

CREDIT RATING AGENCIES AND THE
“WORLDWIDE CREDIT CRISIS”: THE
LIMITS OF REPUTATION, THE
INSUFFICIENCY OF REFORM, AND A
PROPOSAL FOR IMPROVEMENT

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The “worldwide credit crisis” has thrust credit rating agencies into the spotlight, with attention focused on their ratings of novel structured finance products. Policymakers have undertaken a number of initiatives intended to address perceived problems with such ratings—enhancing competition, promoting transparency, reducing conflicts of interest, and reducing ratings-dependent regulation. These approaches are all broadly consistent with the dominant

academic theory of rating agencies, the “reputational-capital” model, which is taken to imply that under the right circumstances a well-functioning reputation mechanism will deter low-quality ratings. The policy initiatives currently under consideration can be seen as efforts to fix discrete problems with the rating market so that the reputation mechanism can work properly.

This Article argues that these efforts are fundamentally incomplete, because even a well-functioning reputation mechanism does not generate optimum rating quality on new products: When a new product is introduced, agencies do not have a reputation for high quality in that product so they have nothing to lose from issuing the rating. Even if low quality for a specific product type harms the agency’s reputation for rating other product types, the agency still will be induced to issue low-quality ratings if the new product type in question is large enough in volume. And as long as rating quality across new product types is high enough on average, it is rational for investors to rely on new-product ratings even if they know that some are of low quality.

The incentive problem can be corrected by requiring an agency to disgorge profits on ratings that are revealed to be of low quality by the performance of the product type over time, unless the agency discloses that the ratings are of low quality. Such a system would be superior both to the current regime, which relies on market forces backed by antifraud rules, and to other alternatives, such as the recent proposal to forbid new-product ratings absent prior SEC approval of the products.

I. INTRODUCTION

The “worldwide credit crisis” that began in 2007 has focused attention on credit rating agencies, with many observers arguing that undeserved high credit ratings on novel financial products contributed materially to the turmoil. A welter of regulatory reports on the crisis assert that high credit ratings on novel financial instruments helped induce investors to purchase these instruments. When the instruments started to appear much riskier than

traditional investments carrying similar ratings, investors lost confidence in the ratings and the novel instruments themselves, leading markets for the products to seize up and thus triggering severe adverse consequences for the global financial system.

Whether this view is accurate or not, it highlights the potential importance of credit rating quality and raises the question whether the agencies have the right incentives to produce high-quality ratings. The dominant view of rating quality in the legal literature and among policymakers comes from the “reputational-capital” model of rating agencies, which holds that a well-functioning reputation mechanism will give rating agencies optimum incentives for producing high-quality ratings. The underlying idea is that if investors determine that a rating agency’s ratings are of low quality, they will stop crediting the ratings, and the agency’s business will lose value.

At the same time, it has been recognized that real-world characteristics of the rating market may cause the reputation mechanism not to function well. For example, academics and policymakers have pointed out that there may be limited competition in the market, that rating agencies face conflicts of interest, that “transparency” (investors’ ability to monitor rating quality and determine how agencies are issuing ratings) is limited, and that demand for ratings may be artificially stimulated because of agency ratings’ place in financial regulation. Although the relative importance of these deviations is debated—many observers think that the reputation mechanism functions well despite their existence, while others believe that the deviations render the “reputational-capital” model empirically incorrect—almost all policy initiatives currently under consideration in the United States are designed to address these deviations and improve the functioning of the reputation mechanism.

This Article argues that even a well-functioning reputation mechanism is unlikely to produce ideal incentives for high quality in the critical area of rating novel instruments, such as those that may have contributed to the

still-unfolding credit market meltdown. This is important because continuing financial innovation has become an important and persistent characteristic of the U.S. economy.

The critical observation supporting this Article's central argument is as underappreciated as it is simple: It is not plausible to argue that rating agencies have a valuable reputation for rating instruments they have never rated before. Thus, an agency faced with the opportunity to issue a rating on a novel product is unlikely to be constrained from doing so by fear of depleting its "reputational-capital," even if the agency knows that it cannot rate the product with high quality. This conclusion is likely to hold even if all the policy measures currently under consideration are successful.

This implies that as long as financial innovation continues—which is to say for the foreseeable future—there is likely to be a problem with rating agencies that will not be fixed by improving the reputation mechanism. One potential solution to this problem would be to require agencies to disgorge profits derived from issuing novel-product ratings that turn out to be of low quality, unless they disclose the low quality at the time of rating. If the reputational-capital view is correct, such an approach ought to be feasible, as the ability to develop a reputation for quality presupposes the ability to monitor and evaluate quality on an *ex post* basis. Moreover, because agency ratings are predictive judgments rather than statements of fact, a quality-based approach is better suited to most agency rating problems than an approach based on liability for "misstatements" or "deception," such as the current fraud-based liability regime or various strict-liability proposals that academics have advanced.

II. CREDIT RATINGS AND THE "WORLDWIDE CREDIT CRISIS"

A. Rating Agencies and Ratings

Credit rating agencies provide evaluations of the likelihood that obligations will be repaid. There are three

major credit rating agencies in the United States: Moody's,¹ Standard & Poor's,² and Fitch.³ The agencies issue ratings on individual issues, such as particular structured-finance offerings and corporate, government, and municipal bonds.⁴ The three major agencies are responsible for 96% of outstanding structured-finance ratings and 98% of all outstanding ratings issued by SEC-recognized agencies.⁵ There are also several smaller rating agencies that are active in the United States,⁶ but some of these are active primarily in niche markets,⁷ and none of them has an overall market share that is comparable to the major agencies'.

Ratings for corporate bonds and structured-finance issues are ranked on a letter scale. For Standard and Poor's and Fitch, AAA is the highest rating, followed by AA, A, BBB,

¹ Moody's conducts its U.S. ratings business through Moody's Investor Service, a unit of Moody's Corporation, a publicly traded company. Moody's Corp., Annual Report (Form 10-K), at 2, 17 (Feb. 29, 2008).

² Standard & Poor's is a unit of The McGraw-Hill Companies, Inc., a publicly traded company, and provides credit ratings in the United States and abroad. THE MCGRAW-HILL COMPANIES, 2007 ANNUAL REPORT 9, 24 (2008).

³ Fitch Ratings is a subsidiary of Fitch Group, and like Moody's Investor Service and Standard & Poor's, provides credit rating services. FIMALAC, ANNUAL REPORT 2006/2007, 15, 24-30 (2008).

⁴ U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 35 (2008) [hereinafter 2008 SEC NRSRO REPORT].

⁵ 2008 SEC NRSRO REPORT, *supra* note 4, at 35. The percentages are computed relative to all ratings issued by agencies that are recognized by the SEC ("nationally recognized statistical rating organizations" or NRSROs, described below).

⁶ As of June 2008, four other companies were registered with the SEC as NRSROs: A.M. Best Company, Inc., DBRS Ltd., Japan Credit Rating Agency, Ltd., and Rating and Investment Information, Inc. Since then, three more have been approved as NRSROs: Realpoint LLC, LACE Financial Corp., and Egan-Jones Rating Company. The previously registered NRSROs rely primarily on an issuer-pays business model, while the three newly registered agencies rely primarily on a subscriber-pays model. 2008 SEC NRSRO REPORT, *supra* note 4, at 39.

⁷ For example, A.M. Best is primarily active in insurance ratings, and Dominion Bond Rating Services is primarily active in rating Canadian issues.

BB, B, CCC, CC, C, and D, with D designating an instrument that has defaulted.⁸ For Moody's, Aaa is the highest rating, followed by Aa, A, Baa, Ba, B, Caa, Ca, C.⁹ Ratings often are modified by a suffix such as "+" or "-", creating finer gradations.¹⁰ In common parlance, instruments with ratings of BBB/Baa or above are "investment grade," while those of BB/Ba or below are "speculative," "high-yield," or "junk."¹¹

The vast majority of fixed-income issues in the United States carry credit ratings from at least one, and usually two, credit rating agencies.¹² Ratings typically are requested and paid for by the issuer or originator of the financial instrument in question, and are made available to the public for free. Although there is an active debate over the reason that ratings are demanded,¹³ the mainstream view is that investors value the agencies' assessments of credit quality. As described in greater detail below, many government rules and private contracts and investment guidelines refer to

⁸ S&P, CORPORATE RATINGS CRITERIA 2008 (2008). Fitch Ratings' definitions are available at Fitch Ratings Definitions, http://www.fitchratings.com/corporate/fitchResources.cfm?detail=1&rd_file=ltr (last visited Mar. 9, 2009).

⁹ MOODY'S INVESTORS SERVICE, UNDERSTANDING MOODY'S CORPORATE BOND RATINGS AND RATING PROCESS 7 (2002).

¹⁰ Standard & Poor's uses the "+" and "-" notation; Moody's uses a three-level numerical code within each rating grade, i.e., B1, B2, B3. TIMOTHY J. SINCLAIR, THE NEW MASTERS OF CAPITAL 36-39 (2005) (table of S&P and Moody's rating gradations).

¹¹ See MOODY'S INVESTORS SERVICE, MOODY'S RATING SYSTEM IN BRIEF (2006) [hereinafter MOODY'S RATING SYSTEM] ("The lowest investment-grade rating is Baa3. The highest speculative-grade rating is Ba1.").

¹² See Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation* 17-18 (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991821 (June 4, 2007) ("Practically all bonds traded today in the USA are rated by Moody's and S&P and also a large majority of international issues are also rated by them. In 2005 Fitch rated 66 percent of all debt securities worldwide.") (citations omitted); Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 59-62 (2004) (describing "two-rating norm" in which most issues are rated by Moody's and S&P).

¹³ See *infra* Part III.A.

ratings, and this pervasive incorporation of ratings into the financial system may imbue them with value apart from their quality as assessments of creditworthiness.¹⁴

B. Ratings and Structured Finance

The growth of securitization, or “structured finance,”¹⁵ has been one of the most important developments in finance in the last twenty-five years.¹⁶ The basic idea of securitization is that bundles, or “pools,” of income-producing financial assets, usually loan-like obligations such as mortgages, corporate loans, auto loans, or credit-card receivables but potentially also revenue sources such as royalty streams, are sold to an entity (a “special purpose vehicle”) that issues claims on the pool income to investors. Once the claims have been sold, the underlying assets have been “securitized.”¹⁷ Securitization transactions are designed so that the investors have no recourse to the party that sold the claims to the investment vehicle,¹⁸ and creditors of the selling party

¹⁴ See *infra* Part III.B.3.

¹⁵ This Article uses these terms interchangeably.

¹⁶ Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1556 (2008) (referring to securitization as “one of the major financial innovations of recent decades”); ARVIND RAJAN, GLEN McDERMOTT & RATUL ROY, *THE STRUCTURED CREDIT HANDBOOK 3* (2007) (explaining that securitization “was pioneered in the mortgage market in the early 1980s and has since also become the key technology behind asset-backed securities”); *Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 2 (2008) [hereinafter *Senate Turmoil Hearings*] (testimony of Arturo Cifuentes, Ph.D., Managing Director, Structured Finance Department, R.W. Pressprich & Co.) [hereinafter *Cifuentes Senate Testimony*] (testifying that securitization and credit derivatives created an “alternative banking system,” “several US\$ trillions in size” that “has been an engine of growth for the U.S. economy”).

¹⁷ For a more detailed recent description of the basics of securitization, see Kettering, *supra* note 16, at 1564-80.

¹⁸ See, e.g., STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: THE PRINCIPLES OF ASSET SECURITIZATION* 7 (3d ed. 2002); Kettering, *supra* note 16, at 1565.

typically have no ability to pursue the assets sold to the investment vehicle.¹⁹

A critical feature of structured finance is allocating the cash flows generated by the pool into different classes of securities, or “tranches.”²⁰ Typically, cash flows are divided into senior, mezzanine and junior tiers, with losses from pool defaults first causing losses in the junior tiers, then in mezzanine tiers once the junior tiers are exhausted, and finally in the senior tiers.²¹ The senior tiers have the smallest default risk exposure, will promise the lowest interest rates to investors, and will carry the highest credit ratings.²² Because the senior tiers pay the least in interest, it is in the originator’s interest to maximize the amount of senior securities issued from the pool. At the same time, the junior tiers must be large enough to provide enough of a “cushion” to make it credible to claim that the senior tiers actually face only low default risk. Calculating just how much principal should be assigned to each tier can be complicated, and it is typically carried out by practitioners skilled in the discipline called “financial engineering” or “quantitative finance.”

Securitized products have become more complicated over time, particularly in the recent past. Structured-finance products that are particularly relevant to this Article include subprime residential mortgage-backed securities (RMBS)

¹⁹ See, e.g., SCHWARCZ, *supra* note 18, at 69; Kettering, *supra* note 16, at 1565-66. This feature has raised concerns that securitization’s benefits for issuers arise from a wealth transfer away from unsecured creditors. See Lois R. Lupica, *Asset Securitization: The Unsecured Creditor’s Perspective*, 76 TEX. L. REV. 595, 597 (1998).

²⁰ Tranches may have structural characteristics other than seniority. For example, many mortgage-based security tranches are “interest-only” or “principal-only”—they pay from either the interest or the principal portion of payments received on the underlying pool of mortgages. See SALOMON SMITH BARNEY GUIDE TO MORTGAGE-BACKED AND ASSET-BACKED SECURITIES 51-52 (Lakhibir Hayre ed., 2001).

²¹ See Ratul Roy & Glen McDermott, *ABS CDOs*, in THE STRUCTURED CREDIT HANDBOOK 335, 335 (Arvind Rajan, Glen McDermott & Ratul Roy eds., 2007).

²² See Roy & McDermott, *supra* note 21, at 335.

and collateralized debt obligations (CDOs) based on subprime RMBS. RMBS are securitized products in which residential home mortgages are the underlying assets. Tranche RMBS themselves are not especially innovative, having been pioneered in the 1980s,²³ but subprime RMBS securitization did not become important until this decade.²⁴ RMBS-backed CDOs are structured finance products in which RMBS are the underlying assets.²⁵ RMBS often are registered²⁶ and CDOs typically are not.²⁷ CDOs are sold via Rule 144A offerings, so the offerees must be qualified institutional investors such as pension plans, hedge funds, investment banks, and municipalities.²⁸

Investors can also be paid to take credit risk associated with particular issuers or tranches via derivatives called credit-default swaps (CDS). The CDS can then be pooled into CDOs. Such CDOs are called “synthetic” CDOs because the underlying credit exposure is taken through derivatives rather than by owning actual loans or mortgages.²⁹

Agency ratings apparently have been crucial for investor acceptance of these new instruments, although commenters do not agree on the reason for this. As explained in more detail below, investors may prefer that novel products carry ratings because of the novelty and complexity of the products (which places a premium on credit risk assessments from

²³ Lakhbir Hayre, *A Concise Guide to Mortgage-Backed Securities (MBSs)*, in SALOMON SMITH BARNEY GUIDE TO MORTGAGE-BACKED AND ASSET-BACKED SECURITIES 9, 45 (Lakhbir Hayre ed., 2001).

²⁴ Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit 2* (Wharton Fin. Insts. Ctr., Working Paper No. 7-43, 2008).

²⁵ Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* 62 (May 3, 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=1027475>.

²⁶ Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Law & Economic Issues in Subprime Litigation* 9-10, 63 fig.3 (Harvard John M. Olin Ctr. for Law, Econ., and Bus., Working Paper No. 612, Nov. 17, 2008).

²⁷ Bethel et al., *supra* note 26, at 59.

²⁸ *Id.* at 35; 17 C.F.R. § 230.144A-7(d)(1) (2008).

²⁹ RAJAN et al., *supra* note 16, at 3.

trusted intermediaries) or because investors need agency ratings to satisfy regulators.

C. The “Worldwide Credit Crisis”

The so-called “worldwide credit crisis” that began in summer 2007 is a sprawling, interrelated series of events that continues to unfold. Any list of principal events seems destined to become outdated immediately, so none is presented here.³⁰ The U.S. officially went into recession at the end of 2007³¹ as the credit crisis intensified, and as of early 2009 the weight of opinion appeared to be that problems in the credit market contributed significantly to problems in the real economy.³²

The crisis likely has a diverse set of interrelated causes,³³ but observers have criticized rating agencies sharply—sometimes in quite colorful terms.³⁴ Official bodies that have

³⁰ An online list of events that appears current as of January 2009 appears at Credit Crisis Timeline, <http://www.creditwritedowns.com/credit-crisis-timeline> (last visited Mar. 9, 2009).

³¹ See NAT'L BUREAU OF ECON. RESEARCH, DETERMINATION OF THE DECEMBER 2007 PEAK IN ECONOMIC ACTIVITY (2008), www.nber.org/cycles/dec2008.pdf.

³² See, e.g., Edward Carr, *Greed—And Fear: A Special Report on the Future of Finance*, THE ECONOMIST, Jan. 24, 2009, at 3 (“When the financial system fails, everyone suffers. Over the past 22 months the shock has spread from American housing, sector by sector, economy by economy.”).

³³ For example, a recent white paper surveys hypotheses that have been advanced to explain the crisis: (1) the underlying asset pools had different risk (increasing use of hybrid ARMs); (2) changing origination and appraisal policies (shift to originate-to-distribute model); (3) home price appreciation masking the underlying credit problems with the mortgages; (4) increasing complexity and decreasing transparency of instruments, as complexity migrated from relatively well-understood RMBS to less transparent CDOs; (5) the market's failure to “fully anticipate the probability or effect of correlated market events or the very small probability of an extremely negative outcome,” including the extent of bank funding risk. Bethel et al., *supra* note 26, at 23-28; see also Ashcraft & Scheuermann, *supra* note 24, at i-iii.

³⁴ William H. Gross, *Looking for Contagion in All the Wrong Places*, PIMCO INVESTMENT OUTLOOK, July 2007, at 1 (arguing that rating

reported on the crisis, including the President's Working Group on Financial Markets,³⁵ the International Organization of Securities Commissions,³⁶ the Financial Stability Forum,³⁷ and the staff of the Securities and Exchange Commission ("SEC" or "Commission",³⁸ have been less colorful but equally critical.

The common thread in these narratives is that the rating agencies did a poor job of assessing the default risk of CDOs and other instruments based on subprime RMBS in the period from 2004 on,³⁹ that high ratings on such securities

agencies were "wooded" by instruments in "hooker heels" bearing "tramp stamps").

³⁵ PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 1 (2008) (arguing that one of the "principal underlying causes of the turmoil in the financial markets" since mid-2007 was "flaws in credit rating agencies' assessments of subprime residential mortgage-backed securities (RMBS) and other complex structured credit products, especially collateralized debt obligations (CDOs) that held RMBS and other asset-backed securities (CDOs of ABS)"). The Working Group's members are the Chairman of the Federal Reserve Board of Governors, the Secretary of the Treasury, the Chairman of the SEC, and the Chairman of the CFTC.

³⁶ TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS., THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS 2 (2008) [hereinafter IOSCO CRA REPORT] ("CRAs and their credit ratings played a critical role in the recent market turmoil.").

³⁷ FIN. STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 32 (2008) [hereinafter FSF Report] ("Poor credit assessments by CRAs contributed both to the build up and the unfolding of recent events.").

³⁸ STAFF OF THE OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, DIVISION OF TRADING & MARKETS & OFFICE OF ECONOMIC ANALYSIS, SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATION OF SELECT RATING AGENCIES 2 (2008) [hereinafter SEC STAFF EXAMINATION REPORT] ("The rating agencies' performance in . . . structured finance products raised questions about the accuracy of their credit ratings generally as well as the integrity of the ratings process as a whole.").

³⁹ FSF Report, *supra* note 37, at 33 ("The severe underestimation by CRAs of the credit risks of instruments collateralised by subprime mortgages resulted in part from flaws in their rating methodologies."); IOSCO CRA REPORT, *supra* note 36, at 2.

had an inordinate effect on markets,⁴⁰ and that when a large number of borrowers started to default on subprime mortgages in 2007, the low quality of the ratings was revealed⁴¹ and systemic consequences ensued.⁴² In particular, investors lost confidence in securitized products generally⁴³ and/or were forced to sell securities at “fire sale” prices for liquidity reasons.⁴⁴

Although the official reports present few specific figures, the evidence suggests that default rates on structured credit products, especially RMBS-backed CDOs, have indeed been very high: In July 2008, analysts reported that CDO

⁴⁰ IOSCO CRA REPORT, *supra* note 36, at 2 (“Unlike securities trading on deeper, more transparent markets, credit ratings have had an inordinate impact on the valuation and liquidity of subprime RMBSs and RMBS-backed CDOs.”); *see also Black Boxes Skew Ratings*, WALL ST. J., May 22, 2008, at C14 (criticizing investors for “blithely accepting” ratings “at face value”).

⁴¹ IOSCO CRA REPORT, *supra* note 36, at 2 (“[A]s the number of delinquencies on subprime mortgages in the United States suddenly increased, some investors began to question the accuracy of many CDO and RMBS ratings, fueling a growing reluctance to invest in these products by increasingly risk-averse investors.”); FSF Report, *supra* note 37, at 32 (“After assigning high ratings to subprime-related RMBSs and CDOs between 2004 and 2007, and thus contributing to the phenomenal growth of subprime lending, since mid-2007 CRAs have announced an inordinate number of rapid multi-notch downgrades of these instruments. This has raised questions about the quality of credit ratings with regard to structured products.”).

⁴² IOSCO CRA REPORT, *supra* note 36, at 2 (“[Q]uestions about the quality of CRA ratings and the integrity of the rating process arguably added to the liquidity crisis that occurred [in] many markets beginning in August 2007.”).

⁴³ FSF Report, *supra* note 37, at 32 (“CRAs assigned high credit ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models. As investors realized this, they lost confidence in ratings of securitised products more generally.”); IOSCO CRA REPORT, *supra* note 36, at 9.

⁴⁴ Bethel et al., *supra* note 26, at 20-21 (arguing that asset writedowns forced financial institutions such as banks to sell assets into a glutted market to meet capital requirements while institutional investors were forced at the same time to sell instruments downgraded below investment grade because of “ERISA restrictions, other legal requirements, and their own stated investing criteria”).

defaults since October 2007 totaled 200 with \$220 billion nominal value, or 36% of all CDOs that were based on United States asset-backed securities.⁴⁵

Critics have emphasized the default rates on the underlying subprime mortgages. But that is not the only problem. Commenters have also taken rating agencies to task for fundamental defects in their methodologies for these products. Moreover, ratings on some products that are not directly tied to subprime mortgages appear to have performed poorly. For example, 2006 saw the introduction of the CPDO (“constant proportion debt obligation”), an instrument designed to meet fixed yield targets by increasing or decreasing leverage depending on market conditions.⁴⁶ The fundamental source of risk and return in a CPDO is an index of corporate credit spreads, so there is no direct connection to subprime mortgages. Nevertheless, in early 2008, Moody’s downgraded twenty-one European CPDOs,

⁴⁵ John Kicklighter, *Traders Push Back Speculation of a Fed Hike as Growth, Markets Sour*, DAILYFX, July 2, 2008; see also Bethel et al., *supra* note 26, at 20 (“[B]y September of 2007, Moody’s had downgraded about \$25 billion, or roughly five percent of the \$460 billion of subprime MBS it rated in 2006. In comparison, Moody’s had only downgraded 2.1 percent by dollar volume in the subprime RMBS sector for the combined 2002-2006 time period, and one percent by dollar volume for all of RMBS.”). Note that CDOs can default due to ratings downgrades, meaning that using CDO defaults to measure rating quality could be criticized as circular. But downgrades lead to cash-flow, or “real” defaults. See Moody’s Investors Service, *Special Comment: Default & Loss Rates of Structured Finance Securities: 1993-2007*, July 2008, at 3 n.4 (“Securities that have been downgraded to Ca/C are virtually certain to sustain losses ultimately.”); *CDO Defaults Driven by Ratings, Not Missed Payments*, DERIVATIVES WEEK, May 26, 2008 (noting that although “very few if any” of 200 CDO defaults to date were due to missing payments, cash-flow-based defaults were expected later in the year). By early June, when 195 CDOs with \$202 billion in aggregate nominal value had defaulted, it was reported that “a few” CDOs had defaulted due to missed payments. Aaron Johnson, *Managers UOB, Babson, RBS See First CDOs Default*, TOTAL SECURITIZATION, June 1, 2008.

