired by both the “sell” and the “buy” sides of the market.

Instead, a more effective way to reduce inflated ratings may be to reduce the legal protection that they offer investors. Today, if a money market fund’s board suffers a major loss on an investment, it will very likely be protected by the business judgment rule (and not be held liable) if an NR-SRO ratings agency gave the flawed security an investment grade rating.⁹² Any attempt to change this protection will provoke intense opposition from money market funds, but the SEC could seek to force the boards of such funds to consider the range of ratings in the market and not deem a single rating as dispositive.⁹³ Over time, “good” ratings might drive out “bad” ratings, but only to the extent that state courts in liability cases against boards refuse to permit reliance on a single rating that deviates from the others.

5. Encouraging Due Diligence

As noted earlier, rating agencies are unique among financial gatekeepers in not conducting factual verification.⁹⁴ Obviously, factual verification would be costly, given the sheer volume of ratings that rating agencies issue. Still, there is an alternative to the rating agencies doing their own factual verification: rating agencies could instead require factual investigation by

⁹⁰ For such a description of their business model, see Cornaggia & Cornaggia, *supra* note 11.

⁹¹ Cornaggia & Cornaggia find that “subscriber paid” ratings are more accurate and timely than those provided by Moody’s and that have investors who relied on “subscriber paid” ratings would receive wealth transfers from those investors who relied on Moody’s ratings. But investors may rely on Moody’s ratings for legal protection more than for investment advice. *See id.*

⁹² Reliance on an expert is a standard defense in suits against corporate directors. Section 141(e) of the Delaware General Corporation Law states that a director shall “be fully protected in relying in good faith upon . . . any other person as to matters the [director] reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.” DEL. CODE ANN. tit. 8 § 141(e) (2010).

⁹³ One obvious path to this end would be for the SEC to create a centralized data repository and to standardize performance histories so that the track record of CRAs could be easily compared by investors at one centralized site. *See Bai, supra* note 9, at 95–98. To date, the SEC has not moved very far in this direction.

⁹⁴ *See Coffee, supra* note 4.

independent experts of the critical facts on which their models rely. As noted earlier, this had been the standard approach in rating structured finance products prior to 2000, as the investment banks and the rating agencies both relied on “due diligence” firms (such as Clayton Holdings and The Bohan Group) that were paid by the underwriters. However, as the housing bubble grew, investment banks cut off this flow of information, possibly because it might alert rating agencies about problems.

The Dodd-Frank Act took several steps by which to restore due diligence. NRSRO agencies are, for example, required by the Dodd-Frank Act to disclose in a mandated disclosure document that must accompany the publication of each credit rating additional factual information, including:

- (v) whether and to what extent third party due diligence services have been used by the nationally recognized statistical rating organization, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third party.⁹⁵

This provision does not mandate factual verification, but it creates an embarrassment cost if the issuer discloses that due diligence services were not used. Also, under it, negative information discovered by the third party due diligence firm may have to be disclosed. Still, some rating agencies may find ways to rationalize their failure to use such a third party expert or to disclose some lesser alternative that they did use.

A stronger incentive for the use of due diligence is created by the liability provision of the Dodd-Frank Act. Section 933 (State of Mind in Private Actions) addresses the scienter requirements for pleading an anti-fraud action (based presumably on Rule 10b-5) against a credit rating agency. It provides that in the case of an action brought against a credit rating agency or a controlling person thereof:

[I]t shall be sufficient for purposes of pleading any required state of mind in relation to such action that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed —

- (1) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or
- (2) to obtain reasonable verification of such factual information of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other

⁹⁵ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L. No. 111-203, § 939F, 124 Stat. 1376, § 932(s)(3)(A)(v) (2010).

sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.⁹⁶

This language (which was drafted by this author) in effect requires that the rating agency must either conduct its own “reasonable investigation” or rely on an “independent” due diligence firm. If the rating agency does not, then particularized factual pleadings of this failure will enable the plaintiff to survive the defendant’s motion to dismiss. To be sure, the plaintiff would still have to show loss causation, reliance, scienter, and the other elements of a Rule 10b-5 cause of action,⁹⁷ but a strong incentive arises to use a third party due diligence firm in this setting.

