REBUILDING THE FALLEN HOUSE OF CARDS: A NEW APPROACH TO REGULATING CREDIT RATING AGENCIES

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The financial crisis highlighted key problems in the structure and business model of credit rating agencies ("CRAs"). With the growth of securitization and innovative, structured finance products, the inherent conflicts of interest present in the issuer-pays model followed by CRAs became even more problematic, as rating agencies faced greater competitive pressures to appease their clients—the issuers of debt—than they did when they were rating only corporate bonds. Both the United States and the EU responded to these concerns with enhanced regulation. In the Dodd-Frank Act, the United States mandated a study on the advantages of the so-called "Franken Proposal," which would create a centralized government platform to assign issuers to rating agencies on a randomized basis.

This Note evaluates the Franken Proposal and its alternatives, rejecting them in favor of a new proposal, which consists of three primary elements: (1) a requirement that issuers obtain a vote from their largest institutional investors, the outcome of which would determine which CRA the issuer hires; (2) the creation of a governmental agency or a self-regulatory organization that evaluates and ranks the performance of individual CRAs; and (3) a requirement that issuers obtain a second rating from a better-performing CRA

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when they choose to hire one whose performance has proven inadequate for a particular asset class.

Requiring issuers to hire a rating agency chosen by voting investors ensures that CRAs will compete for the favor of investors rather than the conflicted issuers. To help investors make educated voting decisions, a ranking of rating agency performance will give investors standardized information about the quality of the CRAs. By requiring issuers who initially purchase a rating from a low-performing CRA to buy a second rating from a better-performing CRA, the penalty provision ensures that business will be diverted to the most efficient rating agencies. This Note concludes that the new proposal is therefore a better solution than the Franken Proposal for the conflict of interest problem faced by CRAs.

I. INTRODUCTION

"[R]ating agencies continue to create an 'even bigger monster—the CDO market.' Let's hope we are all wealthy and retired by the time this house of cards falters."[1] Now that the house has fallen, what do we do?

Greed, speculation, deregulation, highly complex financial products, and cheap money flowing from China's large holdings of U.S. debt—these factors punctured a hole in the American economic system leading to the global financial crisis. One major link in the chain of destructive events leading to the crisis was the credit rating industry. Indeed, the industry's failure to identify and expose risk made credit rating agencies ("CRAs") an easy target to blame.

Statistics show there were several indicators that should have put CRAs on notice of higher default probabilities before the end of 2006, when the first major wave of downgrades occurred. Figure 1 illustrates the rapid deterioration in credit quality associated with subprime lending. By 2003, over 40% of subprime loans were low or no-document loans (i.e., loans extended with very little or no income verification) and this percentage continued to increase. However, it took until July 2007 for the rating agencies to downgrade rapidly influential lenders en masse (whose structured products were created using subprime

[1] This quote originates in an infamous e-mail exchange between colleagues working at a credit rating agency. SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 12 n.8 (2008), *available at* www.sec.gov/ news/studies /2008/craexamination070808.pdf.

lending).[2] Figure 2 shows the surge in securities downgrades that occurred in 2007, which includes almost $35 billion of asset-backed securities. Twenty-six percent of all downgrades affected the subprime mortgage-backed securities market. Given this data, the question is: Where were the rating agencies before 2007?

In retrospect, one of the key problems that CRAs faced was the conflict of interest inherent in the "issuer-pays" business model they used. In response to the financial crisis, the United States enacted major financial regulatory reform through the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which also addressed reforms thought necessary for the credit rating industry. The Dodd-Frank approach to dealing with the CRAs' conflict of interest problem has been associated with the "Franken Proposal," which will be officially implemented if no better solution is presented by 2012.[3] This Note analyzes the pros and cons of the Franken Proposal and its alternatives, concluding that an even better solution may exist for regulating the conflicts of interest that rating agencies face.

It begins by exploring the significance of CRAs in a deregulated market, the problems with the CRAs' business structure, and the ways in which these problems facilitated the financial crisis. Next, this Note details the regulatory approaches adopted to date in the United States and the European Union ("EU") to remedy the situation. As will be discussed, these regulatory approaches are not sufficiently robust because they fail to address the major conflict of interest problem inherent in the issuer-pays model under which the CRAs operate. Recognizing the shortcomings of credit rating regulation, scholars around the world have published proposals to adequately regulate the industry.

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2 STAFF OF S. SUBCOMM. ON INVESTIGATIONS, COMM. ON HOMELAND SEC. AND GOV'T AFFAIRS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 263 (Comm. Print 2011), *available at* www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf.

3 Dodd-Frank Wall Street Reform and Consumer Protection Dodd-Frank Act § 939(f), Pub. L. No. 111-203, 124 Stat. 1376, 1471 (2010).

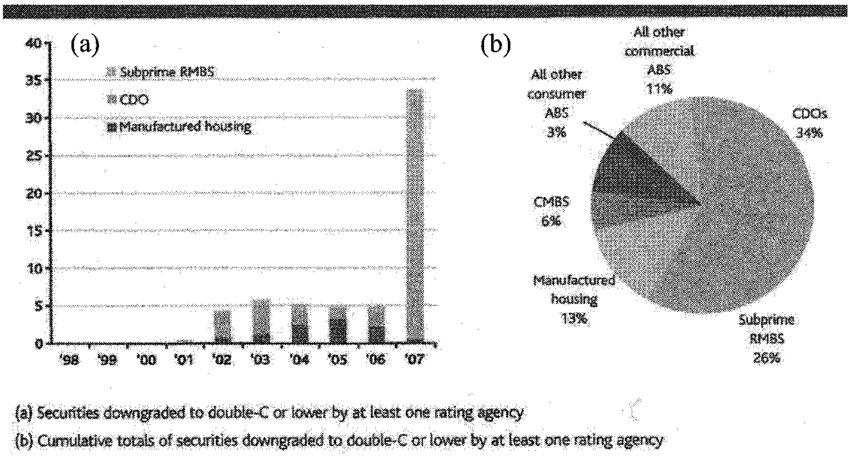
This Note evaluates the pros and cons of several proposed ideas and then offers a new approach. This Note concludes with an evaluation of the new proposal's advantages relative to the discussed alternatives.

FIGURE 1: SUBPRIME MORTGAGE LENDING 2001–2006: SHOWING THE RAPID DETERIORATION IN CREDIT QUALITY ASSOCIATED WITH SUBPRIME LENDING[4]

Year	Low / No-doc Share	Debt Payments / Income	Loan / Value	Adjustable Rate Mortgages 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%

4 *Competition and Credit Rating Agencies: Hearing Before the Competition Comm. of the Organization for Economic Cooperation and Development* 8 fig.2 (2010) [hereinafter OECD *Hearing*], *available at* www.oecd.org/dataoecd/ 28/51/46825342.pdf.

FIGURE 2: SURGES IN DOWNGRADED SECURITIES[5]



II. VALUE OF CRAS: WHY WE HAVE THEM IN THE FIRST PLACE

CRAs are private firms that offer judgments about the creditworthiness of debt issued by various entities and measure the likelihood of default on these obligations. They express their judgments in the form of credit ratings that are typically letter grades. A CRA's main function is to provide information to investors to save them the expensive and wasteful duplicative efforts of collecting and processing comparable information.[6] By providing this information, CRAs facilitate efficient transactions and make the debt markets more liquid.[7] Many securities, such as structured

[5] Karen Weaver, *U.S. Asset-Backed Securities Market Review and Outlook*, *in* GLOBAL SECURITIZATION AND STRUCTURED FINANCE 18, 20 fig.3 (Deutsche Bank 2008), www.globalsecuritisation.com/08_GBP/GBP_GSSF08_018_021_DB_US_ABS.pdf.

[6] *See* Paul Schultz, *The Credit Rating Conundrum*, NOTRE DAME CENTER FOR THE STUDY OF FIN. REG., Spring 2010, at 4-5, *available at* http://business.nd.edu/uploadedFiles/Academic_Centers/Study_of_Financial_Regulation/pdf_and_documents/Finance%20Newsletter%20Spring%2010%205_24.pdf.

[7] *Id.*

finance products, are so complex that investors require considerable resources and nonpublic information to analyze and understand them adequately.[8] Although institutional investors often have adequate information-gathering capacities and may conduct their own credit-risk analysis, the ratings serve as points of comparison for these highly complex securities. Institutional investors use ratings as one of many factors in their internal credit-risk evaluation or to help them identify pricing discrepancies that benefit their trading operations.[9] Additionally, many institutional investors are subject to regulatory restrictions with respect to the types of risky investing they can engage in, and are required to invest in securities with specific threshold credit ratings.[10] Broker-dealers also use ratings "to recommend and sell securities" and to determine "collateral levels for outstanding credit exposures."[11]

III. HOW CRAS FACILITATED THE FINANCIAL CRISIS

It is important to understand how CRAs operate, who relies on them, and how these factors impact the economy before proposing a solution. The following factors explain why the credit rating agencies were vulnerable to conflicts of interest, and how their business structure facilitated the financial crisis.

A. The Issuer-Pays Model and Conflicts of Interest

An inherent conflict of interest exists in the business structure of most CRAs that operate under an issuer-pays

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8 *See* Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 242–43 (2009).

9 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-240, CREDIT RATING AGENCIES: ALTERNATIVE COMPENSATION MODELS FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 6 (2012) [hereinafter GAO REPORT], *available at* www.gao.gov/assets/590/587832.pdf.

10 *See infra* Figure 3.

11 GAO REPORT, *supra* note 9, at 6.

model, where the entities that issue the debt instruments or sell them to investors are also the entities that pay the rating agencies to rate their products. Essentially, clients pay to have their products rated in a market in which the value of the product—and therefore the cost of borrowing—is highly dependent on the rating it is given. CRAs may thus be inclined to inflate the client's rating, or fail to downgrade a security, in order to appease the client, maintain a good relationship, and facilitate future business. This conflict becomes more serious when the client can credibly threaten to take its business elsewhere and go "rating shopping" to find the best deal. Rating shopping concerns arise when several competing rating agencies exist. In fact, studies show that there is a correlation between inflated ratings and increased competition in the market.[12]

Interestingly, CRAs operated on an *investor*-pays rather than *issuer*-pays basis until the 1970s.[13] However, free-riding problems attributable to the public-good nature of ratings information made this system unprofitable and therefore unsustainable.[14] Ratings provided to investors were easily copied and transferred between different parties.[15] This development prompted a shift in CRA payment structure to an issuer-pays model, which has been in place ever since, and has now proven to be especially problematic for structured debt.[16]

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[12] *See* Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?* 8, 30 (Harv. Bus. Sch., Working Paper No. 09-051, 2010), *available at* www.hbs.edu/research/pdf/09-051.pdf.

[13] OECD *Hearing*, *supra* note 4, at 6.

[14] *See id.*

[15] *Id.*

[16] Not all CRAs operate this way. Out of the now nine agencies the SEC has recognized as Nationally Recognized Statistical Rating Organizations "NRSROs", three operate on an investor-pay basis. SEC, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 6 (2011) [hereinafter SEC ANNUAL REPORT], *available at* www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf.