⁴⁶ See Paul J. Davies & Sarah O’Connor, *Default Protection Puts CPDOs at Risk*, FIN. TIMES, Feb. 19, 2008, at 27.

about half the total number it had rated.⁴⁷ At least some of the CPDO downgrades apparently reflected a coding error in Moody's software that the company did not correct for several months.⁴⁸ Problems with agency models may have been amplified by ratings-driven herding behavior among CDO arrangers: Once an arranger devised a structure that received the desired ratings, others may have followed, so that any deficiencies in the rating agency methodology were able to spread.⁴⁹

If agency models were deficient across the board, as these commentators suggest, then agencies did not just fail to anticipate the performance of subprime loans or get taken in by fraud on the part of subprime borrowers and originators. Instead, agencies did not know what they were doing on a fundamental level, at least with respect to some (but not necessarily all) novel securities. Without endorsing this view—examining that question seriously would require an article in itself, even if the right data were available—this Article argues that *if* rating agencies do not know what they are doing, they are likely to find it to be in their interest to issue ratings on novel products anyway.

D. Regulatory Initiatives Regarding Rating Agencies

The worldwide crisis and the perceived deficiencies in agency ratings on structured products have spurred a flurry of regulatory and legislative activity, as well as litigation.

With some irony, the crisis broke just as Congress and the SEC finished work on a new regulatory regime for rating

⁴⁷ Aaron Lucchetti & Kara Scannell, *New Debt Products Test Moody's Methods*, WALL ST. J., May 22, 2008, at C12.

⁴⁸ In early 2007, Moody's reportedly discovered that it had erroneously rated several billion dollars worth of CPDOs at the AAA level as a result of a coding error affecting data integrity. Sam Jones, Gillian Tett & Paul J. Davies, *Moody's Error Gave Top Ratings to Debt Products*, FIN. TIMES, May 20, 2008; Aaron Lucchetti, *Moody's Loses A Key Player Amid Probe About Error*, WALL ST. J., July 2, 2008, at C1. In mid-2008, the SEC staff started a review of CPDO rating methodologies. 2008 SEC NRSRO REPORT, *supra* note 4, at 34.

⁴⁹ Bethel et al., *supra* note 26, at 27-28.

agencies that was supposed to address the problems allegedly laid bare by the corporate scandals of 2001-2002. The Sarbanes-Oxley Act of 2002 ordered the SEC to hold hearings on rating-agency performance, and the Commission issued a report in 2003 raising questions in several areas about this subject.⁵⁰ After several sets of hearings and an SEC initiative to revamp its rules that stalled in 2005, Congress enacted the Credit Rating Agency Reform Act ("2006 Act") in 2006.⁵¹ The 2006 Act gave the SEC express regulatory authority over rating agencies in several areas, but also sharply circumscribed its jurisdiction. For example, the 2006 Act affirmatively denies the SEC and the states the power to "regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings."⁵² The SEC adopted rules under the 2006 Act in June 2007.⁵³

A month later, the worldwide credit crisis broke, renewing regulatory scrutiny of rating agencies from several quarters. State attorneys general in New York, Connecticut, and Ohio commenced investigations⁵⁴ (with the New York

⁵⁰ See U.S. SEC. & EXCH. COMM'N., REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS AS REQUIRED BY SECTION 702(B) OF THE SARBANES-OXLEY ACT OF 2002 (2003) [hereinafter SEC SOX REPORT].

⁵¹ Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78o-7 (2008).

⁵² 15 U.S.C. § 78o-7(c)(2). The 2006 Act also requires that all SEC rules adopted "pursuant to this title, as they apply" to NRSROs be "narrowly tailored to meet the requirements of this title applicable to" NRSROs, *id.*, and "creates no private right of action." § 78o-7(m)(2). The 2006 Act does contain a saving provision maintaining the authority of state securities commissions to bring actions for "fraud or deceit" against rating agencies and their personnel. § 78o-7(o)(2). In recent Congressional testimony, a credit rating agency official expressed her agency's view that the 2006 Act "reflects a judicious balance between oversight and analytical independence." *Senate Turmoil Hearings, supra* note 16, at 7 (prepared testimony of Vickie A. Tillman, Executive Vice President, S&P).

⁵³ See SEC 2007 Rule, *infra* note 67.

⁵⁴ *AAAsking for Trouble*, THE ECONOMIST, July 14, 2007 (Ohio AG's fraud investigation); *Credit Rating Agencies Reach Agreement with New*

Attorney General announcing a settlement with the major rating agencies in June 2008). The SEC conducted a staff examination of the agencies⁵⁵ and proposed additional rules governing structured products.⁵⁶ Congress held more hearings⁵⁷ and considered additional legislation governing structured products.⁵⁸ The President's Working Group on Financial Markets issued a statement describing "flaws in credit rating agencies' assessments" of certain products as a "principal underlying cause" of global market turmoil.⁵⁹ International quasi-official bodies reviewed the role of rating agencies and made recommendations.⁶⁰

As described in more detail below, the fundamental orientation of policy reform was the same before and after the crisis: The authorities' efforts continued to be aimed at promoting competition, increasing transparency (meaning both investors' ability to understand how agencies arrive at

York AG, CONSUMER BANKR. NEWS, July 3, 2008 (Connecticut AG's antitrust investigation).

⁵⁵ The SEC staff began its examination of the agencies in August 2007 and published its report in July 2008. SEC STAFF EXAMINATION REPORT, *supra* note 38, at 14.

⁵⁶ See References to Ratings of Nationally Recognized Statistical Rating Organizations; Security Ratings; Proposed Rules, 73 Fed. Reg. 40,088, 40,106, 40,124 (proposed July 1, 2008) (to be codified at 17 C.F.R. §§ 240, 242, 249) [hereinafter SEC July 1 Proposal]; Proposed Rules for Nationally Recognized Statistical Rating Organizations; Proposed Rule, 73 Fed. Reg. 36,212 (proposed June 16, 2008) (to be codified at 17 C.F.R. §§ 240, 249b) [hereinafter SEC June 16 Proposal].

⁵⁷ *Senate Turmoil Hearings*, *supra* note 16; *The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs.*, 110th Cong. (2007) [hereinafter *House Structured Finance Hearings*].

⁵⁸ See Aaron Lucchetti, *New Rules Loom for Bond-Rating Firms*, WALL ST. J., July 14, 2008, at C3 (describing bill that would deny regulatory recognition to ratings on innovative products unless the products had received prior SEC approval).

⁵⁹ PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 1 (2008).

⁶⁰ IOSCO CRA REPORT, *supra* note 36, at 29-31 (recommendations adopted as modifications to IOSCO CRA Code of Conduct); FSF Report, *supra* note 37, at 3-4 (recommendations).

ratings and their ability to monitor how ratings perform), and reducing conflicts of interest. The SEC also considered—but did not adopt—rules designed to reduce its use of ratings in its rules. Authorities showed no interest in devising or enhancing remedies providing direct relief for low-quality ratings, focusing instead on measures to improve rating agencies' market incentives and to adjust investors' degree of reliance on agency ratings.

Although regulators now seem marginally more aggressive, policymakers before and during the crisis showed little interest in fundamentally changing the way the credit rating industry works. The SEC was the only U.S. regulator to take action; as detailed below, it adopted in February 2009 a dramatically scaled-back version of a proposal that was limited to begin with. This has led some commenters to dismiss the reform efforts undertaken during the crisis as insignificant.⁶¹ Whether the reforms are in fact insignificant or not, they are radically incomplete, because they all share the incorrect fundamental premise that perfecting the reputation mechanism will lead to optimum rating quality.

III. THE “REPUTATIONAL-CAPITAL” VIEW OF RATING AGENCIES AND ITS RELATIONSHIP TO POLICY

A. The “Reputational-Capital” View of Rating Agencies

Adherents of the “reputational-capital” school of thought—including both scholars and the agencies themselves⁶²—generally believe that the function of rating

⁶¹ See, e.g., Kara Scannell & Aaron Lucchetti, *Credit Crunch: SEC to Seek Added Disclosure on Bond Rating Firms—Proposals Unlikely to Quell Criticism That More Be Done*, WALL ST. J., June 11, 2008, at C2 (“The hodgepodge of proposals so far is merely ‘modifying various practices around the edges,’ said Jerome Fons, an investment consultant and former Moody’s managing director. ‘There’s little interest in real reform.’”).

⁶² See, e.g., *Assessing the Current Oversight and Operation of Credit Rating Agencies: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs.*, 109th Cong. (2006) [hereinafter *Senate CRA Oversight*].

agencies is to make high-quality assessments of issuer creditworthiness available to market participants,⁶³ and that the value of a rating agency's business derives from the agency's reputation for issuing high-quality ratings.⁶⁴ This reputation can be seen as a capital asset that produces returns, hence the term "reputational-capital."

Adherents of the "reputational-capital" model believe that market discipline, in the form of fear of loss of reputation, does (or at least can) provide the right incentives for high-quality ratings.⁶⁵ These scholars unanimously believe that

Hearings], at 12-13 (prepared testimony of Vickie A. Tillman, Executive Vice President, S&P) ("The hallmark of S&P's success in the markets and of our prospects for future success is our reputation for independence and objectivity. Without that reputation, S&P could hardly have achieved its place as one the world's most respected credit rating agencies.").

⁶³ The agency's contribution may arise from some combination of reducing duplication of effort (market participants could duplicate agency results, but it would cost them a lot to do so) or from the fact that the agency is particularly good at assessing creditworthiness, possibly because of access to private information. See IOSCO CRA REPORT, *supra* note 36, at 3 (agency access to private information); Mason & Rosner, *supra* note 25, at 18 ("[T]he lack of liquidity, transparency, history, and available data coupled with unprecedented complexity" has "increased reliance on the CRAs.").

⁶⁴ See Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 961 (1998) ("The value of both debt rating agencies lies in their ability to convince financial purchasers of the validity and accuracy of their ratings."); Gregory Husisian, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 421 (1990) (arguing that rating agencies add value because they "analyze issues less expensively than institutional investors"); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 26 ("Rating agencies are already motivated to provide accurate and efficient ratings because their profitability is directly tied to reputation. Historical data confirm that the reputational motivation is sufficient. Additional regulation of rating agencies thus would impose unnecessary costs and thereby diminish efficiency."); Dittrich, *supra* note 12, at 7 ("The reputation mechanism . . . lies at the heart of the credit rating business model.").

⁶⁵ See Choi, *supra* note 64, at 918; Husisian, *supra* note 64, at 425-27 ("[I]t is not at all apparent that any system of regulation is needed for the

poor performance will be deterred by the prospect of loss of reputation, and accordingly do not believe that liability or other ex post legal remedies are an appropriate adjunct to the reputation mechanism.⁶⁶

B. Perceived Problems of the Rating Market

Observers have identified several aspects of the rating market that arguably cause it to perform worse than it could. These include perceived lack of competition, absence of transparency, conflicts of interest, and rating-dependent regulation.⁶⁷ Opinions on the importance of these deviations

regulation of bond rating agencies” because each agency faces “competitive pressures on several fronts.”); *id.* at 434-39, 445-46.

⁶⁶ See Choi, *supra* note 64, at 918-19 (concluding “gatekeeper liability is too heavy-handed a response to market defects” and recommending “self-tailored liability,” in which intermediaries may specify the type of due diligence procedures to which they are bound, including choosing from among criminal penalties and invoking public enforcement and monitoring); Jacob Fisch, *Rating the Raters: Reflections on Proposals for Regulatory Reform of the Credit Rating Agencies*, 5 U.C. DAVIS BUS. L.J. 3 (2004), available at <http://blj.ucdavis.edu/article.asp?id=549> (“[E]vidence that new organizations have emerged that pressure the market to place appropriate weight on reputational capital again suggests that the market may produce its own best medicine.”); Hill, *supra* note 12, at 45, 89-90; Husisian, *supra* note 64, at 426, 444 (arguing that adoption of a negligence standard for bond ratings is inadvisable because “the market system gives firms the utmost reason to pursue accuracy” because “the bond rating agency sells its reputation along with every rating”); *id.* at 425 (“[C]ontinuing reputation for accuracy” is “the lifeline of the rating agencies’ business.”); Dittrich, *supra* note 12, at 145-46 (“[I]t is difficult to argue for higher rating agency liability [*i.e.*, a higher standard than negligence] It makes more sense to strengthen the reputation mechanism.”).

⁶⁷ The 2006 Act also addressed two sets of issues not directly tied to rating performance: insider trading and tying-like practices. Insider trading is a potential issue because agencies that make their ratings public may use nonpublic information in making their determinations, see Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations; see also Final Rule, 72 Fed. Reg. 33,564, 33,586 (June 18, 2007) [hereinafter SEC 2007 Rule], and enjoy an exemption from Regulation FD, which prohibits the selective dissemination of material nonpublic information. See 17 C.F.R.

vary from the view that they are critically important⁶⁸ to the view that they are not important at all.⁶⁹

These deviations, separately or in combination, could cause the reputation mechanism to perform poorly, and policymakers have been discussing action to address each of them at least since the corporate scandals of 2001-02. The 2006 Credit Rating Agency Reform Act and the SEC's 2007 rules under the Act represent the culmination of this "post-Enron" regulatory effort. A new wave of regulatory proposals, focusing on the same general types of issues, but with an emphasis on a more muscular regulatory approach to structured-product ratings, appeared after the credit crisis began to unfold in summer 2007. With minor exceptions, all the regulatory proposals that have been adopted or that are under consideration are aimed at addressing the discrete problems identified above, and can be seen as undergirded by faith in the reputation mechanism to produce good results if some or all of the problems are corrected.

§ 243.100(a), (b)(2)(iii) (2004). The 2006 Act directs NRSROs to adopt policies and procedures to prevent the misuse of material, nonpublic information. 15 U.S.C. § 78o-7(g) (2008). The 2006 Act directs the SEC to prohibit particular rating practices if it determines that they are coercive, 15 U.S.C. § 78o-7(i), and calls the SEC's attention to three generally tying-like practices, the most controversial of which is "notching": lowering ratings on, or refusing to rate, asset- or mortgage-backed securities unless a portion of the assets in the pool underlying the securities is also rated by the NRSRO. After a contentious debate, the SEC ultimately decided to permit notching absent an "anticompetitive purpose." See SEC 2007 Rule, at 33,623; 17 C.F.R. § 240.17g-6(a)(4).

⁶⁸ For example, Frank Partnoy argues that rating-dependent regulation undermines the fundamental empirical validity of the "reputational-capital" model and proposes an alternative model, the "regulatory license" model, to replace it. See Frank Partnoy, *The Siskel & Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 627-704 (1999).

⁶⁹ The rating agencies argue that the potential conflict of interest created by the "issuer-pays" business model is not a problem at all. *Senate CRA Oversight Hearings*, *supra* note 62, at 10 (prepared testimony of Vickie A. Tillman, Executive Vice President, S&P) (concerns about issuer-pays model are "unfounded" because "[n]umerous studies have found that any potential conflicts of interest attendant to the model either have not materialized or have been effectively managed").

Thus, surveying these discrete issues and the regulatory approaches that have been pursued to address them is a convenient vehicle for reviewing the regulatory initiatives of the last decade and for illustrating their fundamental inadequacy. Because regulatory reform efforts have focused almost exclusively on addressing these issues, regulators by and large have ignored the possibility that reputational constraints on low quality are *fundamentally* insufficient in some situations—such as in rating novel financial products—and that no amount of tinkering will cause the reputation mechanism to work in those circumstances.

1. Limited Competition

The rating-agency business was dominated for decades by two major long-established companies, Moody's and S&P. Since the early 1990s, Fitch, which is also a long-established incumbent but had been a distant third, has increased its market share significantly—in part through acquisitions.⁷⁰ Currently, the three major agencies have a market share that is variously reported at 85%⁷¹ and at more than 99%.⁷²

Although a high degree of market concentration does not automatically establish that the market is noncompetitive, concentration as high as that found in the rating agency market conventionally is seen as strongly suggesting that

⁷⁰ See Richard Tomlinson, *Fitch's CDO Cash Cow*, BLOOMBERG.COM, July 26, 2007, http://www.bloomberg.com/apps/news?pid=20601510&sid=a4360AExMgV8&refer=markets_mag ("Fitch has shot ahead of smaller competitors in the past decade to become the world's third-largest rating firm. Fimalac, the company's owner, has bought up smaller rivals. Fitch, with 16 percent of the global credit rating market, trails S&P, with 40 percent, and Moody's, with 39 percent.").

⁷¹ IOSCO CRA REPORT, *supra* note 36, at 13.

⁷² SEC 2008 NRSRO Report, *supra* note 4, at 35; *see also id.* at 35-36 (reporting Herfindahl-Hirschmann Index [HHI] for all NRSRO ratings outstanding of "3,778, which is the equivalent of . . . 2.65 equally sized firms"). The difference between the SEC and IOSCO estimates presumably reflects different methodologies. The SEC number is based on outstanding ratings (no matter when issued) by SEC-recognized rating agencies. The IOSCO number may reflect a different time frame or set of agencies.

possibility.⁷³ The concern is exacerbated by the “two-rating norm,” the practice of receiving ratings from two different firms on each issue. Arguing that this practice means that the first two rating firms do not have to compete at all, some have described the credit-rating market as effectively a “partner monopoly” shared by Moody’s and S&P.⁷⁴

In the structured-finance segment, all three major agencies apparently have used generally similar models, albeit with some limited agency-specific variation.⁷⁵ If all agencies’ models were indeed of low quality for some products, that would seem inconsistent with one intuitive picture of a highly competitive market, in which vibrantly

⁷³ See, e.g., U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines § 2.0 (1997) (“Other things being equal, market concentration affects the likelihood that one firm, or a small group of firms, could successfully exercise market power.”); *id.* § 1.51 (defining three levels of market concentration, “unconcentrated,” “moderately concentrated,” and “highly concentrated” and defining “highly concentrated” as those where HHI is over 1800—less than half the HHI of the rating market as computed by the SEC).

⁷⁴ See REPORT OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS TO ACCOMPANY S.3850, CREDIT RATING AGENCY REFORM ACT OF 2006, S. REP. NO. 109-326, at 5 (2006); see also Hill, *supra* note 12, at 63 (two-rating norm in many segments causes S&P and Moody’s not to compete in those segments, although they do compete in markets where the two-rating norm is absent).

⁷⁵ See, e.g., Ashcraft & Scheuermann, *supra* note 24, at 37-38, 40-43. The agencies also may have given similar ratings. See Cifuentes Senate Testimony, *supra* note 16, at 8 (independent study to determine whether major-agency ratings are independent is a “much needed exercise”); House Structured Finance Hearings, *supra* note 57, at 117-19 (prepared statement of Joseph Mason) (describing rating-agency failings in terms of a “crisis . . . of financial engineering” without differentiating among agencies, suggesting that agencies used similar allegedly defective methodologies). The same goes for results. See Senate Turmoil Hearings, *supra* note 16, at 3 (statement of Stephen W. Joynt, President & CEO, Fitch, Inc.) (“Like all the major rating agencies, our structured finance ratings have not performed well and have been too volatile.”). Performance comparisons across rating agencies are not easy because the agencies report their data in different ways and because the ratings mean different things, see *infra* Part IV.A. Regulators who have examined the rating agencies have treated rating problems as common to the three major agencies.

different approaches are tested in the crucible of experience with the most viable ones winning out.⁷⁶

Up until recently, there has been a fairly obvious regulatory barrier to entry into the rating market, and reducing that barrier was the principal focus of the 2006 Act. That barrier has been the SEC's process for designating rating agencies "nationally recognized statistical rating organizations" ("NRSROs"). The NRSRO designation arguably is a barrier because only NRSROs can issue ratings that carry official weight under SEC and other agency rules.⁷⁷ Moreover, some users might view the NRSRO designation as the mark of a "real" rating agency. The SEC created the NRSRO category in the 1970s,⁷⁸ and rating agencies became designated as NRSROs by a "no-action letter" process in which the candidate agency would submit an application to the SEC and wait to receive a "no-action letter" indicating that the agency would be treated as an NRSRO. Apparently the criteria for this determination were unclear and decisions were often a long time coming.⁷⁹

⁷⁶ Another effect of the similarity in approaches has been that an "investor who disagrees with the rating agencies[] approach to structural risk rating is often precluded from any investments in an entire asset class." Mason & Rosner, *supra* note 25, at 18.

⁷⁷ See *infra* Part III.B.4.

⁷⁸ The 1975 amendments to the SEC's Net Capital Rule for broker-dealers apparently marked the first appearance of the term "nationally recognized statistical rating organization." See Kettering, *supra* note 16, at 1695; Securities Exchange Act of 1934 Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2008).

⁷⁹ See, e.g., *Examining the Role of Credit Rating Agencies in the Capital Markets: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 109th Cong. 197 (2005) [hereinafter *2005 Senate CRA Hearings*] (statement of Kent Wideman, Executive Vice President, Dominion Bond Rating Service) ("[T]he current practice of designating such agencies through a no-action letter process is unnecessarily cumbersome and insufficiently transparent."); *H.R. 2990*, 109th Cong. (2005); *The Credit Rating Agency Duopoly Relief Act: Hearing Before the H. Comm. on Financial Services*, 109th Cong. 21 (2005) (testimony of Sean Egan, Managing Director, Egan-Jones Rating Co.) ("[T]he current regulators aren't willing to state what the problems are [with unapproved

The regulatory barrier to entry may not have been the cause of high market concentration. There apparently was no significant market entry between the 1920s and the 1970s despite the absence of the NRSRO designation.⁸⁰ After the corporate scandals of the early 2000s, the SEC considered and rejected elimination of the category, apparently because of a belief that rating-dependent regulation could not function without a regulatory process for keeping out “fly-by-night” rating agencies.⁸¹ Congress, however, took aim at the regulatory barrier—already a target of scholars⁸²—in the 2006 Act. The Act established substantively undemanding criteria for registration as an NRSRO and subjected the SEC to a strict timetable for granting NRSRO recognition.⁸³ The SEC adopted rules under these directives in June 2007.⁸⁴

NRSRO applications], why the[] applications haven’t been approved or disapproved, or what even the status of the application is.”).

⁸⁰ JOHN C. COFFEE, JR., *GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE* 294 (2006); Hill, *supra* note 12, at 62-63.

⁸¹ SEC SOX REPORT, *supra* note 50, at 24; Hill, *supra* note 12, at 44.

⁸² See Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, 1152 (2003) (“The obvious place to start [with rating agency reform] is the government-created (or at least government-strengthened) near-duopoly.”); Hill, *supra* note 12, at 44 (“The main problems regulatory change could address are those resulting from market concentration in the rating agency industry.”); *id.* at 45.

⁸³ Applicants for registration must provide “credit ratings performance measurement statistics over short-term, mid-term, and long-term periods,” 15 U.S.C. § 78o-7(a)(1)(B)(i) (2008), describe “the procedures and methodologies that the applicant uses in determining credit ratings,” 15 U.S.C. § 78o-7(a)(1)(B)(ii), and provide certifications from at least ten unaffiliated qualified institutional buyers, with each certification indicating that the buyer has “used the credit ratings of the applicant for at least the 3 years immediately preceding the date of the certification.” 15 U.S.C. §§ 78o-7(a)(1)(C)(i), (a)(1)(C)(iv)(II). The Commission is required to act within ninety days of the application for registration, and is to grant registration or institute proceedings to determine whether registration should be denied. 15 U.S.C. § 78o-7(a)(2)(A). Such proceedings must be concluded within 120 days of the application date unless the SEC extends the deadline for good cause. The extension may not exceed ninety days. 15 U.S.C. §§ 78o-7(a)(2)(B)(i)(II), (a)(2)(B)(iii). Applications that contain the prescribed information are to be granted unless the Commission determines that (a) “the applicant does not have adequate financial and

The SEC's proposed actions in response to the crisis continued the agency's emphasis on increasing competition as the solution to the rating market's ills. In June 2008, the Commission proposed that information provided to an NRSRO in the rating process for structured products be publicly disclosed so that other agencies would have the opportunity to rate the same instrument.⁸⁵ It also proposed to reduce references to the NRSRO status in its rules,⁸⁶ reducing the effect of any remaining barrier to entry, and to require the agencies to disclose more performance information so that investors could more easily determine how well agencies perform.⁸⁷ By January 2009, the SEC had adopted only the last of these proposals (and that only in a sharply limited version requiring disclosure of information about a random sample of 10% of ratings),⁸⁸ underscoring

managerial resources to consistently produce credit ratings with integrity and to materially comply" with the rating procedures it says it follows or (b) the applicant or person controlling the applicant has been convicted of a felony or has been punished for committing certain securities violations. 15 U.S.C. § 78o-7(a)(2)(c)(ii)(II), (d).

⁸⁴ See SEC 2007 Rule, *supra* note 67.

⁸⁵ See SEC June 16 Proposal, *supra* note 56, at 36,251; SEC 2008 NRSRO Report, *supra* note 4, at 41-42.