In Europe, the litigation lever is both less favored and less available as a means by which to influence the behavior of market actors. Still, European regulators could simply mandate the use of a third party “due diligence” firm to conduct factual verifications, at least in the case of structured finance offerings. Both in Europe and the United States, the use of a third party due diligence firm is likely to be preferred by the rating agencies to any requirement that it conduct its own due diligence, both because (1) the cost of the third party firm’s services can be directly passed on to the underwriters or deal arrangers, and (2) overlapping factual investigations by each rating agency are duplicative and inefficient. In a new and changed environment in which multiple rating agencies are likely to rate the same security, use of a third party expert spares society the costly and senseless duplication of requiring each rating agency to conduct a separate investigation of the same facts. Any such report provided by a third party expert should presumably fall within the earlier discussed “equal access” rule and so be accessible to all rating agencies.⁹⁸

6. *Increasing Competition*

The creation of a Credit Agency Review Board (as the Franken Amendment would mandate) may encourage some new entrants to become NRSRO rating agencies, and, even more likely, it may encourage some “niche” firms that are already NRSROs to extend the zone within which they rate securities. But this amendment does not seem likely by itself to produce greater competition based on quality of services or price. To be sure, if the Board used relative accuracy as its basis for choice, this would eventually produce

⁹⁶ See Dodd-Frank Act § 933(b)(2)(B).

⁹⁷ See Dodd-Frank Act § 933(a) (specifying that the same standards apply to prove a cause of action against a credit rating agency as in the case of a cause of action against an auditor or securities analyst). Potentially, the complete failure to conduct any factual due diligence or to receive reasonably reliable reports from independent third parties may show a reckless indifference to factual accuracy that also can demonstrate scienter, but this will depend on the facts and circumstances of individual cases.

⁹⁸ See SEC Rule 17g-5 (17 C.F.R. § 240.17g-5 (2009)); Securities Exchange Act Release No. 34-61050 (Nov. 23, 2009) (requiring that information given to one credit rating agency be given to others requesting it).

competition for greater accuracy, but only after an extended transitional period. A reliable and measurable reputation for accuracy would probably take a decade or more to develop, particularly for new entrants.

An arguably quicker route to more robust competition would be to require institutional investors to obtain their own credit rating from an approved “subscriber pays” rating agency. This would subsidize a new market, without requiring the government to choose the rater. Still, there remains the danger that some rating agencies might specialize in giving inflated ratings to institutions desiring them. Thus, this Article prefers the collectively chosen rating agency (although it would not permit investors to purchase “subscriber pays” ratings if such agencies become viable).

Another sensible reform that seeks to encourage competition is the “equal access” rule. It is a response to the complaints raised by the few “subscriber pays” rating agencies that issuers will not give them access to the material facts about their deals. From the issuer’s perspective, the issuer does not need to hire every available credit rating agency, and many issuers may regard the few existing “subscriber pays” rating agencies as unwelcome nuisances because they arguably have an incentive to distinguish themselves by giving lower ratings than the Big Three. As a result, issuers had generally declined to release confidential data to them, and, particularly in the field of structured finance, this chilled competition.

In response, the SEC has adopted Rule 17g-5,⁹⁹ and the E.U. Commission’s proposed rules take a similar approach. Although not a complete solution or alone sufficient to spur the development of a “subscriber pays” system, these are at least steps in the right direction.

7. *Staleness Reforms*

Much criticism has pointed out that rating agencies are slow to update their ratings or downgrade them. One reason for this tendency is economic: today, there is little, if any, revenue in downgrading a client’s rating and some risk of a loss of future business. Also, some investors dislike downgraded ratings, which necessitate write-downs of their portfolios. One relevant response to this problem would be to require the issuer to enter into a multi-year contract with the rating agency to monitor the issuer’s rating for a defined period after a rating’s issuance. This pattern is already beginning to develop, but should be mandated. The issuer would be required to pay a “reasonable” annual fee for this service. If the initial rater were picked by a neutral body (such as the Credit Rating Agency Review Board), this reform would seem promising. But both “issuer paid” and individually selected “subscriber pays” rating agencies will probably remain slow to down-

⁹⁹ See 17 C.F.R. § 240.17g-5 (2009) (as modified by Sec. Exchange Act Release No. 34-61050 (Nov. 23, 2009)).

grade—in part because many investors do not like downgrades as they preclude them from holding risky, but high yielding, securities.