B. Growth of Securitization and Structured Finance Products

The growth of securitization and structured finance greatly changed the environment in which rating agencies operated and increased the potential for conflicts of interest, especially given the volume of business that developed. Essentially, mortgage securitization involves packaging large numbers of cash flows from individual mortgage loans into products called residential mortgage-backed securities ("RMBS"). These pooled mortgages are separated into different tranches of debt and each tranche is rated by the CRAs.[17] The top tranche is given the highest rating, because it has priority access to the cash flows from the pooled loans; the lowest tranche receives the lowest rating because it has the lowest priority and, consequently, the highest risk.

The big problem was that CRAs began marketing advisory and consulting services to clients—the issuers—to attract their business.[18] They advised issuers on how to obtain their desired rating using the riskiest loans that would meet the threshold requirements for the desired rating for each tranche.[19] Although they advised on how to structure tranches, they did not perform due diligence with respect to the underlying securities; they simply accepted the originators' assumptions with respect to the likelihood of default.[20] This cozy relationship gave issuers the ability to take advantage of loopholes in the models used by the very rating agencies they hired to rate their products. For example, obtaining an AAA rating required that the pool of loans have an *average* FICO score of 615.[21] Originators

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[17] MICHAEL LEWIS, THE BIG SHORT 23–28 (1st ed. 2010).

[18] *Turmoil in the U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 110th Cong. 2 (2008) [hereinafter 2008 *Hearings*] (statement of John C. Coffee, Jr., Professor, Columbia University School of Law), *available at* http://banking.senate.gov/public/_files/OpgStmtCoffeeSenateTestimonyTurmoilintheUSCreditMarkets.pdf.

[19] *See id.* at 12–13.

[20] *See infra* Part III.D.

[21] *See* LEWIS, *supra* note 17, at 99.

would take advantage of this by creating pools of loans of which over half had scores lower than 615, with the balance having FICO scores high enough to bring the average to 615.[22] Clearly, a pool of loans in which half the borrowers have FICO scores lower than 615 has a greater default rate than a pool of loans where most scores are actually at 615—yet they were rated the same way.[23] Additionally, the issuers used loans given to people with "thin-file" FICO scores that appeared to be relatively high scores only because of a lack of credit history.[24]

The markets' exposure to the risk of inaccurate ratings was further magnified when the RMBS themselves were pooled together and packaged into new financial products such as collateral debt obligations ("CDOs") or "synthetic CDOs" that were sold in various tranches.[25] Synthetic CDOs are similar to CDOs except that purchasers did not own the underlying securities. Rather, interests in CDOs simply referenced the packaged RMBS securities and were linked to these securities using derivatives called credit default swaps. The existence of synthetic CDOs allowed demand to expand indefinitely, even as the actual supply of subprime mortgages remained limited. The problem was that the ratings given to these new innovative products were linked to the questionable accuracy of the original ratings assigned to the RMBS tranches.[26] This layering multiplied the exposure of investors to the risk of inaccurate initial ratings, thereby compounding the risk of these inaccurate ratings even further.[27]

Due to the novelty of these structured products, there was very little information concerning past performance on which

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22 *See* LEWIS, *supra* note 17, at 99–101.

23 *Id.*

24 *Id.*

25 Matthew Richardson & Lawrence J. White, *The Rating Agencies: Is Regulation the Answer?*, *in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 101, 106 (Viral V. Acharya & Matthew Richardson eds., 2009).

26 *Id.*

27 *Id.*

the CRAs could rely for risk evaluation models. Therefore, they were forced to make certain assumptions—many of which were flawed. "For mortgage-related securities, estimated losses would depend [both] on estimates of foreclosure rates and loan-loss severities, which are themselves driven by assumptions about fundamental factors such as house prices and interest rates," and on assumptions about the correlation of defaults among the individual borrowers.[28] Underestimating the default correlation and relying heavily on the continued increase of housing prices proved problematic. Once housing prices stopped increasing and eventually started to decline, mass defaults ensued.[29]

Compared to corporate or sovereign bonds, the structured products were subject to more severe multiple-notch downgrades because their structure made their ratings more dependent on underlying assumptions about the growth of the housing market and the levels of default by homeowners.[30] Small deviations from these assumptions had the potential to increase risk exponentially.[31] With such a discrete risk distribution, either many borrowers defaulted

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[28] Amadou N.R. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets* 19 (IMF, Working Paper No. 09/129, 2009), *available at* www.imf.org/ external/pubs/ft/wp/2009/wp09129.pdf.

[29] WALL STREET AND THE FINANCIAL CRISIS, *supra* note 2, at 263.

[30] Sy, *supra* note 28, at 18–20.

[31] A study of a rating process explains that:

> [A]n AAA rating is highly sensitive to the chosen assumptions on correlation and loss severity, with the associated risk of abrupt downgrades. . . . [I]f the asset [default] correlation were 15 percent, AAA subordination would have to increase from 16 to 25.6 percent (64 defaults). In fact . . . if the correlation were to jump from 5 to 15 percent, the originally rated AAA tranche should be downgraded to single-A or below (the probability of more than 40 defaults jumps from 0.06 percent to 1.88 percent, and the target default probabilities for A and BBB ratings are 0.46 and 2.32 percent, respectively). Increasing the loss severity from 50 to 70 percent (holding the correlation at 5 percent) would also downgrade the AAA tranche to single-A or below, and downgrading the underlying credits from BB to B could downgrade the AAA tranche ratings to BB or below.

Id. at 20–21.

or almost none defaulted, implying that there was not a justifiably large difference in risk associated with an AAA tranche and a non-investment grade tranche. Thus, credit rating models mistakenly applied linear functions to estimate the non-linear "option-like" behavior of the structured products.[32]

Additionally, before structured finance overtook corporate debt issuances, no single client of the CRAs accounted for a large amount of the CRAs' business.[33] With the growth of structured finance, the rating agencies dealt with fewer clients who brought in a greater amount of their business on a continuing basis, and, therefore, who had increasingly credible bargaining power.[34] The issuers thus had an incentive to engage in "rating shopping," which created a conflict of interest for the CRAs.[35]

C. Regulatory Licensing

Another problem stems from the fact that regulators in the United States have historically incorporated credit ratings into specific regulations.[36] These regulations require that certain institutions or investors purchase only securities above a threshold credit rating issued by a CRA that is designated as a Nationally Recognized Statistical Rating Organization ("NRSRO"). Figure 3 provides examples of regulations that incorporate NRSRO ratings. Europe has similarly albeit to a lesser extent conferred such power on CRAs through regulations such as Basel II, which assesses capital based on risk-weighted assets and thus imposes higher capital requirements on banks that hold lower rated

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32 *Sy, supra* note 28, at 20–21.

33 John C. Coffee, Jr., *Ratings Reform: The Good, the Bad, and the Ugly*, 1 HARV. BUS. L. REV. 232, 237–38 (2011).

34 *Id.*

35 *Id.* at 238.

36 *See infra* Figure 3.

bonds (0% for AA-rated government bonds and between 20 and 150% for corporate bonds rated CCC or below).[37]

Essentially, this allowed CRAs with the NRSRO designation to confer "governmentally-delegated permission to buy upon institutional investors that are legally restricted to purchasing securities rated investment grade. . . . Put bluntly, an NRSRO can sell its services to issuers, even if the market distrusts the accuracy of its ratings, because it is in effect licensing the issuer to sell its debt to certain regulated investors."[38] Many of the big institutional investors or originators that held these securities, and were responsible for fueling the growth of structured products, were also subject to these legal restrictions referencing ratings. These restrictions forced them to purchase only investment-grade products and also applied write-down provisions requiring greater capital holdings for non-investment-grade debt. The result was that NRSROs had incentives to award high ratings to appease their clients. At the same time, there was little incentive to regularly review and downgrade ratings that ceased to be accurate as a result of subsequent developments. CRAs were not paid by their clients to do so, and it only harmed their clients if they acted on their own initiative. Studies also show that CRAs made questionable upward adjustments to their own models in an effort to increase the size of the senior tranche that could be rated AAA.[39]

[37] OECD *Hearing*, *supra* note 4 at 69 (statement of Karel Lannoo, CEO, Ctr. For European Policy Studies).

[38] *The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing Before the S. Comm. On Banking, Hous. & Urban Affairs, 110th Cong.* 8 (2007) [hereinafter 2007 *Hearings*] (testimony of John C. Coffee, Jr.).

[39] *See* John M. Griffin & Dragon Yongjun Tang, *Did Subjectivity Play a Role in CDO Credit Ratings?* 16 (McCombs Research Paper Series, Paper No. FIN-04-10, 2010), *available at* http://ssrn.com/abstract=1364933.

FIGURE 3: EXAMPLES OF RATINGS EMBEDDED IN U.S. REGULATIONS[40]

Year	Rating Dependent Regulation	Minimum Rating	Regulator / Regulation
1936	Prohibited banks from purchasing "speculative securities"	BBB	OCC, FDIC and Federal Reserve joint statements
1989	Allowed pension funds to invest in high rated ABS	A	Department of Labor relaxation of ERISA restriction
1991	Required money market mutual funds to limit holding of low rated paper	A1	SEC amendment to rule 2a-7 under the Investment Company Act of 1940
1994	Imposes differing capital requirements on banks holding different tranches of ABS	AAA and BBB	Federal Reserve, OCC, FDIC, OTS Proposed Rule on Recourse and Direct Substitutes

D. Lack of Due Diligence

Up until now, rating agencies also did not do their own due diligence. They simply disclosed that they were relying on information and assumptions provided to them by the issuers.[41] This decision was probably due to a lack of sufficient resources given the volume of products that were rated.[42] Therefore, CRAs were relying on what was essentially unverified data. Especially in the context of the housing bubble, neither issuers nor investors had an incentive to provide adverse data to the CRAs.[43] The result was reliance on questionable assumptions by issuers, investors, and CRAs, and a significant decrease in the

40 OECD *Hearing*, *supra* note 4, at 8 fig.2.

41 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, 618 (2009).

42 *Id.*

43 Coffee, *supra* note 33, at 245.

issuers' investment in due diligence.[44] Issuers were familiar with the agencies' models, so they had incentive to withhold specific adverse information to influence the outcome of their ratings.[45] With respect to structured debt in particular, originators also lacked "skin in the game" because as soon as they benefited from origination fees they were able to move the risky mortgages off their balance sheets to avoid bearing the credit risk of the mortgage borrowers.[46] This has been called the originate-to-distribute model.[47]

E. Weak Incentives to Provide Current Information

Not only did rating agencies have little incentive to discover adverse information about the issuers' products, they had almost no incentive to update ratings once they found inaccuracies in their models. Rating agencies claim to issue "stable ratings" that take a longer-term view and ignore temporary or cyclical variations.[48] This meant that they must delay judgment about a movement in the credit rating to determine if changes in market conditions are really sustained movements or merely part of a reversible cycle.[49] Therefore, it is difficult to differentiate a good faith failure to adjust a rating, due to the delay in determining whether sustained movements have occurred, from calculated indifference to what is happening to the securities rated. The CRAs used this uncertainty to their advantage.

Furthermore CRA receives no revenue from downgrading a security, but risks straining business relations with the client if they do downgrade the security.[50] So even once the CRAs recognized their models were flawed and updated

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[44] Coffee, *supra* note 33, at 245.

