# CREDIT RATING AGENCY REFORM: A REVIEW OF DODD-FRANK SECTION 933(B)'S EFFECT (OR LACK THEREOF) SINCE ENACTMENT

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*Credit rating agencies have come under increased scrutiny since the global financial crisis of 2007–2008, and they have been recognized as holding a key gatekeeping role in the capital markets. As such, an entire subtitle of the comprehensive Dodd-Frank Act—Subtitle C of Title IX—is dedicated to rating agency reform. In particular, given the importance of private enforcement in the overall regulatory framework, the language of Section 933(b) is especially promising, as it relaxes the scienter requirement for complaints filed as part of private class action suits against rating agency defendants. Indeed, that section received specific attention immediately following the passage of the Dodd-Frank Act for its potential to effect reform.*

*Using a framework of policy and economic considerations, this Note analyzes the theoretical effectiveness of Dodd-Frank Section 933(b) in comparison with its actual effect since enactment. The discussion explores potential explanations, both intrinsic and extrinsic to the legal system, for why the observed effect of the provision has thus far fallen short of expectations. The analysis suggests that rating agencies have reacted to Section 933(b) by adopting generic provisions in their respective codes of conduct stipulating compliance, greatly decreasing the efficacy of the provision in private securities litigation in light of pleadings standards that have*

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*become increasingly stringent over the past decade. The Note concludes by proposing potential solutions to this inefficacy.*

I. Introduction ..... 186
II. Credit Rating Agencies as Gatekeepers ..... 188
A. Essential Function: Information Cost Reduction ..... 188
B. Effect on Systemic Risk and Role in the Recent Financial Crisis ..... 189
C. Proposed and Adopted Solutions ..... 193
1. Enhanced Competition ..... 194
2. Stricter Liability Scheme ..... 196
3. Increased Monitoring ..... 197
4. Mitigation of Conflicts of Interest ..... 198
5. Summary ..... 199
III. Significance of Private Securities Litigation ..... 200
A. Policy Considerations Regarding the Implied Private Right of Action ..... 200
B. History of the PSLRA ..... 203
IV. Case Discussion and Analysis of Section 933(b)'s Effectiveness ..... 205
A. Private Actions Against CRAs Prior to Dodd-Frank's Enactment ..... 206
1. In re *National Century Financial Enterprises, Inc., Investment Litigation* ..... 206
2. In re *Moody's Corp. Securities Litigation* ..... 207
B. Private Actions Against CRAs Since Dodd-Frank's Enactment ..... 208
C. Inquiry into Changes in CRA Best Practices Since Dodd-Frank's Enactment ..... 209
V. Possible Explanations of Section 933(b)'s Perceived Ineffectiveness ..... 211
A. Reduced Efficacy of 10b-5 Litigation ..... 211
B. Boilerplate Assertions by CRAs in Their Respective Codes of Conduct ..... 212
C. Potential Non-Judicial Reasons for Perceived Ineffectiveness ..... 213
1. Out-of-Court Settlements ..... 214

2. Changes in Underlying Ratings Methodology ..... 214
3. Countercyclical Applicability of CRA Reform ..... 215
VI. Conclusion ..... 216

## I. INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Dodd-Frank Act") includes a number of reform provisions in Title IX, Subtitle C targeted at credit rating agencies ("CRAs").[1] Among the most notable is the provision relaxing the scienter requirement for private class action suits against credit rating agencies: section 933(b) of Dodd-Frank ("Section 933(b)").[2] This provision exposes rating agencies to discovery requests by private plaintiffs, unless the rating agency can show in its motion to dismiss that plaintiffs were unable to

> state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed . . . to conduct a reasonable investigation of the rated security . . . or . . . to obtain reasonable verification . . . from other sources . . . that were independent of the issue and underwriter.[3]

Effectively, Section 933(b) removes the "discovery stay" privilege that the Private Securities Litigation Reform Act of 1995 ("PSLRA") granted to other defendants in class action securities suits.[4] This was supposed to be an important step

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 931–939H, 124 Stat. 1376, 1872–90 (2010) (codified as amended in scattered sections of the U.S. Code) [hereinafter Dodd-Frank Act].

2 Dodd-Frank Act § 933(b), 15 U.S.C. 78u-4(b)(2) (2012); *see, e.g.*, Eric S. Pendergraft, Note, *Section 933(b): Nimble Private Regulation of the Capital Market Gatekeepers*, 39 FLA. ST. U. L. REV. 511, 512, 521–23 (2012).

3 Dodd-Frank Act § 933(b), 15 U.S.C. § 78u-4(b)(2)(B) (2012).

4 15 U.S.C. § 78u-4(b)(3) (2012).

in facilitating private class actions against CRAs, thereby increasing their accountability.[5] However, in the five years since the enactment of the provision, very few federal class action suits have been brought against rating agencies, and even fewer, if any, have progressed to the discovery stage.[6]

This Note aims to provide an analysis of Section 933(b)'s effects since its enactment and to offer an explanation of why the provision may not be working as intended. Part II begins with a brief description of the role of CRAs as gatekeepers and explains the circumstances leading to Section 933(b)'s enactment. Also, it discusses categories of proposed policy changes and notes the relevant portions of the Dodd-Frank Act that fall under each category. Part III provides a policy discussion on private enforcement of securities regulations and discusses the significance of Section 933(b) in the context of the history of private securities litigation. Part IV evaluates the effectiveness of Section 933(b) empirically, by comparatively analyzing private securities suits filed before and after Dodd-Frank's enactment. Part V offers possible explanations for the perceived ineffectiveness of Section 933(b) and proposes solutions in each case.

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[5] The threat of discovery alone is often sufficiently disciplinary to effect positive change. *Cf.* J. Maria Glover, *The Federal Rules of Civil Settlement*, 87 N.Y.U. L. REV. 1713, 1726 n.52 (2012) ("[T]he *threat* of discovery may be as problematic as discovery itself."); John Lippert, *Credit Ratings Can't Claim Free Speech in Law Giving New Risks*, BLOOMBERG BUS. (Dec. 8, 2010, 12:01 AM), http://www.bloomberg.com/news/articles/2010-12-08/credit-ratings-can-t-claim-free-speech-in-law-bringing-risks-to-companies [http://perma.cc/94XX-MP27] ("Just a threat of discovery will force caution, says Columbia University Law Professor John Coffee . . . .").

[6] A review of federal dockets on PACER shows only a handful of complaints filed against CRAs under the PSLRA since July 2010. A comprehensive search on Westlaw and LexisNexis returned no federal trial court decisions on private securities class actions brought under the PSLRA against CRAs since 2010.

# II. CREDIT RATING AGENCIES AS GATEKEEPERS

## A. Essential Function: Information Cost Reduction

Gatekeepers in the capital markets have been broadly defined as agents who act as "reputational intermediar[ies]," essentially providing quality assurance for investors who, due to the diversity of their portfolios and the complex nature of securities trading today, cannot practicably assess the risk of their investments on their own.[7] Common examples of gatekeepers include the array of professionals who work with issuers to prepare and certify information released as part of the issuers' securities offerings (e.g., underwriters, accountants, and attorneys).[8]

CRAs act as important gatekeepers to debt markets.[9] In issuing and updating their ratings, they perform both quantitative and qualitative analyses[10] of publicly available and non-public information[11] to provide the market with objective signals as to the relative expected risk of default for a particular debt security. Because they specialize in carrying out these analyses, CRAs are repeat players who are able to develop "reputational capital" that they can pledge to the issuers of the securities they rate.[12] Assuming the analysis is done well, this process helps investors with correctly pricing securities and eliminates the need for individual investors to undertake their own assessments of default risk. This greatly reduces investors' information costs, which include the cost of obtaining and distilling

7 JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2 (2006) [hereinafter COFFEE, GATEKEEPERS].

8 *See id.*

9 *See* Dodd-Frank Act § 931(2), 15 U.S.C. § 78o-7 note (2012) (Findings).