Were the issuer to default on these annual monitoring payments, regulations might provide that the initial rating would have to be immediately withdrawn with a prominent notation made on the rating agency's web site. This would be substantially equivalent to an auditor withdrawing its audit opinion, which is a well-known "red flag."

8. *Internal Governance*

An obvious (and politically irresistible) approach toward reform of the credit rating agencies is to regulate their internal corporate governance. Section 932 of the Dodd-Frank Act does this in a variety of ways. It amends Section 15E of the Securities Exchange Act of 1934 to require NRSRO rating agencies to:

- (1) establish, maintain, enforce and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings;
- (2) submit to the SEC an annual internal control report;
- (3) separate the rating function from sales and marketing activities;
- (4) appoint a compliance officer with specified duties; and
- (5) provide additional disclosure with each rating, setting forth the details of its methodology and the data relied upon.¹⁰⁰

Many of these provisions seem to have been borrowed from the 2002 global settlement reached by the SEC, the New York State Attorney General, the National Association of Securities Dealers, and other agencies with the securities industry regarding securities analysts. Debate continues over how effective that settlement has been.

In general, many of these corporate governance reforms were already in place at investment banks, such as Bear Stearns, Lehman, and Merrill Lynch, and there is little evidence that they worked to bring adverse information to the attention of those boards. Compliance officers, for example, are required at all broker-dealer firms and will be required by SEC rules at all NRSRO rating agencies.

From a policy perspective, it is difficult to place great hope on these reforms, but they are low cost reforms that may sometimes provide useful information to experienced regulators.

¹⁰⁰ See Dodd-Frank Act § 932.

9. *Administrative Regulation*

Consensus exists in both the United States and Europe that credit rating agencies should be registered with a government agency and subjected to its continuing oversight. To this extent, reliance on self-regulation and voluntary codes of conduct has been abandoned in Europe. In the United States, the Dodd-Frank Act will create a new office within the SEC—the “Office of Credit Ratings”—to oversee credit rating agencies; the Dodd-Frank Act also requires annual oversight of their internal controls and the consistency of their methodologies.¹⁰¹ Skeptics have doubted the efficacy of such efforts, because governmental agencies have little expertise in evaluating credit risk (and the SEC in particular has far less expertise in this area than do bank regulators, such as the FDIC and the Federal Reserve). Worse yet, when faced with a choice between fundamental reform and reforms that simply increase their bureaucratic authority, the tendency for bureaucratic agencies is to prefer the option that increases their power, even if this does little to benefit investors. Here, independent selection of the initial credit rating agency would benefit investors but would not increase the SEC’s own power. Conversely, reforms focused on ensuring procedural regularity at rating agencies may do little for investors but will enhance the power of the regulatory agency.

Still, a role for some procedural review does exist. Recent empirical research, particularly that noted by Griffin and Tang,¹⁰² has identified a suspicious pattern of discretionary upward adjustments that inflated the size of AAA-rated tranches in structured finance offerings. This is the type of pattern on which regulatory oversight should properly focus. Indeed, the SEC has begun to respond. In 2009, SEC Rule 17g-2(a)(2) was amended to require NRSROs (in the case only of structured finance products) to document the reasons for a deviation when a final credit rating materially deviates from the rating implied by the NRSRO’s quantitative model.¹⁰³ Europe needs to adopt a similar rule, because it should be a priority for regulators on both sides of the Atlantic to monitor deviations by rating agencies from their valuation models and demand detailed justifications.

III. APPRAISING THE TRADEOFFS

Progress towards ratings reform started swiftly, but has recently slowed—and, in the United States, to a snail’s pace. In the United States, the SEC’s activism has been curtailed by budgetary problems, and it has announced that it does not intend to staff the “Office of Credit Ratings” con-

¹⁰¹ Most of these provisions are in the Dodd-Frank Act § 932.

¹⁰² See Griffin & Tang, *supra* note 23, at 4.