[45] 2008 *Hearings*, *supra* note 18, at 10.

[46] Amiyatosh Purnanandam, *Originate-to-Distribute Model and the Subprime Mortgage Crisis* 2 (American Finance Association, 2010 Atlanta Meetings Paper, 2010), *available at* http://ssrn.com/abstract=1167786.

[47] *Id.* at 1.

[48] Richardson & White, *supra* note 25, at 106.

[49] *Id.*

[50] Coffee, *supra* note 33, at 269.

them, the outstanding ratings were often never updated or were updated after it was already too late.[51]

F. Immunity from Liability

Prior to Dodd-Frank, CRAs were immune from liability to investors under Rule 463(g)(1) of the Securities Act of 1933.[52] This result was partially due to a First Amendment claim that the CRAs' ratings are "opinions" no different from the views expressed by columnists in financial newspapers, which have traditionally been afforded First Amendment protection.[53] Without a fear of liability the CRAs could safely risk being less diligent and prudent than they otherwise would have been.

IV. REGULATORY APPROACHES

A. The United States

In 1975, the Securities and Exchange Commission ("SEC") created the NRSRO status, a designation required to issue ratings that can be relied on for regulatory purposes.[54] However, the designation involved no direct regulation when it was implemented. This changed in 2006 when the Enron scandal prompted criticisms of the CRAs because they delayed rating downgrades of Enron debt.[55] In 2006,

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51 2008 *Hearings*, *supra* note 18, at 3.

52 Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers* 84 (Univ. San Diego Law Sch., Research Paper No. 07-46, 2006).

53 CRAs have successfully applied the First Amendment defense in some cases. *See* In re Pan Am Corp., 161 B.R. 577, 586 (Bankr. S.D.N.Y. 1993) (holding that Standard & Poor's as a "publisher of publicly distributed financial ratings . . . deserv[es] . . . the full breadth of First Amendment safeguards"). However, CRAs have been less successful in other cases. *See* Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155 (S.D.N.Y. 2009) (rejecting ratings agencies' claims to First Amendment protection).

54 Coffee, *supra* note 33, at 247.

55 *Id.*

Congress enacted the Credit Rating Agency Reform Act, which sought to "facilitate entry by new agencies into the NRSRO market and . . . mandate greater accountability by existing NRSROs."[56] Following the passage of the 2006 Act, the SEC expanded the number of NRSROs to ten, although the current number of NRSROs is nine, after one agency withdrew its NRSRO status.[57]

Pursuant to the powers it was granted in the 2006 Act, the SEC promulgated a series of rules to enhance rating transparency and to increase NRSROs' record keeping and reporting obligations. Most importantly, these regulations include Rule 17g-2(a)(2), amended in 2009, to require NRSROs to "document the reasons for a deviation when a final credit rating materially deviates from the rating implied by the NRSRO's quantitative model."[58] They also include Rule 17g-5, also amended in 2009, which is an equal access rule requiring NRSROs to make available to all other NRSROs information they received from issuers who hired them.[59] However, a judgment was made to not require regulatory approval of the models used to produce ratings. Unique to the United States, Section 15E(c)(2) of the Exchange Act expressly prohibits the SEC from regulating "the substance of credit ratings or the procedures and

56 Coffee, *supra* note 33, at 247.

57 On October 13, 2011, Rating and Investment Information, Inc., which was registered with the SEC as an NRSRO since 2007, furnished the SEC with a notice of withdrawal, effective November, 2011. *See* SEC, REPORT TO CONGRESS: CREDIT RATING STANDARDIZATION STUDY 7 (2012) [hereinafter CREDIT RATING STANDARDIZATION STUDY], *available at* www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf. Additionally, the SEC is now suing one of the nine remaining rating agencies, Egan-Jones, for material misrepresentations and omissions regarding their experience in rating debt in the company's July 2008 application to register as a NRSRO. *See* Press Release, SEC, Egan-Jones Ratings Co. and Sean Egan Charged with Making Material Misrepresentations to SEC (Apr. 24, 2012), www.sec.gov/news/press/2012/2012-75.htm.

58 Coffee, *supra* note 33, at 271.

59 *Id.* at 248.

methodologies by which an NRSRO determines credit ratings."[60]

In 2010, the Dodd-Frank Act was passed. It established an Office of Credit Ratings at the SEC with the authority to administer the rules of the SEC with respect to CRAs.[61] The new regulations include, in relevant part:

1) Provisions to increase the transparency of the credit rating process. Section 932 requires an asset backed security ("ABS") issuer or underwriter to make publicly available the findings and conclusions of any third-party due diligence report.[62] The section also requires CRAs to disclose their rating methodologies and the performance of previous ratings for each type of security.[63] Furthermore, Section 932 gives the SEC authority to suspend or de-register a CRA if it finds that the CRA does not have the ability to produce ratings with integrity.[64]
2) A private right of action against credit rating agencies. This claim is for knowing or reckless failure to investigate the facts relied upon to make the rating.[65]

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60 15 U.S.C. § 78o-7(c)(2) (2010).

61 So far the SEC has adopted three of nine rulemaking requirements, which implement all or part of certain requirements and proposed rules for the remaining requirements. Additionally, the SEC examination staff submitted, in September of 2011, the first cycle of annual examinations of each NRSRO as required by Dodd-Frank. *See* Highlights, GAO REPORT, *supra* note 9, at 8.

62 Dodd-Frank Wall Street Reform and Consumer Protection Act § 932, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

63 *Id.*

64 *Id.*

65 The exact wording of the statute is as follows:

> In the case of an action for money damages brought against a credit rating agency or a controlling person under this title, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed—
>
> (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied

3) A provision that makes CRAs liable, in the same manner as accountants are with respect to their audit reports, when ratings are included in registration statements.[66] These ratings can only be included with the consent of the preparer. Therefore, rating agencies must now consent to public references by others to their ratings and may be subject to liability as experts if they do.[67] It has become industry practice and the SEC has even required it for publicly-registered asset-backed securities to disclose ratings information relating to most debt issuances in registration statements, either directly or by incorporation through disclosure in the issuer's Form 10-K or Form 10-Q.[68] As a result, when this provision was passed, rating agencies reacted by withholding the necessary consent to include such ratings. This threatened a standstill of capital markets activity. The SEC had to step in and make a public statement that it would not take action against issuers if they could not

> upon by its own methodology for evaluating credit risk; or
> (ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.

Dodd-Frank Act § 933(b).

66 Liability of accountants for parts of registration statements that they prepare or certify is governed by § 11(a)(4) of the Securities Act of 1933. *See* 15 U.S.C. § 77k(a)(4) (1933).

67 *See* Dodd-Frank Act § 933(a); *see also IFR-ABS: Bill Reversing Rating Agency Liability Advances*, REUTERS, July 20, 2011, *available at* http://www.reuters.com/article/2011/07/20/abs-ratingagencies-idUSN1E76J17U20110720.

68 Erika Weinberg, *Dodd-Frank Reform Act: Elimination of Rating Agencies Protections and Implications for Bond Issuers*, FINANCIAL REGULATORY REFORM CENTER, WEIL, GOTSHAL & MANGES LLP http://financial-reform.weil.com/asset-backed-securities/doddfrank-reform-act-elimination-rating-agencies-protections-implications-bond-issuers (last visited Dec. 19, 2012).

disclose ratings or identify rating agencies due to the CRAs refusal to consent to the use of their ratings.[69]

4) A requirement to consider information other than information provided by the issuer of the security when rating a security. This requirement becomes relevant if the CRA finds the information credible and potentially significant to a rating decision.[70]
5) A provision advocating universal rating symbols. The SEC will issue rules requiring NRSROs to establish, maintain and enforce policies and procedures that assess the probability of default by assigning clearly defined ratings symbols in a consistent manner for all types of securities.[71]
6) The removal of references to credit ratings in federal statutes. The goal is to help reduce the dependence of government and markets on credit ratings.[72]
7) A proposal for regulating conflict of interest issues. This provision requires the SEC to conduct a study, due two years after Dodd-Frank's passage, regarding the credit rating process for structured finance products and the conflicts of interest associated with the compensation of rating agencies. Furthermore, the SEC is to evaluate the feasibility of establishing a system where an independent utility would assign NRSROs to rate structured finance products (the Franken Proposal).[73] Although the study was due on July 21, 2012, the SEC did not release the study as required by section 939F of Dodd-Frank.[74] There are "no consequences if a regulatory agency does

[69] Edward F. Greene, *Dodd-Frank: A Lesson in Decision Avoidance*, 6 CAP. MKTS. L.J. 29, 59 (2010).

[70] Dodd-Frank Wall Street Reform and Consumer Protection Act § 935, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[71] Dodd-Frank Act § 938(a).

[72] Dodd-Frank Act § 939.

[73] Dodd-Frank Act § 939F(b).

[74] *SEC Misses Franken Amendment Report Deadline*, AM. SECURITIZATION F., (July 21, 2012), www.americansecuritization.com/content.aspx?id=7336#.UI9an7TNlFI.

not meet the prescribed deadline in the Act."[75] In a recent speech, Mary Schapiro, now-former Chairman of the SEC, explained the progress that the SEC has made in implementing legislation related to credit rating agencies, and stated specifically that the SEC is "also considering proposing regulations that would require NRSROs to . . . [p]rotect against any conflicts of interest more effectively."[76] However, the SEC has yet to set a date or time frame for releasing the mandated study.

B. The European Union

Similarly, Europe historically had not regulated CRAs until very recently. Early EU legislation governing CRAs was based on three directives that indirectly applied to CRAs and had to be adopted as national legislation before becoming effective.[77] In 2004, the International Organization of Securities Commissions created a voluntary code of conduct ("IOSCO code") to ensure accountability of CRAs in an effort to strengthen self-regulation.[78] The European Commission ("EC") recommended that the CRAs incorporate the IOSCO code into their own code of conduct—essentially operating under a "comply or explain model."[79]

Following the Enron scandal, the EC asked the Committee of European Securities Regulators ("CESR") to issue a report on whether a stronger regulatory framework

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75 *SEC Misses Franken Amendment Report Deadline*, AM. SECURITIZATION F., (July 21, 2012), www.americansecuritization.com/content.aspx?id=7336#.UI9an7TNlFI. *See generally* Alexander Eichler, *Regulators Have Missed Three-Fourths of Dodd-Frank Deadlines So Far*, HUFFINGTON POST (Jan. 4, 2012, 3:32 PM), www.huffingtonpost.com/2012/01/04/dodd-frank-deadlines_n_1184060.html.

76 Mary Schapiro, Chairman, SEC, Remarks at the George Washington University Center for Law, Economics and Finance Fourth Annual Regulatory Reform Symposium (Oct. 26, 2012), *available at* www.sec.gov/news/speech/2012/spch102612mls.htm.

77 *See* Sy, *supra* note 28, at 6–7.