⁸⁶ See SEC July 1 Proposal, *supra* note 56, at 40,088 ("The Commission believes that today's proposals could reduce undue reliance on credit ratings and result in improvements in the analysis that underlies investment decisions.").

⁸⁷ See SEC June 16 Proposal, *supra* note 56, at 36,251-52; SEC 2008 NRSRO Report, *supra* note 4, at 42.

⁸⁸ See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342, at 102-03, (Feb. 2, 2009), available at <http://www.sec.gov/rules/final/2009/34-59342.pdf> (to be codified at 17 C.F.R. § 240.17g-2(d)) (requiring NRSROs to make and keep available ratings action information for 10% of ratings in each class of credit rating for which it maintains 500 or more ratings paid for by the issuer, underwriter, or sponsor, subject to a six-month lag). The SEC also now requires each NRSRO to furnish an unaudited report of the number of ratings actions it takes in each rating class, *id.* at 104 (to be codified at 17 C.F.R. § 240.17g-3(a)(6)), and to keep (but not publish) a record of all rating actions. *Id.* at 102-03 (to be codified at 17 C.F.R. § 240.17g-2(a)(8)). At the same time as it released its final rule requiring disclosure of 10% of rating actions in each class, the SEC proposed

that significant reforms are politically difficult even when they are consistent with the regulator's preexisting direction.⁸⁹

Regulatory barriers to entry make an easy target for market-oriented reformers, and enhancing competition in an industry is a goal that is easy for policymakers to adopt. Even so, some have argued that competition can *reduce* rating quality given other departures from the ideal in the rating market. Agencies may engage in "competitive laxity," competing to give originators, especially structured-finance arrangers, the high ratings they want. IOSCO has observed that structured-finance arrangers are a concentrated group of major banks that have greater power than traditional issuers. Thus, even if an agency were unwilling to sell out its reputation to benefit a single traditional issuer,⁹⁰ which

requiring disclosure of 100% of actions on issuer-paid ratings with a one-year lag time. See Re-proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59343, at 93 (proposed Feb. 2, 2009). It also re-proposed, in somewhat different form, the rule requiring disclosure of underlying asset pools for structured products. *Id.* at 94-95 (proposing that rating agency maintain a list of asset-backed issues it rates and obtains from sponsors, underwriters, or originator of each such issue a representation that information made available to the agency will be made available to other rating agencies so that they can issue their own ratings). The SEC apparently dropped or tabled the proposal to reduce its reliance on agency ratings in its rules.

⁸⁹ See Kara Scannell & Aaron Lucchetti, *Crisis on Wall Street: SEC Tightens Rules for Ratings Firms*, WALL ST. J., Dec. 4, 2008, at C3 (quoting sources describing SEC's December 3 actions as "baby steps" and asserting that the SEC "is trying to demonstrate action without taking much action"); *Do the SEC's New Rating Agency Rules Have Any Bite?*, KNOWLEDGE@WHARTON, Dec. 10, 2008, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2112> (reporting Financial Economists Roundtable's view that SEC "pulled the teeth that would have made the regulations effective" by omitting provisions reducing regulatory dependence on ratings and failing to require a "margin for error" on structured products).

⁹⁰ IOSCO CRA REPORT, *supra* note 36, at 13 ("By effectively mandating that an issuer seek opinions from a relatively small group of CRAs, . . . investor requirements [for investment-grade ratings] make it difficult for an issuer to pressure a CRA into providing a favorable rating

would likely be one of thousands of corporations, “CRA competition and the lack of transparency typical in structured finance transactions may combine to undermine the integrity of the credit rating process for these products.”⁹¹ Similarly, it has been asserted that new competitors were the guiltiest of “grade inflation,” suggesting that increasing competition may decrease quality, especially in light of the possibility of ratings shopping.⁹² Others have contested this, arguing that conscious rating inflators will be found out and punished—eventually.⁹³

or else risk losing its business or losing access to critical issuer information.”).

⁹¹ IOSCO CRA REPORT, *supra* note 36, at 14 (“Supporting this view are news reports that some CRAs very rapidly lost market share in the market for rating commercial mortgage-backed securities (CMBSs) by requiring more conservative assumptions following instability in the RMBS market.”); *see also* Mason & Rosner, *supra* note 25, at 10 (stating that twelve banks account for over 70% of European structured-finance transactions; in 2005, three law firms accounted for over 60% of the legal work in the French CDO market, and three others accounted for over 50% of volume in the French RMBS market); Johnson, *supra* note 45 (stating that as of June 2008, three underwriters accounted for more than half of defaulted CDOs). Ancillary revenue from advising arrangers about the rating consequences of proposed structures raises related concerns. *See* IOSCO CRA REPORT, *supra* note 36, at 12 (noting it is a “serious question” whether “the current process for rating structured finance involves advice that is, in fact, an ancillary business operation which necessarily presents a conflict of interest”); Mason & Rosner, *supra* note 25, at 19. *Cf.* Kettering, *supra* note 16, at 1680-81 (emphasizing rating-agency initiatives to opine that standard bankruptcy-remoteness measures are effective, because contrary determination imperils all securitization).

⁹² *House Structured Finance Hearings*, *supra* note 57, at 114 (testimony and prepared statement of Joseph R. Mason, Associate Professor, Drexel University).

⁹³ *See Senate CRA Oversight Hearings*, *supra* note 62, at 6-7 (statement of Glenn L. Reynolds, Chief Executive Officer, CreditSights, Inc.) (“That ratings inflation game worked for a while in the commercial paper business in the 1980’s, but the market’s sophistication has now moved far beyond that.”). The commercial-paper example seems fully consistent with the argument of this Article: Even if poor-quality ratings are eventually found out and punished, a strategy of issuing low-quality ratings apparently can be successful for a while. A general appeal to

It is too early to tell whether the competition-enhancing efforts of the past few years are wise in light of other characteristics of the market or whether they are effective in practice. But competition and a well-functioning reputation mechanism go together. The mere existence of many competitors does not guarantee quality unless there is something causing high-quality producers to benefit and low-quality producers to suffer. In the rating market, where quality presumably cannot be determined in advance, quality is rewarded because high-quality producers amass reputational capital. Thus, the official focus on increasing competition can be seen as reflecting faith in the ability of reputation to bring about good results under the right circumstances.

2. Lack of “Transparency”

Regulators were interested in promoting rating-agency transparency before the worldwide credit crisis, and they have become much more interested since the crisis began. The topic incorporates two types of transparency: *methodological* transparency (an outsider’s ability to tell just how the agencies reach the ratings they award) and *performance* transparency (the ability to discern how well the ratings perform). “Transparency,” like “competition,” is a concept for which it is easy to garner political support. Performance transparency, at least, seems clearly important for the reputation mechanism to work, and regulators’ interest in it attests to their faith in the reputational model.

a. Methodological Transparency

The 2006 Act and 2007 rules attempted to address the issue of methodological transparency by requiring NRSROs to make public their registration material, including their rating procedures.⁹⁴ NRSROs also are to update and amend

“market sophistication” seems unconvincing in connection with participants’ apparent lack of understanding of novel structured products.

⁹⁴ 15 U.S.C. § 78o-7(a)(3) (2008). The SEC decided not to require disclosure of rating methodologies, but rather to require disclosure of “a

their registrations to ensure that they remain current.⁹⁵ The rules do not seem to have resulted in an increase in usable information about agency methodologies, as the major agencies' descriptions of their procedures in SEC filings are quite vague.⁹⁶ The SEC's first set of methodological disclosure rules appears to have added little to what was already available. In the area of structured finance specifically, the agencies already made voluminous information about their rating criteria available, and this information seems much more specific and useful than that contained in the SEC filings,⁹⁷ although some commentators have criticized these documents on the ground that they are not specific enough for an outsider to determine exactly how a given security will be rated.⁹⁸

The SEC's 2008 proposed rules contained provisions intended to enhance methodological transparency. The SEC's proposal called for agencies to disclose how frequently credit ratings are reviewed, whether different models or

description of rating procedures and methodologies." SEC 2007 Rule, *supra* note 67, at 33,575. As a result, current rating agency certifications contain a wealth of information on agency committee processes, but little information on how they substantively decide on ratings. *See, e.g.*, SEC STAFF EXAMINATION REPORT, *supra* note 38, at 16; Moody's Investors Service, *Application for Registration as a Nationally Recognized Statistical Rating Organization*, at 10-17 (Mar. 28, 2008).

⁹⁵ 15 U.S.C. § 78o-7(b).

⁹⁶ The SEC apparently agreed to such vague descriptions when it decided to require rating agencies to "describe" their procedures and methodologies rather than actually make the procedures and methodologies themselves available. *See* SEC 2007 Rule, *supra* note 67, at 33,575.

⁹⁷ STANDARD & POOR'S, THE FUNDAMENTALS OF STRUCTURED PRODUCT RATINGS 14 (2007) ("All our structured finance assumptions, criteria, and methodologies are public—none of them is secret."); Ashcraft & Scheuermann, *supra* note 24, at ii, 17.

⁹⁸ *House Structured Finance Hearings*, *supra* note 57, at 18 (testimony of Joseph R. Mason, Associate Professor of Finance, Drexel University) ("While the general statistical methods for NRSRO ratings criteria are disclosed, the NRSRO ratings criteria are not disclosed to a level of replicability. The reason is that the NRSROs do not release the economic assumptions they include in the models.").

criteria are used for reviews as opposed to initial ratings, and whether changes to models are applied retroactively to existing ratings. For structured products, the SEC's proposal called for disclosure of how information about verification performed on the underlying assets, and the quality of the originators of those assets, is incorporated into ratings.⁹⁹ Although these disclosures seem unobjectionable, one might ask why the market has not demanded them from the agencies already.¹⁰⁰ In any event, the SEC did not adopt the disclosure requirements.¹⁰¹

In paying lip service to transparency in all its forms while adopting rules that appear to be of limited effect, the SEC appears to be assuming that greater transparency leads to better investor monitoring of rating agencies and better functioning of the reputation mechanism. But the most important aspect of methodological transparency may be the extent to which it undermines the reputational model. The fact that agencies are willing to give away their models suggests that something is wrong with the "reputational-capital" model. It suggests that the rating agencies' credit-assessment techniques are not valuable, so that ratings derive their value from something other than high quality. The SEC does not seem to have considered this point.

⁹⁹ SEC June 16 Proposal, *supra* note 56, at 36,233-34, 36,251-52.

¹⁰⁰ One area in which methodological transparency does seem desirable is in relationships with structured-product arrangers. In principle, arrangers ought to be able to understand the methodologies in determining how to structure their offerings. Concerns about the fact that agencies and originators engage in a dialogue that allows the originator to optimize the offering with knowledge of the rating outcomes of various structures, *see* SEC 2007 Rule, *supra* note 67, at 33,574, seem misplaced unless coupled with some specific argument that other market defects make the practice undesirable.

¹⁰¹ *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release 34-59342, *supra* note 88, at 102-03 (to be codified at 17 C.F.R. § 240.17g-2(a)(2)(iii)) (requiring NRSROs to keep *private* records of departures from quantitative models when such models are a substantial component of the rating process for a structured-finance transaction).

b. Performance Transparency

The 2006 Act and 2007 rules addressed performance transparency by requiring disclosure of agency performance statistics.¹⁰² Reports on the worldwide credit crisis took the agencies to task for insufficient transparency in this area,¹⁰³ and the SEC staff report recommended that the agencies review their disclosures to ensure that they complied with existing rules.¹⁰⁴ The SEC's 2008 proposed rules contained a number of disclosure provisions intended to improve performance transparency, but only a sharply scaled-back version of one provision was adopted.¹⁰⁵

The major agencies already issue regular performance reports,¹⁰⁶ and the SEC declined to prescribe a standardized

¹⁰² 15 U.S.C. §§ 78o-7(a)(1)(B)(i) (requiring disclosure of "credit ratings performance measurement statistics" in NRSRO application), 78o-7(b)(1)(A) (requiring annual updating of performance information).

¹⁰³ FSF Report, *supra* note 37, at 33 (noting that "currently many CRAs do not publish verifiable and easily comparable historical performance data regarding their ratings," asserting that "[t]he comparability of rating performance would promote competition by allowing customers to better assess the accuracy of the CRAs' past ratings," and recommending that CRAs "disclose past ratings in a more systematic way, and improve the comparability of their track records").

¹⁰⁴ SEC STAFF EXAMINATION REPORT, *supra* note 38, at 15, 17.

¹⁰⁵ Specifically, the SEC's proposed rules would require disclosure of the performance of credit ratings in SEC-defined classes over one-year, three-year, and ten-year periods, including historical ratings transition and default rates within each of the credit rating categories. The rules also would prescribe that the default statistics include defaults relative to the initial rating and incorporate defaults that occur after a credit rating is withdrawn. *See* SEC June 16 Proposal, *supra* note 56, at 36,231-33, 36,251-52. The SEC adopted a rule requiring only that rating agencies disclose information about a random sample of 10% of issuer-paid ratings for classes of instruments for which the agency maintains 500 or more ratings, although it solicited comment on the idea of requiring disclosure of 100% of rating actions. *See supra* note 88.

¹⁰⁶ *See, e.g.*, FITCH RATINGS, FITCH RATINGS 1991-2007 GLOBAL STRUCTURED FINANCE TRANSITION AND DEFAULT STUDY (2008); MOODY'S INVESTORS SERVICE, DEFAULT & LOSS RATES OF STRUCTURED FINANCE SECURITIES: 1993-2007 (2008); MOODY'S INVESTORS SERVICE, THE PERFORMANCE OF STRUCTURED FINANCE RATINGS: FULL-YEAR 2007 REPORT

format for reporting credit rating performance; it appears that the agencies must simply attach their already-public performance reports to an annual certification.¹⁰⁷ It is extremely unclear that this regulatory effort has increased transparency at all, at least for the major agencies that already made performance reports public.

Performance transparency is critical in that reputation cannot function without it. Thus, efforts to promote performance transparency, like efforts to promote methodological transparency, can be seen as ancillary to the reputation mechanism. If investors cannot determine how an agency's ratings have performed, they cannot develop informed views about the quality of those ratings. Indeed, performance transparency is so critical that any need for special disclosure requirements raises the question why the market has not demanded this kind of disclosure already. If a need for regulatory intervention in this area exists, that suggests that there is something very wrong with the idea that a well-functioning reputation mechanism currently governs the rating market. If other interventions, such as promoting competition and reducing rating-dependent regulation, are successful and the reputation mechanism is fundamentally capable of deterring low-quality ratings, then the need for special rules to guarantee transparency ought to be limited. They should be needed only as a transitional measure until other reforms produce their intended effects.

3. Rating-Dependent Regulation

Agency ratings are incorporated into financial regulation¹⁰⁸ and into private contracts and investor

(2008) [hereinafter STRUCTURED FINANCE RATING PERFORMANCE 2007]; STANDARD & POOR'S, STRUCTURED FINANCE RATING TRANSITION AND DEFAULT UPDATE AS OF JULY 18, 2008 (2008); STANDARD & POOR'S, DEFAULT, TRANSITION, AND RECOVERY: 2007 ANNUAL GLOBAL CORPORATE DEFAULT STUDY AND RATING TRANSITIONS (2008).

¹⁰⁷ SEC 2007 Rule, *supra* note 67, at 33,574.

¹⁰⁸ The SEC comprehensively discusses the role of ratings in its own regulatory scheme in connection with its proposal to reduce regulatory reliance on ratings, published in the Federal Register. See SEC July 1

guidelines. This could create a source of demand for ratings that is not tied directly to their quality: An issuer may demand a rating because investors need the rating to fulfill regulatory or other requirements, even if neither party believes that the rating is a high-quality assessment of creditworthiness.¹⁰⁹ If this were a serious problem, fear of loss of reputation would not constrain agencies from issuing low-quality ratings.¹¹⁰

Although academic commentators have been arguing for some time that regulatory reliance on ratings explains how rating agencies can do well even if the quality of their analysis is poor,¹¹¹ the SEC has only recently begun a serious reevaluation of the role of agency ratings. Reducing rating-dependent regulation might well improve rating quality by removing a source of demand for ratings that is not tied

Proposal, *supra* note 56, at 40,089-97. For academic compilations of rating-dependent rules in the United States, see SINCLAIR, *supra* note 10, at 47-49; Partnoy, *supra* note 68, at 686-701; Richard Cantor & Frank Packer, *The Credit Rating Industry*, F.R.B.N.Y. Q. REV., Summer-Fall 1994, at 6 tbl.3.

¹⁰⁹ Indeed, Frank Partnoy proposes a “regulatory license” theory of rating agencies, arguing that rating-dependent regulation is so important that regulation, rather than reputation, is the fundamental source of value of rating agencies’ business. He argues that this explains rating-agency prosperity despite poor quality. See COFFEE, *supra* note 80, at 288-89, 292; Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 509-10 (2001). The major policy recommendation flowing from this view is that rating-dependent regulation should be dismantled. See Partnoy, *supra* note 68, at 704. This view has become increasingly popular during the 2007-09 credit crisis. See, e.g., Statement, Financial Economists Roundtable, Statement on Reforming the Role of the Statistical Ratings Organizations in the Securitization Process 10 (Dec. 1, 2008) (“The FER strongly endorses eliminating from SEC regulations every prescriptive mandate that is or would be based solely on credit ratings set by NRSROs.”).

¹¹⁰ In this scenario, it is possible that fear that ratings would stop being incorporated into financial regulation and private contracts and guidelines would deter rating agencies from low-quality production. Although this might *reduce* any impairment of the reputation mechanism arising from rating-dependent regulation, it seems unlikely to eliminate it.

¹¹¹ See generally Partnoy, *supra* note 68, at 621-22. See Hill, *supra* note 12, for a review of contrary evidence.

directly to quality, but it creates other problems for financial regulation, and, in any event, the effort to reduce dependence is quite modest in scope so far. More fundamentally, efforts to improve rating quality by reducing rating-dependent regulation share the assumption that a well-functioning reputation can in principle produce high quality—an assumption that is highly questionable in the case of novel products.

a. The Scope of Rating-Dependent Regulation

NRSRO ratings have regulatory significance across a broad swath of financial regulation.

i. Federal Rules

The SEC reports that at least forty-four of its rules and forms currently incorporate agency ratings.¹¹² It recently highlighted three of the provisions in particular: (1) Rule 3a-7 under the Investment Company Act, which exempts structured-finance vehicles from the Act¹¹³ as long as the securities that are issued receive one of the four highest ratings from an NRSRO and meet other requirements;¹¹⁴ (2) Rule 15c3-1 under the Securities Exchange Act of 1934, which requires that broker-dealers maintain net capital

¹¹² See Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Statement on Proposal to Increase Investor Protection by Reducing Reliance on Credit Ratings (June 25, 2008).

¹¹³ Such an exemption is important for structured finance arrangers because securitization vehicles arguably meet the technical definition of an "investment company" under the Act. See 15 U.S.C. § 80a-3(a)(1)(A) (2008) (defining "investment company" as "any issuer which—is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities"). At the same time, it seems highly impractical for such vehicles to meet the Act's requirements, which are designed for mutual funds.

¹¹⁴ 17 C.F.R. § 270.3a-7(a)(2) (2008). The SEC recently proposed to change this rule to remove reference to ratings and to exempt structured-finance vehicles that sell only to qualified institutional buyers and accredited investors (as opposed to retail investors). SEC July 1 Proposal, *supra* note 56, at 40,127-28, 40,141.

equal to a fraction of liabilities¹¹⁵ and provides that debt securities, commercial paper, and other instruments count for more toward the net capital requirement if they receive high ratings from NRSROs,¹¹⁶ and (3) Rule 2a-7 under the Investment Company Act of 1940, which limits money-market funds to investments in “Eligible Securities,” a category that includes only securities that have high NRSRO ratings, or “that [are] of comparable quality” to a security meeting the NRSRO-based test.¹¹⁷ Notably, the SEC’s proposed rule changes may not make much practical difference in any of the three areas: The Commission stated that most structured-finance issues do not depend on Rule 3a-7,¹¹⁸ that broker-dealers “that wish to continue to rely on [credit] ratings may do so,”¹¹⁹ and that money-market managers would “still be able to use . . . NRSRO ratings that they conclude are credible.”¹²⁰

¹¹⁵ *Id.* § 240.15c3-1(a)(1).

¹¹⁶ Specifically, the rule provides that a security’s contribution to the broker-dealer’s net capital is its market value less a “haircut.” The haircuts for commercial paper, banker’s acceptances, certificates of deposit, nonconvertible debt securities, and cumulative nonpreferred stock all are smaller if they are rated by an NRSRO in one of the three or four top rating categories. 17 C.F.R. § 240.15c3-1(c)(2).

¹¹⁷ 17 C.F.R. § 270.2a-7(a)(10), (a)(21), (c)(3)(i). The SEC has proposed rules that would remove the reference to credit ratings in the rule and would allow money market fund managers to invest in any assets that the managers determine meet quality and liquidity requirements. SEC July 1 Proposal, *supra* note 56, at 40,125-27, 40,139-40.

¹¹⁸ Apparently, most structured products are sold to non-retail investors already, and products sold to such investors are covered by an existing exemption. SEC July 1 Proposal, *supra* note 56, at 40,127.

¹¹⁹ *Id.* at 40,092.

¹²⁰ *Id.* at 40,126. The SEC’s proposal drew criticism from a leading money market fund manager, which stated that the proposal “is akin to outlawing seat belts with the hope that drivers will be less likely to be injured if a defective belt fails in a crash.” Comment Letter of John J. Brennan, Chairman & CEO, The Vanguard Group, Inc., to Florence E. Harmon, Acting Secretary, U.S. Sec. & Exch. Comm’n, on SEC July 1 Proposal 2 (Aug. 1, 2008).

Agency ratings have been incorporated into the U.S. bank regulatory system since at least 1931.¹²¹ The system apparently will continue to rely on ratings as the United States implements the Basel II banking accord, which keys capital requirements to the riskiness of bank assets. U.S. regulators currently intend to permit banks to choose either to create an internal rating regime (subject to a number of constraints) or to rely on agency ratings to measure asset risk.¹²²

The ERISA framework also incorporates ratings. ERISA fiduciaries direct the investment of assets held by pension and health plans covered by ERISA¹²³ and are therefore a

¹²¹ In 1931, the Office of the Comptroller of the Currency determined that national banks were required to carry bonds that did not receive an investment-grade rating at a discount to cost, while bonds with investment-grade ratings could be carried at cost. These rules were further elaborated through the 1930s. Partnoy, *supra* note 109, at 687-88. The FDIC “prevents insured banks from investing in speculative-grade securities or enforces risk-based capital requirements that use credit ratings to assess risk-weights.” Ashcraft & Scheuermann, *supra* note 24, at 10. Federal savings associations supervised by the Office of Thrift Supervision can hold commercial paper only if the instrument has one of the top two NRSRO ratings and can hold corporate debt securities only if the security has one of the top four ratings. See 12 C.F.R. § 560.40 (2008). A Federal Home Loan Bank that acquires loan pools from members or housing associates must implement a risk-sharing structure that ensures that the acquired assets expose the bank to credit risk “equivalent to” a rating in the top four NRSRO grades, and an NRSRO must confirm in writing that the Bank’s analysis is “comparable to a methodology that the NRSRO would use” in rating the assets in a securitization transaction. See 12 C.F.R. § 955.3(a), (b).

¹²² See Robert F. Hugl, Jason H.P. Kravitt & Carol A. Hitzelberger, *U.S. Adoption of Basel II and the Basel II Securitization Framework*, N.C. BANKING INST., Mar. 2008, at 50-51; see also IOSCO CRA REPORT, *supra* note 36, at 9; COFFEE, *supra* note 80, at 291.

¹²³ Employee Retirement Income Security Act (ERISA) § 3(21)(A), 29 U.S.C. § 1002(21)(A) (2008) (a person is a plan fiduciary “to the extent” he (i) exercises discretionary authority or control over plan management or any authority or control over management or disposition of plan assets, (ii) renders investment advice regarding plan assets for a fee or other compensation or has authority or responsibility to do so, or (iii) has any discretionary authority or responsibility in plan administration).

critical group of investors.¹²⁴ They apparently are limited to securities that receive “investment-grade” ratings from the NRSROs.¹²⁵ Moreover, some commenters have stated that investment banks that are deemed to be ERISA fiduciaries cannot act as sponsors of structured-finance vehicles that issue “equity,” and that getting an investment-grade rating is a way of avoiding the equity label.¹²⁶

ii. State Rules and Judicial Decisions

Many state rules governing investment by public pension funds reportedly require investments in instruments that carry high agency ratings,¹²⁷ as do rules of the Securities Valuation Office of the National Association of Insurance Commissioners, which monitors the financial condition of insurers.¹²⁸ Requirements keyed to credit ratings also appear in state laws governing investment of non-pension public funds,¹²⁹ as well as state banking regulations.¹³⁰

Courts have held that a fiduciary’s reliance on ratings can help establish that the fiduciary acted prudently: “[E]ven

Investment companies are excluded from this definition. ERISA, § 3(21)(B), 29 U.S.C. § 1002(21)(B) (2008).