¹⁰³ See 17 C.F.R. §§ 240.17(g)–2(a)(2) (2009). Technically, this rule applies only when a quantitative model is a “substantial component” of the rating process. *Id.*

templated by the Dodd-Frank Act because of funding limitations.¹⁰⁴ In Europe, ESMA will acquire new powers to fine rating agencies and to force them to justify their ratings, as of July 2011.¹⁰⁵ Nonetheless, the European Commission has still not opted among specific reform strategies, and in late 2010, it issued a “public consultation” on credit rating agencies, showing that it is still studying how to advance its goals of increased competition and reduced investor reliance on credit ratings.¹⁰⁶

With decisive action still to be taken, this is an appropriate moment to review what measures seem most likely to advance or retard greater accuracy in credit ratings. This Article has expressed skepticism that strategies such as fostering competition or deregulating credit ratings will, by themselves, work to increase ratings accuracy. But what then would work? And what would be counterproductive?

A. *The Good*

Both in the United States and Europe, steps are being taken to reduce the conflicts of interest in which credit rating agencies are virtually embedded. But these steps are piecemeal and incomplete. Three simple truths need to be recognized:

First, an “issuer pays” business model leads to the sacrifice of “surplus” reputational capital in return for high current revenues. Issuers can afford such sacrifices because little reputational injury appears to follow from disclosure of a weak performance history.¹⁰⁷

Second, competition is only good when it enhances consumer choice, not issuer choice. Increasing competition fails as a reform strategy if CRAs compete for the favor of issuers, rather than for that of investors.

Third, in a market bubble, no one, including investors, may have a strong interest in learning the truth. Both in their inattention to “red flags” and their tolerance for “thin” subordination, the CRAs appear to have been indifferent to ratings accuracy.¹⁰⁸ The process of ratings inflation continues

¹⁰⁴ See Jesse Eisinger, *Postcrisis, a Struggle Over Mortgage Bond Ratings*, N.Y. TIMES, Jan. 5, 2011, <http://dealbook.nytimes.com/2011/01/05/after-financial-crisis-a-struggle-over-rating-mortgage-bonds/> (noting that the Office has been placed “on hold”).

¹⁰⁵ See Sarah Collins, *Financial Market Supervision: EU Gets New Powers to Fine and Raid Credit Rating Agencies*, EURO POLITICS, Dec. 15, 2010, available at <http://www.europolit-ics.info/business-competitiveness/eu-gets-new-power-to-fine-and-raid-credit-rating-agencies-art290362-8.html>.

¹⁰⁶ See European Commission Directorate General Internal Market and Services, *Public Consultation of Credit Rating Agencies*, May 2010, available at http://ec.europa.eu/internal_market/consultations/docs/2010/cra/cpaper_en.pdf; Huw Jones, *EU Plans for Financial Services in 2011*, HEDGEWORLD DAILY NEWS, Jan. 10, 2011.

¹⁰⁷ Thus, Professor Bai finds an inverse relationship between a strong performance history and market share. That is, the larger firms with the greater market share had the poorer performance history. See Bai, *supra* note 9, at 88–95.

¹⁰⁸ Moreover, the Big Three continue to produce ratings that quickly prove inaccurate. See generally Eisinger, *supra* note 104 (reporting decision by Standard & Poor’s to downgrade some 1,200 complex mortgage securities that were originally rated in 2010).

and even accelerates—at least until short sellers realize that enormous profits can be made from betting against inflated ratings.

From this perspective, neither the SEC nor the European Commission has yet taken a significant step that is likely to spur the creation of a “subscriber pays” market for credit information. At most, the SEC and the EU Commission have endorsed an “equal access” rule that, if enforced, would preclude the most blatant form of issuer hostility to a “subscriber pays” model. But useful as the SEC’s “equal access” rule is, it is insufficient to prod a “subscriber pays” market into existence.

Instead, incentives are needed. Appropriate incentives could be created in a variety of ways. Rules could require investors or deal arrangers to obtain a second rating from a CRA selected by investors. In the United States, the Franken Amendment—whose ultimate fate must await a two-year study by the SEC—does take an initial, but imperfect, step in this direction by severing the connection between issuer payment and issuer selection of the CRA. But the problem with the Franken Amendment is that it does nothing to encourage competition among CRAs for the favor of investors (and thus to incentivize CRAs to conduct independent research or verification). If, however, the initial rater were chosen through a vote (or even a poll) of likely investors, then the focus of the competition would change, and the CRAs would need to compete for the favor of investors. Even then, some investors would prefer inflated and stable ratings that give them legal protection, but others would come to see that accurate ratings can produce trading gains.¹⁰⁹