78 *Id.*

79 *See* Coffee, *supra* note 33, at 249.

was necessary.[80] In 2005, CESR issued a report that stated no further legislation was necessary to regulate CRAs because the EU directives covered CRAs indirectly and the industry was generally in compliance with the IOSCO code.[81]

However, the financial crisis led Europe to reconsider this advice. Indeed, in 2009, the European Parliament adopted a "Proposal by the European Commission for a Regulation on Credit Rating Agencies" (the "Proposal"). CRAs operating in Europe are now subject to mandatory registration and, in 2010, the European Security Markets Authority ("ESMA") was chosen as the body to supervise CRAs.[82] Professor Coffee highlights that this is the first European body with regulatory authority over the securities markets.[83] It also has marginally greater authority than the SEC because it is empowered to evaluate and regulate the substantive methodologies used by CRAs.[84]

On May 30, 2012, the EC published regulatory technical standards for credit rating agencies in the *Official Journal of*

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80 CESR, CESR/06-545, CESR'S REPORT TO THE EUROPEAN COMMISSION ON THE COMPLIANCE OF CREDIT RATING AGENCIES WITH THE IOSCO CODE 2 (2006) [hereinafter First CESR REPORT], *available at* http://ec.europa.eu/internal_market/securities/docs/agencies/report_en.pdf; *see also* Sy, *supra* note 28, at 7. Note that in CESR's second 2008 report, it urges the Commission "as an immediate step" to form "an international CRAs standard setting and monitoring body to develop and monitor compliance with international standards in line with the steps taken by IOSCO, using full public transparency and acting in a 'name and shame' capacity to enforce compliance with these standards via market discipline." CESR/08-277CESR'S SECOND REPORT TO THE EUROPEAN COMMISSION ON THE COMPLIANCE OF CREDIT RATING AGENCIES WITH THE IOSCO CODE AND THE ROLE OF CREDIT AGENCIES IN STRUCTURED FINANCE 3 (2008), *available at* www.esma.europa.eu/system/files/CESR_ 08_277.pdf.

81 First CESR REPORT, *supra* note 80, at 2.

82 *See generally* PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, COM, 2011/0136, (2011) 747 final (Nov. 15, 2011) [hereinafter EC *PROPOSAL*], *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0747:FIN:EN:PDF.

83 *See* Coffee, *supra* note 33, at 249.

84 *See id.* at 250.

the European Union.[85] These technical standards set out (1) the information to be provided by a credit rating agency in its application for registration to ESMA; (2) the presentation of the information to be disclosed by CRAs in a central repository; (3) how ESMA will assess rating methodologies; and (4) what information CRAs have to submit to ESMA.[86] Additionally, on October 5, 2012 the EC adopted three implementing decisions, which confirm that the rules in place for CRAs in the United States, Canada, and Australia are equivalent to the EU rules on credit rating agencies.[87] These equivalence decisions allow smaller CRAs in the United States, Canada, and Australia to apply for certification in the EU, with the result being that their ratings can be used by EU financial institutions for regulatory purposes.

C. Similarities and Differences

Both the United States and the EU have moved from essentially no regulation to regulated regimes, and there has been a clear convergence between the two regimes.[88] The approaches taken by each overlap in certain areas, such as barring rating agencies from providing consulting or advisory services to clients whose securities they rate, and requiring issuers of structured finance products to publicly

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85 *See generally* COMMISSION REGULATION 445/2012, O.J. (L 140) 2 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:140:0002:0013:EN:PDF.

86 *Id.*

87 COMMISSION IMPLEMENTING DECISION ON THE RECOGNITION OF THE LEGAL AND SUPERVISORY FRAMEWORK OF THE UNITED STATES OF AMERICA AS EQUIVALENT TO THE REQUIREMENTS OF REGULATION, COM (2012) (Oct. 5, 2012) *available at* http://ec.europa.eu/internal_market/securities/docs/agencies/20121005-equiv-usa_en.pdf.

88 *See* Piero Cinquegrana, *The Reform of the Credit Rating Agencies: A Comparative Perspective* 8 (Eur. Capital Mkts. Inst. Policy Brief No. 12, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1489743.

disclose the information they provide to a CRA they hire in order to encourage unsolicited ratings by other CRAs.[89]

Differences between the regimes include a heavier reliance on private litigation in the United States to deter wrongdoing relative to Europe's greater reliance on public enforcement.[90] The ESMA also has marginally greater authority than the SEC because it is empowered to evaluate substantive methodologies and business models used by CRAs, while the SEC is prohibited from interfering with the content and substantive methodologies of rating agencies.[91] Additionally, although Europe has granted CRAs some de facto regulatory power (for example, indirectly through regulations such as Basel II), ratings embedded in regulation are much less prevalent there than they are in the United States and should be a lesser concern in Europe.[92]

Noteworthy political tensions also affect the types of solutions that have been considered credible. The EU is not only weary of inflated ratings but has also been highly critical of the recent downgrades CRAs have assigned (and continue to assign) sovereign and other European debt across Europe.[93] The criticism of the EC has been that these downgrades destabilize the markets and disfavor politically important local companies.[94] In light of these concerns, the idea of creating a government-sponsored European rating agency to compete with the "big three" (Moody's, S&P, and

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[89] *See* Coffee, *supra* note 33, at 250–51; *see also* Lannoo, *supra* note 37, at 72.

[90] *Id.* at 235.

[91] *Id.* at 250.

[92] *See id.* at 235.

[93] *See, e.g.*, Liz Alderman & Rachel Donadio, *Downgrade of Debt Ratings Underscores Europe's Woes*, N.Y. TIMES, Jan. 14, 2012, at A1; *see also Spain Credit Rating Slashed by Moody's, Egan-Jones*, CNBC, (June 13, 2012, 5:21PM), www.cnbc.com/id/47802891/Spain_Credit_Rating_Slashed_by_Moody_s_Egan_Jones (noting that even Egan-Jones, one of the few NRSROs that operate under a investors-pay model, recently downgraded Spain's credit rating).

[94] *See* Peter Spiegel & David Oakley, *Europe Lashes Out Over Downgrades*, FIN. TIMES (July 6, 2011 5:57PM), www.ft.com/intl/cms/s/0/23a44f2a-a7ee-11e0-afc2-00144feabdc0.html#axzz1fG4ZehZC.

Fitch) gained momentum in Europe—an idea not seriously considered in the United States.[95]

V. THE CONFLICT OF INTEREST PROBLEM AND THE FRANKEN PROPOSAL

Today, the public has increasingly recognized the gravity of the conflict of interest problem that CRAs face. A Google search on November 29, 2012 for "rating agency conflict of interest" yielded 1,530,000 hits—a huge increase from the 688,000 hits yielded on April 11, 2011 and the 274,000 hits yielded in 2010—suggesting a growing public awareness of the issue.[96] William Harrington, a former Senior Vice President at Moody's, stated in a filing to the SEC, "The salient . . . conflict of interest permeates all levels of employment, from entry-level analysts to the Chairman and Chief Executive Officer of Moody's Corporation."[97] However, even with the new wave of regulations, neither the United States nor Europe has sufficiently addressed the conflict of interest concerns of the issuer-pays business model.

One way to deal with the conflict of interest problem is the so-called "Franken Proposal," which mandates the creation of a Credit Rating Agency Review Board (the "Board") under the SEC. The Board would assign an issuer of structured debt securities to an NRSRO and would require that issuer to receive a rating for a "reasonable" fee from the specified NRSRO before it could solicit any other NRSRO for

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95 *See* Maria Sheahan & Kathrin Jones, *Europe Rating Agency Would Cost 300 Million Euros*, REUTERS, July 18, 2011, *available at* www.reuters.com/article/2011/07/18/us-ratings-idUSTRE76H29R20110718; *see also* EC PROPOSAL, *supra* note 82, at 11 (discussing the pros and cons of a European Rating Agency, but explicitly providing that the proposal does not aim to set up such an agency for the time being).

96 Search Results for "Rating Agency Conflict of Interest," GOOGLE, www.google.com (last visited Dec. 19, 2012); *see also* Claire A. Hill, *Limits of Dodd-Frank's Rating Agency Reform*, 15 CHAP. L. REV. 133, 136 (2010) (showing that search on Google for "rating agency conflict of interest" yielded approximately 688,000 results in April 2011).

97 Comment Letter from William J. Harrington to SEC 10 (Aug. 8, 2011), www.sec.gov/comments/s7-18-11/s71811-33.pdf.

additional ratings.[98] Pursuant to Dodd-Frank, the SEC is required to conduct a study that "give[s] thorough consideration" to such a system by 2012, and implement it unless the SEC determines that an alternative system better serves the public interest and the protection of investors.[99]

Although such a system continues to rely on issuers paying the CRAs their fees, it avoids the issuer-pays conflict of interest problem by denying the issuer a chance to "ratings shop" and select the NRSRO of its choice. The advantage of this system is that it is a simple and direct method. It also has the potential of encouraging entry into the market. The Board could match issuers with new agencies who have little reputational capital and thus help those new agencies enhance their visibility and acceptance in the market. Such a system could encourage new entrants to become NRSROs or encourage existing, smaller NRSROs to increase the scope of the securities they rate.[100] In addition, this system could lead to greater diversity of opinions, since the issuer is only required to go through this mandatory assignment system for an initial rating, and could subsequently pay for a second rating from the NRSRO of its choice.[101]

However, the model has several disadvantages. Government agencies are themselves vulnerable to biases and political pressure. Any indication of such biases could severely hamper the credibility of the system, making it seem like an unfair allocation of market power. For instance, in response to S&P's recent U.S. sovereign debt downgrades, a government agency may be tempted to shift

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[98] *See* Coffee, *supra* note 33, at 256; *see also* CLEARY, GOTTLIEB, STEEN & HAMILTON LLP, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT POISED TO USHER IN SWEEPING REFORM OF U.S. FINANCIAL SERVICES REGULATION 34–35 (2010), *available at* www.cgsh.com/files/News/8a4361fa-131b-46b9-a3ad-779430dac8a6/Presentation/NewsAttachment/153327b9-3da0-4d63-b2cb-32c8022d8159/Cleary%20Gottlieb%20Dodd-Frank%20Alert%20Memo.pdf.

[99] Dodd-Frank Wall Street Reform and Consumer Protection Act § 939F(d)(1), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[100] *See* Coffee, *supra* note 33, at 268.

[101] *Id.* at 257.

business away from S&P to other agencies with a more optimistic view of U.S. debt.[102] Selecting members of the Board also will be a significant challenge in itself, since there are many ways in which the individual members could be conflicted.[103] In particular the system could create undesirable incentives for rating agencies to lobby and support particular Board members in order to obtain increased business.

Under this proposal, the allocation system could be a completely random allocation of rating contracts, or instead, an allocation that awards rating agencies of higher quality with proportionately more business. There are several problems with an allocation system based on a random lottery without consideration of performance measures.[104] If based on random allocations, the assumption would be that all ratings are equivalent or interchangeable, based on comparable assessments and diligence. In effect, this presupposition could create a minimum standard of competence sufficient to receive rating contracts, the result of which might be that all ratings will converge to that standard. CRAs meeting this minimum operating standard may then have little incentive to compete with each other and attain a higher level of competence, given that the government basically assures their market share.[105] The outcome could be to chill market competition and significantly decrease expenditure on innovative rating techniques.[106]

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[102] Binyamin Appelbaum & Eric Dash, *S&P Downgrades Debt Rating of U.S. for the First Time*, N.Y. TIMES, Aug. 16, 2011, at A1.