¹²⁴ According to the Department of Labor, ERISA covers “most voluntarily established pension and health plans in private industry.” U.S. Department of Labor, Employee Retirement Income Security Act—ERISA, <http://www.dol.gov/dol/topic/health-plans/erisa.htm> (last visited Mar. 9, 2009).

¹²⁵ Mason & Rosner, *supra* note 25, at 10 (“The largest market for securitized assets . . . is constrained to invest in only ERISA-eligible securities, i.e., securities rated investment grade by the NRSROs.”).

¹²⁶ See Bethel et al., *supra* note 26, at 14-15. The list of federal uses of credit ratings presented here is nonexclusive. Other federal rules apparently rely on credit ratings as well. See Neil Roland, *SEC Plan to Lessen Credit Raters’ Clout Hemmed in by Other Regulators*, FIN. WK., July 3, 2008.

¹²⁷ Roland, *supra* note 126.

¹²⁸ Partnoy, *supra* note 68, at 700-01 (1999).

¹²⁹ See, e.g., OHIO REV. CODE ANN. § 135.143(A)(6) (West 2008) (public investment in commercial paper).

¹³⁰ See, e.g., OHIO REV. CODE ANN. § 1151.34(B) (West 2008) (S&Ls); § 1161.54(B) (savings banks).

though the ratings of Standard & Poor's and Moody's are not per se determinative of prudence, they are significant factors in . . . deciding whether a particular [investment] should be purchased for plan participants."¹³¹

b. Reform of Rating-Dependent Regulation

Although scholars have been criticizing rating-dependent regulation since at least 1999, policymakers did not take action on this score,¹³² and rating-dependent regulation apparently became even more pervasive in the 2000s.¹³³ In the wake of the crisis, official reports have renewed the call to revisit rating-dependent regulation, especially to the extent that regulations use a high credit rating as a proxy for low volatility and high liquidity.¹³⁴

¹³¹ *Glennie v. Abitibi-Price Corp.*, 912 F. Supp. 993, 1002 (W.D. Mich. 1996); see also COFFEE, *supra* note 80, at 294 (additionally citing *In re Bartol*, 38 A. 527 (Pa. 1897); *In re Detre's Estate*, 117 A. 54 (Pa. 1922)). Although judicial reliance on agency ratings as evidence of compliance with fiduciary obligations arguably is not "rating-dependent regulation," it functions similarly: Courts tend to rely on previous decisions about what kind of evidence is probative, and federal reliance in the ERISA context presumably makes it even harder to challenge ratings reliance. Judicial reliance, once established, is "sticky" and difficult for a court to abandon even if rating quality is poor.

¹³² See, e.g., SEC SOX REPORT, *supra* note 50, at 6-8, 28-29, 43-45 (reviewing regulatory use of credit ratings and declining to include rating-dependent regulation in list of areas for continued inquiry).

¹³³ For example, when the Basel Committee on Banking Supervision, a committee of bank supervisory authorities for the G-10 countries, adopted revisions to international standards for bank risk management, it incorporated agency ratings ("external credit assessments") into its approach. See BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS 19 ¶ 50 (2006) ("The Committee permits banks a choice between two broad methodologies for calculating their capital requirements for credit risk. One alternative, the Standardised Approach, will be to measure credit risk in a standardised manner, supported by external credit assessments.").

¹³⁴ IOSCO CRA REPORT, *supra* note 36, at 3 ("[R]egulators may need to revisit policies that equate low default risk with low volatility and liquidity risk"); see also *id.* (questioning these policies, which "encourage some market participants to rely entirely on credit ratings in

The SEC introduced a proposal in summer 2008 to reduce, but not eliminate, its reliance on ratings.¹³⁵ The SEC cited the possibility that rating-dependent regulation poses “a risk that investors interpret the use of the term [NRSRO] as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to place undue reliance on the credit ratings issued by these entities.”¹³⁶ As of February 2009, the status of that proposal is unclear: Although the SEC had adopted some of its summer 2008 proposals and re-proposed others in modified form, it had not taken any action on the proposal to reduce its reliance on agency ratings.¹³⁷

Despite the concerns that have been expressed about rating-dependent regulation, it may be the least bad approach to a fundamental problem of financial regulation. Institutions such as commercial and investment banks, broker-dealers, and insurance companies are subject to “net capital” regulation intended to ensure that they can meet their obligations to depositors, clients, and insured parties. Given that these organizations all invest in fixed-income

place of . . . conducting a thorough and separate risk assessment themselves”).

¹³⁵ See SEC July 1 Proposal, *supra* note 56, at 40,089 (proposing to amend rating-dependent rules because they may “encourage undue reliance” on ratings but declining to propose amendments to “a small number of forms and rules . . . where we believe it is important to retain the reference to NRSRO ratings”); see also Christopher Cox, Chairman, U.S. Sec. & Exch. Comm’n, Statement on Proposal to Increase Investor Protection by Reducing Reliance on Credit Ratings (June 25, 2008) (commenting that proposal will eliminate eleven of forty-four references to credit ratings in SEC rules and forms, will “substitut[e] . . . a standard based on a more clearly stated regulatory purpose or other concept” in twenty-seven cases, and will leave the reference unchanged in six cases).

¹³⁶ See SEC July 1 Proposal, *supra* note 56, at 40,125.

¹³⁷ See Scannell & Lucchetti, *supra* note 89 (“The SEC put off more controversial changes . . . that would reduce agency rules’ reliance on the use of credit ratings for such things as investments by money-market mutual funds.”).

securities, the regulator needs some way of determining the credit risk of the regulated entity's investment.¹³⁸

There are several possible ways of doing this, none of which is perfect. First, the regulator may attempt to determine credit risk itself. This is problematic because it could require a massive commitment of regulatory resources—for example, Standard & Poor's maintains around 1.25 million ratings.¹³⁹ Second, the regulator can rely on the regulated party to rate the instruments and can confine itself to judging the adequacy of the regulated party's internal rating system. Although the Basel II approach to banking regulation contemplates this as an option for sophisticated banks, the approach seems open to conflicts of interest unless regulators are prepared to spend significant resources monitoring the development and implementation of the internal rating systems. Third, the regulator could rely on market assessments of credit risk, or "credit spreads"—in effect, on the prices at which the instruments are trading.¹⁴⁰ This approach is problematic because market prices may not be available, especially in periods of market stress, and because market prices reflect factors other than default probability and loss given default, such as risk aversion. The regulator may wish to incorporate a "pure" measure of credit risk into its rules.

Finally, the regulator can rely on assessment of credit risk by an independent third party such as a rating agency. Although that approach may induce overreliance on agency ratings, it may be the least bad alternative.¹⁴¹

¹³⁸ See John Patrick Hunt, *One Cheer for Credit Rating Agencies: How the Mark-to-Market Accounting Debate Highlights the Case for Rating—Dependent Capital Regulation*, 60 S.C. L. REV. (forthcoming 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1331633.

¹³⁹ SEC 2008 NRSRO Report, *supra* note 4, at 35.

¹⁴⁰ This is the approach suggested by Partnoy in his seminal article, *The Siskel and Ebert of Financial Markets?*, see *supra* note 68.

¹⁴¹ Even so, the SEC is to be commended for reconsidering its use of credit ratings as proxies for qualities other than creditworthiness, such as liquidity and price stability. It should continue (or resume) consideration of this alternative.

In any event, rating-dependent regulation does not face imminent demise. The SEC's proposal, as explained, only reduces and does not eliminate reliance on credit ratings. To the best of the author's knowledge, no other authority that uses rating-dependent regulation has introduced an analogous proposal.

Moreover, ratings are hard-wired into the financial infrastructure because they are important in *private* arrangements, not just in regulation. Covenants for actively managed CDOs establish minimum weighted average rating requirements and limit the fraction of securities with a low rating in the vehicle's portfolio.¹⁴² Ratings are frequently used by investors other than ERISA fiduciaries as investment guidelines.¹⁴³ Moreover, many other private contracts, including bond indentures, contain "rating triggers," under which a rating downgrade below a particular level is a technical default. At least for the medium term, it seems most unlikely that these uses of credit ratings will wither away. Credit ratings will continue to have value derived from a source other than the quality of their assessment of credit risk.¹⁴⁴ This means both that the quality of credit ratings is likely to remain a critically important issue, and that market incentives to produce high-quality ratings may continue to be blunted.

Regardless of its prospects for making a major difference in rating quality, the SEC's initiative to reduce regulatory dependence on ratings reflects an effort to improve the reputation mechanism by reducing a non-quality-dependent source of demand for ratings.

¹⁴² Ashcraft & Scheuermann, *supra* note 24, at 10.

¹⁴³ Hill, *supra* note 12, at 53 ("Certain types of investors are required to invest all or some proportion of their funds in investment-grade debt.").

¹⁴⁴ See Partnoy, *supra* note 68, at 681-82. A 1973 article made the fundamental point underlying the argument: "[T]he evidence would seem to support the hypothesis that the primary reason for the nexus between ratings and yields is the use of the former as a tool of financial regulation." Richard R. West, *Bond Ratings, Bond Yields, and Financial Regulation: Some Findings*, 16 J.L. & ECON. 159, 168 (1973). If ratings affect yields (cost of capital to issuers) because of regulation, then regulation provides ratings with some value to issuers.

4. Conflicts of Interest

Rating agencies face a number of potential conflicts of interest, the most obvious of which arises at the firm level and comes from the fact that the agencies are paid by the issuers or originators of the products they are rating.¹⁴⁵ Rating agencies and others argue that this is not a problem with respect to traditional instruments because the rating agencies have far more to lose by imperiling their reputation for objectivity than they have to gain by pleasing any single client. As explained above, this argument has less force for structured-finance products, where the market is dominated by just a few participants that arrange issues.¹⁴⁶

Other areas of conflict arise at the level of the individual person and come from the fact that rating agency analysts may wish to move to more lucrative jobs—for example at investment banks that arrange structured products—and from the fact that rating agency executives are compensated in part with stock options.¹⁴⁷ Option-based compensation

¹⁴⁵ Moody's Corp., *supra* note 1, at 3 ("Rating fees paid by debt issuers account for most of the revenue of Moody's Investors Service."); *Senate CRA Oversight Hearings*, *supra* note 62, at 10 (prepared testimony of Vickie A. Tillman, Executive Vice President, S&P) ("The market has accepted the long-standing, global practices of S&P and others to charge issuers or the[ir] agents rating fees."). Commentators often suggest that major rating agencies made the transition from a subscriber-pays to an issuer-pays model to address a free-rider problem created by the spread of photocopying technology in the 1970s. *See, e.g.*, Lawrence White, *An Industrial Organization Analysis of Rating Agencies*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 41, 47 (Richard Levich et al. eds., 2002). One skeptic of this view points out that other information providers did not change their fee structure at that time and argues that the growth of the mutual fund industry explains the shift. *See* Dittrich, *supra* note 12, at 19.

¹⁴⁶ *See supra* note 91 and accompanying text.

¹⁴⁷ *See, e.g.*, Moody's Corp., Proxy Statement, at 20 (Mar. 19, 2008) (2007 equity compensation for Moody's key officers was 55-70% in the form of equity); *id.* at 24 (equity compensation for 2007 was 50% restricted stock and 50% equity options).

may encourage rating-agency executives to engage in short-term thinking and excessive risk-taking.¹⁴⁸

The 2006 Act directed the SEC to adopt rules addressing agency conflicts of interest,¹⁴⁹ and the Commission did so in this area in 2007.¹⁵⁰ Its rules were quite modest. Rating agencies simply must disclose that they are paid by issuers and disclose their procedures for managing this conflict,¹⁵¹ the SEC does not engage or plan to engage in any substantive review of these procedures. The SEC staff's report on its 2007-2008 examination of the agencies raised questions about whether the agencies' procedures were adequate and suggested that the agencies review them.¹⁵² The SEC proposed further rules in this vein, with emphasis on structured products, in June 2008¹⁵³ and adopted them with modifications in February 2009.¹⁵⁴ Most of these rules cover the relationship between individual analysts and issuers.¹⁵⁵ They do not even seem relevant to the potential

¹⁴⁸ See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 154 (2004) (noting that option-based executive compensation may encourage excessive risk-taking but that this may simply counter other forces causing managers to be risk-averse).

¹⁴⁹ 15 U.S.C. § 78o-7(h)(2) (2008).

¹⁵⁰ SEC 2007 Rule, *supra* note 67, at 33,593-605, 33,622-23; 17 C.F.R. § 240.17g-5 (2008).

¹⁵¹ The 2007 Rule requires that NRSROs "maintain[] and enforc[e] procedures" to "address and manage" the issuer-pays conflict and disclose these procedures, 17 C.F.R. § 240.17g-5(a)(2), but prohibits very little: NRSROs may not issue credit ratings "solicited by" an issuer that is responsible for 10% of the NRSRO's total net revenue, 17 C.F.R. § 240.17g-5(c)(1); 15 U.S.C. § 78c(a)(63) (2008), and may not maintain ratings on company that it controls or is controlled by, 17 C.F.R. § 240.17g-5(c)(3). Individual credit analysts may not own stock in or serve as officers and directors of the entities they rate. 17 C.F.R. § 240.17g-5(c)(2), (4).

¹⁵² SEC STAFF EXAMINATION REPORT, *supra* note 38, at 25-27.

¹⁵³ SEC June 16 Proposal, *supra* note 56, at 36,218-28, 36,251.

¹⁵⁴ See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release 34-59342, *supra* note 88, at 105-06 (to be codified at 17 C.F.R. § 240.17g5(c)(5)-(7)).

¹⁵⁵ The new rules prohibit persons involved with the rating process from negotiating fees with issuers or receiving gifts in excess of \$25 from

problem, which is that the agency as a whole has an incentive to inflate ratings for every issuer. The agencies, facing regulatory pressure,¹⁵⁶ have made changes intended to address this concern.¹⁵⁷

The SEC's rules seem to reflect the view that no serious regulatory intervention is needed to deal with agency conflicts of interest.¹⁵⁸ Although the Commission has the power to ban agency conflicts of interest generally,¹⁵⁹ and

issuers. *Id.* They also prohibit NRSROs from making "recommendations" to issuers or arrangers "about the corporate legal structure, assets, liabilities, or activities" of obligors or issuers. *Id.* The major agencies assert that they already refrain from such recommendations, so the practical effect of this rule seems limited. The rule requiring disclosure of rating performance information for a random sample of 10% of issuer-paid ratings, discussed above, does reflect some concern about the issuer-pays problem, along with continued conviction that the market's reputation mechanism can solve this problem. *See supra* note 88 and accompanying text.

¹⁵⁶ Moody's Corp., *supra* note 1, at 3 (Moody's reorganized in 2007 to separate the ratings and non-ratings portions of its business in anticipation of potential regulatory changes).

¹⁵⁷ *Senate Turmoil Hearings*, *supra* note 16, at 9-10 (prepared testimony of Claire Robinson, Senior Managing Director, Moody's Investors Service) (summarizing Moody's initiatives, including formalizing separation of ratings-related and non-ratings-related businesses, codifying analyst-issuer communication policies, and re-reviewing the work of Moody's analysts who are hired away by financial intermediaries representing issuers); *Senate Turmoil Hearings*, *supra* note 16, at 2-6 (prepared testimony of Vickie A. Tillman, Executive Vice President, S&P) (describing similar initiatives at S&P).

¹⁵⁸ The State of New York, following a tradition of sometimes greater aggression than the SEC in addressing perceived systemic problems in finance, announced a settlement with the three major rating agencies apparently intended to address conflicts of interest. The settlement provides that a rating agency would be paid some more-than-nominal amount to review a proposed structured finance issue backed by subprime or Alt-A mortgages, even if it did not ultimately issue a rating. Aaron Lucchetti, *Bond-Rating Shifts Loom in Settlement*, WALL ST. J., June 4, 2008, at C1. The settlement agreement also requires the firms to "disclose on a quarterly basis the fees they are paid for nonprime-mortgage-backed securities." *Id.*

¹⁵⁹ *See* 15 U.S.C. § 78o-7(h)(2) (2008) (SEC to "prohibit" or "require the disclosure and management" of NRSRO conflicts of interest).

although it recognizes that the issuer-pays model does in fact present such a conflict,¹⁶⁰ the SEC apparently has not even considered banning the practice. The SEC has not explained its decision, but the rating agencies have argued that the issuer-pays model “promotes the wide and free dissemination of information to the market quickly” and consequently promotes market scrutiny of agency ratings.¹⁶¹

The SEC’s light-handed approach suggests that the Commission believes in the power of reputation. After all, in a competitive, transparent market where agencies make money because investors value ratings’ informational content, there may be no need for intrusive conduct regulations such as substantive regulatory review of internal procedures. According to the reputational model, rating agencies that inflate ratings to please issuers will—eventually—lose investor trust and fail.

IV. RATING AGENCY REPUTATION IS NOT LIKELY TO CONSTRAIN LOW-QUALITY RATING OF NOVEL PRODUCTS

This Part argues that even a well-functioning reputation mechanism is unlikely to constrain rating agencies from issuing ratings on novel securities they do not know how to

¹⁶⁰ 17 C.F.R. § 240.17g-(5)(b)(1)-(3); *see also* 2008 SEC NRSRO REPORT, *supra* note 4, at 41 (“NRSROs that are compensated by subscribers appear less likely to be susceptible to ‘ratings shopping’ or reducing quality for initial ratings to induce revenues . . .”).

¹⁶¹ *See Senate CRA Oversight Hearings, supra* note 62, at 10-11 (prepared testimony of Vickie A. Tillman, Executive Vice President, S&P). It seems questionable, to say the least, whether the benefits of making ratings available to end users who are not willing to pay for them outweigh the cost of embedding a fundamental conflict of interest in the system. In a forthcoming article, Jeffrey Manns argues that a user-fee system could preserve the public availability of ratings while resolving the issuer-pays conflict. Jeffrey David Manns, *Rating Risk After the Subprime Mortgage Crisis*, N.C. L. REV. (forthcoming 2009) (manuscript at 47-56), available at <http://ssrn.com/abstract=1199622>. The user-fee idea is an interesting candidate for resolving the competing concerns presented, although it seems to have the drawback of insulating agencies from market discipline.

rate. It follows that reputation did not constrain rating agencies from issuing low-quality ratings on novel products in the past, does not do so in the present, and is unlikely to do so in the future, even if the reputation-enhancing mechanisms under consideration are successful. There is a problem in the rating market that does not arise from any of the specific deficiencies that have been identified and that will persist even if remedies under consideration are successful at combating the specific deficiencies at which they are aimed.

This Part first defines rating quality, then presents a simple, general setting in which reputation is valuable but in which rating agencies will not be deterred from issuing low-quality ratings on novel products. It then defends key features of the simple setting.

A. Defining Rating Quality

The idea that reputation guarantees quality depends on the agencies' ability to cultivate a reputation for high-quality ratings, so this section begins by defining what "quality" is in the rating context. I employ the definitions of "quality" that the rating agencies themselves have adopted. Because investors use ratings for purposes beyond those for which the agencies say they are designed,¹⁶² and tort-law precedent would suggest that the purpose for which a product is actually used should define the scope of the producer's responsibility,¹⁶³ using the agencies' definition of rating quality is a conservative approach. If the agencies do a poor job according to their own measures, it is unlikely that they do better according to other measures.

¹⁶² STRUCTURED FINANCE RATING PERFORMANCE 2007, *supra* note 106, at 4 ("[A]lthough relative rating accuracy is our primary objective, Moody's recognizes that many investors are also concerned with the cardinal accuracy of the rating system."); *id.* (Moody's tracks cardinal-accuracy measures including investment-grade loss rates and average rating during thirty-six months before default).

¹⁶³ See, e.g., RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2(b) (1998) (product design defect assessed relative to "foreseeable risks of harm posed by the product").

1. Agencies Describe Ratings as Based on Credit Risk, Not Other Characteristics

Rating agencies describe their ratings as intended to reflect only credit risk¹⁶⁴ and not risks arising from other factors, such as liquidity.¹⁶⁵ Credit risk is conventionally thought of as having two components: probability of default (“PD”) and expected loss in the event of default (“loss given default” or “LGD”).¹⁶⁶ Ratings combine PD and LGD in different ways across product types and from agency to agency. Apparently, Moody’s ratings on traditional products are intended to reflect PD and not LGD,¹⁶⁷ while its ratings on structured finance products reflect both PD and LGD.¹⁶⁸

¹⁶⁴ Rating agencies apparently try to maintain rating stability, which may make them more reluctant to downgrade or upgrade ratings. This appears to be a consideration that competes with purely measuring credit risk, although a bias toward stability may make sense in that ratings’ regulatory role makes rating volatility costly (because securities effectively become available or unavailable to certain investors based on their ratings). See FITCH RATINGS, *INSIDE THE RATINGS: WHAT CREDIT RATINGS MEAN* 4 (Aug. 2007) (“Fitch’s traditional credit ratings are designed as ‘through-the-cycle assessments Pro-cyclical ratings . . . would reduce the ability of ratings to communicate relative changes in creditworthiness between two issuers, above and beyond cyclical developments affecting all issuers.”); *id.* at 6 (asserting that similar considerations apply to structured finance).

¹⁶⁵ SEC 2008 NRSRO Report, *supra* note 4, at 37.

¹⁶⁶ One can think of credit risk simply as expected loss resulting from default risk: the product of probability of default and expected loss on default. This is in some respects oversimplified because different investors will have different preferences (one investor may prefer a small probability of a large loss and another will prefer a large probability of a small loss). Moreover, other characteristics of the loss-given-default distribution other than its expected value (mean) may be important. However, the common, expected loss formulation will be used here.

¹⁶⁷ MOODY’S INVESTORS SERVICE, *MOODY’S RATING SYMBOLS AND DEFINITIONS* 8 (June 2008) (long-term corporate obligation ratings “address the possibility that a financial obligation will not be honored as promised”).

¹⁶⁸ *Id.* at 12 (explaining that structured finance long-term ratings “primarily address the expected credit loss an investor might incur on or before the legal final maturity of such obligations vis-à-vis a defined

Fitch's ratings apparently are just the opposite: traditional-product ratings reflect PD and LGD,¹⁶⁹ while structured-finance ratings reflect PD only.¹⁷⁰ It appears that S&P's ratings reflect PD only in both cases.¹⁷¹

Although credit risk is an important part of an investor's decision whether to buy a fixed-income security, it is not the only consideration. Other key elements include the security's market price and the investor's risk preferences.¹⁷² Major-agency ratings do not take these considerations into account,¹⁷³ and, accordingly, the agencies stress that their ratings are not recommendations to buy or not to buy particular securities.¹⁷⁴ Such assertions are not total disclaimers of responsibility for investor reliance on the quality of ratings as assessments of credit risk, and agencies are not in a position to make such disclaimers. To the extent their business depends on a reputation for high-quality ratings—as they claim¹⁷⁵—it would make little sense for the

promise. As such, these ratings incorporate Moody's assessment of the default probability and loss severity of the obligations.”).

¹⁶⁹ FITCH RATINGS, *supra* note 164, at 2 (ratings for corporate and sovereign issues incorporate both probability of default and loss on default); FITCH RATINGS, FITCH RATINGS DEFINITIONS (2008), *available at* <http://www.fitchratings.com> (an issue may have a higher or lower rating than its issuer “to reflect relative differences in recovery expectations”).

¹⁷⁰ FITCH RATINGS, *supra* note 164, at 2 (“Ratings in structured finance primarily reflect the relative probability of default of the rated liability, and not its loss severity given a default, although loss severity on underlying *assets* is incorporated in the analysis.”).

¹⁷¹ STANDARD & POOR'S, STANDARD & POOR'S RATINGS DEFINITIONS (2008), *available at* <http://www2.standardandpoors.com> (issue rating “evaluates the obligor's capacity and willingness to meet its financial commitments as they come due”).

¹⁷² For a list of additional potential considerations, see STANDARD & POOR'S, THE FUNDAMENTALS OF STRUCTURED FINANCE RATINGS 6-7 (2007)

¹⁷³ IOSCO CRA REPORT, *supra* note 36, at 4 (“[T]he opinions of [credit rating agencies] relate solely to the likelihood that a given debt security will perform according to its terms”); COFFEE, *supra* note 80, at 292 (ratings concentrate almost exclusively on default risk).