10 Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 13 N.Y.U. J. LEGIS. & PUB. POL'Y 253, 293 & n.174 (2010) [hereinafter Bai, *Conflicts of Interest*].

11 Deryn Darcy, Note, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 610 (2009).

12 *See* COFFEE, GATEKEEPERS, *supra* note 7, at 2, 284.

relevant information from issuers, as well as the cost of monitoring the securities and issuers in order to ensure that the information is current.[13]

## B. Effect on Systemic Risk and Role in the Recent Financial Crisis

Systemic risk has emerged as a key term in the aftermath of the global financial crisis of 2007–2008.[14] It "refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components."[15] CRAs issue ratings on many types of debt securities across a broad range of industries, from sovereign debt to corporate bonds to structured finance products.[16] The securities they rate are widely held across the market by both retail and institutional investors.[17] Indeed, Congress issued a finding

13 *See* INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: SOVEREIGNS, FUNDING, AND SYSTEMIC LIQUIDITY 86 (2010), http://www.imf.org/External/Pubs/FT/GFSR/2010/02/pdf/text.pdf [http://perma.cc/YK8L-FADC].

14 *See, e.g.*, *Hedge Funds and the Financial Market: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 29 (2008) (written testimony of Andrew Lo, Harris & Harris Group Professor, MIT Sloan School of Management) (noting that "*systemic risk* [is] a term that has come into common usage but which has so far resisted formal definition and quantification"); *see also* Dan Awrey, *Toward a Supply-Side Theory of Financial Innovation*, 41 J. COMP. ECON. 401, 402 (2013); Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 68 (2012).

15 George G. Kaufman & Kenneth E. Scott, *What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?*, 7 INDEP. REV. 371, 371 (2003).

16 *See* 15 U.S.C. § 78c(a)(62)(A) (2012).

17 *See, e.g.*, U.S. SENATE PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE S. COMM. ON HOMELAND SEC. AND GOVERNMENTAL AFFAIRS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE: MAJORITY AND MINORITY STAFF REPORT 313 (2011), http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf [http://perma.cc/F9FE-KQ6L] ("When credit agencies issue inaccurate credit ratings, both retail investors and regulated financial institutions may mistakenly purchase financial instruments that are riskier than they intended or are permitted to buy."); HERWIG M. LANGOHR & PATRICIA T.

that "the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators" render credit rating agency activities "matters of national public interest."[18] Because the entire market can be affected by their actions, CRAs' failure to effectively carry out their role as gatekeepers can increase systemic risk.

In the case of the credit crisis of 2007, CRAs—and Nationally Recognized Statistical Rating Organizations ("NRSROs")[19] in particular—received a great deal of attention for failing to properly carry out their role as gatekeepers.[20] The key securities at issue in the credit crisis were subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") of subprime RMBS.[21] The CRAs' failure to properly price these securities proved especially detrimental as the market for securitized products had become "information-insensitive"[22]—investors did not perform their own analyses

LANGOHR, THE RATING AGENCIES AND THEIR CREDIT RATINGS: WHAT THEY ARE, HOW THEY WORK AND WHY THEY ARE RELEVANT 380 (2008) ("Fixed income institutional investors link portfolio allocations to rating standards. They therefore use ratings in their bond purchase decisions, and to ensure subscription, issuers must get their issues rated by an appropriate CRA.").

18 Dodd-Frank Act § 931(1), 15 U.S.C. § 78o-7 note (2012) (Findings).

19 Credit rating agencies may apply under 15 U.S.C. § 78o-7 to be registered as NRSROs. 15 U.S.C. 78o-7(a)(1) (2012). NRSRO registration confers upon rating agencies significant regulatory benefits. *Id.*; *see, e.g.*, Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 60–61 (Yasuyuki Fuchita & Robert E. Litan eds., 2006); Jonathan R. Macey, *The Regulator Effect in Financial Regulation*, 98 CORNELL L. REV. 591, 595 (2013).

20 *See* Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1013 (2009).

21 Darcy, *supra* note 11, at 607.

22 Debt is considered "information-insensitive" if "it is not profitable for any agent to produce private information about the assets backing the debt, the collateral." Gary Gorton & Guillermo Ordoñez, *Collateral Crises*, 104 AM. ECON. REV. 343, 344 (2014).

of the underlying collateral, but instead relied completely on the credit ratings assigned to particular tranches of asset-backed securities.[23] Once the market for these securities began to falter, investors lost their trust in the CRAs' ratings and were forced to withdraw their investments as they were unable to carry out their own analyses.[24] This, in turn, caused the RMBS and CDO market to become fatally illiquid,[25] and the repercussions were felt across the global financial market because of the widely-held nature of these securities.[26]

While CRAs maintained that their ratings for these structured finance products were consistent with their ratings for corporate bonds,[27] a number of key differences between these two types of debt securities may explain why this was likely false.[28] Because the RMBS market is much

23 *See* Samuel G. Hanson & Adi Sunderam, *Are There Too Many Safe Securities? Securitization and the Incentives for Information Production*, 108 J. FIN. ECON. 565, 580 (2013).

24 *See id.*

25 *See* Press Release, BNP Paribas, BNP Paribas Investments Partners Temporaly Suspends the Calculation of the Net Asset Value of the Following Funds: Parvest Dynamic ABS, BNP Paribas ABS EURIBOR and BNP Paribas ABS EONIA (Aug. 9, 2007), http://www.bnpparibas.com/en/news/press-release/bnp-paribas-investment-partners-temporaly-suspends-calculation-net-asset-value-fo [http://perma.cc/JY25-NJ4P] ("The complete evaporation of liquidity in certain market segments of the US securitisation market has made it impossible to value certain assets fairly regardless of their quality or credit rating."). BNP's decision to freeze withdrawals from two of its funds is recognized by some as marking the beginning of the financial crisis. *See, e.g.*, JOHN ZINKIN, REBUILDING TRUST IN BANKS: THE ROLE OF LEADERSHIP AND GOVERNANCE 149 (2014) ("[T]he Global Financial Crisis began in August 2007 with the closing of two BNP Paribas money market funds on August 9, 2007.").

26 *See* June Rhee, *Getting Residential Mortgage-Backed Securities Right: Why Governance Matters*, 20 STAN. J.L. BUS. & FIN. 273, 275 (2015) ("Before the financial crisis, RMBS was a popular investment opportunity widely held by pension funds, mutual funds and other financial firms."); Hanson & Sunderam, *supra* note 23, at 580.

27 *See* Darcy, *supra* note 11, at 610.

28 *See* Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1126 (2009).

younger than the corporate bond market, analytical models for RMBS and the securitized products derived from them necessarily relied on "relatively short performance histor[ies] and a very thin market infrastructure."[29] Market analysts and CRAs alike were unable (or unwilling) to fully price in the aggregate risk associated with large-scale declines in the prices of assets underlying these securities.[30] This problem was likely exacerbated by the inherent conflicts of interest for CRAs arising from the existing payment and liability schemes.