B. *The Bad*

The major alternative to a focus on the issuer’s incentives is a policy of deregulation, which would be achieved by eliminating existing requirements for credit ratings. Although it is certainly desirable to make investors less reliant on credit ratings, it is doubtful that this can be achieved simply by regulatory or legislative action. Inflated ratings are ultimately less the product of any licensing power given to the rating agencies and more the consequence of the deeper fact that issuers and many end users of ratings prefer ratings that understate the true risk of debt securities. Inflated ratings enable financial institutions that are locked in intense competition for investors’ funds to hold riskier portfolios, and they also provide legal protection for such end users if an investment sours. Finally, even an end user who did innocently rely on an inflated rating may still not welcome a downgrade that reduces the value and liquidity of that security after it has purchased. Hence, this shared preference for inflated grading and limited downgrades necessi-

¹⁰⁹ For the finding that use of “subscriber paid” ratings make possible trading gains, see Cornaggia & Cornaggia, *supra* note 11. This study, however, assumes that investors who rely on inflated ratings for legal protection also trade on such information, and that is far less certain.

tates some regulation and also implies that complete deregulation would likely produce some casualties, including failures at money market funds and other sensitive financial institutions. Under deregulation, the business model of the major rating agencies would likely remain focused on serving a coalition of issuers and risk-tolerant institutional end users that favor inflated ratings and slow downgrades. Only the threat of liability or embarrassment (if credible competitors promulgated demonstrably more accurate ratings) is likely to change their behavior.

What can solve this problem? The traditional answer is disclosure; ideally, disclosure should be focused so as to embarrass those CRAs with inferior performance histories. But there are problems with this simple answer. One recent empirical study of CRAs' disclosures of their performance "failed to reveal any value of performance disclosures in shaping market share allocations for the credit rating industry."¹¹⁰ Possibly, as this study suggests, the problem could be that CRA disclosures are sufficiently inconsistent and unstandardized as to render "industry-wide comparisons of credit rating agencies performance measurements a difficult and tedious task."¹¹¹ In short, investors will not make the effort.

Although that could be part of the problem, the deeper problem may be that many investors actually want inflated (and seldom downgraded) ratings, which have rarely required them to write down the value of the securities that they held in their portfolios. In short, conflicts of interest could be nearly as serious a problem in terms of investor incentives as in terms of issuer incentives.

If this were the conclusion, then the deregulatory critics might well argue that the CRAs were socially harmful and reliance on them should be discouraged. For several reasons, however, such a conclusion tends to throw the baby out with the bath water. First, better, more standardized comparative data about the performance histories of CRAs should cause some institutions to pressure issuers to use the more reliable CRAs. Second, there is at least some evidence that "subscriber paid" ratings are more accurate, suggesting that they do cater to a market that does (at least for the most part) want accuracy.¹¹² Finally, and more importantly, if some form of the Franken Amendment were accepted by the SEC, the board choosing the CRA to give the initial rating could reward ratings accuracy by preferring the most accurate CRA. Disclosure would then directly influence the choice of rating agency.

Properly incentivized, credit rating agencies should be able to play a socially useful and economically efficient role as informational in-

¹¹⁰ See Bai, *supra* note 9, at 94. In fact, the relationship between rating accuracy and market share seems to be an inverse one. *Id.* at 91 (finding that "inferior rating stability" was "actually associated with bigger market shares").

¹¹¹ *Id.* at 63.

¹¹² See Cornaggia & Cornaggia, *supra* note 11 (finding "subscriber pays" ratings to be more accurate).

intermediaries—if the competitors can be induced to compete on the basis of relative accuracy.¹¹³ This conclusion rests on the premise that specialization is efficient. Because structured finance products are complex and opaque and because the rate of innovation in the field is rapid, “do-it-yourself” credit analysis even by sophisticated institutional investors will be inefficient. Economies of scale characterize the production of financial information, and thus even a large institutional investor, particularly if diversified, will not have the same broad range of expertise that a properly motivated CRA should have. Over time, “subscriber paid” rating agencies could emerge that would focus on offering trading gains to investors who seek to trade on their ratings (and rating revisions).