¹⁷⁴ See STANDARD & POOR'S, *supra* note 171.

¹⁷⁵ See, e.g., *Senate Turmoil Hearings*, *supra* note 16, at 48 (prepared testimony of Vickie A. Tillman, Executive Vice President, S&P)

agencies to tell investors that their evaluations of credit risk are unreliable.

2. Ratings Are Described Primarily as Ordinal, Not Cardinal, Assessments of Risk

The agencies stress that their ratings are—at least primarily—“ordinal,” rather than “cardinal.”¹⁷⁶ In other words, highly rated instruments are supposed to default less frequently than lower-rated instruments, but a given rating is not supposed to reflect any specific probability of default or level of expected loss.¹⁷⁷ Agencies explain this by noting that overall default rates and losses—and thus defaults and losses within each rating class—are determined to some extent by economic cycles and not by the differences in the issue or issuer credit quality that ratings are intended to assess.¹⁷⁸ Perhaps recognizing that the ordinal-default argument is not a terribly compelling value proposition, the agencies also make claims about their absolute performance,

(responding to question about consequences of poor-quality ratings: “I mean, our reputation is everything. The market evaluates us every day.”); *Senate CRA Oversight Hearings, supra* note 62, at 12 (prepared testimony of Vickie A. Tillman) (“The hallmark of S&P’s success in the market and of our prospects for future success is our reputation for independence and objectivity. Without that reputation, S&P could hardly have achieved its place as one of the world’s most respected credit rating agencies and we have every incentive to preserve it.”).

¹⁷⁶ MOODY’S RATING SYSTEM, *supra* note 11 (“Moody’s credit ratings represent a rank-ordering of creditworthiness, or expected loss While a credit rating summarizes the credit risk characteristics of an obligor or obligation, it is not a statement as to which obligors or obligations will default in the future. Rather, it is expected that lower rated entities and obligations will default, on average, at a higher frequency than more highly rated entities and obligations.”); MOODY’S INVESTORS SERVICE, *supra* note 167, at 8 (long-term corporate obligation ratings “are opinions of the relative credit risk of fixed-income obligations with an original maturity of one year or more” (emphasis added)).

¹⁷⁷ STANDARD & POOR’S, *supra* note 172, at 9 (“The definitions of each rating category also make clear that we do not attach any quantified estimate of default probability to any rating category.”).

¹⁷⁸ FITCH RATINGS, *supra* note 164, at 1.

asserting that highly rated (“investment grade”) bonds rarely default.¹⁷⁹

3. Ratings Are Described as Consistent Between Traditional and Novel Instruments

Rating agencies assert that their ratings are intended to be consistent across types of instruments, so that the AAA/Aaa rating for a traditional corporate bond should mean approximately the same thing as the AAA/Aaa rating for a structured-finance instrument.¹⁸⁰ As Standard & Poor’s puts it,

If an asset manager buys 10,000 ‘A’ rated bank bonds and 10,000 ‘A’ rated commercial mortgage-backed securities (CMBS), are we really claiming that, after 10 years, the number of defaults on both portfolios will be exactly the same? Of course not. However, we believe there is a good chance that their average long-term default experience through the economic cycle will be broadly similar.¹⁸¹

¹⁷⁹ STANDARD & POOR’S, *supra* note 172, at 10; MOODY’S RATING SYSTEM, *supra* note 11; STRUCTURED FINANCE RATING PERFORMANCE 2007, *supra* note 106, at 4 (“[W]e regularly track investment-grade loss rates and the average rating of securities during the 36 months prior to impairment. Both of these measures should be low if the rating system is accurate in a cardinal sense.”).

¹⁸⁰ FITCH RATINGS, *supra* note 162, at 8 (“It is Fitch’s aim that creditworthiness should be broadly comparable by category across all major sectors of debt (with the exception of US Public or Municipal Finance . . .).”); STANDARD & POOR’S, *supra* note 172, at 10 (“Do ratings have the same meaning across sectors and asset classes? The simple answer is ‘yes.’”); MOODY’S INVESTORS SERVICE, STRUCTURED FINANCE LONG-TERM RATINGS (2008) (structured finance ratings “are calibrated to the Moody’s Corporate Scale”). Ratings for municipal bonds have been an important exception; an “A” rating for a municipal bond has corresponded to a much lower default risk than an “A” rating for a corporate bond.

¹⁸¹ STANDARD & POOR’S, *supra* note 172, at 10; *see also* MOODY’S INVESTORS SERVICE, REQUEST FOR COMMENT: SHOULD MOODY’S CONSIDER DIFFERENTIATING STRUCTURED FINANCE AND CORPORATE RATINGS? 2 (Feb. 2008) (“Our role in the structured finance market is fundamentally the same as the role Moody’s has played over the last hundred years in the

Agencies would be expected to say this—mapping the risk of novel products to the traditional rating scale has been crucial to the growth of structured product markets and thus of the rating agencies' business.

Ratings on novel financial products have, however, behaved differently from corporate bond ratings during the credit crisis, with multi-notch downgrades far more common among structured-finance issues. This divergence in behavior has led to questions about the validity of using the same rating scale for traditional and structured products.¹⁸² Indeed, the SEC proposed that agencies be required to use a special modifier to denote structured-finance ratings.¹⁸³ The agencies predictably opposed that proposal,¹⁸⁴ and it has not been adopted to date.¹⁸⁵

corporate bond markets. Moody's rating processes are very similar in the two sectors and, across a range of aggregate measures, our ratings performance reveals a high degree of consistency between structured finance and corporate ratings.”)

¹⁸² See Lucchetti & Scannell, *supra* note 47 (reporting criticisms of CPDO ratings on the ground that CPDO values depend heavily on market perceptions of risk, as opposed to fundamental creditworthiness). One agency explains the difference in performance by stating that while corporate managers can respond flexibly to adverse events, structured products typically are based on fixed pools of assets, have less flexibility, and thus are more subject to large swings in creditworthiness. FITCH RATINGS, *supra* note 164, at 8.

¹⁸³ SEC June 16 Proposal, *supra* note 56, at 36,235-36 (proposing use of separate symbol for structured-finance ratings, or, in the alternative, distribution of a report with every structured-finance rating describing the methodological difference between structured-finance and other instruments).

¹⁸⁴ See Comments of Standard & Poor's on SEC Release No. 34-57967 at 29-30 (July 24, 2008) (opposing special-symbol requirement on legal and cost-benefit grounds); Comments of Fitch Ratings on SEC Release No. 34-57967 at 10 (July 25, 2008) (“[W]e do not believe that a different symbol for structured finance ratings makes sense.”); Comments of Realpoint LLC on SEC Release No. 34-57967 at 1 (July 14, 2008) (special reports or symbols will not benefit investors and will dissuade investors from investing in structured products).

¹⁸⁵ See Scannell & Lucchetti, *supra* note 879.

4. “Opinions,” But Not Untestable Assertions

Although the rating agencies assert that their views are “opinions,” they acknowledge—as they must—that the opinions they offer are not mere unprovable assertions like “dogs are better than cats.” Instead, agencies describe their ratings as opinions about “the likelihood of future events” and as “[f]orward-looking predictions.”¹⁸⁶ They assert that “history has shown our opinions to be very good predictors of default risk.”¹⁸⁷

5. A Basis for Measuring Rating Quality

Thus, although rating agencies understandably try to minimize the types of claims about their ratings for which they may be held responsible¹⁸⁸—for example by asserting that their ratings are not recommendations to purchase or sell securities¹⁸⁹—they do make concrete assertions about what ratings are supposed to do: Ratings provide an ordinal rating of some mixture of probability of default and loss given default that should be broadly comparable across asset classes.

That explanation—which seems to be the minimum one could ask for from credit ratings—provides a potential basis

¹⁸⁶ STANDARD & POOR’S, *supra* note 172, at 9.

¹⁸⁷ *Id.* at 10.

¹⁸⁸ *See, e.g., id.* at 8 (“Let’s not forget that ratings are not guarantees. The rating agencies possess no crystal ball and no time machine.”).

¹⁸⁹ FITCH RATINGS, *supra* note 164, at 10 (“[R]atings are not a recommendation or suggestion, directly or indirectly, to buy, sell, make, or hold” the rated securities.). The agencies’ potentially litigation-driven assertions about the limitations on what their ratings are intended to accomplish might be disregarded by a court or regulator. For example, in the context of defective-product liability, a manufacturer is responsible for known uses of the product, not just authorized uses. *See supra* note 163. Given the agencies’ knowledge that investors use ratings to sort between “good” and “bad” investments and as cardinal measures of default likelihood, *see* STRUCTURED FINANCE RATING PERFORMANCE 2007, *supra* note 106, at 4, it may make sense to go beyond the ordinal quality standard agencies embrace and impose quality standards keyed to these factors.

for measuring the quality of the ratings, and rating agencies assert that they do accomplish their stated goals with high quality.¹⁹⁰ The assertions about the probability of future events that credit ratings embody can be evaluated on an ex post basis based on the performance of the rated instruments over time.

Although some assert that it is impossible to monitor quality because it is impossible to tell even after the fact whether rating agencies performed poorly, or just experienced bad luck,¹⁹¹ that contention is inconsistent with any argument that reputation guarantees high quality. A reputation for quality presumes that market participants are able to engage in ex post monitoring of product quality. If customers can never determine whether goods or services are of high quality or not, there can be no meaningful “reputation” for high-quality production. Thus, if reputation plays a role in rating-agency markets as agencies and many observers assert, it is possible to monitor quality.

B. Reputation Is Unlikely to Guarantee High-Quality Ratings on Novel Products

Adherents of the “reputational-capital” model apparently believe that in a well-functioning market rating agencies will not knowingly issue low-quality ratings because of fear of loss of reputation. As discussed, this assumption seems to have undergirded reform efforts since 2001, both before and during the credit crisis. But even a well-functioning reputation mechanism is unlikely to deter low-quality ratings on novel products. To show this, I first describe a simple setting free of the problems policymakers are

¹⁹⁰ See, e.g., *House Structured Finance Hearings*, *supra* note 57, at 16 (testimony of Vickie A. Tillman, Executive Vice President, S&P) (S&P has an “excellent record of evaluating the credit quality of RMBS transactions.”); STANDARD & POOR’S, *supra* note 172, at 8 (S&P “has an excellent and proven track record of rating corporate, government, and structured finance debt.”).

¹⁹¹ See Ashcraft & Scheuermann, *supra* note 24, at 39 (arguing that low default rates on highly rated products make it difficult to establish whether a particular realized default rate implies poor quality).

addressing, and show that in such a setting reputational considerations will not deter rating agencies from issuing low-quality ratings on novel products. I then argue that key assumptions underlying the simplified setting are valid and are likely to remain so.

1. Reputation Does Not Deter Low-Quality Ratings in a Simple Setting

Consider the introduction of a novel financial product (such as CPDOs or subprime RMBS) in a simple setting, in which there are one or more credit rating agencies and a number of investors, who are assumed for convenience to be identical.

The rating agency sells ratings directly to investors. Ratings can be of two quality levels, high or low. The rating agency may be able to produce ratings at high quality, and if it can produce high-quality ratings it will do so. For a given new product, the probability that the agency will be able to produce at high quality is p . The agency knows whether it can produce high-quality ratings or not. The cost of producing ratings is ignored, as incorporating cost complicates the analysis without materially changing the conclusion.

Investors assign a value V_H to high-quality ratings and a lower value V_L to low-quality ratings. Investors' willingness to pay for ratings depends solely on their expectations of the quality of the ratings, and investors cannot tell in advance whether ratings on a given new product are in fact of high or low quality. Investors believe that there is some probability a that the agency will know what it is doing and will rate the new instrument with high quality. They believe that with probability $1-a$ the agency will not know what it is doing, so that its ratings will be of low quality. Thus, the investor will be willing to pay up to the weighted average of V_H and V_L (the "pool value") for a rating on a new instrument: $aV_H + (1-a)V_L$.¹⁹² Depending on competitive dynamics, the price

¹⁹² In equilibrium, the investor's belief a will match the probability p that the rating actually is of high quality given that the agency has issued

observed will be somewhere between zero and the pool value.¹⁹³

If, for example, a high-quality rating on a new instrument is worth \$1000, a low-quality rating is worth -\$500 (because low-quality ratings steer investors to poorer investments than they would choose on their own), and the probability that the agency rates with high quality is 75%, then the expected value of the rating is $\$750 - \$125 = \$625$. The investor will purchase and rely on ratings, even though the investor correctly perceives the risk that the ratings are of low quality.

In this one-period setting, an agency will issue ratings on novel products, even if it knows that the rating is of poor quality, because its choice is between (1) issuing the rating and collecting the market price on the rating, or (2) declining to issue the rating and collecting nothing. The agency is not constrained by fear of losing reputational capital because, as discussed in more detail below,¹⁹⁴ its reputation for quality rating on *existing* products is not at risk.

Before moving to consideration of multiple periods, it is worth pausing to note that in the important case where the product market will not develop absent the agency's rating, the one-period analysis is sufficient. If the agency declines to issue the rating, it will collect nothing in *any* period because the market will not develop. There is no downside to issuing the low-quality rating. This case, where the rating agency is a gatekeeper for the product, is discussed further below.¹⁹⁵

In a multiple-period setting, a "period" is defined as the amount of time needed for rating quality to become evident,

the rating. I assume that the perceived pooled value is greater than zero—that is, on average, investors perceive rating agencies are good enough at rating new products that it is worthwhile to rely on their ratings. I also assume that a rating agency will issue high-quality ratings if it is able to do so.

¹⁹³ Although the market price need not be equal to the pool value, it is assumed to be an increasing function of the pool value, that is, of perceived quality.

¹⁹⁴ See *infra* Part IV.C.1.

¹⁹⁵ See *infra* Part IV.C.3.a.

and equivalently it is assumed that quality is observed perfectly after one period. As noted, the “reputational-capital” model assumes that rating quality does become evident and can be monitored on an ex post basis. The length of a period might be expected to be approximately the length of a credit cycle, so that market participants could observe the performance of instruments relative to their ratings under a variety of conditions.

Reputation fits naturally into this analysis. If an agency issues low-quality ratings, it will gain a (deserved) reputation for low quality after one period and will be able to charge only V_L in subsequent periods after its quality is revealed. A high-quality agency will gain a reputation for high quality and will be able to charge V_H .¹⁹⁶ Thus, a reputation for quality is valuable.

Even so, an agency that is not capable of producing high-quality ratings (for example, because it lacks the technology to do so) has no reputation-based incentive to decline to issue low-quality ones. Its choice is between (1) collecting the price based on the pool value for one period and collecting some lesser amount, possibly as little as zero, in future periods, and (2) collecting zero. As the first choice is always superior to the second, the agency will produce low-quality ratings. Reputation does not deter the agency from issuing low-quality ratings.¹⁹⁷

¹⁹⁶ This can be interpreted as consumer belief that agency type (high- or low-quality) is immutable, which implies that an agency that has issued low-quality ratings in a segment cannot learn to issue high-quality ratings in that segment. Although that assumption may be questioned, note that if it is assumed (1) that a low-quality agency can learn to produce with high quality and (2) that consumers are aware of this, then the reputational loss from low-quality production is even smaller and the reputational constraint on low-quality production is even weaker.

¹⁹⁷ Further considerations relevant to the multiple-period case are discussed *infra*, at Part IV.C.3.

2. The Conclusion That Reputation Is Likely To Be Ineffective Holds Even If the Problems Policymakers Are Addressing Are Solved

The argument presented above does not rely on the presence of any of the potential problems discussed in Part II.B. and therefore does not fail in their absence.¹⁹⁸ Each of those problems is discussed in turn.

a. Competition

The conclusion does not rely on the absence of competition. If there are more competitors, then the probability that at least one of them will produce high-quality ratings is higher. That benefits investors, but does not affect the incentives of a low-quality agency to issue ratings. The dynamics of competition also would be expected to affect the price level,¹⁹⁹ but not the basic conclusion that

¹⁹⁸ Jeffrey Manns makes a well-reasoned argument that rating agencies are not constrained from issuing poor-quality ratings because they are not subject to reputational constraints, possess market power, face conflicts of interest, can issue unsolicited ratings, and do not face liability. See Manns, *supra* note 161, at 35-43. He argues that agencies are not subject to reputational constraints because of market psychology, imperfect ex post observation of rating quality, and the agencies' status as gatekeepers. *Id.* at 35-37. Although Manns argues that the problems of market power or conflicts of interest will not be solved by current initiatives, *id.* at 37-40, he does not address whether there is a problem with rating agencies that exists even if these problems are resolved, as this Article endeavors to do. Indeed, it appears that the fundamental problem with rating agencies that he identifies—temptation to do the bidding of the issuers or arrangers that are their clients—arises from the issuer-pays model. *Id.* at 9-11. The argument for failure of reputation here is more general and does not depend on any of the characteristics Manns asserts: actors are assumed to be rational and risk-neutral, rating quality is observed perfectly ex post, there are no assumed conflicts of interest, and agencies need not be gatekeepers (although the case where they are gatekeepers is important). Conversely, Manns does not address the reasons for reputational failure that are advanced here.

¹⁹⁹ In the extreme case of classic, atomistic perfect competition, price would be driven down to cost (here, zero). In that case, agencies cannot appropriate any benefits from a high reputation because price is always

the low-quality agency gets some revenue if it issues low-quality ratings and nothing if it refrains from doing so.

b. Transparency

The argument is not based on the assumption that performance transparency is a problem. Instead, it is assumed above that investors are able to monitor rating quality perfectly as quality is revealed over time. The argument does assume that investors cannot determine rating quality in advance,²⁰⁰ and it could be argued that perfect methodological transparency would permit investors to determine in advance whether ratings are of high quality. Investors could evaluate agency models on their own and determine how trustworthy they are.

That contention, however, undermines the argument that reputation deters low-quality ratings. If investors are able to determine rating quality in advance, then it is that *ex ante* determination, not “reputation,” that constrains poor-quality rating. It also comes close to directly undermining the rationale for rating agencies’ existence. If an investor is so good at analyzing credit risk that it can determine in advance that agency ratings are of high or low quality, it seems likely that that investor can determine for itself whether the rated instruments themselves are risky or not. It is not at all clear that that investor needs credit rating agencies.

equal to marginal cost, so there is no incentive to develop reputation, and reputation does not constrain rating quality.

²⁰⁰ See Dittrich, *supra* note 12, at 21 (explaining that in the rating context, reputation is important because “investors cannot assess the quality of a given rating *ex ante* but have to rely on *ex post* information about the quality of past credit ratings. While the average quality can be perfectly monitored, there is no way to determine the quality of a single rating because of its nature as probability.”).

c. Rating-Dependent Regulation and Conflicts of Interest

In the simplified setting, ratings are valued solely for their perceived quality as assessments of default, not for their value in satisfying regulatory requirements or for their value in helping issuers sell instruments. Thus, the conclusion that reputation does not deter low-quality ratings on novel products does not depend on the existence of rating-dependent regulation. Nor does it depend on any conflict of interest at the agency level, such as the practice of being paid by issuers, that might cause agencies to focus on considerations other than quality. Likewise, because the model analyzes rating agencies, not their agents, it does not depend on conflicts of interest that are internal to the rating agencies, such as competing incentives of individual analysts or officers.

C. Key Assumptions Underlying the Conclusion That Reputation Is Likely To Be Ineffective Are Justified

This Part explains and justifies certain assumptions that, if incorrect, would weaken the conclusion that reputation is ineffective in constraining poor rating quality for novel financial products. I also discuss whether the conclusion that reputation generates insufficient incentives for high-quality rating of novel products holds if each assumption is violated.

1. Rating Agencies Face No Negative “Spillover” from Issuing Low-Quality Ratings in New Segments

Ratings on different products require different technologies and rely on the behavior of different empirical data, so there is no necessary connection between skill in one segment and skill in another. For example, Moody’s has been rating the corporate bonds of Johnson & Johnson for nearly 100 years. Whatever one may think of the reliability of Moody’s Aaa rating on Johnson & Johnson debt, one is not likely to revise it much if it is revealed that Moody’s did not

know how to issue high-quality rating on subprime-RMBS-backed CDOs.²⁰¹

The reaction to the credit crisis suggests that this assumption is factually correct. Rating agencies suffered revenue loss in the structured-products segment during the worldwide credit crisis²⁰² and their stock prices suffered²⁰³ as certain areas of securitization ground to a halt. The traditional corporate-bond rating business continued apace during this time, with much smaller declines (indeed, Moody's investment-grade bond rating revenues increased).²⁰⁴ Official reports on the crisis did not indicate

²⁰¹ It is plausible that reputation could be transferred across segments in that customers who believe Moody's ratings on Johnson & Johnson are reliable will be more likely to trust novel-product ratings from Moody's than ratings from an upstart. That is consistent with the fact that the two leading agencies developed strong positions in rating new products. However, it seems unlikely that this works in reverse: Beliefs about Moody's quality in Johnson & Johnson bonds, based on decades of experience with the performance of those ratings and bonds, are unlikely to be revised much based on Moody's success or failure in rating subprime RMBS-backed CDOs.

²⁰² Moody's Corp., Moody's Corporation Reports Results for Second Quarter 2008 (July 30, 2008) (Moody's global structured finance revenue down 56% year over year); McGraw-Hill Cos., The McGraw-Hill Cos. Reports Second Quarter EPS of \$0.66, Including \$0.05 Restructuring Charge (July 29, 2008) (reporting year-over-year S&P Credit Market Services (rating) revenue decline of 20.1%, citing 94.5% decline in mortgage-backed security issuance and 88.2% decline in CDO issuance).

²⁰³ The stock price for Moody's Corporation, the traded entity that is closest to a pure-play rating agency, peaked at \$74.84 on February 8, 2007, and declined to close at \$30.97 on July 15, 2008. The stock closed at \$40.03 on August 15, 2008. The McGraw-Hill Cos., parent of Standard & Poor's, has numerous important nonrating businesses, but its stock price followed the same general pattern; it peaked at \$71.96 on June 4, 2007, declined to close at \$35.20 on March 17, 2008, and closed at \$44.99 on August 15, 2008. See Bloomberg Financial Information Service, GP function (last visited Mar. 9, 2009).

²⁰⁴ Moody's Corp., *supra* note 202, (reporting "[s]ignificant revenue growth" year over year from rating U.S. investment grade debt, countered by declines in high-yield and bank loan ratings); McGraw-Hill, *supra* note 202, (reporting U.S. corporate new issue volume, including both investment-grade and high-yield, down 15.1% year over year). The volume of U.S. investment-grade corporate bond issuance was almost exactly the

that agencies did a poor job in the corporate segment. Indeed, regulatory authorities' studies drew a fundamental distinction between agencies' traditional and structured-finance ratings and criticized only the latter.²⁰⁵ Further, the

same in the twelve months August 2007-July 2008 as in the preceding 12 months. Average monthly volume was \$59.4 billion in the 2007-2008 period and \$59 billion in the 2006-2007 period. See Bloomberg Financial Information Service, USFIIIVST Index, HP function (last visited Mar. 9, 2009). Based on the author's observations as a corporate bond and credit derivative analyst with responsibility for new issues during this period, the overwhelming majority of corporate new issues continued to receive ratings from Moody's and S&P.

²⁰⁵ See IOSCO CRA REPORT, *supra* note 36, at 2 (noting "questions about the quality of CRA ratings and the independence of the CRAs rating RMBSs and CDOs" (emphasis added)); *id.* at 8 ("[A] CRA rating of a structured financial product is qualitatively different from a corporate bond rating based on an issuer's past financial statements."); *id.* at 10 (noting "differences in the amount of historical data available regarding 'traditional' debt instruments such as corporate and municipal bonds versus structured finance products"); FSF Report, *supra* note 37, at 32 ("CRAs assigned high ratings to complex structured subprime debt based on inadequate historical data and in some cases flawed models. As investors realized this, they lost confidence in ratings of securitised products more generally One of the important triggers of the current turmoil was the precipitous decline in confidence in ratings of structured credit products." (emphasis added)); SEC June 16 Proposal, *supra* note 56, at 36,218 (referencing "loss of confidence among investors in the reliability of RMBS and CDO credit ratings issued by the NRSROs") (emphasis added); SEC STAFF EXAMINATION REPORT, *supra* note 38, at 37 ("[E]ach of the examined firms [Moody's, S&P, and Fitch] can take steps to improve their practices, policies, and procedures with respect to rating RMBS and CDOs, and other structured finance securities." (emphasis added)); PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 1 (2008) (identifying "flaws in credit rating agencies' assessments of subprime residential mortgage-backed securities (RMBS) and other complex structured credit products, especially collateralized debt obligations (CDOs) that held RMBS and other asset-backed securities (CDOs of ABS)" as a "principal underlying cause[]" of "turmoil in financial markets"); see also STRUCTURED FINANCE RATING PERFORMANCE 2007, *supra* note 106, at 2 ("Performance was mixed among the various sectors of structured finance. US HEL, US RMBS, and global CDOs all experienced lower than average one-year accuracy ratios and higher than average one-year investment-grade loss rates compared to the historical experience.").

rating agencies suggest that different types of products within the universe of structured finance show fundamentally different rating behavior. This bolsters the view that it is rational for investors to segregate products and product types in assessing agency quality.²⁰⁶

The conclusion that reputation does not constrain low-quality rating on novel products is robust to relaxing the assumption that there is zero negative spillover. If expected benefits from rating novel products are high enough relative to the size of the agencies' existing business or the expected magnitude of negative spillover is low enough—for example because the probability of detection is low—then one would expect the agencies to risk negative spillover.