In the decade leading up to the credit crisis, CRAs derived "approximately 90 to 95% of their annual revenues from issuer fees."[31] Known as the "issuer-pays model," the payment scheme for CRAs (whereby issuers are charged an issuer fee rather than investors being charged a subscription fee) developed in part as a response to the "public good" quality of ratings information[32] and gives rise to the potential for "rating shopping" by issuers.[33] At the same time, the liability scheme for CRAs in the period prior to the credit crisis was fairly lenient—CRA defendants benefited from the discovery stay granted by the PSLRA in class action suits,[34] and many were able to successfully claim First

29 *Id.*

30 *See* Sumit Agarwal et al., *The Asset-Backed Securities Markets, the Crisis, and TALF*, 34 ECON. PERSP. 101, 106–07 (2010), https://www.chicagofed.org/~/media/publications/economic-perspectives/2010/4qtr2010-part1-agarwal-barrett-cun-denardi-pdf.pdf [http://perma.cc/NK4X-XGNU]; *see also* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, xxv, 43–45 (2011), https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [http://perma.cc/WUZ8-MYXE].

31 Darcy, *supra* note 11, at 622.

32 *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 654 (1999).

33 *See* Nan S. Ellis et al., *Conflicts of Interest in the Credit Rating Industry After Dodd-Frank: Continued Business As Usual?*, 7 VA. L. & BUS. REV. 1, 8 (2012). The potential for ratings shopping may compromise the integrity of CRAs' ratings and is especially an issue when CRAs rate structured finance products like RMBS. *See* Darcy, *supra* note 11, at 623.

34 *See* 15 U.S.C. § 78u-4(b)(3)(B) (2006).

Amendment (or similar state) protection from liability.[35] NRSROs also benefited from an exemption from section 11 expert liability.[36]

## C. Proposed and Adopted Solutions

A wide range of policy changes have been suggested in response to the failure of CRAs to perform as effective gatekeepers, both in the aftermath of the recent credit crisis and in the periods following earlier crises (e.g., the downfalls of Enron and WorldCom). The suggested policy changes can be roughly grouped into four types: proposals to (1) enhance competition in the ratings industry; (2) adopt a more stringent liability scheme to hold CRAs to higher standards of accountability; (3) heighten training and monitoring standards; and (4) resolve the conflicts of interest inherent in the current issuer-pays model.[37] Each type of policy proposal has its respective advantages and drawbacks. This Subpart briefly discusses each category of proposal and describes the

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35 Manns, *supra* note 20, at 1055 ("[The] First Amendment hurdle has made it extraordinarily difficult to establish that rating agencies engaged in libel and has left issuers without legal recourse except in outlier cases."); *see, e.g.*, Compuware Corp. v. Moody's Inv'rs Servs., Inc., 324 F. Supp. 2d 860, 862 (E.D. Mich. 2004); Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Inv'rs Servs., Inc., 175 F.3d 848, 860 (10th Cir. 1999).

36 17 C.F.R. § 230.436(g) (2015). Under section 11(a)(4) of the Securities Act of 1933, experts are liable for untrue statements, or omissions, of material fact in any part of a registration statement which they have certified or prepared. 15 U.S.C. § 77k(a) (2012). An expert has a defense from this section 11 liability only if

> (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact . . . , or (ii) . . . the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert.

15 U.S.C. § 77k(b)(3)(B) (2012).

37 *See* COFFEE, GATEKEEPERS, *supra* note 7, at 298.

relevant provisions adopted under Title IX, Subtitle C of Dodd-Frank.

### 1. Enhanced Competition

Proponents of the first category of proposals believe that the dominant credit rating agencies do not hold a natural monopoly, and thus support the market-based solution of increasing competition in the market.[38] The primary concern with allowing increased competition is that it may lead to a "race to the bottom," where the quality of ratings declines as new entrants offer inducements to issuers to obtain their business.[39] This would lower the integrity and consequently the usefulness of ratings as a whole.

While there is some empirical evidence to suggest that a "race to the bottom" scenario is likely to result from increased competition in the rating agency market,[40] there is other evidence that new entrants instead focus on niche sectors that previously received less than the optimal amount of ratings coverage.[41] If the latter case is more likely,

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38 *See id.*

39 *See id.* at 289, 299–300. In order to consistently offer price concessions (i.e., to sustain more competitive pricing than established players in the market), new entrants must employ lower cost business models (at the expense of ratings quality). New entrants may also attempt to compete by offering more attractive ratings directly. *See id.* at 300. The argument is that this would incentivize established players to offer superficially higher ratings as well. *See* Bai, *Conflicts of Interest*, *supra* note 10, at 263 ("Except in cases where the rating from a particular rating agency is required by investors, rating agencies that give out lower (although honest) ratings risk their ratings not being selected and thus losing revenue to their less honest peers.").

40 *See, e.g.*, RICHARD CANTOR & FRANK PACKER, FEDERAL RESERVE BANK OF NEW YORK, STAFF REPORT NO. 12, MULTIPLE RATINGS AND CREDIT STANDARDS: DIFFERENCES OF OPINION IN THE CREDIT RATING INDUSTRY 27 (1996) (concluding that less established "[t]hird agencies, such as Fitch and Duff & Phelps, on average assign higher ratings than Moody's and Standard and Poor's").

41 For example, Fitch was able to successfully enter and establish itself in the market partly by focusing on specialized submarkets and international markets. *See* COFFEE, GATEKEEPERS, *supra* note 7, at 284.

then facilitating increased competition will, on balance, be beneficial. Regulators have been mindful of the potential for a "race to the bottom" in selecting which proposals to adopt and how they are implemented, but the risk of this phenomenon likely does not outweigh the potential benefits of increased competition on the whole.

Suggestions under this category of proposals include (i) amending the Securities and Exchange Commission's ("SEC") NRSRO policy to encourage new entrants;[42] (ii) decreasing the regulatory benefits of NRSRO status;[43] and (iii) promoting the market for alternative service providers to perform a similar functional role as rating agencies.[44] Performance disclosure requirements adopted by the SEC in 2007,[45] which were strengthened in 2009,[46] are intended to carry out suggestion (i), by making it easier for investors to assess the track records of all rating agencies, and consequently easier for new entrants to establish themselves in the rating agency market.[47] Sections 939 and 939A of Dodd-Frank effectively adopt suggestions (ii) and (iii) by removing statutory references to credit ratings and requiring each federal agency to conduct a review of its

A.M. Best Co. similarly established its presence through specialization in one particular industry (the insurance industry). *See id.* at 301.

42 *See id.* at 302.

43 *See* Macey, *supra* note 19, at 615.

44 *See id.* For example, the National Association of Insurance Commissioners relied on loss projection analysis performed by BlackRock to bypass the need for NRSRO ratings in determining capital requirements for certain asset-backed securities. *See* Lippert, *supra* note 5.

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

46 *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6456, 6457 (Feb. 9, 2009) (to be codified at 17 C.F.R. pts. 240 & 249b).

47 *See* Lynn Bai, *The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?*, 7 N.Y.U. J.L. & BUS. 47, 51 (2010) ("[Disclosure requirements] help break the entry barrier for smaller rating agencies with strong performance records in a market that is dominated by certain established names . . . .").

reliance on assessments of credit-worthiness and to substitute reliance on credit ratings (i.e., assessments granted only by NRSROs) with other appropriate standards of credit-worthiness.[48]

### 2. Stricter Liability Scheme

The proposals under this category aim to promote greater rating agency accountability by increasing the consequences of failing to exercise proper diligence.[49] This type of policy proposal should work best regardless of the nature of the market (i.e., whether or not established CRAs hold a natural monopoly) and complement other adopted measures, as it is aimed at addressing the CRAs' responsibility to the market as gatekeepers.[50]

A potential drawback of increasing liability of CRAs is that they will likely seek to pass on the costs and risks to their clients, the issuers, who will in turn pass on their increased costs to investors. Another difficulty with this type of proposal is that it requires enforcement, which is usually costly and time-consuming. It also must be implemented either through legislation or through judicial decision-making, both of which are resource-intensive. The SEC and other federal agencies are often constrained in their resources, so private enforcement would be necessary to supplement enforcement by regulators. The policy considerations surrounding private enforcement are discussed in greater detail below in Part III.A.