[103] *Oversight of the Credit Rating Agencies Post Dodd-Frank: Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Fin. Servs.*, 112th Cong. 23 (2011) [hereinafter 2011 *Hearings*] (statement of James H. Gellert, Chairman and CEO of Rapid Ratings Int'l, Inc.), *available at* www.rapidratings.com/images/custom/gellert_testimony_to_house_cfs_oversight_and_investigations_july_27_2011_final_w_bio.pdf.

[104] OECD *Hearing*, *supra* note 4, at 11.

[105] Coffee, *supra* note 33, at 258.

[106] 2011 *Hearings*, *supra* note 104, at 23.

Instead, a larger share of rating contracts could be awarded based on the quality of past performance. This may revive competition and innovation, but still raises other concerns, particularly about the intrusion of government control in the private markets. Some have expressed concern about the expertise and ability of government agencies to determine the metrics that define "quality" and further doubt their ability to control for quality.[107] More specifically, the private market could essentially lose all control over the competitive distribution of rating contracts and be found to rely on the sole judgment of the Board to determine which agencies deserve more business. Devising quality determinations is also a burdensome and highly complex task for any one body to take on, let alone an understaffed, underpaid, and unqualified government entity like the Board. Having the government involved in this manner may also create the impression that the government is certifying or endorsing the ratings. This consequence would be dangerous because it could increase investor reliance on ratings instead of encouraging investors to make their own risk assessments as well.[108]

Since the regulation would not preclude an issuer from soliciting a second rating after the initial rating has been given, there is also a viable risk that the "big three" (Moody's, S&P, and Fitch) would just abandon their NRSRO status and focus exclusively on issuing "second opinions," which the market would accept as more reliable.[109] The danger would be that the market would largely ignore the initial ratings produced by the government-assigned NRSROs, therefore reinstating the same conflict-of-interest concerns the Franken Proposal sought to eliminate.[110] This result assumes, however, that the market would be comfortable with the ratings produced by a CRA that has withdrawn its NRSRO status.

107 Richardson & White, *supra* note 25, at 109.

108 Cinquegrana, *supra* note 88, at 9.

109 Coffee, *supra* note 33, at 264.

110 *Id.* at 264.

These are all reasons why the Franken Proposal may not be the best solution after all. So the question is: What other options are there?

VI. POTENTIAL ALTERNATIVES TO THE FRANKEN PROPOSAL

A. Government Rating Agency

Ratings already have many characteristics of a public good, so a logical solution could be creating a public governmental entity that issues credit ratings. This solution would avoid the conflict of interest problem of the issuer-pays model and the free rider problems of the investor-pays model.[111] However, the cost of putting in the apparatus for a single rating agency to replace a multibillion-dollar industry is probably unrealistically high.[112] If the large cost of setting up such a governmental system cannot be fully funded by fees from investors and issuers (which is very likely, because high fees could dramatically increase an issuer's borrowing costs and force it to exit the market), taxpayers will be forced to pay for services that benefit only a small class of investors. Additionally, the government is not as good at keeping up with financial innovations in the private sector because governments cannot pay their employees as much, which generally translates into less skill, research, and quality.[113]

Rating agencies also rate government debt and so a government rating agency would be faced with a serious conflict of interest since it would be subject to political pressures. Giving a negative rating to a favored country or influential firm would create tension among politically

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[111] *See* Yair Listokin & Benjamin Taibleson, *If You Misrate, then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 102 (2010).

[112] *See, e.g.*, Maria Sheahen & Kathrin Jones *Europe Rating Agency Would Cost 300 Million Euros*, REUTERS, July 18, 2011, *available at* http://www.reuters.com/article/2011/07/18/us-ratings-idUSTRE76H29R20110718.

[113] Coffee, *supra* note 33, at 260.

powerful entities. This is similar to, and even more problematic than, the bias concerns associated with the Franken Proposal, since the government entity itself would be issuing the credit rating, not just deciding which CRAs receive the rating contract. Illustrating this point, Professor Coffee suggests that the idea of creating a European CRA was triggered in part by *political* disapproval of the downgrading of European sovereign debt.[114]

In response to some of these concerns, a "government utility model" has been proposed. In this model, a government rating agency would not replace existing agencies but simply add its own ratings to the ones already available in the market.[115] This way, the investors could "compare the Moody's or S&P rating against the governmental rating."[116] However, if the government ratings are less reliable as a result of inferior skill, political pressure, and all the other reasons mentioned above, any value in comparing them to other credit ratings will be lost and rendered meaningless.

B. Return to Investor-Pays Model

Perhaps the most common alternative proposed is a return to the investor-pays model, under which CRAs originally operated. In its most basic form, this model would require every institutional investor to purchase its own ratings from a rating agency of its choice before purchasing a debt security. The goal of this model is to induce CRAs to compete for investor favor, thus avoiding the issuer-pays conflict of interest.

The classic problem with the investor-pays setup, which led the CRAs to move away from this structure in the first place, is the potential for free riding.[117] After buying a rating, an investor could re sell or leak the information to other investors, who would then in turn re sell or leak it to

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114 Coffee, *supra* note 33, at 261.

115 OECD *Hearing*, *supra* note 4, at 12.

116 Coffee, *supra* note 33, at 257.

117 *Id.*

others—effectively disgorging the CRAs of their profits.[118] One way to deal with this problem is to simply mandate that "substantial" institutional investors hire and pay for the ratings.[119] However, as Professor Coffee points out, proposals that affirmatively require investors to take action would extend the SEC's power from regulating the behavior of some select individual institutions to regulating the behavior of investors as a group.[120] Such an enlargement of centralized power could be met with fierce opposition. Investors are also likely to resist having to pay for the ratings and could constitute a powerful political lobby against such a reform.[121]

Additionally, the investor-pays model may not solve the incentive problems that currently haunt the industry as investors suffer from their own conflicts of interest.[122] Many institutional investors can only hold investment-grade securities, so inflated ratings offer them the opportunity to purchase riskier, and thus higher-yielding, securities.[123] Alternatively, before the securities are issued, some investors would prefer more conservative ratings so they could purchase the securities at depressed and undervalued prices.[124] As emphasized above, in a market bubble no player has a strong incentive to learn the truth, so

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118 Coffee, *supra* note 33, at 257.

119 *Id.* at 258–59.

120 *Id.* at 259 n.72.

121 *Id.*

122 Richardson & White, *supra* note 25, at 107.

123 *Id.* at 105 ("Further, if (subsequent to issuance) the bond markets realize that the rating offered by a NRSRO is too optimistic, which causes the markets to reprice the bond downward and thus increase its yield, then a bank that wishes to increase its risk profile can invest in that higher-yielding (but riskier) bond but can still appear to be adhering to its regulator's safety standards because of the NRSRO's (excessively optimistic) rating.").

124 *Id.* at 107 (arguing that investors prefer lower ratings at the time of issuance since they will receive higher returns, as would short sellers of any security, but at the time of subsequent ratings changes, investors who already hold the bonds would favor upgrades and disfavor downgrades, whereas short sellers prefer the opposite).

competition will once again be distorted.[125] However, there is general agreement in the literature that "these potential [investor] conflicts seem much less severe than those of the issuer-pays model."[126]

Another significant drawback with the investor-pays approach is the danger of implicit collusion between issuers and CRAs through bribes or bonus payments that sidestep the investors, even though the investors are still the nominal payers. Additionally, there is the possibility of issuers influencing investor choice by offering reimbursement of expenses under specified conditions. This would result in "the conflict of interest problem now re-enter[ing] through the back door."[127]

Grundfest and Hochenberg have proposed a more radical version of the investor-pays model.[128] They propose that the market continue to offer issuer-paid NRSRO ratings, but that issuers also be required to purchase an accompanying rating from a so-called Investor Owned and Controlled Rating Agency ("IOCRA").[129] These are essentially rating agencies owned by the largest debt market investors. The authors of this proposal suggest that:

> Because IOCRAs would be under the control of the sophisticated investor community, and because any one investor's ownership interest in an IOCRA would be capped, the incentives of IOCRAs should be oriented to generating ratings that accurately reflect the risks of holding specific debt instruments, even though their fees would also be paid by issuers. . . . [I]f IOCRAs were to fail in anticipating credit market

125 Coffee, *supra* note 33, at 272.

126 Richardson & White, *supra* note 25, at 107.

127 Coffee, *supra* note 33, at 259.

128 *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://papers.ssrn.com/sol3/papers.cfm?abstract_id=1494527.

129 *See id.*

> issues, the investor community would, at the end of the day, have only itself to blame.[130]

Although certainly creative, the approach is unrealistic. Institutional investors are often in active competition with each other and do not share information freely.[131] Additionally, there is no way to mandate the creation of such institutions, which likely would have been established already if they were profitable or viable. Finally, the model carries the potential risk that issuers will pay for the cheapest and least reliable IOCRA ratings simply to satisfy their requirement and then solicit ratings from CRAs of their choice, causing the market to rely primarily on the same problematic ratings as before.[132] This would undermine the entire set-up envisioned by Grundfest and Hochenberg.

C. Sanctions

Using sanctions to discipline the rating agencies is another solution that has been put forward.[133] The aim is to solve the problems associated with lags between the time when a rating is purchased and the time when the accuracy or quality of a rating can be measured.[134]

One option is to defer compensation. This way, CRAs' profits would increase "if bonds they rate as investment grade perform well and fall if such bonds default more often than expected."[135] Larry Harris suggests that CRAs put a

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130 Grundfest & Hochenberg, *supra* note 128, at 6.

131 Coffee, *supra* note 33, at 259.

132 *See id.* at 258 ("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.").

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

134 *Id.*

135 Larry Harris, *Pay the Rating Agencies According to Results*, FIN. TIMES (Jun. 3, 2010, 8:16 PM), www.ft.com/intl/cms/s/0/a2d8d710-6f3d-11df-9f43-00144feabdc0.html#axzz1fG4ZehZC.

certain percentage of their fees into an escrow and that this money eventually be returned to the agencies if their performance is satisfactory.[136]

Alternatively, regulation could require clawbacks of fees earned if ratings prove to be inaccurate, or award bonuses if ratings prove accurate. Professor Hunt explains that reputational threats are not adequate protection against incentives to inflate ratings of new products.[137] This is because CRAs have no reputation to protect for rating these new products and will therefore be able to charge high prices for low-quality ratings until the market catches on and the product dies out.[138] To fix this problem, Professor Hunt suggests that the government disgorge all profits that CRAs receive from issuing ratings for new products that fall below a predetermined quality level.[139] Interestingly, Professor Hunt would provide a safe harbor for CRAs that disclose that they are issuing low-quality ratings ahead of time.[140] He explains, "[I]nvestors who are not good at judging risk for themselves might find such [low-quality] ratings useful."[141]

Professor Coffee proposes to sanction poor performance of CRAs by having the SEC remove their NRSRO status for a particular asset class.[142] The duration of this suspension as an NRSRO would continue until the particular agency's five-year default rate falls back within the acceptable parameters for ratings of that particular asset class.[143] This approach would have been a more severe penalty prior to Dodd-Frank, when the NRSRO status gave ratings meaningful legal significance through incorporation of ratings in regulations. However, even after Dodd-Frank forfeiture of the NRSRO status would heavily stigmatize a rating agency operating in

136 Harris, *supra* note 135.

137 Hunt, *supra* note 133, at 156.

138 *Id.* at 163–64.