Revenues from ratings on novel products seem likely to have been large enough to cause agencies to risk negative spillover. Issuance of structured finance instruments—especially CDOs—has been a fast-growing area: The Securities Industry and Financial Markets Association reports that worldwide CDO issuance was \$157 billion in 2004, \$272 billion in 2005, and \$521 billion in 2006.²⁰⁷ Although not all structured finance products receive ratings,²⁰⁸ structured-finance ratings have been critical to the growth of the rating agencies' business, as both commentators²⁰⁹ and the agencies themselves²¹⁰ have observed.

²⁰⁶ See STANDARD & POOR'S, *supra* note 172, at 11.

²⁰⁷ SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, GLOBAL CDO MARKET ISSUANCE DATA (2008), http://www.sifma.org/research/pdf/CDO_Data2008-Q4.pdf. CDO issuance plunged as the crisis took hold: issuance was \$482 billion in 2007 and \$56 billion in 2008. *Id.*

²⁰⁸ IOSCO CRA REPORT, *supra* note 36, at 5 (“Not all structured finance products are rated by CRAs. Indeed, for many particularly complicated or risky CDOs, credit ratings are unusual.”).

²⁰⁹ See Mason & Rosner, *supra* note 25, at 17.

²¹⁰ Moody's Corp., *supra* note 1, at 3 (“Growth in issuance of structured finance securities has generally been stronger than growth in straight corporate and financial institutions debt issuance”); see also *id.* at 2 (as of 2007, Moody's had rated “more than 110,000 structured finance obligations”). Moody's stated that “[c]ompared with 2007, Moody's

Data from Moody's, the only major agency that presents rating revenues by category, suggest that revenues from novel product ratings were high enough to have tempted it to risk its reputation in traditional-product ratings.²¹¹ Moody's structured-finance ratings revenue grew 87% from 2003 to 2006, accounted for 54% of all rating revenue in 2006, and accounted for two thirds of all rating revenue growth over the period. From 1999 to 2007, structured product revenue rose from \$172 million to \$891 million—an increase of over 415%.²¹²

Thus, even if agencies faced a risk of reputational spillover, evidence from the recent past suggests that novel-product ratings were lucrative enough to tempt them to take that risk, and that if financial innovation continues to be important, then agencies will continue to face that temptation.

expects a decline in structured finance revenue at least through 2008 and possibly into 2009 and beyond." *Id.*

²¹¹ See, e.g., Moody's Corp., Annual Report (Form 10-K) (Mar. 8, 2005); Moody's Corp., Annual Report (Form 10-K) (Mar. 1, 2006); Moody's Corp., Annual Report (Form 10-K) (Mar. 1, 2007). S&P (a unit of the McGraw-Hill Companies) does not separately report structured-finance revenues, but McGraw-Hill's 2006 Annual Report makes a similar point, stating: "Financial Services segment continued to experience double-digit growth in revenue and operating profit in 2006, increasing 14.4% and 18.0%, respectively, over 2005 results. The increases in revenue and operating profit were due to the performance of structured finance and corporate (industrial and financial services) and government ratings, which represented approximately 55.4% and 33.7%, respectively, of the growth in revenue." MCGRAW-HILL COMPANIES, 2006 ANNUAL REPORT 39 (2007). The first item mentioned in explaining the increases is that "[i]n the U.S., strong growth was experienced in the issuance of commercial mortgage-backed securities (CMBS) and collateralized debt obligations (CDOs)." *Id.*

²¹² Moody's Corp., *supra* note 1, at 76; Moody's Corp., Annual Report (Form 10-K), at 39 (Mar. 22, 2002).

2. The Rating Agency Knows Whether It Is Capable of Rating New Instruments with High Quality

This point depends on evidence from inside the rating agencies, which is limited. The material that is available suggests that it is plausible both that agency ratings were of low quality and that agencies were aware of this.

Observers of all stripes have suggested that agency models and available data simply were not good enough for the agencies to issue high-quality ratings on novel products such as subprime RMBS. Market participants have raised the question of agency competence,²¹³ and commenters have argued, for example, that: (1) the default risk of the pools of mortgages underlying subprime RMBS could not be known at the inception of deals, because their performance would be revealed only over time;²¹⁴ (2) limits on the amount of historical data available increased the level of model risk; and (3) the agencies did not take account of the “substantial weakening of underwriting standards for products associated with certain originators.”²¹⁵ The staff report on the SEC’s

²¹³ See Aaron Lucchetti, *McGraw Scion Grapples with S&P’s Woes—Chairman Helped Set Tone in Profit Push as Ratings Firms Feasted on New Products*, WALL ST. J., Aug. 2, 2008, at B1 (reporting hedge-fund manager’s asking McGraw-Hill CEO “whether bond ratings downgraded by the company’s Standard & Poor’s Ratings Services unit amid recent market turmoil should have ever been issued in the first place”).

²¹⁴ *House Structured Finance Hearings*, *supra* note 57, at 19, 115-16 (testimony and prepared statement of Joseph R. Mason, Associate Professor of Finance, Drexel University).

²¹⁵ FSF Report, *supra* note 37, at 33. The FSF noted that “rating methodologies themselves have been rapidly revised in the light of market events.” *Id.*; see also IOSCO CRA REPORT, *supra* note 36, at 2 (“[T]here are also serious questions whether the CRAs should have reassessed the quality of their methodologies and underlying assumptions when rating subprime structured finance instruments in light of credible information regarding housing market bubbles in the United States, the lack of incentives for mortgage lenders to conduct proper due diligence, and a possible increase in mortgage fraud, among other things.”). Rating agencies argue that they have the ability to rate novel, complex products with high quality, pointing out with some justification that “they are

recent examination of the agencies suggests that agencies were aware that their ratings on novel products were of relatively low quality.²¹⁶

The conclusion that reputation imposes a meaningfully insufficient constraint on poor quality rating is somewhat robust to violations of this assumption. As long as the rating agency has some idea, even an imperfect one, of the quality of its ratings, deterrence of issuing ratings the agency thinks are low quality will reduce issuance of low-quality ratings, although at the cost of deterring issuance of high-quality ratings to some extent as well.

3. The Agency Does Not Perceive That Waiting to Enter the New Segment Will Result in Greater Profits Than Entering Immediately

An agency confronting the opportunity to rate a novel product that it does not know how to rate with high quality faces an obvious temptation to issue the rating anyway. In principle, however, the agency might find it more attractive to pursue a strategy of (a) not issuing ratings immediately; (b) trying to learn how to issue high-quality ratings; and (c) entering the market with high-quality ratings later if it learns how to rate the product with high quality. In other

variations of structures and technologies that have long histories.” STANDARD & POOR’S, *supra* note 172, at 8. This Article does not take issue with this assertion in general, as the argument here assumes that the rating agencies have some probability of being able to issue high-quality ratings on novel products and that that is the reason that investors are willing to pay for novel-product ratings.

²¹⁶ The SEC staff report cites rating agency internal e-mails to the effect that ratings on structured finance deals were issued even when questions on specific deals were unresolved. SEC STAFF EXAMINATION REPORT, *supra* note 38, at 12 & n.7. The report states that an analyst wrote in an e-mail that “her firm’s model did not capture ‘half of the deal’s risk, but that ‘it could be structured by cows and we would rate it’” and that a manager wrote, “our staffing issues, of course, make it difficult to deliver the value that justifies our fees”. *Id.* at 12. The report also states that an analyst described the CDO market as an “even bigger monster” (than what is not clear) and expressing the hope “that we are all wealthy and retired by the times this house of cards falters.” *Id.* at 12 n.8.

words, it might defer immediate profits from low-quality entry for the promise of higher profits later as a result of building a reputation for high quality.

This argument is different from the argument that adherents of the reputational model have actually made, namely that fear of loss of reputation that the agency already has accumulated will deter agencies from issuing low-quality ratings. It is inherently speculative, and it does not appear that evidence has emerged of rating agencies waiting to issue ratings on novel products pending methodological improvements.

There are several possible reasons that agencies would not have found this “wait-learn-and-enter” strategy optimal in the past and would not find it optimal in the future.

a. Agency As “Product Gatekeeper”

If the market for the novel product will not develop unless the agency issues ratings, then there is no benefit to the agency from waiting to enter, because there will be no market to enter later.

The evidence suggests that each major agency may have acted as a gatekeeper in the development of the structured-finance market. Certainly, rating-agency acceptance in general has been critical to development of the market.²¹⁷ As one commentator recently noted, “[s]ecuritization is, and always has been, a rating-driven product.”²¹⁸ Structured-finance products are set up so that the securities that the structure issues receive particular ratings. That makes sense, because a major economic benefit that securitization is said to provide is “completing markets”—matching the risk levels of available investments with the risk preferences of investors. Generally speaking, the perception has been that before securitization, there were “too few” investments

²¹⁷ See Hayre, *supra* note 23, at 13; FSF Report, *supra* note 37, at 32 (rating agencies’ “assigning high ratings to subprime-related RMBS and CDOs between 2004 and 2007 . . . contribut[ed] to the phenomenal growth of subprime lending”).

²¹⁸ Kettering, *supra* note 16, at 1673.

offering very low credit risk (for example, only a few of the most stable corporations offer AAA-rated debt),²¹⁹ so that securities offering minimal risk could be sold at a premium. Securitization allows the arranger to take a lot of medium-quality debt and turn it into a mix of high- and low-quality debt. Because changing debt quality is the essence of what has been called “the alchemy of asset securitization,”²²⁰ it is unsurprising that the products are designed to satisfy the established arbiters of credit quality, the rating agencies.²²¹

That ratings are needed in general for products to be adopted does not necessarily imply that each agency individually was necessary for the development of each product market. If one agency declines to rate a particular type of security, others may do so and that may permit the market to develop. Nevertheless, evidence suggests that if any one of the major agencies had declined to go along with a

²¹⁹ See RAJAN ET AL., *supra* note 16, at 2 (2007); *AAAasking for Trouble*, THE ECONOMIST, July 14, 2007 (“[O]nly six American non-bank companies carry a triple-A rating today, including Berkshire Hathaway and General Electric.”); Mary E. Kane, *An Introduction to the Asset-Backed Securities Market*, in SALOMON SMITH BARNEY GUIDE TO MORTGAGE-BACKED AND ASSET-BACKED SECURITIES 69, 71 (Lakhbir Hayre ed., 2001) (citing “a wide universe of triple-A and other investment-grade assets,” “greater liquidity,” and “lower ratings volatility” as reasons investors benefit from securitization).

²²⁰ Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. OF LAW, BUS. & FIN. 133 (1994).

²²¹ *Id.* at 136 (“The interest rate necessary to entice investors to purchase the SPV’s securities is often a function of the ‘rating’ that the SPV’s debt securities receive.”); IOSCO CRA REPORT, *supra* note 36, at 5 (“Because structured financial products are designed to take advantage of different investor risk preferences and investment time horizons, they are, in a sense, designed for a particular credit rating (even in cases where no CRA opinion or formal credit rating is sought).”); STANDARD & POOR’S, *supra* note 172, at 2-3 (“The efficiency in [the structured-finance] process is that it allows different investors with different interests and risk appetites to purchase exactly the risks they want [I]t follows that arrangers will seek to tailor their structure to generate the rating for each tranche that matches what the buyers are seeking.”); see also Bethel et al., *supra* note 26, at 13-14 (rating agency ratings on real-estate-based products “dramatically changed the investment opportunities of many pension funds” by permitting them to invest in real estate).

particular structured product, the market would not have developed.²²²

Contemplated market reforms, if successful, would be expected to undermine whatever gatekeeper status individual agencies currently possess. But comparable efforts have a mixed record of success,²²³ and there may not be demand for more than a few major rating agencies, as the incumbent agencies assert. As a practical matter, the major agencies' gatekeeper status seems unlikely to change for some time.

b. Agency Unable to Rate with High Quality Without Entering

If an agency cannot learn to rate a novel product with high quality while it is not in the market, then it has no reason to delay entry in order to take market share away from low-quality competitors. If agencies in fact "learn by

²²² See, e.g., *Senate CRA Oversight Hearings*, *supra* note 62, at 6 (statement of Glenn L. Reynolds, Chief Executive Officer, CreditSights, Inc.) ("The bulk of institutional investors have credit ratings parameters that set out requirements for average ratings or minimum ratings for securities they own in their portfolio or for counterparty risks. These parameters more often than not *specifically* cite Moody's and S&P and not 'any NRSRO.' . . . Ratings-based pricing grids in bank loan agreements, ratings triggers built into bond and bank loan terms, ratings-based haircuts on loans used in setting margins on debt securities as collateral, over-the-counter swap agreements that include ratings-based termination provisions, internal credit limits by issuer in portfolios, and many other risk management practices cite the specific rating agencies—namely, S&P and Moody's."). The frequent observation that issuers engage in "rating shopping"—the practice of speaking to multiple agencies about ratings and retaining only the agencies that are willing to render the highest ratings, *see, e.g.*, Kettering, *supra* note 16, at 1681—does not undermine this point. Rating shopping is possible only once enough competitors (two, or given the two-rating norm, three) are rating the relevant type of instrument to make it possible.

²²³ See generally RICHARD H.K. VIETOR, *CONTRIVED COMPETITION* (1994) (chronicling managers' responses to government efforts to move from heavy regulation to competition in airline, banking, natural gas pipeline, and telecommunications industries).

doing” as some assert,²²⁴ then learning to rate with high quality without actually issuing ratings seems difficult, especially given that underlying data for structured products typically is not public. On the other hand, the existing practice of disclosing rating methodologies, possibly soon to be buttressed with an additional disclosure requirement designed to permit all agencies to rate a given structured transaction,²²⁵ may enable agencies to learn how to rate even if they do not enter the market. But the better agencies are at learning over time, the less likely rational investors are to penalize them for past low-quality ratings, because rating quality is more likely to improve over time. Even as the ability to learn increases the benefits of the wait-learn-and-enter strategy, it decreases the costs of immediate low-quality entry. Although an agency that cannot rate at present with high quality will enter immediately if it cannot learn (and other conditions are met), it will not necessarily be deterred from entering just because it can learn.

c. Reputational Barriers to Entry

It is often argued that the fact that some agencies enjoy a reputation for high quality in itself creates a barrier to entry.²²⁶ If so, the wait-learn-and-enter strategy is less

²²⁴ See Mason & Rosner, *supra* note 25, at 21.

²²⁵ See *supra* Part III.B.2.a.

²²⁶ See, e.g., *The Ratings Game: Improving Transparency and Competition Among the Credit Rating Agencies: Hearing Before the H. Subcomm. on Capital Mkts., Ins., and Government Sponsored Enterprises of the Comm. on Financial Servs.*, 109th Cong. 8 (2004) (statement of Barron H. Putnam, President & Chief Economist, LACE Fin. Corp.) (“Moody’s, Standard & Poor’s, and Fitch have tremendous name recognition and market share. That is a tough act to compete against.”); *id.* at 9 (statement of Alex J. Pollock, Resident Fellow, AEI) (“[T]he need to establish reputation” is a “natural barrier[] to entry in the credit rating business.”); *Senate Turmoil Hearings*, *supra* note 16, at 18 (testimony of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School) (“[T]here are still significant barriers to entry, as ‘reputational capital’ is not easily acquired.”); *Senate CRA Oversight Hearings*, *supra* note 62, at 3 (testimony of Damon A. Silvers, Assoc. Gen. Counsel, AFL-CIO) (“[T]he scale and prominence of the existing firms are

effective because an agency that follows it may face barriers from high-quality incumbents when it does decide to enter.²²⁷ There is some evidence that agencies issued ratings out of fear that other agencies would garner a lead in novel product markets, supporting the view that reputational barriers would deter a wait-learn-and-enter strategy.²²⁸

The effort to promote competition makes the reputational-barrier scenario *more* likely to be realized. If the number of competent competitors in the market increases, then the probability that at least one of them will know how to rate a novel product with high quality increases. This decreases the attractiveness of the wait-learn-and-enter strategy because it makes it more likely that the “waiting” firm will be frozen out of the market by reputational barriers to entry. In this respect, increasing the number of firms makes it more likely that low-quality ratings on novel products will be issued.

d. Delay Cost: Time Value of Money

Even if one assumes that low-quality agencies lose all demand for their ratings upon revelation of the low quality of their product, for example, if investors assign a value of zero to low-quality ratings and a low-quality agency cannot learn, a wait-learn-and-enter strategy still may not be viable because of the time value of money. The agency contemplating immediate low-quality entry must choose in

a formidable barrier to entry . . .”). The (“Stiglerian”) counter to this argument is, roughly, that all agencies have the ability to develop reputations for quality and that if a reputation for quality is generating economic profits, an entrant ought to be willing to invest enough (possibly via operating a money-losing but reputation-building business) to develop its own reputation for quality.

²²⁷ A similar effect would be created if the high-quality entrant enjoys a “first-mover” advantage, if there are significant switching costs, or for any other reason that is consistent with the commonly held view that it is difficult to take market share from a high-quality established incumbent.

²²⁸ See Aaron Lucchetti, *Rating Game: As Housing Boomed, Moody's Opened Up*, WALL ST. J., Apr. 11, 2008, at A1 (suggesting Moody's changed standards for mortgage-based structured products to gain market share when it was “a small player” in the market).

this case between a short-lived stream of cash flows received immediately and a long-lived stream of cash flows (possibly of different size) received after a delay. In the simple case of choosing between the first and second parts of a perpetuity, the breakeven point is around seven years for discount rates of 11-12%²²⁹ (this is a reasonable estimate of the cost of capital for Moody's Corporation, the traded entity that is closest to a pure-play rating agency).²³⁰ Given that it may take approximately the length of a credit cycle to determine the quality of credit ratings on a given set of products, this suggests that the wait-learn-and-enter strategy might not be attractive for major rating agencies purely for time value reasons, ignoring all the considerations above.

V. A "DISCLOSE OR DISGORGE" SOLUTION FOR RATINGS ON NOVEL FINANCIAL PRODUCTS

This Part describes a narrowly tailored, minimally intrusive proposal for addressing the problem of low-quality ratings on novel financial products: Agencies should be required to disgorge profits derived from issuing ratings on particular types of new products if the ratings turn out to fall below a specified level of quality, unless the agency discloses in advance that the ratings are of low quality. This Part first describes the solution, then explains why it is consistent with the First Amendment and why it is superior to other solutions based on liability or regulation. Finally, it discusses certain issues presented in implementing the "disclose or disgorge" approach.

²²⁹ If the agency receives twice as much per year in the second period as the first, the breakeven is ten to eleven years for discount rates in this range.

²³⁰ Moody's Corp.'s WACC for the second quarter of 2008 was 11.97%, according to the WACC function on the Bloomberg financial information system. Bloomberg Financial Information Service, WACC function (last visited Mar. 9, 2009).

A. The “Disclose or Disgorge” Approach to Novel Product Rating

The problem identified in the preceding Part is that rating agencies have strong incentives to issue ratings on novel products even if they do not know what they are doing. Because investors do not know the quality of the ratings on these new instruments in advance, they may rationally rely on them to their detriment and, as recent events suggest, to the detriment of the wider financial system.

This problem can be solved either by deterring rating agencies from issuing such low-quality ratings or by making their quality known to investors. A straightforward way to do this is to subject rating agencies to disgorgement of profits derived from ratings on new instruments that turn out to be of low enough quality,²³¹ while allowing the agency to avoid disgorgement by disclosing at the time of rating that its ratings are of low quality.

This proposal removes the incentive to issue undisclosed low-quality ratings, permits investors to decide for themselves whether to use low-quality ratings (investors who are not good at judging risk for themselves might find such ratings useful), and avoids unnecessary, error-prone, and irrelevant inquiries into the agency’s “intent to deceive” and the ex ante “reasonableness” of its determinations that would be required under fraud or negligence rules. It also does not rely on administrative foresight to the same extent as a pending proposal apparently intended to require agencies to get SEC approval before issuing ratings on novel instruments.²³²

²³¹ This proposal presupposes that there is perfect monitoring and enforcement of the rule. If there is imperfect enforcement, disgorgement of a multiple of profits may be appropriate. Cf. John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 349-52 (2004) (proposing a system of strict “gatekeeper” liability for issuer fraud in which gatekeepers are liable for a multiple of annual fees received from the issuer and asserting that proposal is based on a “deterrence framework”).

²³² See *infra* Part V.C.5.

B. First Amendment Concerns Should Not Foreclose Consideration of “Disclose or Disgorge”

Rating agencies argue consistently that they are “members of the media”²³³ and “publishers,”²³⁴ that they function as “journalists”²³⁵ and that their ratings are “opinions”²³⁶ on “matters of public concern.”²³⁷ They assert that the First Amendment therefore bars all manner of efforts to regulate them or hold them liable for the quality of their ratings. These claims have captured the imagination of some commentators.²³⁸

In making such claims, rating agencies invariably ignore the fact that the only Supreme Court case to evaluate First Amendment claims in the context of credit reports, *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*,²³⁹ reached precisely the opposite of the conclusion the agencies urge. The Court rejected a credit-report publisher’s contention that the First Amendment shielded it from defamation liability

²³³ 2005 Senate CRA Hearings, *supra* note 79 (statement of Stephen W. Joynt, President & CEO, Fitch Ratings).

²³⁴ Senate Turmoil Hearings, *supra* note 16, at 1 (testimony of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School).

²³⁵ Legislative Solutions for the Rating Agency Duopoly: Hearing Before the H. Subcomm. on Capital Mkts., Ins. & Government Sponsored Enterprises of the Comm. on Financial Servs., 109th Cong. 16 (2005) (testimony of Rita M. Bolger, Managing Director & Assoc. Gen. Counsel, S&P) [hereinafter 2005 Bolger Testimony]; 2005 Senate CRA Hearings, *supra* note 79, at 5 (statement of Stephen W. Joynt, President & CEO, Fitch Ratings) (“[R]ating agencies . . . function as journalists and thus should be awarded the high level of protection guaranteed by the First Amendment.”).

²³⁶ S&P Motion to Dismiss, Blomquist Action, at 4; 2005 Bolger Testimony, *supra* note 235, at 16.

²³⁷ 2005 Bolger Testimony, *supra* note 235, at 16.

²³⁸ See, e.g., Husisian, *supra* note 64, at 454 (“[B]ond ratings are indeed the world’s shortest editorials. As editorials, courts should grant them the same deference they grant any other protected first amendment publication.”); Dittrich, *supra* note 12, at 142-43 (“In the USA, e.g, ratings are considered as opinions protected by the First Amendment . . .”).

²³⁹ 472 U.S. 749 (1985).

absent a showing of actual malice.²⁴⁰ Five Justices agreed that the report, which was “solely motivated by the desire for profit”²⁴¹ and “[a]rguably . . . more objectively verifiable than speech deserving of greater protection,”²⁴² was not speech on a “matter of public concern.”²⁴³

It certainly is debatable whether a court evaluating a contemporary challenge to rating-agency liability for poor-quality ratings would reach the same conclusion the Court reached in *Dun & Bradstreet*, for several reasons. The credit report in *Dun & Bradstreet* was distributed to only five subscribers, all of whom were prohibited by contract from disseminating it further,²⁴⁴ and it falsely reported the bankruptcy of a construction contractor in Vermont.²⁴⁵ The contrast in significance from matters affecting the integrity of the global financial markets could not be starker (although great significance would not necessarily in itself render the subject of speech a “matter of public concern” under the Court’s analysis).²⁴⁶ In addition, the case dealt with a false

²⁴⁰ *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 763 (1985).