Suggestions here include (i) lowering the required burden of proof for private plaintiffs and regulators at various stages of the enforcement litigation process,[51] (ii) increasing the

48 *See* Dodd-Frank Act §§ 939–939A, 12 U.S.C. §§ 1817(b)(1)(E)(i), 1831e(d) (2012), 15 U.S.C. § 78c(a)(41), (53)(A) (2012), 15 U.S.C. § 78o-7 note (2012) (Review of Reliance on Ratings).

49 *See* COFFEE, GATEKEEPERS, *supra* note 7, at 298.

50 *See id.*

51 This includes lowering or removing the scienter requirement at the pleadings, class certification, summary judgment, and/or trial stages.

civil penalties for failing to exercise due diligence,[52] and (iii) eliminating the availability of affirmative defenses and exemptions.[53] The congressional findings in Dodd-Frank § 931 state that CRAs are "fundamentally commercial in character."[54] Thus, the ratings they produce are now excluded from First Amendment protections. Section 939G also implements suggestion (iii) in repealing the exemption previously afforded to credit rating agencies from expert liability under section 11 of the Securities Act of 1933. Section 933(b) removes the requirement of pleading "with particularity facts giving rise to a strong inference" of scienter.[55] This section thus implements suggestion (i) with respect to the pleadings stage by eliminating the stay of discovery in private actions against CRAs.[56]

### 3. Increased Monitoring

The underlying rationale for the third category of policy changes is that CRAs are natural monopolies (i.e., it is more efficient for market power to be concentrated in a few players) and should be regulated as such (e.g., in the same

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52 Examples here include requiring CRAs to disgorge profits garnered through dissemination of misleading ratings. *See* Darcy, *supra* note 11, at 661.

53 Affirmative defenses included the First Amendment defense discussed above, see *supra* Part I.B and note 35, as well as the defense of unreasonable reliance on ratings by investors. *See* Timothy M. Sullivan, Note, *Federal Preemption and the Rating Agencies: Eliminating State Law Liability to Promote Quality Ratings*, 94 MINN. L. REV. 2136, 2150 (2010) (citing Quinn v. McGraw-Hill Cos., 168 F.3d 331, 336 (7th Cir. 1999)). Exemptions included the stipulation that credit rating agencies were not considered "experts" under section 11 of the Securities Act of 1933 and the safe harbor for forward-looking statements under section 21E of the Securities Exchange Act of 1934. *See* 17 C.F.R. § 230.436(g) (2010) (SEC rule providing prior section 11 exemption), *repealed by* Dodd-Frank Act § 939G; *see also* Securities Exchange Act of 1934 § 21E, 15 U.S.C § 78u-5 (2012) (safe harbor for forward-looking statements).

54 Dodd-Frank Act § 931, 15 U.S.C. § 78o-7 note (2012) (Findings).

55 15 U.S.C. § 78u-4(b)(2)(A) (2012).

56 *See supra* text accompanying note 4.

way that public utilities are regulated).[57] Because greater regulatory compliance costs may deter new entrants, proposals under this category in some ways directly contradict the policy goals of proposals in the first category (which are designed to increase competition in the ratings industry). These proposals are also costly to carry out, as they must be implemented through a regulatory framework and are not a market-based solution.

The bulk of Title IX, Subtitle C, of the Dodd-Frank Act adopts proposals in this category. Specifically, section 932 provides for "enhanced regulation, accountability, and transparency" of NRSROs.[58] This provision requires, inter alia, that NRSROs establish internal controls on the quality of their ratings, as well as policies and procedures to protect against conflicts of interest at the individual analyst level and on a firm-wide level.[59] Section 936 also requires the SEC to promulgate rules governing the qualifications of individual analysts employed by NRSROs.[60]

### 4. Mitigation of Conflicts of Interest

A typical suggestion under the fourth type of policy proposal is to change the issuer-pays model to one where the information user directly pays the CRA.[61] This is difficult to achieve through regulation and may not be economically feasible due to the public good quality of credit ratings.[62] Investors are unlikely to pay high fees for information that can be transferred at virtually no cost once it is generated—this is the classic free-rider problem associated with public goods. Consequentially, rating agencies would not be able to sustain the current breadth or depth of their coverage, and

57 *See* COFFEE, GATEKEEPERS, *supra* note 7, at 298.

58 Dodd-Frank Act § 932, 15 U.S.C. § 78o-7 (2012).

59 Dodd-Frank Act § 932(a)(2)(B), (a)(4), 15 U.S.C. § 78o-7(c)(3), (h)(4) (2012).

60 Dodd-Frank Act § 936, 15 U.S.C. § 78o-7 note (2012) (Qualification Standards for Credit Rating Analysts).

61 *See* COFFEE, GATEKEEPERS, *supra* note 7, at 298.

62 *See id.* at 298–99.

would either need to scale back their operations or suffer further declines in the quality of their ratings, or possibly both.

An innovative suggestion is to require issuers to obtain at least one rating from a rating agency that uses a subscriber fee revenue model or "a hybrid rating agency owned and supervised by a consortium of institutional investors."[63] Another way of mitigating conflicts of interest caused by the issuer-pays model is to enforce disgorgements of CRA profits in the event of a misleading rating caused by a failure in due diligence.[64] Under this proposal, CRAs will not be incentivized to sacrifice ratings quality in order to increase their revenues, as they will not be able to retain the profits from doing so. However, enforcement would be crucial and may be difficult as it would need to be carried out at the micro level (i.e., with respect to each misleading rating issued).

### 5. Summary

Dodd-Frank's Title IX, Subtitle C, adopts a combination of different types of proposed policy changes, with a focus on increasing monitoring and enforcing a stricter liability scheme. Among the individual provisions enacted, Section 933(b) is drafted to effect significant change. However, its effectiveness depends heavily on the practicability of its enforcement, particularly by private investors. The policy considerations surrounding this private enforcement are often debated; Part III provides a discussion of the key points in this debate.

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63 JONATHAN KATZ, EMANUEL SALINAS & CONSTANTINOS STEPHANOU, WORLD BANK GRP. CRISIS RESPONSE NOTE NO. 8, CREDIT RATING AGENCIES: NO EASY REGULATORY SOLUTIONS 6 (2009), http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/Note8.pdf [http://perma.cc/T9EM-MC9N].

64 *See* Darcy, *supra* note 11, at 661.

# III. SIGNIFICANCE OF PRIVATE SECURITIES LITIGATION

## A. Policy Considerations Regarding the Implied Private Right of Action

There is no explicit provision for a private right of action in the text of section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)") or in the corresponding SEC Rule 10b-5 ("Rule 10b-5").[65] However, the U.S. Supreme Court has held since 1971 that "a private right of action is implied under [section] 10(b)."[66] Recent cases have upheld and qualified this implied right, holding that it does not apply to aider and abettor liability suits[67] and limiting the scope of recoverability to defendants with ultimate authority over misleading statements.[68]

While it may seem reasonable to allow a private right of action for compensatory reasons, the recovery in securities cases is usually against the corporation itself, and thus the compensatory effect of a successful suit is merely to shift the

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65 *See* 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2015).