Moreover, even if large institutional investors could assemble similar expertise in-house, investments by rival institutions in developing such an in-house capacity are essentially duplicative and wasteful, as all these institutions are thereby acquiring information that they could more cheaply purchase from specialized firms. For these reasons, any campaign to abolish credit rating agencies or discourage their use seems misguided.

Attempts to attribute the dominance of the Big Three to their de facto regulatory licensing power ignore history. Their market dominance preceded the SEC’s creation of NRSROs, prevailed in Europe as well as the United States, despite the absence of any similar regulatory authority in Europe, and has persisted in the United States even after the Credit Agency Reform Act of 2006, which effectively ended any legal basis for their predominance. Their oligopolistic position seems attributable less to their licensing power than to their willingness to sell legal protection in the form of inflated and stable ratings. That factor, plus the high barriers to entry into this market, which require that a new firm acquire reputational capital before it can acquire clients, has blocked new entrants.

C. *The Ugly*

Worse yet, there is an even darker side to reform, as the creation of a governmental rating agency presents special dangers. Not only might such an agency be frequently conflicted, but there is a more ominous danger that if private CRAs disagree with its rating analysis, the regulator might take their disagreement as evidence of a deficiency in the procedures or methodologies of the non-governmental CRAs. As anger against the CRAs mounts, the prospect of retaliation for politically incorrect ratings lurks in the background. Ironically, while the CRAs have been justly criticized in the United

¹¹³ Empirical studies have documented the informational value of credit ratings and shown them to be independent of and additive to the informational value that can be derived from credit default swap prices. See generally Lars Norden & Martin Weber, *The Comovement of Credit Default Swap, Bond and Stock Markets: An Empirical Analysis* (Cent. for Econ. Policy Research Discussion Paper No. 4674, Oct. 2004), available at <http://ssrn.com/abstract=635981>.

States for inflated ratings, they may face even greater hostility in Europe for downgrades that are perceived as excessive or premature.

IV. CONCLUSION

How much regulation is needed? If the market incentivized CRAs to compete for the favor of investors (most of whom do not prefer inflated ratings), less regulation and oversight would be required. The first step towards a competition based on ratings accuracy is for the regulator to play a central role in collecting and disseminating accurate and easily understood comparative data on ratings accuracy. That means centralized data repositories and standardization of performance data should be pursued so that the investors can rank CRA performance, as easily as consumers can rank the fuel efficiency of rival cars in terms of miles per gallon.¹¹⁴ Only if the relevant information is simplified and presented in an accessible, standardized form will the major rating agencies suffer any meaningful embarrassment cost from a weak performance history.

But there are limits to what improved disclosure can achieve, and thus this first step needs to be supplemented by a second step. Under the Franken Amendment's procedures, the board selecting the rating agency should prefer the most accurate CRA, using a metric that looked to both initial accuracy and promptness at updating.¹¹⁵ This responds to the conflicts on the investors' side. Even if the Franken Amendment is ignored by the SEC, the end users of ratings information (i.e., the major institutional investors) should be compelled to justify their debt investments based on an awareness of the relative reliability of different CRAs.

More generally, regulatory oversight should focus less on the resources of the ratings agency and more on the quality of its output. Recent empirical research has identified a pattern of discretionary adjustments that CRAs made to inflate their ratings.¹¹⁶ Unfortunately, the tendency of a bureaucratic regulator is often to focus more on procedural regularity, record-keeping, and adequate staffing than on output. Such procedurally-oriented bureaucratic oversight promises little benefit, and the regulator's attention should be instead on upward adjustments and deviations from the CRA's normal valuation model.

Precisely because the term "oversight" is vague and regulatory supervision can sometimes degenerate into bureaucratic nitpicking (or worse), a

¹¹⁴ For more specific recommendations, see Bai, *supra* note 9. The industry will fiercely resist governmental ranking, but if the data is clear enough, others (including Google, Yahoo, and Morningside) can do this for investors.

¹¹⁵ This is not incompatible with allowing institutional investors to choose the initial rater by some majority voting procedure. Either one could decide that the majority of institutional investors are not affected by conflicts of interest (even if a minority are), or the SEC could provide data to the institutions voting on the choice of initial rater showing the performance history of all the candidates.