²⁴¹ *Id.* at 762. The quotations are from the lead opinion of Justice Powell, which Justices Rehnquist and O’Connor joined. Chief Justice Burger and Justice White each concurred separately, and each agreed that the credit report at issue did not address a matter of public concern. *Id.* at 764, 774.

²⁴² *Id.* at 762.

²⁴³ *Id.* at 761-62.

²⁴⁴ *Id.* at 751.

²⁴⁵ *Id.* at 751-52.

²⁴⁶ The Court did not set forth a comprehensive definition of “matter of public concern” in *Dun & Bradstreet*, but it suggested that speech that touches on political and social concerns, rather than purely economic ones, is more likely meet the test. See *Dun & Bradstreet*, 472 U.S. at 755 (“[F]reedom of expression upon public questions is secured by the First Amendment” and “debate on public issues should be uninhibited, robust, and wide-open.” (citations and quotations omitted)); *id.* at 759 (“The First Amendment ‘was fashioned to assure unfettered interchange of ideas for the bringing about of political and social changes desired by the people.’ . . . ‘[S]peech concerning public affairs is more than self-expression; it is the essence of self-government.” (citations omitted)); *id.* at 759 n.5 (economic communications such as “exchange of information about

statement of fact, not an opinion,²⁴⁷ and the Court left open the possibility that credit assessments other than the one before it might receive a greater degree of First Amendment protection.²⁴⁸ More generally, the Court may have become more inclined to protect speech rendered in a purely commercial context over the intervening decades.

The key point, though, is that in *Dun & Bradstreet*, the existence of a First Amendment limit on regulation in the credit context turned on the fact-specific determination

securities, corporate proxy statements, the exchange of price and production information among competitors, and employers' threats of retaliation for the labor activities of employees" are "regulated without offending the First Amendment" (citations omitted)). Moreover, the Court's reasoning suggests that the object of analysis is the specific instance of speech at issue, rather than the general class of speech to which the specific instance belongs. The Court did not analyze the general importance of trade credit reporting to the economy; it analyzed the significance of the bankruptcy of a specific contractor in Vermont. The courts in both *Orange County* and *Enron* followed the same mode of analysis, although they set a low threshold. See *In re Enron Secs., Deriv., & "ERISA" Litig.*, 511 F. Supp. 2d 742, 819 (S.D. Tex. 2005) ("[N]ationally published credit agency ratings reports regarding Enron, a top Fortune 500 company, in 2000 are matters of public concern."); *County of Orange v. McGraw-Hill Cos.*, 245 B.R. 151, 155 (C.D. Cal. 1999) (rating agencies are matters of public concern because they induced County to "incur \$500 million in debt and contributed to the largest municipal bankruptcy in history"). A court could find that the creditworthiness of each individual asset-backed instrument or class of instruments is not of public concern, even if "securitization" as a whole does rise to that level.

²⁴⁷ *Dun & Bradstreet*, 472 U.S. at 751. Cf. *Lowe v. SEC*, 472 U.S. 181, 210 n.58 (1985) ("[B]ecause we have squarely held that the expression of opinion about a commercial product such as a loudspeaker is protected by the First Amendment, it is difficult to see why the expression of opinion about a marketable security should not also be protected." (citations omitted)). Rating agencies rely on defamation cases to supply what they claim is the relevant legal standard, so they apparently do not view the difference between opinion and fact as dispositive for the First Amendment analysis. See *In re Enron*, 511 F. Supp. 2d at 810-11 (describing agencies' reliance on defamation cases for proposition that plaintiff must show "actual malice" in order "to impose liability on a publisher for statements about matters of public concern").

²⁴⁸ *Dun & Bradstreet*, 472 U.S. at 762 n.8.

whether an “expression’s content, form, and context”²⁴⁹ rendered its subject a matter of public concern.

In the lower courts, the agencies have won high-profile, if sketchily reasoned, victories on the First Amendment issue in the *Orange County*²⁵⁰ and *Enron*²⁵¹ litigation, where the courts relied on defamation cases for the principle that agencies could not be held liable for low-quality ratings absent a showing of “actual malice.” Another recent decision in this context, *Commercial Financial Services, Inc. v. Arthur Andersen LLP*,²⁵² rejected the agencies’ more extravagant claims for First-Amendment-based immunity, finding that the First Amendment did not affect the duty of care that rating agencies owed to a structured-finance issuer that had paid them to issue ratings on the instruments it issued: “While the Rating Agencies gave ‘opinions,’ they did so as professionals being paid to provide their opinions to a client.”²⁵³ Courts have split on the claim that agency analysts are “journalists” entitled to invoke press shield laws.²⁵⁴

²⁴⁹ *Id.* at 761.

²⁵⁰ *County of Orange v. McGraw-Hill Cos.*, 245 B.R. 151 (C.D. Cal. 1999). *Orange County*, an issuer, sued the rating agencies for giving it too high a rating. *Id.* at 151. The court found, citing its previous unpublished orders, that the First Amendment required the county to show “actual malice” to prevail. *Id.* at 154-57. The court nevertheless denied summary judgment with respect to ratings issued while the agency was “aware of . . . potential disaster” and while the agency was making “public comments” that “support the County’s inference of a cover-up to protect S&P’s reputation.” *Id.* at 161.

²⁵¹ *In re Enron*, 511 F. Supp. 2d at 825 (“The Court finds that the challenged ratings are a combination of subjective, nonactionable evaluation and verifiable facts. The Court concludes that the actual malice standard should apply here because the nationally published credit ratings focus upon matters of public concern, a top Fortune 500 company’s creditworthiness.”).

²⁵² 94 P.3d 106 (Okla. Civ. App. 2004).

²⁵³ *Id.* at 110.

²⁵⁴ *Compare In re Fitch, Inc.*, 330 F.3d 104 (2d Cir. 2003) (agency not like journalist in that it “cover[ed] only its own clients” and took “an active role in the planning of the transactions it analyzes”) *with Compuware v. Moody’s Investors Servs.*, 324 F. Supp. 2d 860, 862 (E.D. Mich. 2004)

The agencies' claims strike some commentators as dubious,²⁵⁵ although scholars apparently have not subjected them to sustained, rigorous scrutiny.²⁵⁶ A complete doctrinal analysis of the First Amendment issues presented by credit ratings is beyond the scope of this Article, but the agencies' First Amendment arguments should not foreclose consideration of proposals to improve rating quality.

Under the "reputational-capital" view of rating agencies, agencies are in the business of making predictive judgments that are of reasonably ascertainable quality. Despite the rating agencies' and some scholars' claims, there are good reasons to believe that a liability or regulatory regime designed to counter economic incentives for low-quality production in this industry would pass muster under the existing positive law of the First Amendment. At the very least, judicial endorsement of the proposal would require

(agency qualified as journalist because it "did not participate in the structuring of the debt it was rating" and therefore did not "step[] outside its role as information gatherer"); *In re Pan Am Corp.*, 161 B.R. 577 (S.D.N.Y. 1993) (agency qualified for protection where it rated almost all public debt, whether issued by clients or not); *see also In re Scott Paper Co. Sec. Litig.*, 145 F.R.D. 366, 369-70 (E.D. Pa. 1992).

²⁵⁵ *See, e.g.,* COFFEE, *supra* note 80, at 313 n.71 ("[The] view of ratings as editorials (or as political speech) seems increasingly dated.").

²⁵⁶ For a critique by practitioners of agency First Amendment arguments in the context of actions alleging that CDOs were over-rated, see David J. Grais & Kostas D. Katsiris, *Not "The World's Shortest Editorial": Why the First Amendment Does Not Shield the Rating Agencies from Over-Rating CDOs*, BLOOMBERG L. REPS., Nov. 2007, available at <http://www.graisellsworth.com/publications.html>. The most serious scholarly critical treatment of which this author is aware is Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 83-86 (Yasuyuki Fuchita & Robert E. Litan eds., 2006). *See also* Francis A. Bottini, Jr., Comment, *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 SAN DIEGO L. REV. 579, 616-19 (1993) (arguing that "the assurance of the integrity of the United States capital markets and the protection of the public from inaccurate ratings" is a "significant government interest" so that a system in which the SEC could proceed against rating agencies for negligence would not violate the First Amendment).

only a minor doctrinal adjustment in an area that is notoriously malleable.²⁵⁷

C. Comparison of “Disclose or Disgorge” to Alternative Regulatory Regimes

Assuming that fear of losing reputation does not deter low-quality ratings on novel products, what is the best response? Several possibilities other than “disclose or disgorge” are available: It might be appropriate to do nothing, because the costs of any intervention may exceed the benefits. Other alternatives include: Relying on the existing securities-fraud regime, to which agencies are already subject; imposing negligence liability, which probably would require a change in law; or subjecting agencies to liability for issuers’ misstatements (“gatekeeper liability”), as some scholars have suggested. “Disclose or disgorge” seems superior to these alternatives.

1. Do Nothing

It might be argued that it is inappropriate to invoke legal or regulatory forces to control ratings quality. A toolmaker that trades on its reputation for high quality, for example, may not be subject to liability if it “cheats” and produces low-quality tools. Even though it might conceivably be optimal for such a company to “cheat” and milk its reputation under some circumstances, we rely on market discipline, in particular, the risk of loss of reputation. Rating agencies are different from the hypothetical toolmaker for at least two reasons.

²⁵⁷ One might interpret the continuing viability of agency First Amendment defenses as evidence that the market is not fully competitive, as the persistence of such near-absolute defenses to liability is anomalous, to say the least. If the market were fully competitive, one might expect investors to demand waiver of such defenses. Relatedly, to the extent that First Amendment defenses prevent the imposition of efficiency-enhancing rules on the rating agencies, that further calls into question the continued advisability of rating-dependent regulation.

First, low rating quality has broader systemic significance, at least according to the official bodies that have scrutinized recent market events. A sudden loss of confidence in ratings in general or on a particular set of instruments can have systemic consequences, as recent events suggest. Although some have characterized this as resulting from “undue reliance”²⁵⁸—and at least one court has held that investors cannot reasonably rely on ratings²⁵⁹—that is too simplistic. Ratings have no real value unless someone somewhere can incorporate them somehow into investment decisions, and the rating agencies recognize that “[i]nvestors use ratings to help price the credit risk of fixed-income securities they may buy or sell.”²⁶⁰ And, as demonstrated above, rational investors may end up relying on poor-quality credit ratings for specific instruments, as long as agencies are good enough *on average* at producing high-quality ratings.²⁶¹ It is quite possible that parties appropriately relied on ratings in gross *ex ante* and appropriately lost confidence *ex post* in ratings on particular instruments and on the credit quality of those instruments.

Second, poor-quality ratings also have broader significance in that they can lead to misallocation of capital *ex ante*, apart from systemic risks arising on revelation of poor quality. The ultimate purpose of capital markets is to match investors’ risk-return preferences with available capital projects. If an investor purchases a triple-A rated CDO tranche because the investor believes that the tranche presents similar credit risk to other triple-A rated

²⁵⁸ SEC July 1 Proposal, *supra* note 56, at 40,125.

²⁵⁹ *See, e.g.,* Quinn v. McGraw-Hill Cos., 168 F.3d 331, 336 (7th Cir. 1999) (affirming dismissal of negligent misrepresentation claim against S&P based on assertion that agency should not have given ‘A’ rating to bonds purchased by bank in which plaintiff was a majority shareholder on the ground that plaintiff could not show “reasonable reliance” on rating).

²⁶⁰ *See* MOODY’S RATING SYSTEM, *supra* note 11.

²⁶¹ This is true even if incorporating ratings into investment decisions reduces investors’ own efforts to check creditworthiness, as long as the agencies can provide high-enough quality information at a cost that is low relative to the *total* cost of each and every investor doing its own creditworthiness research. *See, e.g.,* Husisian, *supra* note 64, at 416-17.

instruments, and the tranche in fact is much riskier, it seems likely that investment capital has been misallocated.²⁶² For these reasons, it seems likely that low-quality ratings can produce social losses that would not be internalized by the party that is paying for the ratings.

Moreover, the do-nothing solution is commonly rejected when the value of what a party provides arises in part from a level of skill that is difficult to monitor. Thus, doctors, lawyers, and accountants are required to meet minimum standards of care in providing services, even though they presumably are concerned with their reputations.²⁶³

2. Fraud Liability

Rating agencies are currently subject to liability for securities fraud, and each of the major rating agencies currently faces a securities fraud class action arising from the subprime crisis.²⁶⁴ In three major respects, the “disclose

²⁶² Formally modeling this point is beyond the scope of this paper, and it is the author's understanding that the economic literature on rating agencies does not address the social-welfare costs of poor investment decisions. Nevertheless, the fundamental point that capital markets function better and increase welfare when investors understand the risks of the securities they are buying seems difficult to contest. Indeed, it underlies the rationale for the existence of rating agencies.

²⁶³ *House Structured Finance Hearings*, *supra* note 57, at 44-48 (colloquy among various Representatives and witnesses regarding professional liability and the anomaly that would result if agencies were not subject to it).

²⁶⁴ Shareholder lawsuits based on securities fraud theories were filed against (1) Moody's, Consolidated Amended Complaint, *In re* Moody's Corp. Secs. Litig., No. 1:07-cv-8375-SWK (S.D.N.Y. June 27, 2008) [hereinafter *Moody's Securities Fraud Complaint*] (briefing completed on defendants' motion to dismiss, Dec. 19, 2008); (2) McGraw-Hill, Lead Plaintiff's Amended Consolidated Class Action Complaint for Securities Fraud, *Reese v. The McGraw-Hill Cos.*, No. 1:08-cv-07202-SHS (S.D.N.Y. Dec. 3, 2008) [hereinafter *S&P Securities Fraud Complaint*]; and (3) Fitch, *Fitch Class Action Complaint for Violations of the Federal Securities Laws*, *Indiana Laborers Pension Fund v. Fimalac, S.A.*, No. 1:08-cv-05994-SAS (S.D.N.Y. July 1, 2008) (voluntarily dismissed, Oct. 3, 2008). The theory of these suits is that the rating agencies failed to disclose to their investors that their ratings for RMBS and RMBS-backed CDOs suffered

from reliance on models they knew to be of poor quality as well as from abandonment of the agency's own rating procedures and poor frequency and quality of ratings surveillance, and that the agencies deliberately overstated the extent of their monitoring. S&P Securities Fraud Complaint, ¶ 4. The plaintiffs allege that these failures to disclose rendered the agencies' optimistic claims about their business false and misleading. Underscoring the difference between a fraud-based standard and direct regulation of agency quality, the S&P complaint states that it is "not about the substance of S&P's ratings" and "is not an attack on the veracity of or reasonableness" of S&P's "opinions," but rather on "false and misleading statements regarding McGraw-Hill's true financial circumstances and future business prospects." S&P Securities Fraud Complaint, ¶ 3. The false statements at issue in these actions are the companies' statements about their businesses, not the ratings themselves. One paper argues that even if the rating agencies engaged in questionable business practices, that does not establish that the stock price failed to reflect the "true value of the business so conducted." Bethel et al., *supra* note 26, at 59. The suggestion appears to be that in light of widespread awareness of the problems, the agencies might have a "truth on the market" defense to securities fraud claims. Further underscoring the difference between fraud-based and quality-based liability, Moody's motion to dismiss the action against it heavily emphasizes arguments that distinguish between low-quality production and fraud, contending: (1) mass downgrades of structured-finance securities reveal only that ratings are "no longer accurate," not that they were "fraudulent when issued." Defendants' Memorandum of Law in Support of Motion to Dismiss the Consolidated Amended Complaint at 16-17, *In re Moody's Corp. Secs. Litig.*, No. 1:07-cv-8375-SWK (S.D.N.Y. Sept. 26, 2008); (2) Moody's claims of integrity and high quality are "mere puffery" and not actionable misstatements, *id.* at 25-27; (3) Moody's did not possess the requisite scienter for fraud, *id.* at 29-37.

In *Blomquist v. Washington Mutual*, No. 07-CV-04108 HRL (N.D. Cal. filed Sept. 10, 2007) [hereinafter *Blomquist Action*], a former real estate agent proceeding *pro se* sought to recover from the three major rating agencies (as well as many other participants in real-estate securitizations) on antitrust and securities fraud theories. Amended Complaint, *Blomquist Action* (Sept. 10, 2007). *Blomquist's* theory of rating-agency liability is unclear, although *Blomquist* argued that all their real-estate security ratings are "tainted with fraud." Opposition to Defendants' Motions to Dismiss; Memorandum of Points & Authorities at 6-7, *Blomquist Action* (July 1, 2008). *Blomquist* addressed the rating agencies' First Amendment defense by asserting that they acted with reckless disregard for the truth by failing to verify borrowers' incomes on stated-income loans. *Id.* at 8. On July 23, 2008, the court granted the rating agencies' motions to dismiss for lack of standing and failure to state

or disgorge” proposal advanced here is different from, and superior to, fraud as a way of dealing with the failures of the reputation mechanism: (1) It entails no inquiry into the agency’s mental state; (2) it is based on the ultimately discovered level of rating quality rather than whether the rating can be characterized as a “misstatement,” which may turn on the “reasonableness” of the agency’s basis for making statements at the time they were made; and (3) it uses a disgorgement rather than a damages remedy.

Intent to deceive is a defining characteristic of fraud, and in the case of securities fraud, a private plaintiff must plead facts giving rise to a strong inference of intent to deceive or its case will be dismissed.²⁶⁵ When an agency issues a rating that it knows to be of relatively low quality, it may be fair to characterize the agency’s action as intended to deceive or it may not. Agencies may issue low-quality ratings without intending to mislead anyone if the right definitions of “intend” and “mislead” are used. Allowing a buyer to believe one’s product is of higher quality than it is can be characterized either as the American way or as deeply nefarious. But the harm or lack thereof arising from the rating has nothing to do with this inquiry into the mental state of an entity that is not a natural person. There is no real reason to believe that the legal definition of scienter in fraud law will generate the right incentives to deter low-quality rating.

The fraud requirement of a “misstatement” is likewise a red herring. Ratings are predictive judgments, not statements that are true or false.²⁶⁶ Such judgments are

a claim for relief, and did not address the agencies’ First Amendment arguments. Order Granting Defendants’ Motions to Dismiss, *Blomquist Action* (July 23, 2008).

²⁶⁵ See 15 U.S.C. § 78u-4(b)(2) (2008); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S. Ct. 2499, 2510 (2007) (securities fraud complaint “will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged”).

²⁶⁶ Ratings are more model-driven in the structured-finance context than in the traditional bond rating context, and that may make them appear less opinion-like. But even structured-finance ratings apparently

sometimes characterized as misstatements by adopting the fiction that they are accompanied by “an implied representation that the speaker rendered the opinion in good faith and with a reasonable basis,”²⁶⁷ but this merely illustrates that the fraud framework is not well-suited to assessing the quality of a product that takes the form of a predictive judgment.²⁶⁸

Moreover, the “reasonable basis” standard itself requires further definition to be useful. Reasonableness is assessed on an *ex ante* basis. It could be understood as “high quality,”

contain a significant element of subjective judgment. See SEC STAFF EXAMINATION REPORT, *supra* note 38, at 13 (quoting agency internal e-mail as stating that “our SF [structured finance] rating approach is inherently flexible and subjective”); *id.* at 14 (asserting that “rating agencies made ‘out of model adjustments’ and did not document the rationale for the adjustment”). In any event, the creation and selection of the model methodology is itself a subjective judgment.

²⁶⁷ See, e.g., *Weiss v. SEC*, 468 F.3d 849, 855 (D.C. Cir. 2006).

²⁶⁸ For the same reason, agency liability for “untrue statements” and “omissions” of “fact” under section 11 of the 1933 Act, 15 U.S.C. § 77k(a) (2008), seems ill-suited to providing the right incentives for optimum rating quality. Several pending lawsuits advance such claims. As of January 2009, none of these cases had advanced past the stage of litigation over forum. See *New Jersey Carpenters Vacation Fund v. HarborView Mortgage Loan Trust*, No. 1:08-CV-05093 (S.D.N.Y. order granting removal to federal court Sept. 24, 2008), No. 08-4861 (Second Circuit appeal of denial of motion to remand to state court, 581 F. Supp. 2d 581, dismissed upon parties’ stipulation Jan. 21, 2009); *New Jersey Carpenters Health Fund v. Royal Bank of Scotland*, No. 1:08-CV-05310 (S.D.N.Y. 2008) (motion to remand to state court pending as of Jan. 27, 2009); *New Jersey Carpenters Health Fund v. Home Equity Mortgage Trust*, No. 1:08-CV-05653 (S.D.N.Y. 2008) (motion to remand to state court dismissed upon stipulation, Oct. 2, 2008). The agencies enjoy an exemption from “expert liability” under section 11 that may cover these claims. Section 11 provides for liability for certain experts that “certify or prepare” part of a false or misleading registration statement. 15 U.S.C. § 77k(a)(4). Also, the SEC has determined that the credit rating of a debt security is not a part of the registration statement certified or prepared by the rating agency. 17 C.F.R. § 230.436(g) (2008). But section 11 also provides for liability for “appraisers” and others that prepare or certify a “report or valuation used in connection with the registration statement,” 15 U.S.C. § 77k(a)(4), and the SEC’s exemption does not cover this type of liability.

so low-quality ratings would be treated as “misstatements.” However, the *ex ante* inquiry into whether a reasonable basis for a judgment exists also might be interpreted as providing the equivalent of a due-diligence defense. As others have noted, such defenses encourage the wasteful creation of litigation-driven checklists that add little value.²⁶⁹

Finally, the disgorgement remedy proposed here is superior to the damages remedy available in fraud actions. The prospect of losing the profits from low-quality ratings should be sufficient to deter knowing production of such ratings.²⁷⁰ Increasing exposure beyond this point magnifies the key drawbacks of the intervention—the risk of overdeterrence—without a corresponding increase in benefits. For example, if damages exposure were to exceed the profits from issuing ratings on a given product by a large amount, even a small possibility of error in applying the standard will overdeter production. Moreover, although it is reasonable to suppose that poor-quality recommendations result in social loss and should be deterred, it is far less reasonable to suppose that this social loss is equal to the investor’s loss on the investment. A minimally intrusive intervention to address the problem in question seems advisable, and disgorgement of rating agency fees is far less

²⁶⁹ Partnoy, *supra* note 109, at 511-14.

²⁷⁰ This limitation of damages neutralizes the criticism that holding agencies responsible for ratings quality turns them into “insurers.” See, e.g., Huisman, *supra* note 64, at 442-43, 445-46. Agencies are not insuring investors against loss under this proposal. All that is at stake is the amount that agencies are paid for the ratings, which is probably much smaller. Rating agencies apparently charge in the neighborhood of 3.25 to 7 basis points (“bps”) of principal to rate traditional corporate bonds, and 7 to 12 bps of principal to rate structured products. Ashcraft & Scheuermann, *supra* note 24, at 39. Fees are thus \$325 to \$1200 per \$1 million of principal. Arguments that rating price would increase also seem unpersuasive: The agency can avoid liability by disclosing low quality or refraining from issuing ratings, and large damage awards will not occur because of the limited nature of the remedy. In any event, rating prices are low relative to the amount of damage poor-quality ratings seem capable of causing.

intrusive than damages for investor losses from failed investments.

3. Negligence Liability

It appears unlikely that rating agencies are subject to state-law negligence claims²⁷¹ under current law. The RESTATEMENT OF TORTS (SECOND) § 552, which recognizes negligence liability for providers of business information, could apply to rating agencies. But the provision focuses on “obtaining and communicating” information—apparently factual information—rather than on the quality of judgments.²⁷² Even if the RESTATEMENT does apply, agencies possess “conventional defenses to liability” based on the absence of duty to investors and on their statements that ratings are not investment recommendations, and at least one commentator finds these defenses “quite potent under

²⁷¹ This discussion covers negligence claims that are not based on claims of “misstatement.” Such claims are subject to a fraud-type analysis with a particular scienter requirement, and the observations in Part V.C.2 apply.

²⁷² RESTATEMENT (SECOND) OF TORTS § 552 (1977). The RESTATEMENT provides:

One who in the course of his business or profession supplies information for the guidance of others in their business transactions is subject to liability for harm caused to them by their reliance upon the information if

(a) he fails to exercise that care and competence in obtaining and communicating the information which its recipient is justified in expecting, and

(b) the harm is suffered

(i) by the person or one of the class of persons for whose guidance the information was supplied, and

(ii) because of his justifiable reliance upon it in a transaction in which it was intended to influence his conduct or in a transaction substantially identical therewith.

traditional principles of tort law.”²⁷³ Most important, the 2006 Act prohibits states from regulating the “substance” of credit ratings.²⁷⁴ State tort liability relating to a subject typically is considered state regulation of that subject,²⁷⁵ so it probably is preempted under current law.