66 Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971); *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313, 318–19 (2007) (noting that the "Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission" and citing J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (acknowledging that the Court's interpretation of an implied private right of action under Rule 10b-5 is "entirely consistent with the Court's recognition in [*Borak*] that private enforcement of Commission rules may '[provide] a necessary supplement to Commission action'").

67 *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994) (reaffirming the implied private right of action but holding that "a private plaintiff may not maintain an aiding and abetting suit under § 10(b)"); *see also* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 164–65 (2008).

68 *See* Janus Capital Grp., Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2302 (2011).

brunt of the loss from one group of shareholders to another.[69] The main rationale behind allowing a private right of action for damages in securities fraud cases, even though Congress specifically tasked the SEC with enforcement of section 10(b), is that it increases deterrence. The private right of action incentivizes investors to act as private attorneys general[70] and thus enables them to provide a necessary enforcement supplement to the SEC.[71] On the other hand, public policy that encourages litigation is often highly contentious because frivolous lawsuits are time-consuming for both individual parties and the courts, and allowing for over-deterrence is inefficient from a social welfare perspective.[72]

These concerns are exacerbated for securities fraud cases because they are generally brought in the form of class actions by designated plaintiffs' law firms.[73] These class

69 *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1557 (2006) [hereinafter Coffee, *Reforming the Securities Class Action*] ("[S]ecurities litigation in this context inherently results in a wealth transfer between two classes of public shareholders—those in the class period and those outside it—and typically neither class is culpable.").

70 *See* Associated Indus. of N.Y., Inc. v. Ickes, 134 F.2d 694, 704 (2d Cir. 1943) (explaining that "private Attorney Generals" include those who have been given the authority to prevent statutory violations through private actions), *vacated as moot*, 320 U.S. 707 (1943).

71 *See Tellabs*, 551 U.S. at 313. This is crucial, as the SEC is tasked with carrying out its myriad of mandates while operating under a rigid budget constraint.

72 *See* Coffee, *Reforming the Securities Class Action*, *supra* note 69, at 1547–48. From an economic perspective, the optimal deterrence level can be attained when meritorious suits are successfully brought but frivolous lawsuits are not allowed.

73 Prior to the enactment of the PSLRA, these suits were typically brought by "professional plaintiffs," who often maintained close relationships with plaintiffs' law firms. *See* Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2059 n.28, 2060–61 (1995) ("[T]he usual pattern is for a lawyer who specializes in representing plaintiffs to take the initiative" and "[t]he most common recruitment practice followed by plaintiffs' attorneys apparently is to maintain a list of potential plaintiffs and their stockholdings.").

actions involve extremely high stakes for corporate defendants. Given the large number of claimants in these class actions,[74] even a slight chance of success on the plaintiffs' part will result in a large expected payout.[75] Additionally, reputational costs associated with litigation are realized regardless of the eventual outcome.[76] Without the means to quickly dismiss meritless claims, corporate defendants may be forced into early settlements that unfairly benefit plaintiffs. This in turn creates a perverse incentive for private plaintiffs to bring weak claims against corporate defendants. Prior to the enactment of the PSLRA, these plaintiffs' firms would often race to file suit, as the earliest firm to file would generally reap most or all of any attorney's fees eventually collected.[77] These conditions gave rise to boilerplate initial pleadings, which could be subsequently amended to include more particular facts.[78] The corporate defense bar was concerned that this facilitated an abuse of the private right of action and led to an unfair burden on corporate defendants.[79]

74 *See* Thomas E. Willging et al., *An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges*, 71 N.Y.U. L. REV. 74, 90 (1996) (noting that "securities classes are generally large" and that "[l]arge class sizes in securities cases often made them distinctive when compared with most nonsecurities classes").

75 *See id.*

76 *See, e.g.*, Lynn Bai et al., *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Targeted Firms*, 158 U. PA. L. REV. 1877, 1897 (2010) (noting that "the combined reputational costs and distractions of the suit are factors that might impair the company's operational efficiency").

77 *See* Coffee, *Reforming the Securities Class Action*, *supra* note 69, at 1541 & n.17.

78 *See* Richard A. Booth, *Windfall Awards Under PSLRA*, 59 BUS. LAW. 1043, 1043 n.1 (2004); Willging et al., *supra* note 74, at 87 & n.49, 91.

79 *See* Coffee, *Reforming the Securities Class Action*, *supra* note 69, at 1534.

## B. History of the PSLRA

In 1995, Congress passed the PSLRA over President Clinton's veto.[80] This was primarily in response to pressure from the corporate defense bar. The Act fulfilled the purpose of establishing "uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits."[81] To this end, the PSLRA introduced a requirement that private plaintiffs' pleadings "state with particularity facts giving rise to a strong inference" of requisite scienter,[82] in addition to the heightened pleading standard[83] consistent with Federal Rule of Civil Procedure 9(b).[84] The PSLRA also set forth a stay of discovery "during the pendency of any motion to dismiss"[85] and restricted lead plaintiff designation, effectively prohibiting "professional plaintiffs" in the context of securities class actions.[86]

The PSLRA added a subsection to Section 21D of the Securities Exchange Act of 1934 specifying that the default liability rule for joint defendants is proportionate liability, allowing a joint and several liability regime only for knowing violations.[87] This strengthened protections for corporate defendants, and indeed the amendment passed under the

80 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.); Willging et al., *supra* note 74, at 81 & n.18.

81 H.R. REP. NO. 104-369, at 41 (1995) (Conf. Rep.).

82 Private Securities Litigation Reform Act of 1995 § 101(b), 15 U.S.C. § 78u-4(b)(2) (2012).

83 *See* 15 U.S.C. § 78u-4(b)(1) (2012) ("[I]f an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.").

84 *See* FED. R. CIV. P. 9(b).

85 15 U.S.C. § 78u-4(b)(3)(B) (2012).

86 *See* 15 U.S.C. § 78u-4(a)(3)(B)(vi) (2012) ("[A] person may be a lead plaintiff . . . in no more than 5 securities class actions brought as plaintiff class actions pursuant to the Federal Rules of Civil Procedure during any 3-year period.").

87 Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, § 201(a), 109 Stat. 737, 758 (codified at 15 U.S.C. § 78u-4(f) (2012)).

heading "Title II—Reduction of Coercive Settlements."[88] The only substantive amendment to the PSLRA prior to Dodd-Frank passed in 1998 and it served to further enhance protections for corporate defendants in private securities litigation by extending the discovery stay privilege to concurrent state court proceedings.[89]

In 2007, the U.S. Supreme Court provided its interpretation of the PSLRA's pleadings standard for scienter[90] in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[91] The Court held that "to qualify as 'strong[,]' . . . an inference of scienter must be . . . cogent and at least as compelling as any opposing inference of nonfraudulent intent."[92] The majority opinion in *Tellabs* focuses on the requirement that courts "comparative[ly] evaluat[e]" the inferences of requisite scienter against any "competing inferences" that can be "rationally drawn from the facts alleged."[93] This represents a shift towards a more stringent standard than that applied in the decision below by the U.S. Court of Appeals for the Seventh Circuit—the Seventh Circuit had considered only the plausibility of the pleaded inference of scienter and declined to consider competing inferences.[94] The new standard is also stricter than those previously applied by the Eighth and Tenth Circuits.[95]

88 *Id.*

89 Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353, § 101(a)(2), 112 Stat. 3227, 3230 (codified at 15 U.S.C. § 77z-1(b)(4) (2012)).

90 *See* 15 U.S.C. § 78u-4(b)(2)(A) (2006).