139 *Id.* at 182.

140 *Id.*

141 *Id.*

142 2007 *Hearings*, *supra* note 38, at 13–14.

143 *Id.*

an industry where reputation is essential.[144] A drawback Professor Coffee identifies himself is that "it could happen that all the major rating agencies might forfeit their NRSRO status (for at least some ratings or some products)."[145]

Listokin and Taibleson propose another creative idea: to require fees to be paid in the form of the actual securities that are being rated instead of cash. This would cause the cost of inflating the value of rated securities to fall on the rating agency.[146] This happens because AAA securities are worth more than BBB securities and so fewer units of debt would be required to pay off a standard, predetermined rating fee. Therefore, misrating a risky security as AAA instead of BBB would cause the CRA to be compensated with fewer units of debt than would actually be required to meet the value of the predetermined rating fee. This means the raters should have earned and received more units of debt as compensation.[147] Professor Coffee points out that CRAs could undermine this proposal by immediately selling the debt securities before any misrating was discovered.[148] Furthermore, "if sales were restricted then the CRA would have to hold a sizable portfolio of securities with resulting liquidity . . . problems."[149] One possible solution would be to require a clawback of funds at the time the misrating is discovered.

The greatest advantage of these sanction-type proposals is that they could be administered at low cost once default criteria have been established, since they are essentially quasi-strict liability regimes.[150] Also, the sanctions are measured, unlike the potentially excessive and unlimited civil liability under Dodd-Frank.[151] However, disgorging profits or requiring funds to be escrowed could lead to

[144] Darcy, *supra* note 41, at 664.

[145] 2007 *Hearings*, *supra* note 38, at 15.

[146] Listokin & Taibleson, *supra* note 111, at 105–06.

[147] *Id.*

[148] Coffee, *supra* note 33, at 254.

[149] *Id.*

[150] *See* Darcy, *supra* note 41, at 662.

[151] *Id.* at 664.

significant liquidity constraints. One suggestion to deal with any liquidity concerns is to allow the CRAs to borrow money against the escrowed funds and use their "future contingent payments as collateral."[152]

VII. A NEW PROPOSAL

The literature dedicated to CRA reform tends to encourage some version of the investor-pays model that is mandated and supervised through regulation. A good solution would encourage rating agencies to compete for the favor of the investing public instead of the issuers. Although the Franken Proposal is one possibility in the spirit of such reform, there are several shortcomings with that proposal.[153] After reviewing alternative proposals and pulling together these ideas, this Note proposes a new solution which contains three basic tenets: (1) a requirement that issuers obtain a vote from their most important potential investors in order to allow investors to determine which CRA is hired by the issuer; (2) the creation of a governmental agency or—better yet—a self regulatory organization that evaluates and ranks the performance of the individual CRAs; and (3) a requirement that issuers obtain a second rating when their investors vote to hire a CRA whose performance has proven inadequate for a particular asset class, based on the ranking of the agency or self regulatory organization in part (2) of this proposal. If the CRA selected by the voting investors is one ranked lower than, for instance, third place, a second rating will have to be purchased from one of the top three CRAs.

A. Vote of the Largest Institutional Investors

The first tenet of the proposal aims to mitigate the conflict of interest issue. The idea is to continue to have the issuers pay for the ratings, but require the issuers to poll their most significant, potential institutional investors to

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152 *See* Harris, *supra* note 135.

153 *See* discussion *supra* Part V.

select the investors' preferred CRA.[154] Such a system will minimize the issuer-pays conflict of interest by ensuring that the CRA is chosen by investors, not issuers, and will ensure that CRAs have an incentive "to cater their services to investors."[155] Additionally, it will avoid free riding problems associated with investor-pays models, since the issuers will continue to pay for the rating, and the rating can be made public immediately.

The most difficult aspect of the investor vote will be defining which investors are eligible to vote, since investors themselves can be conflicted. For example, those investors who already have a link to the issuer or issuing company, because they hold previously issued debt, may have an incentive to seek inflated ratings if they plan to exit from the investment in the near future.[156] At the time of the issuance, other interested investors may instead have an incentive to seek a deflated rating when purchasing debt in order to receive higher short-term returns. Once the markets realize the rating is deflated, those high yields will start to fall but at that point the investor can then sell the security at a higher price (price and yields are negatively correlated) and exit the market.

Additionally, some institutional investors, such as money market funds, face intense competition in the market while being legally restricted to investments in safe investment-grade securities. They therefore have a preference for inflated ratings because "investment-grade" ratings offer them legal protection while still allowing them to invest in risky securities with higher yields.[157] This happens because

154 This requirement would not apply to the three newest NRSROs (Egan-Jones Rating Company, LACE Financial Corp., Realpoint LLC), which operate under an investors-pay model. Their model operates by having "investors and other market participants purchase the right to access the pool of credit ratings issued by these NRSROs." although they will not be users of all credit ratings provided. *See* SEC ANNUAL REPORT, *supra* note 16, at 15.

155 *See* Coffee, *supra* note 33, at 260.

156 Inflated ratings mean they can sell their debt for more when they plan on exiting from their investment.

157 Coffee, *supra* note 33, at 260.

bond markets come to realize that an NRSRO is too optimistic (with its inflated rating) and thus prices will fall while yields will rise. The money market fund is then left with an investment in a high yielding and riskier security that still adheres to the regulatory rating thresholds because of the inflated ratings provided by NRSROs. By contrast, other institutional investors, such as pension funds, already have their clients locked in, and thus do not have the same desire for risky investments and inflated ratings. Since the preferences of the investing bodies vary, a collective vote would minimize the impact conflicted parties have on the final decision of which rating agency to hire.[158]

Even where the potential conflicts of interest discussed above do not cancel out in a vote, and investors end up choosing a CRA with a skewed model that unduly inflates (or understates) ratings, the third tenet of this proposal will help minimize the effect of this problem by requiring issuers to purchase a second rating from a CRA that has better performance statistics, as discussed below.

Defining the group of eligible voters will be key in this step of the new proposal. In a public offering, the issuer will typically contract with an underwriter that aims to sell the issuer's securities and solicits indications of interest from potential investors before the debt is issued. One possibility for narrowing and defining the universe of eligible voters would be to condition underwriting upon an obligation to assemble a group of potentially interested purchasers to which the offering will be limited and require the most important investors to participate in the voting process.

The goal is to have voters who are truly interested in purchasing the debt, and also voters without preferences for inflated or understated ratings—ideally, although unrealistically, a voting body made up of large pension funds. Of these potential investors, only those making a representation that they are bona-fide interested investors and potential purchasers will be given a chance to vote on which rating agency to select. Such a representation will

[158] Coffee, *supra* note 33, at 260.

mitigate the concern that investors or issuers may recruit allies who will vote but do not actually intend to purchase the security. It may also make sense to require disclosure of the selected voting investors so that the SEC or a self-regulatory organization can monitor voters that have a tendency to vote but not actually purchase debt.

The type of voting structure is also an important factor. In order to simplify the process, the candidates for selection should be limited to NRSROs—currently leaving nine options. However, since some of these rating agencies only rate specific types of debt, there may be even fewer options for any specific vote, depending on the type of debt being issued. Issuers or underwriters could be asked to select the CRAs that are able to rate the type of debt they want to sell and the investors will then choose from this selection.

Obviously there are various ways in which the vote could be organized. However, one good option would be a variation of plurality voting. Investors could be asked to rank the rating agencies by preference. Points could then be allocated to each one of their choices, with their first choice receiving the greatest number of points. The rating agency that receives the highest number of cumulative points from all participating investors will win the rating contract. Many potential investors may prefer not to vote either because they do not care or because they are afraid to make enemies. To remedy the latter issue, the vote could be anonymous to all but the SEC or the self-regulatory organization in charge of overseeing the procedure.

There is also an issue of the timing of the votes. This becomes relevant in the case of a company that makes use of shelf registration and wants to issue a second tranche of debt on notes previously issued. Should a vote take place and a credit rating be given only at the time of initial registration, or should a new vote be held and a new credit rating given each time new debt is issued? Since a company can choose to issue new tranches of the same debt for up to two years,[159] it

[159] *See* Rule 415 of Regulation C of the Securities Act of 1933. 17 C.F.R. § 230.415 (2012).

is preferable to receive up-to-date ratings at the time the new debt is issued. However, to mitigate any delay in accessing capital markets, the same rating agency selected at the initial issuance should presumptively be awarded the second rating contract as well, unless it has fallen below the top three-performing rating agencies on the rankings supplied by the government agency, or self-regulatory organization in part (2) of the proposal, in which case a better-performing CRA will need to be selected.

B. A Rater of Rating Agencies

If investors are expected to select which CRA to hire, they need to have access to information that will allow them to compare the different CRAs and make educated decisions. To facilitate this decision-making process, the second step of the proposal involves the creation of a governmental agency or a self-regulatory organization that evaluates and ranks the performance of the individual CRAs.[160]

U.S. Supreme Court Justice Louis Brandeis highlighted the importance of disclosure through his famous words: "sunlight is the best disinfectant." [161] However, a recent study shows that, even with disclosure, "there is no evidence debt issuers have considered ratings agencies' historical performances before making their selections. Instead, debt issuers appear to be brand-conscious and have exhibited a tendency of selecting rating agencies based on the latter's pre-existing market positions and name recognitions."[162] Disclosure was probably ineffective in altering choices because CRA disclosures are inconsistent and nonstandard, so "industry wide comparisons of credit rating agencies' performance measurements" became a "difficult and tedious

[160] *See generally* Lynn Bai, *The Performance Disclosures of Credit Rating Agencies: Are they Effective Reputational Sanctions?*, 7 N.Y.U. J. L. & BUS. 47 (2010).

[161] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 62 (Nat'l Home Library Found. ed. 1933) (1914).

[162] Bai, *supra* note 160, at 95.

task."[163] Therefore, disclosure on its own is not a sufficient solution, and information must "take the form of simple cues or associations" in order to affect consumer choice and award the efficient CRAs the largest share of the market.[164]

Through Dodd-Frank, policymakers have enacted significant disclosure requirements that can be used to measure the accuracy of the ratings issued by CRAs. Similarly, in Europe, the ESMA will create a central repository where CRAs will make available historical performance data.[165] But these progressive steps alone are not enough. To synthesize the huge amount of disclosed information and to facilitate comparison across agencies, an "entity that functions as a rater of rating agencies" should be established.[166] The "rater of rating agencies" could disclose these rankings on an easily accessible website. The website should also offer access to the information used to create the rankings, in order to facilitate individualized risk determinations by investors. There could be one general performance ranking or, ideally, rankings of CRAs' performances in rating different asset classes (i.e., separate rankings for structured finance and corporate bonds).

Deciding which metrics should influence the evaluation and rankings of CRAs is so complex—and also so essential—that it may be necessary to request a period of public comment on the matter. One obvious metric affecting evaluations should be the performance statistics of CRAs. This would likely be measured as the correlation between an NROSO's ratings and default-and-recovery rates on issues rated. Looking at the reason for past downgrades may be very helpful to assess performance. However, it will be important to differentiate those downgrades caused by faulty

163 Bai, *supra* note 160, at 63.

164 *Id.* at 98.