¹¹⁶ See Griffin & Tang, *supra* note 23.

clear regulatory agenda needs to be specified for Europe's new ESMA in its oversight of CRAs. As just noted, one priority should be to focus on upward deviations or adjustments from the CRA's methodology, which methodology should be publicly disclosed, at least in the case of "issuer paid" CRAs.¹¹⁷ If, however, a clear shift to a "subscriber pays" system is not possible, then ESMA's priorities should include:

- (1) implementation of a detailed "equal access" rule;
- (2) the requirement of multi-year fee contracts between the issuer and a rating agency hired or paid by the issuer so that follow-up monitoring of the initial rating is required;
- (3) a corresponding requirement that when a CRA changes its methodology, it must revise all existing ratings that would have been originally affected by that change within a defined period;
- (4) the development of publicly available performance data for each CRA, expressed in a standardized format that ranks the principal CRAs in terms of relative accuracy;¹¹⁸
- (5) prohibition of certain clear conflicts of interest, including rating offerings on which the CRA consulted (i.e., "self-rating");¹¹⁹
- (6) a rule requiring the disclosure of any "preliminary" ratings to discourage rating shopping; and
- (7) rules and policies encouraging the use of third party "due diligence" firms to assure factual verification.

Much is changing. In this flux, the optimist will see the possibility that "subscriber paid" rating agencies could begin to compete on the basis of relative ratings accuracy. The pessimist will sense instead that regulators are behaving bureaucratically or are increasingly ready to punish CRAs for politically sensitive ratings downgrades (either of a locally favored company or a sovereign debt where the effect is to destabilize the market or a currency).

¹¹⁷ As just discussed, SEC Rule 17g-2(a)(2), adopted only in 2009, requires NRSROs to document the reasons for a deviation from their quantitative valuation models. See text and note *supra* note 93. SEC Rule 17g-1 also requires public disclosure by the CRA of the methodology that it uses to determine ratings, and such disclosure must be sufficiently detailed to provide users of the ratings with a clear understanding of the process used by the NRSRO. In the case of "subscriber paid" rating agencies, their need to protect the secrecy of a proprietary methodology makes the case for public disclosure less clear.

¹¹⁸ The SEC has gone only a short distance toward such a goal. SEC Rule 17g-2 requires rating histories to a limited extent. Under it, the CRA must disclose 10% of the ratings, chosen at random, for each class of ratings in which the NRSRO rating agency participated. Under a 2009 amendment to this rule, the 10% requirement increases to 100% for ratings issued after June 26, 2007. See 17 C.F.R. § 240.17g-2 (2009).

¹¹⁹ SEC Rule 17g-5 precludes an NRSRO issuer from issuing or maintaining a credit rating with respect to an issuer or obligor where it (or any associated person) "made recommendations . . . about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security." See 17 C.F.R. § 240.17g-5(c)(5) (2009).

Both conclusions may have some justification. The practice of “blaming the messenger” for bad news is a tradition that has persisted for millennia. Unacceptable as the performance of the CRAs has been, the future could see them caught between Scylla and Charybdis: sued by investors in the United States for inflated ratings, but disciplined by politically-motivated regulators in Europe for downgrades that destabilize markets or disfavor politically powerful local companies.

Amidst all this change, one priority must stand out: the failure to address the “issuer pays” business model, while addressing only more specific conflicts (such as those addressed by the “equal access” rule), amounts to re-arranging the deck chairs on the Titanic, while ignoring the gaping hole created by the iceberg. On both sides of the Atlantic, there should be a recognition that (1) the existing market for ratings failed, (2) voluntary self-regulation and reliance on the rating agency’s desire to protect its “reputational capital” are inadequate, and (3) disclosure will work only to the extent that it can embarrass a CRA about its poor performance history and slowness to downgrade.

Although regulatory supervision can mitigate conflicts of interest, the intensity of such supervision always eases once “boom” times arrive again, and thus the cycle leads back to laxity. Because of the inevitability of this sine curve of regulatory intensity, meaningful reform must encourage a “subscriber pays” model that can compete with the current “issuer pays” model. Still, because of the “public goods” nature of financial information, a “subscriber pays” (or “platform pays”) model will not arrive naturally, and regulatory interventions are necessary to prod it into existence. The Franken Amendment is one (but not the only) means to this end, and a role for investor choice should be found. Ultimately, if we get the incentives right, relatively little regulation is needed. But if the incentives remain poorly aligned, regulatory oversight alone is unlikely to ensure ratings accuracy.