91 Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

92 *Id.*

93 *Id.*

94 *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 602 (7th Cir. 2006), *vacated and remanded by* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007).

95 *See* Sarah S. Gold & Richard L. Spinogatti, *Pleading 'Strong Inference' of Scienter Under PSLRA*, N.Y.L.J., Feb. 14, 2007, at 22 ("Two circuits, the Eighth and the Tenth, consider all inferences, both of scienter and of an innocent mental state, using the innocent inferences to test

In this context, Dodd-Frank Section 933(b) stands out from the largely defendant-favoring (with respect to the PSLRA) legislative actions and judicial decisions in the two decades since the PSLRA's passing. The recent financial crisis perhaps served as an indication that the balance between unfairly burdensome litigation and under-deterrence of inefficient activities (such as securities fraud) had tipped too far in favor of corporate defendants and needed to be realigned. Part IV of this Note examines the effectiveness of Section 933(b) in contributing to this realignment through a discussion of securities private actions filed before and after Dodd-Frank's enactment.

## IV. CASE DISCUSSION AND ANALYSIS OF SECTION 933(B)'S EFFECTIVENESS

Section 933(b) amends the PSLRA's requirements for securities fraud actions, which apply to all private actions brought under Chapter 2B of Title 15,[96] including private actions for violations of Section 10(b).[97] In the past, most private securities fraud suits filed in federal court relied on Section 10(b) and Rule 10b-5.[98] Private plaintiffs may also opt to bring securities misrepresentations claims under sections 11 and 12 of the Securities Act of 1933.[99] The "strong inference of scienter" standard does not apply to those claims, since proof of scienter is not required in those

whether the culpable interest is strong, but do not directly weigh one against the other.").

96 *See* 15 U.S.C. § 78u-4(b)(1)–(2) (2012) (providing that these subsections apply to "any private action arising under this chapter," i.e., Chapter 2B).

97 *See* 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2015).

98 *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1302 (2008).

99 *See* 15 U.S.C. §§ 77k, 77*l* (2012); *see also* James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 913 (1996).

sections.[100] The case discussion in Part IV.A focuses on claims under Section 10(b).

## A. Private Actions Against CRAs Prior to Dodd-Frank's Enactment

Prior to Dodd-Frank's enactment, in order to successfully state a claim under Section 10(b) and Rule 10b-5 against any corporate defendant, including CRAs, plaintiffs were required to "allege, in connection with the purchase or sale of securities: '(1) a misstatement or omission, (2) of a material fact, (3) made with scienter, (4) justifiably relied on by plaintiffs, and (5) proximately causing them injury.'"[101] The following cases apply the *Tellabs* standard for the scienter requirement and illustrate the necessary qualities for a complaint to survive a motion to dismiss.

### 1. In re *National Century Financial Enterprises, Inc., Investment Litigation*

The relevant claim in In re *National Century Financial Enterprises, Inc., Investment Litigation*[102] was Lloyds Bank's "claim against Moody's for violating Section 10(b) of the Securities Exchange Act, . . . and Rule 10b-5(b) promulgated thereunder . . . ."[103] The U.S. District Court for the Southern District of Ohio found that the plaintiff's allegations of factual misrepresentations were sufficient to survive a motion to dismiss under Federal Rule of Civil Procedure

100 *See* 15 U.S.C. §§ 77k, 77*l* (2012).

101 *In re* Nat'l Century Fin. Enters., Inc., Inv. Litig., 580 F. Supp. 2d 630, 637 (S.D. Ohio 2008) (quoting Helwig v. Vencor, Inc., 251 F.3d 540, 554 (6th Cir. 2001) (en banc)). The U.S. Supreme Court has reserved the issue of the requisite level of scienter in Section 10(b) and Rule 10b-5 cases. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). However, "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007).

102 580 F. Supp. 2d 630 (S.D. Ohio 2008).

103 *Id.* at 637.

12(b)(6).[104] It also dismissed the defendant's First Amendment arguments.[105] While the court found that the plaintiff would not be able to show reliance based on the facts as alleged, it nevertheless went on to discuss at great length what appeared to be the more dispositive issue for this claim—scienter.[106]

The court applied the "strong inference" standard pursuant to subsection (b)(2) of the PSLRA as interpreted in *Tellabs*[107] and found that the plaintiff's allegations were insufficient to meet this standard.[108] The court dismissed the plaintiff's argument that the defendant's "access to information, coupled with its alleged role, supports a strong inference of scienter."[109] Instead, the court's standard required the plaintiff to directly allege in its complaint that the rating agency defendant had knowledge of the corporate violations that ultimately resulted in a ratings downgrade.[110] The court suggested that the plaintiff should have identified in its complaint the specific document or documents which "alerted [the rating agency defendant] to information that should have caused [the defendant] to refuse to give favorable ratings" to the notes at issue.[111] This would have been extremely difficult, if not impossible, for the plaintiff to do, given the stay on discovery that was in place pending the motion to dismiss.

### 2. In re *Moody's Corp. Securities Litigation*

The court in In re *Moody's Corp. Securities Litigation*[112] applied the Second Circuit standard for scienter pleadings,

104 *See id.* at 637–39.

105 *Id.* at 640.

106 *See id.* at 638, 640–44.

107 Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

108 *In re* Nat'l Century, 580 F. Supp. 2d at 640, 644.

109 *Id.* at 642.

110 *See id.* at 641–42.

111 *Id.* at 641.

112 599 F. Supp. 2d 493 (S.D.N.Y. 2009).

noting that "[p]laintiffs can establish scienter either by: (a) 'alleging facts to show that defendants had both motive and opportunity to commit fraud,' or (b) 'alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.'"[113] The court then stated that plaintiffs can meet the high standard for establishing circumstantial evidence of scienter "by alleging, inter alia, that defendants (1) 'engaged in deliberately illegal behavior;' (2) 'knew facts or had access to information suggesting that their public statements were not accurate;' or (3) 'failed to check information they had a duty to monitor.'"[114] Thus, under the Second Circuit standard prior to Dodd-Frank, plaintiffs' allegation of a CRA's access to information suggesting inaccuracy of its public statements was sufficient to survive a motion to dismiss. Importantly, the new standard under Section 933(b) may in application be more stringent than the previous Second Circuit standard.

## B. Private Actions Against CRAs Since Dodd-Frank's Enactment

Private actions filed against CRAs since mid-2010 have relied almost exclusively on claims under common law fraud or section 11 of the Securities Act of 1933.[115] To date, the only complaint that references CRAs' duty of reasonable verification was filed in *First National Bank v. McGraw-Hill Companies, Inc.*[116] No complaint to date has relied on the

113 *Id.* at 514 (quoting Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001)).

114 *Id.* (quoting Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000)).

115 *See, e.g.*, Space Coast Credit Union v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 12-60430-CIV, 2014 WL 1230719 (S.D. Fla. Mar. 25, 2014) (common law fraud claims); Genesee Cty. Emps. Ret. Sys. v. Thornburg Mortg. Sec. Tr. 2006-3, 825 F. Supp. 2d 1082 (D.N.M. 2011) (section 11 claim); Anschutz Corp. v. Merrill Lynch & Co., Inc., 785 F. Supp. 2d 799 (N.D. Cal. 2011) (common law negligent misrepresentation claim).

116 Complaint at 53 n.9, First Nat'l Bank & Tr. Co. of Rochelle, Ill. v. McGraw-Hill Cos., Inc. (N.D. Ill. Aug. 9, 2013) (No. 1:13-cv-05693). On March 27, 2015, the U.S. District Court for the Northern District of Illinois

new standard in 15 U.S.C. § 78u-4(b)(2)(B) in a private action against CRA defendants. This lack of case law is unexpected, given Section 933(b)'s anticipated significance.[117] The following Subpart E examines indications of Section 933(b)'s success in forms other than private actions filed.