165 "Any registered and any certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data including the ratings transition frequency and information about credit ratings issued in the past and on their changes." EC *PROPOSAL*, *supra* note 82, at 31.

166 *See* Bai, *supra* note 160, at 103.

initial evaluations of CRAs from those downgrades caused by unforeseen and unpredictable market developments affecting the entire economy.

Other important considerations should include the frequency with which the rating is updated or reaffirmed. Where a CRA changes its model for rating a particular product, prompt updates to older ratings are essential, and failures to update should significantly impact rankings. However, this will need to be balanced against other considerations, since updating ratings too often can be problematic as well. Updates can trigger capital calls, leading to severe liquidity constraints for issuers. Therefore, frequent updates could destabilize the market and undermine the essence of the "ratings through the cycle" methodology to which CRAs adhere.[167]

Another factor that should affect rankings is the extent to which the CRA deviated from its own model by making either upward or downward adjustments when rating a particular product; more frequent and larger adjustments should negatively impact the rankings given. This would discourage the practice of unwarranted adjustments to increase the size of the investment-grade tranches.

Consideration could also be given to a practice of red-flagging the ratings of securities whose yields, once traded in the markets, prove to be higher than the average yields for securities given the same credit rating. The logic here is that, in general, debt securities with the same rating should have very similar yields and associated risk. Finding notable deviations from this general pattern could help identify inflated ratings and discourage issuers and investors from influencing CRAs to give risky, high yielding debt unjustifiably high ratings actually meant for less risky, lower yielding debt. It should be kept in mind that many factors affect appropriate yields for a security, including the maturity of the debt and the type of debt in question.

Ranking CRAs by performance will incentivize CRAs to maximize their accuracy through innovation and prudent

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[167] *See* Richardson & White, *supra* note 25, at 112.

behavior. However, the downside is that there is a lag between the time a rating is issued and the time an effective evaluation of its performance can take place. Performance data can take over a decade to develop, so new entrants would be prejudiced by such a system. However, it is questionable whether new entrants are necessary at all. The market for rating securities may simply not be conducive to large-scale competition and perhaps does not need many players; instead, needing only assurance of continued competition among current players.[168] There are currently nine NRSROs, so some of the smaller NRSROs expand to rate more than just niche securities.[169] Due to the SEC's "equal access" rule, Rule 17g-5, the smaller CRAs have access to the same information as the established rating agencies and thus have the ability to issue unsolicited, competing ratings to promote themselves.[170] This should also incentivize established players to consistently improve their models.

The greatest challenge will be determining out which body should take on the role of the "rater of rating agencies." A government agency such as the SEC may not have the resources to take on such a big task, and may not be the most qualified body to do so. Additionally, the United States, unlike the EU, has prohibited regulating the substantive methodologies used by CRAs.[171] There is a tension here, because in order to evaluate and rank the CRAs performances, the agency responsible would need access to the CRA methodologies. This does not necessarily

[168] *See generally* Becker & Milbourn, *supra* note 12 (empirical study showing that inflated ratings peaked as Fitch's relative market share increased and it became a viable competitor to S&P and Moody's).

[169] CREDIT RATING STANDARDIZATION STUDY, *supra* note 57, at 7.

[170] *See* SEC ANNUAL REPORT, *supra* note 16, at 18; 17 CFR § 240.17g-5 (2012).

[171] Dodd-Frank does not give the SEC any power to regulate the substantive models of CRAs. *See* 15 U.S.C. § 78o–7(c)(2)(2012). By contrast, the European proposal states that "CRAs should . . . submit the proposed methodologies to ESMA . . . . The new methodologies may only be used once they have been approved by ESMA." EC *PROPOSAL*, *supra* note 82, at 9.

mean the agency is advocating or discouraging the use of certain models, but it may be viewed as coming dangerously close to outright regulation of the substantive models. There is also a very potent danger that government involvement will be improperly understood as government endorsement of the ratings, leading to more reliance by investors and thus less diligence.

Another weakness present whenever a governmental entity is involved is the danger of political bias distorting the rankings awarded to CRAs. A possible (but perhaps unrealistic) idea to help with this problem could be the creation of a U.S.-based governmental entity and a EU-based governmental entity, both of which would independently rank CRAs performances. The two rankings would provide investors with a means to compare the two judgments, acting as a partial check on the political bias of either entity.

A better candidate than the government for the "rater of rating agencies" would be a self-regulatory organization. These are non-governmental organizations that have the statutory authority to create and enforce industry standards that have the force of law. Examples of self-regulatory organizations include stock exchanges, the Financial Industry Regulatory Authority ("FINRA"), which enforces industry standards and requirements related to securities brokerage and trading;[172] the Public Company Accounting Oversight Board ("PCAOB") created by the Sarbanes Oxley Act of 2002, which regulates and enforces authority over all accounting firms that audit publicly traded companies;[173] and the Municipal Securities Rulemaking Board ("MSRB"), granted authority to promulgate rules governing the sale of municipal securities by broker-dealers and municipal securities dealers exempted from much of the federal securities laws.[174]

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[172] FINRA is a self-regulatory organization, all securities firms dealing with the public must be members. FINRA is registered with the SEC pursuant to the Maloney Act of 1938. *See* 15 U.S.C. § 78o-3 (2012).

[173] *See* Sarbanes-Oxley Act § 101, 15 U.S.C. § 7211 (2012).

[174] *See generally* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

If within its authority, the SEC could require FINRA to expand its responsibility and take on this role as a "rater of rating agencies." Otherwise, the securities Acts (or other legislation) could be amended to mandate the creation of an independent body that would synthesize the disclosure of rating agencies' performance statistics by creating a ranking of rating agencies. A respected and independent self-regulatory organization would mitigate the problems of implicit government endorsement of ratings and also mitigate the issue of politically biased or motivated rankings. This organization could help promulgate non-binding standards of performance for the industry and be involved in disciplinary actions that would parallel the enhanced Dodd-Frank liability CRAs now face. To fund such an enterprise, fees could be charged to view and access the published rankings of the CRAs created by the self-regulatory organization. Additionally, part of the SEC registration fee charged to debt issuers in public offerings could be used to help fund the self-regulatory organization.

If this organization is set up like FINRA, then CRAs would have to either become members of the organization or agree to act in compliance with the promulgated rules before being able to provide public ratings. However, this raises a potential First Amendment issue: can CRAs be barred from providing "opinions" about credit risk if they do not comply with the relevant rules? This could be especially problematic in the case of unsolicited ratings, such as those rating sovereign debt. First Amendment concerns would thus be a significant obstacle to regulating CRAs in this manner. However, even if they cannot be barred from providing their "opinions," at the very least CRAs could be barred from receiving NRSRO rating status if such a status is conditioned on membership in the self-regulatory organization and compliance with its rules. Therefore, in order to control CRAs, it will be important to maintain the NRSRO status and continue to make it valuable to CRAs.

Consideration should be given to whether CRAs should have the opportunity to challenge the ranking given to them by the "rater of rating agencies." If the self-regulatory organization is the body that creates the rankings, an appeal to the SEC could be an option, and a ranking decision could be reviewed under an "arbitrary and capricious" standard. Rules would then need to be developed to govern what happens to the contested ranking until the challenge is resolved.

If this proposal is accepted, it will be very important to emphasize to the investing public that by ranking a CRA high on its list, the government or the self-regulatory organization is not endorsing this CRA's rating or ensuring its accuracy; it is merely synthesizing information. Investors should not blindly rely on any credit ratings and should always do their own risk analysis to the greatest extent possible.

C. Purchase of an Additional Rating When Hiring a Low Performing CRA

The final step of this proposal is essentially a "belt and suspenders" provision in case the first two steps do not lead to a market that sufficiently penalizes inaccuracy. Where a CRA's credit rating later proves to be below an acceptable level of accuracy, it will be designated as "low-performing" by the governmental agency or self-regulatory organization for that particular asset class. This designation will apply until the particular agency's rating has returned to acceptable levels of accuracy. The requirement that will be imposed as a result of the "low-performing" designation for a particular asset class, is that any issuer hiring such a rating agency must purchase an additional rating from a CRA with better performance statistics for that asset class. A useful bright line rule should be that the designation is triggered as soon as a rating agency is ranked below the top three places in the rankings published by the governmental agency or self-regulatory organization described in part (2) of this proposal. The second rating would then have to be purchased from one of the CRAs ranked in the top three places.

The effect of this requirement will be to divert business away from inefficient rating agencies, since the issuers (or rather, the voting investors) will face a choice of: (1) hiring a less efficient CRA with the additional cost of obtaining a second rating, or (2) simply paying the more efficient CRA directly without any added cost.[175] Essentially, this model will replicate an efficient market that drives out poorly performing players. The "low-performing" designation will be applied only to particular asset classes so that a designated CRA will still have the ability to be profitable if its ratings in other asset classes are accurate.

For purposes of complying with regulations that impose certain rating thresholds, where the purchase of two ratings is mandated in accordance with this proposal, *both* ratings should carry legal force. This means that if the two ratings were to diverge, say in the extreme case that one rating is investment-grade while the other is non-investment-grade, that security will not have met an investment-grade threshold for purposes of complying with a regulation that requires an investment-grade rating.

The advantage of this idea over various types of sanctions, such as profit disgorgement, debt compensation, or deferred payments, is that it is much simpler. There will be no need to make complex calculations of profits that will be disputed by CRAs and require investigation. Additionally, there will not be liquidity problems due to large and unexpected disgorgements of profits or deferred payments. Although this proposal will allow the CRAs to keep the profits they have already earned from inaccurate ratings and prevent them only from making further profits, it is complimented by Dodd-Frank's imposition of civil liability, which threatens large damages payments. Additionally, the proposal would impose huge reputational penalties on CRAs designated as low-performing. Imagine the effect of disclosing the truth that default rates on CDOs rated *investment-grade* by Moody's were between 17 and

[175] An underlying assumption of this analysis is that issuers will reflect any increased cost they face in the prices they charge their investors. Therefore, the voting investors will have an incentive to choose an efficient CRA that will minimize the issuer's costs and indirectly minimize their own costs as well.

24%![176] The requirement that a second rating must be purchased will also reward the accurate rating agencies with more business. Unfortunately, as previously discussed, any sanction or benefit relying on past performance measures will punish bad behavior or reward good behavior only after a significant lapse in time.

Instead of imposing a bright line rule, which would trigger the requirement to purchase a second rating as soon as a CRA falls below the top three performers, more specific performance triggers could be imposed. One way to do this is by using default rates of traditionally high-quality bond ratings as a benchmark and comparing default rates across classes.[177] The regulatory organization could define a maximum acceptable default rate for each letter grade in a particular asset class: for example, "the SEC might specify an 8% default rate for Moody's Baa rating and a tighter 3% default rate for its AA rating."[178] Different asset classes would have differing acceptable default rates, recognizing that structured products do not operate in the same way as corporate bonds do. The acceptable default rates will also need to be adjusted in certain circumstances; for example, when unanticipated external events (such as an unanticipated fall in housing prices, natural disasters, etc.) impact the market and affect the default rate of all securities. Clearly, the bright-line rule would be easier to apply than these specified performance triggers.