## C. Inquiry into Changes in CRA Best Practices Since Dodd-Frank's Enactment

Section 933(b) redefined the scienter requirement in private suits against rating agency defendants as knowing or reckless failure to carry out reasonable investigation or reasonable verification of the factual elements used to arrive at their ratings.[118] The major CRAs have since adapted to this standard by preemptively adopting codes of conduct stipulating to reasonable investigation of factual elements, as well as reasonable verification when available.[119] CRAs

granted the CRA defendants' joint motion to dismiss, and the plaintiff's appeal was dismissed on November 9, 2015. *See* First Nat'l Bank & Tr. Co. of Rochelle, Ill. v. McGraw-Hill Cos., Inc., 85 F. Supp. 3d 963, 965 (N.D. Ill. 2015), *appeal dismissed*, First Nat'l Bank & Tr. Co. of Rochelle, Ill. v. Moody's Inv'rs Serv., Inc., No. 15-1742 (7th Cir. Nov. 9, 2015) (mandate ordering dismissal of case).

117 *See supra* note 2 and accompanying text.

118 *See* Dodd-Frank Act § 933(b), 15 U.S.C. § 78u-4(b)(2)(B) (2012).

119 *See* FITCH RATINGS, CODE OF CONDUCT 16 (2014), https://www.fitchratings.com/web_content/credit_policy/code_of_conduct.pdf [http://perma.cc/UJ9K-N9AZ] ("Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction."); MOODY'S INV'RS SERV., INC., ANNUAL CERTIFICATION OF FORM NRSRO 2013, at 89, https://www.moodys.com/sites/products/ProductAttachments/SP27707_MIS_NRSRO%202014.pdf [http://perma.cc/M2HW-D8Z5] ("Before using data provided by an Issuer or its agent, [Moody's Investors Service] generally will investigate and obtain reasonable verification of key factual elements using an independent source, including by comparison to other information that comes from sources that are independent of the Issuer. [Moody's Investors Service] adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources [it] considers to be reliable . . . .").

prefer to rely primarily on third-party due diligence service providers to satisfy the due diligence requirements imposed by Section 933(b), citing the prohibitive expense of carrying out their own investigations.[120] Thus, the pertinent standard has shifted from actual or constructive knowledge to a duty of reasonable verification.

The Securities Exchange Commission adopted its final rules applicable to NRSROs pursuant to Dodd-Frank sections 932, 936, and 938.[121] The key new rules, in light of the shift to reasonable verification, are Rules 15Ga-2 and 17g-10.[122] For asset-backed securities, section 15E(s)(4)(B) of the Securities Exchange Act of 1934 requires that a written certification be provided by due diligence service providers "[i]n any case in which third-party due diligence services are employed by" an NRSRO.[123] The new Rule 17g-10 implements section 15E(s)(4)(B) and specifies the use of the new Form ABS Due Diligence-15E.[124] New Rule 15Ga-2 requires issuers or underwriters of asset-backed securities to be rated by NRSROs and to make available the findings and conclusions of any third-party due diligence report obtained, using Form ABS-15G.[125] These new rules took effect on June

120 *See, e.g.*, Fitch Ratings, Comment Letter on Proposed Rule on Issuer Review of Assets in Offerings or Asset-Backed Securities (Nov. 15, 2010), https://www.sec.gov/comments/s7-26-10/s72610-36.pdf [http://perma.cc/R3U4-RVZ5].

121 *See* Press Release, SEC, SEC Adopts Credit Rating Agency Reform Rules (Aug. 27, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542776658#.VLSirGTF8p4 [http://perma.cc/FEB8-H8JF]; *see also* Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. 55,078 (Sept. 15, 2014) (to be codified at 17 C.F.R. pts. 232, 240, 249, & 249b) [hereinafter SEC Release].

122 17 C.F.R. §§ 240.15Ga-2, 240.17g-10 (2015).

123 15 U.S.C. § 78o-7(s)(4)(B) (2012).

124 *See* Nationally Recognized Statistical Rating Organizations, 76 Fed. Reg. 33,420, 33,471 (proposed June 8, 2011) (to be codified at 17 C.F.R. pts. 232, 240, 249, & 249b); *see also* SEC Release, *supra* note 121, at 55,245.

125 *See* Nationally Recognized Statistical Rating Organizations, 76 Fed. Reg at 33,466–67; *see also* SEC Release, *supra* note 121, at 55,183–84.

15, 2015,[126] and as a result, the dynamic between NRSROs, issuers, and third-party due diligence service providers has changed. It is uncertain at this point which party will bear the greater risk of litigation as a result of a ratings failure, and how these new rules will affect Section 933(b)'s effectiveness going forward.

## V. POSSIBLE EXPLANATIONS OF SECTION 933(B)'S PERCEIVED INEFFECTIVENESS

### A. Reduced Efficacy of 10b-5 Litigation

An important factor to consider in determining why Section 933(b) has not produced its anticipated effect in the judicial system is the efficacy of federal securities fraud litigation in general, especially relative to litigation grounded in Securities Act section 11 and 12 claims, or state common law fraud claims. Because Section 933(b) modifies the PSLRA's requirements for securities fraud actions, it affects only claims of violations of the Securities Exchange Act of 1934, which are primarily Section 10(b) claims.[127] U.S. Supreme Court decisions in recent years have greatly narrowed the scope of private actions under Section 10(b) and Rule 10b-5.[128] As a result, private plaintiffs have fallen back on state common law claims of fraud and negligent misrepresentation.[129] One can thus infer that Section 933(b)'s potential pro-plaintiff effect on private securities fraud litigation is not sufficient to overcome the concurrent reduction in the efficacy of Section 10(b) litigation in general, at least as perceived by plaintiffs when evaluating their choice of which claims to allege. Consequently, Section 933(b)'s effect has not been apparent through private actions filed in recent years.

126 *See* SEC Release, *supra* note 121, at 55,078.

127 *See supra* Part III.B.

128 *See supra* Part III.B. The restriction against private recovery for aider and abettor liability as well as the restriction on recovery from any defendant who lacked ultimate authority over misleading statements have rendered Section 10(b) much less effective for private plaintiffs.

129 *See supra* Part IV.B.

To address this issue, policymakers would need to either address the underlying barriers to success in Section 10(b) litigation or change the public perception of Section 933(b)'s potential effectiveness in overcoming these barriers. The former would require undoing much of the Court's recent Section 10(b) jurisprudence, and as such, will most likely prove to be prohibitively difficult and unadvisable. The latter option is more promising, and it might be carried out through clarifications on the specific elements required to prove a failure by CRAs to carry out reasonable investigation and verification of the factual elements of the ratings they issue. The SEC could issue these clarifications in a timely manner, and they would function similarly to the Court's clarification of the heightened pleadings standard in *Tellabs*, which gave teeth to the standard introduced by the PSLRA.[130] The current uncertainty with respect to how this failure might be alleged and proven is likely to influence prospective plaintiffs in their decision over whether to file a claim under Section 10(b). This in turn reduces the efficacy of Section 933(b).