A major difficulty is that investors may strongly oppose this model because they bear the burden of the CRAs' foul play. Even though investors will have the option of hiring more efficient CRAs without added cost, a mass migration of business to the more efficient CRAs will cause increased demand for those CRAs and therefore, also increased fees (unless there is some way to cap fees). The issuers will pass these fees along to investors, who may be a strong political lobby against such reform. Additionally, mandating the

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[176] 2007 *Hearings*, *supra* note 38, at 7.

[177] Hunt, *supra* note 133, at 205.

[178] 2007 *Hearings*, *supra* note 38, at 14.

purchase of a second rating could be problematic since "the SEC . . . ha[s] no delegated power over investors [or issuers] as a group (but only selected institutions, such as mutual funds)" and it would not be "politically easy to pass legislation requiring investors . . . [or issuers] to bear specified costs . . . ."[179]

However, this situation is not quite like a mandatory requirement, since purchasing a second rating can be avoided simply by turning to the more accurate rating agency from the beginning, which is the goal of the proposal. Additionally, the general practice in the past already has been to purchase two ratings for a particular debt issuance, known as the "two-ratings norm," which will likely make this requirement more acceptable to issuers and investors.[180]

Enforcement of this rule could be left to the SEC, which already functions as the overseer of securities distributions in the public markets. The SEC, in addition to requiring credit ratings in public registration statements, could promulgate new securities rules that require compliance with the rules of this proposal as part of the process for issuing public debt. Most importantly, this would ensure an investor's vote and that the penalty requiring mandatory purchase of a second rating (if the CRA selected falls below the top three CRAs ranked by the governmental agency or self-regulatory agency in part (2) of this proposal) would be enforced. Although this would directly impact only public issuances, the hope is that the rules will become a best practice in the industry of debt issuances, and that this will have a knock-on effect in the private markets without a need to promulgate extra rules for those markets. However, if need be, the SEC could promulgate such rules for private issuances as well, for example, as a condition for relying on Rule 144A for private debt issuances. [181]

This arrangement would also provide a solution to the problem that developed after Congress enacted a provision in

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[179] Coffee, *supra* note 33, at 259 n.72.

[180] Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 13 N.Y.U. J. LEGIS. & PUP. POL'Y 253, 266 (2010).

[181] 17 C.F.R. §230.144A (2012).

Dodd-Frank making CRAs liable for ratings included in registration statements in the same way accountants are for their audits. This resulted in NRSROs refusing to give issuers the required consent to use their ratings in their registration statements.[182] If this proposal is implemented, the hope is that ratings will be more reliable, and that the SEC could therefore simply allow issuers to provide the ratings in their registration statements even without the CRA's consent, provided issuers follow the rules laid out in this proposal.

Enforcement responsibilities could also be passed on to a self-regulatory organization such as FINRA instead of the SEC. It is important to note that the extent to which the SEC's existing statutory authority would allow it to act itself or to create a self-regulatory organization that could enforce such requirements and function as the "rater of rating agencies" is a complex issue. If there is no such authority, passing new legislation that must get through Congress will be very difficult and time consuming. Additionally, even if created lawfully, there may be certain limitations on the ability of a self-regulatory organization to seek judicial enforcement of their rules and requirements. For instance, in October 2011, the Second Circuit held in *Fiero v. FINRA* that FINRA lacks the statutory authority to bring court actions to collect disciplinary fines it imposed on its members, even though it does have the power to impose such fines.[183]

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182 See *supra* Part VI.A. (item three in the list of new Dodd-Frank provisions).

183 660 F.3d 569, 574 (2d Cir. 2011). In particular, the court held that the 1934 Act did not provide this authority to FINRA. *Id.* at 574–77. Under Section 15A(b) of the 1934 Act, self-regulatory organizations [SROs] have statutory authority to "appropriately discipline[]" their members for violating the federal securities laws or their own rules by "expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction." 15 U.S.C. § 78o-3(b)(7) (2012). But, the court noted, "there is no express statutory authority for SRO's [sic] to bring judicial actions to enforce the collection of fines," and it stated in a footnote that "the power granted to SRO's [sic] by Section 15A of the

D. A Key Difference Between the New Proposal and the Franken Proposal

The key difference between this new, three-step proposal and the version of the Franken Proposal that would have a Board assign rating contracts to NRSROs based on quality measures[184] is that in this model, the market—not the government—identifies and awards the CRAs providing the highest-quality services. Investors will vote on the CRA *they* decide is the best. As guidance, they will receive consolidated disclosure about the "quality" of rating agencies from, ideally, an independent self-regulatory organization (not tied to the government) that ranks the CRAs by the quality of their services. However, the quality determinations of the self-regulatory organization are not binding in the sense that investors have a choice to disregard the recommendations, albeit at the expense of purchasing a second rating to protect against potential conflicts of interest. CRAs may also have the possibility to challenge ranking decisions they disagree with.

By contrast, under the Franken Proposal, the government's quality determinations would stand uncontested, leaving them as the sole distributor of rating contracts and thus also market share. As the Securities Industry and Financial Markets Association ("SIFMA") warns, the Franken Proposal "would represent an unprecedented intrusion of government control into a private financial market."[185]

VIII. CONCLUSION

The financial crisis highlighted key problems in the structure and business model of CRAs. With the growth of securitization and innovative structured finance products,

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Exchange Act to discipline their members applies to all SRO's, and not just FINRA." *Fiero*, 660 F.3d 569 at 574 & n. 6.

184 *See* discussion *supra* Part V.

185 Letter from Sec. Indus. & Fin. Mkts. Ass'n to SEC 5-6 (Sept. 13, 2011), *available at* www.sifma.org/issues/item.aspx?id= 8589935396.

the inherent conflict of interest present in the issuer-pays model became problematic. Rating agencies faced greater competitive pressure to appease their clients—the issuers of debt—than they did when they were rating only corporate bonds.[186] Due to the inclusion of benchmark ratings in regulation, issuers sought high ratings in order to increase the pool of investors eligible to buy their products.[187] This led CRAs to override their own models, by applying unjustified upward adjustments, in an effort to increase the amount of debt that could be rated investment-grade.[188] The accuracy of the ratings were highly dependent on assumptions such as the continuous appreciation of housing prices, and due to the innovative nature of the structured products, the models themselves were based on very limited historical data.[189] Additionally, there were weak incentives to provide updated information or timely downgrades of debt.[190] Investors, issuers, and CRAs were all profiting from the bubble, so there was also no pressure to engage in accurate due diligence.[191] As the products trading in the markets became more complex, it is only natural that investors increasingly began to rely on ratings agencies to do their risk analysis.

Both the United States and the EU responded to these concerns with enhanced regulation. The United States implemented Dodd-Frank, which, among other things, has removed references to ratings in regulations, allowed private rights of action against CRAs, and mandated additional disclosure. To deal with the conflict of interest problem, Dodd-Frank mandated a study about the advantages of the Franken Proposal, in relation to other options, and seeks to implement that proposal "unless the commission determines that an alternative system would better serve the public

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186 Coffee, *supra* note 33, at 238.

187 *See* 2007 *Hearings supra* note 38, at 8.

188 *See generally* Griffin & Tang, *supra* note 39.

189 Sy, *supra* note 28, at 19.

190 2008 *Hearings*, *supra* note 18, at 10.

191 *Id.*

interest."[192] The Franken Proposal would create a centralized government platform that assigns issuers to rating agencies on a randomized basis. However, many alternative solutions have been proposed.

This Note sought to review and evaluate the Franken Proposal and its alternatives, using them as a basis for a new proposal. The new proposal combines three steps: (1) a requirement that issuers obtain a vote from their largest institutional investors and allow the outcome of the vote to determine which CRA the issuer hires; (2) the creation of a governmental agency or a self-regulatory organization that rates and ranks the performance of individual CRAs; and (3) a requirement that issuers obtain a second rating from a better performing CRA when they choose to hire a CRA whose performance has proven inadequate for a particular asset class.

Requiring issuers to hire a rating agency chosen by voting investors will allow the issuer-pays model to remain intact, but will remedy the conflict of interest problem by transferring the choice of rating agency to investors. The CRAs will therefore compete for the favor of investors and no longer have to do the same for issuers. However, in order to make educated decisions about which rating agency to vote for, investors will need standardized information about the performance of the rating agencies. A self-regulatory organization or a government entity that ranks the existing NRSROs by the quality of their ratings and publishes these rankings can provide exactly this type of standardized information. Investors may therefore use the rankings to help them make their voting decisions, and CRAs will have incentives to be accurate and make it to the top of the rankings.

To bolster this structure, an inaccurate rating agency will also suffer a further consequence if it lands at the bottom of the rankings list. The third step of the proposal will require the government to impose a "low performance" designation

[192] Dodd-Frank Wall Street Reform and Consumer Protection Act § 939F(d)(1), Pub. L. No. 111-203, 124 Stat. 1376, 1471 (2012); *see also* GAO REPORT, *supra* note 9, at 3.

on ratings that have fallen below an acceptable level of accuracy for a given asset class or, more simply, if they are not ranked in the top three CRAs as established by the governmental or self-regulatory organization. Any client looking to buy a rating from a low-performing agency will be required to purchase an additional rating from a better-performing agency without such a designation. Business will therefore be diverted to the most efficient rating agencies until the low-performing agency has adapted its models and returned to an acceptable level of accuracy.

Assuming this proposal is accepted and U.S. regulators go through the effort of implementing such an extensive plan, it will be imperative to re-evaluate the decision to remove all references to credit ratings in regulations. Requiring the government, institutional investors, and others to engage in their own in-house credit analysis is wasteful in a market where CRAs operate with the right incentives to compete for accuracy. There is also the risk of inconsistency between the different approaches used to evaluate risk if no standards are mandated. Keeping the NRSRO status valuable to CRAs, in part by incorporating references to the NRSRO ratings in regulations, will also encourage participants to remain NRSROs and submit to regulations governing the right to hold the designation. This allows for tougher regulatory requirements that can be imposed on a defined and more easily monitored group. Despite some concerns, regulatory power is also not the explanation for the market dominance of Moody's, S&P, and Fitch since it "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 SEC expanded the number of NRSROs in the market to ten.[193]

This is not to say that by reinstating credit ratings in regulation investors should not individually evaluate the risks of the products they buy. In fact, it is essential that investors remain aware that ratings are mere predictions of

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193 Coffee, *supra* note 33, at 275.

risk. Even with the right incentives in place, CRAs or any other mechanism in the market inevitably may be inadequate for estimating the risk associated with new products for which there is little historical data. Ratings, whether accurate or not, also inherently create systemic risk by perpetuating boom and bust cycles since "[u]nanticipated abrupt downgrades of securities are . . . negative shocks to securities markets and can affect one issuer, a whole sector, or the entire financial system."[194] Therefore, investors must always be cautious. If the crisis has taught us anything, it should be that the difficulty to of keeping up with the rapid growth and changes that characterize our modern financial system carries uncertainty and risk that no regulation can completely protect against.

194 Sy, *supra* note 28, at 3.