## B. Boilerplate Assertions by CRAs in Their Respective Codes of Conduct

Another closely-related, potential reason for Section 933(b)'s lack of perceived effect in the courts is the perceived difficulty in pleading with particularity CRAs' failure to carry out their due diligence duties, in light of the major CRAs' adoption of boilerplate assertions of due diligence in their respective codes of conduct and Forms NRSRO.[131] Prior to discovery, it is unlikely that prospective plaintiffs will have sufficient information as to the internal processes of a CRA and specific deviations from the proper due diligence procedures asserted in its codes of conduct to be able to allege such deviations with particularity (i.e., as "factual contentions [with] evidentiary support"), as required by

130 *See* Cozzarelli v. Inspire Pharm. Inc., 549 F.3d 618, 624 (4th Cir. 2008).

131 *See supra* note 119 and accompanying text.

Federal Rule of Civil Procedure 11(b).[132] Plaintiffs likely will not be able to overcome the boilerplate provisions in CRAs' codes of conduct without running a significant risk of being sanctioned under Federal Rule of Civil Procedure 11(c).[133]

Potential policy changes to address this problem include instituting a safe harbor from sanctions for plaintiffs in the particular situation of private 10(b) suits against rating agencies. This can be justified given the elevated asymmetry in access to information between plaintiffs and rating agency defendants in private securities fraud actions,[134] as well as the overall importance of CRAs' role as gatekeepers to the financial markets.[135] Another potential policy fix would be to allow limited discovery pending a motion to dismiss in private securities fraud actions against CRAs.

## C. Potential Non-Judicial Reasons for Perceived Ineffectiveness

In addition to the potential reasons listed in Parts IV.A and IV.B above, there are a number of non-judicial factors that may be contributing to the perceived ineffectiveness of Section 933(b). These factors may not require a policy response, but they are important to consider when evaluating the overall effectiveness of Section 933(b).

132 FED. R. CIV. P. 11(b).

133 *See* FED. R. CIV. P. 11(c).

134 Arthur R. Miller, *From* Conley *to* Twombly *to* Iqbal*: A Double Play on the Federal Rules of Civil Procedure*, 60 DUKE L.J. 1, 45 (2010) ("This problem of information asymmetry—which generally is a much more formidable concern for plaintiffs than for defendants—presents itself in many litigation contexts. It is prevalent in actions challenging the conduct of large institutions—for example, antitrust and securities cases—when the necessary information relating to issues such as fraud, conspiracy, price-fixing, and corporate governance can be found only in the defendant's files and computers. The problem is exacerbated in multiple-defendant situations in which access to information is critical to indicating the alleged wrongdoing in order to focus on the alleged wrongdoer.").

135 *See supra* Part II.

### 1. Out-of-Court Settlements

Only a fraction of all legal disputes proceed beyond the initial pleadings stage, often because they are dropped or settled out of court.[136] However, corporate defendants generally have very little incentive to settle cases with private plaintiffs in the initial pleadings stages, since they benefit from the stay on discovery pending motions to dismiss, and the process of filing a motion to dismiss is not resource-intensive. Thus, the potential for disputes to be settled outside of the judicial process does not explain the lack of decisions ruling on Rule 12(b)(6) motions to dismiss. Furthermore, out-of-court settlements would not explain the complete lack of complaints filed in federal court against CRAs citing the lowered scienter requirement.[137]

### 2. Changes in Underlying Ratings Methodology

A potentially positive reason for the lack of perceived effectiveness of Section 933(b) in federal securities actions brought since Dodd-Frank's enactment could be that CRAs have changed their underlying ratings methodologies to reflect greater attention to independent verification and due diligence, thus preemptively reducing their exposure to private securities class actions. If this were the case, it might imply that Section 933(b) has been effective at bringing about desired CRA reform. However, it would be difficult to isolate the changes attributable to Section 933(b) in particular, given the array of policy changes adopted as a package in Dodd-Frank. It is also fairly unlikely that this underlying improvement in the CRA ratings process has taken place—ratings agencies likely would not willingly incur the significant costs associated with overhauling their ratings processes and conducting substantially more due diligence without a much greater threat of litigation. Given

136 *See generally* Theodore Eisenberg & Charlotte Lanvers, *What Is the Settlement Rate and Why Should We Care?*, 6 J. EMPIRICAL LEGAL STUD. 111, 111 (2009).

137 *See supra* Part IV.B.

the reasons listed in Parts V.A and V.B, Section 933(b) most likely does not present a sufficient threat. It is more likely that CRAs have tried to assign greater litigation risk to issuers and third-party due diligence providers, as discussed in Part IV.C. Thus, this potentially positive explanation for the lack of perceived effect should not be enough reason on its own to neglect policy changes in the area of private securities litigation against CRAs.

### 3. Countercyclical Applicability of CRA Reform

A final non-judicial reason for Section 933(b)'s perceived ineffectiveness is the inherently countercyclical applicability of CRA reform. Many more suits are brought against financial market players, including CRAs, in the immediate aftermath of a financial market downturn.[138] Since Dodd-Frank's enactment, the financial markets have largely been in recovery,[139] and thus there has not been much occasion for suits against CRAs in recent years. The vast majority of claims arising from the years leading to the global financial crisis of 2007–2008 would have been time-barred by the

138 *See* CLAIRE ECKSTEIN, SECURITIES LITIGATION: WILL THE CURRENT CRISIS REVERSE THE RECENT DOWNWARD TREND? 1 (2009), http://www.stern.nyu.edu/sites/default/files/assets/documents/uat_024427.pdf [http://perma.cc/AE8S-8F6H] ("Market volatility and the recession of 2008 led to an increase of 31% in class-action filings since 2007—of which 43% were related to the credit crisis. Half of all filings were against financial institutions."); JAMES E. LYONS & SCOTT D. MUSOFF, SECURITIES CLASS ACTIONS: NO SHRINKING ICE CAP 1 (2009), http://www.skadden.com/sites/default/files/publications/Publications1612_0.pdf [http://perma.cc/HLC8-PTFD] ("Securities class action filings reached a 10-year low in 2006. . . . [T]he combination of the sudden onset of the global credit crisis and the increased volatility in the securities markets in the last 18 months has led to an unprecedented resurgence in securities litigation.").

139 *See* CRAIG K. ELWELL, CONG. RESEARCH SERV., ECONOMIC RECOVERY: SUSTAINING U.S. ECONOMIC GROWTH IN A POST-CRISIS ECONOMY (2013), http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=2112&context=key_workplace [http://perma.cc/4VDW-K9D5] ("Economic recovery began in mid-2009. Real gross domestic product (GDP) has been on a positive track since then . . . .").

statute of limitations.[140] Thus, it is fairly probable that the full effect—or lack of effect—of Section 933(b) will not be observable until the next major financial market downturn. Nevertheless, given CRAs' essential role in the markets and their potential to affect systemic risk, policymakers cannot afford to simply wait until the next downturn to act and should still carefully consider the implications of the potential problems preventing Section 933(b) from achieving its designed effect.

## VI. CONCLUSION

The observed effect of Section 933(b) since its enactment has fallen short of expectations. This may be due to a number of factors, both intrinsic and extrinsic to the legal system. Rating agencies have reacted to Section 933(b) by adopting generic provisions in their respective codes of conduct stipulating compliance. This is unlikely to be very helpful in preventing another collective failure by CRAs to carry out their crucial roles as gatekeepers to the financial markets. Despite its potential for abuse, private securities litigation remains an essential supplement to the SEC and DOJ in the deterrence of such failures. Thus, policymakers cannot afford to neglect Section 933(b)'s perceived inefficacy in achieving private deterrence since its enactment, and should consider additional reform and clarifications of the pleadings requirements in bringing about Section 933(b)'s fully intended effect.

140 The Sarbanes-Oxley Act of 2002 provides that private claims under 10(b) "may be brought not later than the earlier of—(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation." 28 U.S.C. § 1658(b) (2012).