On the level of policy, a remedy of disgorgement rather than damages makes sense in this context, as explained, so a classic negligence action is inappropriate. Moreover, the “reasonable care” standard for negligence liability poses similar problems to the “reasonable basis” standard for fraud, such as the fact that it does not in itself define a usable standard on its own, but only delegates to courts the problem of fashioning a standard.²⁷⁶ In addition, negligence-based standards of care are criticized for addressing only the manner in which an activity is carried out and not whether the activity should be carried out at all.²⁷⁷ The latter consideration is critical in the case of ratings on novel financial products.

A credit rating can be thought of as an information product,²⁷⁸ and Justice Traynor’s classic argument for strict

²⁷³ Kettering, *supra* note 16, at 1691.

²⁷⁴ 15 U.S.C. § 78o-7(c)(2) (2008).

²⁷⁵ See Lohr v. Medtronic, Inc., 518 U.S. 470, 504-05, 510 (1996) (“[I]nsofar as [a federal statute] pre-empts a state requirement embodied in a state statute, rule, regulation, or other administrative action, it would also pre-empt a similar requirement that takes the form of a standard of care or behavior imposed by a state-law tort action.”); see also Riegel v. Medtronic, Inc., 128 S. Ct. 999, 1008 (2008); Geier v. American Honda Motor Co., 529 U.S. 861, 886 (2000).

²⁷⁶ See, e.g., Manns, *supra* note 161, at 63-67. Manns advocates a system in which rating agencies would be subject to SEC-administered sanctions for negligence and to liability for gross negligence but does not explain specifically what these standards would look like in the rating-agency context. Given that the standards are not fleshed out, it is unclear why gross negligence is the right standard for liability, beyond the fact that it reduces rating-agency exposure.

²⁷⁷ See, e.g., Miriam Hechler Baer, *Insuring Corporate Crime*, 83 IND. L.J. 1035, 1050 (2008) (“Negligence fails to secure optimal activity levels.”).

²⁷⁸ See RESTATEMENT (THIRD) OF TORTS: PRODUCT LIABILITY § 19(a) (1998) (“A product is tangible personal property distributed commercially for use of consumption.”). Ratings are not “tangible personal property,”

products liability seems appropriate: “Even if there is no negligence . . . public policy demands that responsibility be fixed where it will most effectively reduce the hazards . . . inherent in defective products that reach the market” and that “the manufacturer can anticipate some hazards and guard against the recurrence of others, as the public cannot.”²⁷⁹

4. Gatekeeper Liability

“Gatekeepers” generally are parties other than the issuer whose cooperation is necessary for securities to be issued. Gatekeepers may include underwriters, lawyers, and accountants, as well as rating agencies. Gatekeeper liability refers to the practice of holding gatekeepers responsible for issuer wrongdoing of some kind, and scholars who recognize a role for liability or other ex post remedies in improving rating-agency performance tend to draw an analogy between rating agencies and other gatekeepers.²⁸⁰

but the only reason the RESTATEMENT gives for limiting the definition of “product” this way is that including information products would raise First Amendment concerns. *See id.* cmt. d. Such concerns are addressed at Part V.B. *supra*.

²⁷⁹ *Cf. Escola v. Coca Cola Bottling Co.*, 24 Cal. 2d 453, 462 (1944) (Traynor, J., concurring) (“Even if there is no negligence, however, public policy demands that responsibility be fixed where it will most effectively reduce the hazards to life and health inherent in defective products that reach the market.”). Whether a strict-liability regime for undisclosed low-rating quality will inefficiently deter rating production depends on how good customers are at assessing quality on their own. Just how bad customers have to be at assessing rating quality for the strict-liability regime to become inefficient depends on how good high- or low-quality ratings are relative to customers’ native ability to assess credit quality.

²⁸⁰ *See Manns, supra* note 161, at 64-65 (proposing that liability is appropriate where “rating agencies could have identified wrongdoing”), *id.* at 7-15; Partnoy, *supra* note 68, at 711 (“[A]gencies should not simultaneously benefit from ratings-dependent regulation and be insulated from lawsuits alleging negligence or misrepresentation. If the agencies truly are private entities surviving based on their reputations, they should be susceptible to the same sorts of lawsuits any similarly-situated private entity would be.”); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH.

Rating agencies argue that they should not be subject to gatekeeper liability and attempt to disclaim responsibility for the accuracy of the information underlying their ratings. They say they do not verify the information they receive,²⁸¹ although they do rely on nonpublic information.²⁸² For example, Fitch explains that it “does not audit or verify . . . or . . . perform any other kind of investigative diligence into the accuracy . . . or completeness” of the information it receives.²⁸³

The “gatekeeper” concept probably is not the best framework for analyzing rating agencies. Rating agencies need not act as gatekeepers, although they probably have done so in the past, and the current effort to reduce rating-dependent regulation seems intended to dislodge them from

U. L.Q. 491, 492 (2001) (proposing a “modified strict liability regime” for securities-fraud gatekeepers, presumably including rating agencies, under which gatekeepers would be liable for a fraction of the investor losses caused by issuer misstatements, and would not enjoy any due diligence defense, but under which the fraction of losses for which the gatekeeper would be responsible would be set by agreement at the time of issuance, subject to a statutory minimum); Coffee, *supra* note 231 (proposing that gatekeepers, including rating agencies, be subject to strict liability for material omissions and misrepresentations that cause investor loss, subject to a statutory cap equal to “some adequate multiple of the highest annual revenues received by the gatekeeper from its client over the last several years”); COFFEE, *supra* note 80, at 303-04 (expressing qualified support for expanding rating agency liability under Rule 10b-5 (in particular SEC-specified procedures that would serve as a safe harbor and could also provide a standard for recklessness), but emphasizing the importance of making it easier for rating agencies to become NRSROs). *But see* Bottini, *supra* note 256, at 584, 609 (finding that “the market is not effectively ensuring a proper standard of care among the rating agencies” but that personal cause of action against rating agencies for negligence “should be rejected”).

²⁸¹ IOSCO CRA REPORT, *supra* note 36, at 3-4 (criticizing originators for lax underwriting standards and potentially misleading rating agencies and noting that agencies do not verify accuracy of underlying information).

²⁸² IOSCO CRA REPORT, *supra* note 36, at 3.

²⁸³ FITCH RATINGS, *supra* note 164, at 10; *see also id.* at 9 (“[A]nalysis of the legal regime is based on the opinions and advice provided by transaction counsel.”).

this role.²⁸⁴ Sophisticated investors might have no need for rating-agency analysis and products could be sold successfully to these investors without ratings. Indeed, some specialized structured products are issued without ratings.²⁸⁵ Moreover, under the standard account, rating agencies add value by furnishing opinions of creditworthiness, not just by ferreting out misstatements or other forms of issuer “wrongdoing.”

Agency ratings can be of poor quality even if they rely on accurate information. If a flawed model states that a certain amount of subordination is needed for a tranche to receive a AAA rating and the arranger provides that amount of subordination in a structured product, the rating can be of low quality even if no one has done anything wrong. Conversely, agencies can produce high-quality ratings even if they rely on information that has some degree of inaccuracy. If one mortgage out of 10,000 in a pool is based on the borrower’s lies about his or her income, the rating may be of good quality as long as the model is good.

Holding agencies responsible for the quality of their ratings directly gives them the proper incentives to monitor the quality of the information on which they rely. Focusing on issuer misstatements instead of overall quality puts too much emphasis on monitoring underlying data quality and too little on the agency’s analysis.

5. “Prior Restraint” of Low-Quality Ratings

A bill introduced July 14, 2008²⁸⁶ would attempt to ensure high-quality ratings on novel products by requiring prior SEC approval for the products before ratings on the products could receive regulatory recognition.²⁸⁷ The

²⁸⁴ See *infra* Part IV.C.3.a.

²⁸⁵ See Banc of America Securities, Synthetic Credit Portfolio Transactions, (July 25, 2001) (discussing issuance of unrated synthetic transactions using credit-linked notes and total return swaps).

²⁸⁶ H.R. 6482, 110th Cong. (2008).

²⁸⁷ Aaron Lucchetti, *New Rules Loom for Bond-Rating Firms*, WALL ST. J., July 14, 2008, at C3.

proposal appears to assume that ratings will continue to be used for regulatory purposes. Against that backdrop, the denial of regulatory recognition to ratings on novel unapproved products seems intended to prohibit such ratings rather than to combat investor “overreliance” on them. So understood, that proposal is more intrusive than the proposal in this Article, because the bill relies on the regulator’s ability to foresee whether instruments can be rated with high quality, while the proposal here merely requires the regulator to be able to monitor quality on an ex post basis.²⁸⁸

D. The Minimum Quality Level

The “disclose or disgorge” system as described here requires that rating quality be measured, that a minimum quality level be established, and that the minimum quality level be applied to observed rating performance. Measuring rating quality should not be difficult; rating agencies already

²⁸⁸ The suggested approach is designed to discourage low-quality ratings. This will deter financial innovation only to the extent that agency ratings are needed for the introduction of new products. To the extent that a formal gatekeeping function is removed, as regulators appear to be considering, it would still be possible to attempt to introduce innovative products without ratings. Although that might not be successful, the failure would reflect the investors’ inability to assess the products’ risks. It appears that product failure in that situation would be a good thing, not a bad thing.

In the case where the rating agency is a gatekeeper, it is possible that the proposal will deter innovation. It might be possible for sophisticated investors to judge the creditworthiness of an innovative security even if the rating agencies cannot. In such a case, if agency ratings are required for the security’s success, then the conjunction of agency gatekeeping and deterrence of low-quality ratings would cause the innovation to fail. Because it is difficult to estimate what welfare enhancements result from financial innovation, it is difficult to weigh the tradeoff between the benefits of improved rating quality and the costs of innovation deterrence in this case. It is worth noting, however, that if this were a serious problem it would increase pressure on the agencies’ status as gatekeepers. That is appropriate, as it is most unclear that agency gatekeeper status is appropriate for instruments that the agencies cannot rate with high quality.

do it and their measures seem appropriate, at least as a starting point. Drawing the line defining the appropriate minimum quality level, on the other hand, may be difficult in practice. This Article sketches out some ideas for accomplishing this while recognizing that resolving the issue requires, at a minimum, additional data.

1. Measures of Rating Quality

As noted, the rating agencies assert, and the notion of reputation presumes, that rating quality can be measured.²⁸⁹ This section describes specific measures of rating quality that could be incorporated into a regulatory system.²⁹⁰

The major performance measure used by credit rating agencies is the “accuracy ratio,” which is a way of expressing the performance of an ordinal rating system in terms of a single number. The accuracy ratio is computed based on a “power curve.”²⁹¹ The accompanying figure presents the power curve for a hypothetical set of ratings. Rated instruments are arranged on the x-axis in increasing order of rating. The cumulative proportion of defaults is plotted on the y-axis. If defaults had no connection to ratings and were evenly distributed among rating classes, the power curve

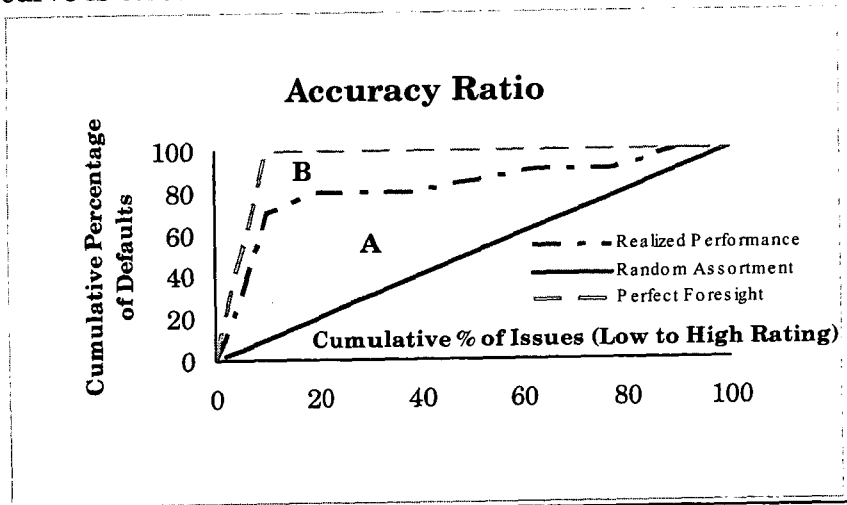
²⁸⁹ See *supra* Part IV.A.

²⁹⁰ It could be argued that courts or regulators cannot apply a quality standard accurately, that regulatory compliance or litigation impose costs that are in themselves socially wasteful, and that uncertainty about the outcome of judicial or regulatory processes would make it more difficult for rating agencies to decide whether to rate novel instruments.

These costs are limited in the case of this proposal, because the idea here is that an objective standard will be applied to rating-agency outputs. Agencies will be subject to disgorgement if their ratings do not meet the designated standard. By making rating agencies responsible for output quality, the proposal avoids the problems and errors associated with intrusive monitoring. For example, the proposal does not call for inquiry into scienter or into the process by which specific ratings are generated.

²⁹¹ See FITCH RATINGS, FITCH RATINGS 1991-2007 GLOBAL STRUCTURED FINANCE TRANSITION AND DEFAULT STUDY 14 (2008). The power curve is also called a “Lorenz curve” and the accuracy ratio is also called the “Gini coefficient.”

would lie along the lower, diagonally upward-sloping line—defaults would be distributed evenly across rating classes. A more “humped” shape to the curve indicates greater concentration of defaults among lower-rated ratings and can be interpreted as indicating greater rating quality. The accuracy ratio is computed by taking the ratio of the area between the diagonal and the actual power curve (numerator) and the area between the diagonal and the power curve that would have been realized if the agency had had perfect foresight (denominator). In other words, it is the proportion of Area A to Area A + Area B. This is represented in the Figure by the upper line. The maximum value for the accuracy ratio is one, and the accuracy ratio for the pictured curve is 0.69.²⁹²



²⁹² As the agencies note, the accuracy ratio: (1) Is just one way of compressing the information in the power curve to a single number; (2) requires a large number of in-sample defaults to be meaningful; and (3) equally weighs Type I error (rating a defaulter too high) and Type II error (rating a non-defaulter too low). MOODY'S INVESTORS SERVICE, SPECIAL COMMENT: MEASURING THE PERFORMANCE OF CORPORATE BOND RATINGS 13 (2003). A related, alternative approach to measuring credit quality is simply to assign a numerical value to each credit rating level and compute the correlation between rating level and default rate. See Dittrich, *supra* note 12, at 21-22; see also STANDARD & POOR'S, *supra* note 172, at 10 ("[T]he measure of any rating agency's success is whether, in aggregate and over the long term, its ratings are correlated with actual default experience.").

Another dimension of quality is comparability of ratings across instruments. As noted, all the major agencies claim that their ratings mean the same thing across all products,²⁹³ and agencies' award of ratings on the same scale to new and traditional products has helped novel products gain investor acceptance.²⁹⁴ The unit of comparison here is simply the default rate for products in each rating class.²⁹⁵

To the extent it is possible to tell from the materials the rating agencies have made available, it appears that rating performance in novel structured products has been relatively poor during the worldwide credit crisis even by the agencies' modest standards.²⁹⁶

²⁹³ See *supra* Part IV.A.3.

²⁹⁴ See *supra* Part IV.C.3.a.

²⁹⁵ The realized comparability of default rates across classes of securities during the recent crisis is a matter of some dispute. Compare *House Structured Finance Hearings*, *supra* note 57, at 18 (testimony of Joseph R. Mason) (asserting that CDOs rated Baa by Moody's are 250 times as likely to default as municipal bonds) *with id.* at 21 (testimony of Vickie A. Tillman, Executive Vice President, S&P) ("I cannot speak to where [Mason] came up with his statistics, but if you take the same statistics on an investment grade CDO . . . at a BBB level over a 5-year period, the average default rate is somewhere around 2 1/2 percent. If you look at a corporate bond . . . rated by Standard & Poor's in the same time period rated BBB, then you have approximately 2 1/2 to 3 percent probability of default.").

²⁹⁶ See STRUCTURED FINANCE RATING PERFORMANCE 2007, *supra* note 106, at 1 ("The one-year accuracy ratio for the most recent cohort was 77.2%, which is 13.1 percentage points lower than its six-months-prior level and 9.0 points lower than the historical average."); *id.* ("The one-year investment-grade loss rate jumped to 0.59% for the cohort ending December 2007, a historical high and a more than five-fold increase from the historical average of 0.11%."). Moody's reports that poor performance was concentrated in a few segments, attributing the drop in the accuracy ratio to an "increase in the number of material impairments in the US HEL [home equity loan] sector, composed mostly of securities backed by subprime mortgages, and within global CDOs, composed mostly of securities backed by a portfolio of other structured finance securities In contrast, the one-year accuracy ratios for US ABS other excluding HEL, US RMBS, US CMBS and international structured finance excluding CDOs and Other SF were essentially unchanged from their six months prior levels and were all above 93%." *Id.* at 4. To the best of the author's knowledge, Fitch and S&P have not published comparable statistics for

2. Setting the Minimum Quality

Setting the actual level of quality that triggers the “disclose or disgorge” standard is a challenge in implementing the proposal advanced here, at least if the regulator is going to set the level.²⁹⁷ One issue is that for ratings of a given quality level, reliance by certain investors (those who are poor at choosing investments without ratings) may increase social welfare, while reliance by other investors (those who are good at choosing investments without ratings) decreases welfare.²⁹⁸ Assuming a two-category system, if the dividing line between high- and low-quality ratings is set too high, then too many ratings will be branded low-quality (or withheld) and investors will not rely enough on ratings. If the dividing line is set too low, then too few ratings will be disclosed as low-quality and investors will rely excessively. Ideally, the quality level that triggers the “disclose or disgorge” requirement in a two-category system would balance these considerations.

The line-drawing exercise of determining the specific quality level to which agencies should be held can be performed in theory. For example, given assumptions about the social benefits of “good” investments, the social costs of “bad” investments, the proportion of good and bad investments in the universe, and investors’ ability to distinguish between the two without ratings, the “right” minimum level of rating quality can be determined. Such an

structured finance broken down by type of instrument since the beginning of the crisis, although Fitch’s *overall* accuracy ratio for structured products appears higher than Moody’s. See FITCH RATINGS, *supra* note 291, at 14 (one-year accuracy ratio of 0.86 across all structured finance segments). Given the heterogeneity of performance across sectors, the difference may be explained at least in part by a difference in product mix.

²⁹⁷ As described *infra*, at Part V.E.2.c, it may be feasible to use a market-based standard.

²⁹⁸ Recall that investors may rely on poor-quality ratings rationally because they do not know the quality of the ratings in advance. As shown above, this situation can exist in equilibrium if the *average* quality of ratings is high enough.

approach requires information that may not be available for which it may be difficult to find easily estimated proxies.

A practical alternative would be to key the minimum quality level to the quality of traditional bond ratings. This quality level provides a familiar benchmark to market participants, as traditional bond ratings have a decades-long performance record. It seems likely that ratings that meet this standard are of high quality. This standard may be too high, however. One might imagine that novel-product ratings could be of somewhat lower quality than traditional ratings and could still be useful.

Another possibility would be to use market experience to provide bounds for the appropriate minimum quality level. If investors' disappointment in the quality of novel-product ratings in fact caused the markets for novel products to collapse, as has been reported,²⁹⁹ this strongly suggests that these ratings fell below the appropriate minimum quality standard. If rating quality below X causes market collapse, then X is likely a good lower bound for the minimum permissible rating quality. This suggests that the appropriate dividing line between high and low quality falls somewhere between traditional-product quality and the realized quality of ratings on, say, CPDOs and subprime RMBS.

3. Applying the Minimum Quality Level

To make the discussion less abstract, consider an example of enforcement for a minimum quality level equal to that for ratings on traditional bonds.

With respect to the ordinal rating quality (the accuracy ratio), a simple comparison and test for statistically significant difference can be employed. The regulator would create a population of products and vintages of high-quality ratings and get the mean and standard deviation of accuracy ratio for this population. The regulator could compare the accuracy ratio for each novel product for each time horizon over a given period to the known high-quality population and

²⁹⁹ See *supra* Part II.C.

order disgorgement if the accuracy ratio for the novel product is significantly less than the accuracy ratio for the known high-quality ratings.

With respect to the comparability of ratings across product classes, the fact that the agencies assert that structured-finance and traditional corporate ratings mean the same thing implies that bonds in the same rating class should exhibit the same default rate over the same time horizon, within the limits of statistical error. A simple comparison of novel product default rates over various time horizons using a basic test for statistical significance can be used to determine whether the novel-product ratings are in fact “the same” as corporate bond ratings. If AAA bonds have a 0.01% annual default rate over a year time horizon and a standard deviation of 0.002%, then novel-product default rates that are outside approximately a two-standard-deviation band, i.e., less than 0.006% or more than 0.014%, would be of low quality and subject to disgorgement.

More sophisticated techniques might be employed in practice. This discussion is intended simply to give a sense of how the minimum quality level might be applied.

E. Implementing “Disclose or Disgorge”

1. General Implementation Issues

The proposal also presents several other implementation issues. First, quality will be measured by statistical techniques. If an apparent decline in quality is observed, then the question whether there was a “real” quality decline or whether the rating agency simply got unlucky will arise. The regulator or court will have to determine what statistical test to apply and what level of significance is appropriate.

Second, the test will be applied on an aggregate basis, e.g., to “S&P ratings of RMBS-backed CDOs from 2006.” This will require the universe of ratings to be segmented into products and vintages. The proper segmentation will not always be clear (i.e., should RMBS-backed CDOs be

considered as a group or be divided into subprime and non-subprime segments?). Unless the segmentation is done on an *ex ante* basis, there will be clear incentives to game the system (i.e., by “gerrymandering” the categories so that they all show adequate quality).

Third, quality must be measured over differing time horizons. The idea is not just to determine what the correlation between default and rating is after six months, but also after one year, two years, etc. The regulatory system will have to define the time horizons at which quality is to be measured and at which the agency will be held responsible.

2. Specific Methods of Implementation

The proposal advanced here consists of a substantive rule of decision: Rating agencies must disgorge profits derived from low-quality ratings on novel instruments unless they disclose in advance that the ratings are of low quality. This rule of decision could be put into practice in a number of different ways: private liability, an administrative system overseen by the SEC, or private contracting.

a. Liability Rule

The “disclose or disgorge” proposal is akin to the familiar strict liability rule for defective products, with a defense for proper warnings. Given that ratings are a product, this approach could be implemented directly by courts without materially extending existing doctrine, although the relief recommended here—disgorgement of profits—would be a departure from current products liability law. Repeal or amendment of the 2006 Act provision prohibiting states from regulating rating quality would be necessary unless a federal cause of action were created. Although it may not be possible to identify defective ratings at the individual rating level, the class-action mechanism seems appropriate for enforcing claims for disgorgement based on a theory that all ratings on a particular product in a given time frame were of low quality. Implementing “disclose or disgorge” through a

state-level liability rule does run the risk that different states would arrive at different views of the appropriate quality level and that that would seriously complicate the rating business.

b. Administrative System

The proposal could be implemented via a regulatory regime. The SEC already has oversight authority over rating agencies, so it is the natural candidate to administer such a regime. The regulator could be empowered to monitor rating quality and impose the disgorgement remedy if rating quality for a given product type and vintage is below the minimum level. A system of escrow for ratings proceeds could be implemented as an adjunct to the regulatory regime to the extent that the agency's inability to pay the required fees is a concern. This approach would require authorizing legislation for the SEC.

c. Contracting

In principle, a quality guarantee could be implemented by contract.³⁰⁰ The rating agency could promise to disgorge profits if ratings turn out to be of low quality.³⁰¹ There are a number of possible explanations for the fact that this has not happened.

First, the "reputational-capital" model could be fundamentally inadequate in describing the rating market. If the fundamental driver of rating agencies' business is something other than a deserved reputation for high-quality ratings, then rating agencies have no incentive to guarantee their rating quality. Second, there could be a collective action problem. If, as rating agencies argue, they have little incentive to respond to the demands of any individual *issuer* because there are so many issuers, they have even less incentive to respond to the demand of an individual *investor*

³⁰⁰ *But see* Dittrich, *supra* note 12, at 15 ("Guarantees . . . are not applicable as rating quality is measured against statistical default rates.").

³⁰¹ If investors were to fund the rating process directly, a disgorgement pledge might well take the form of a money-back guarantee.

to guarantee rating quality—especially given that agencies derive most of their revenue from issuers and not investors. It might not be practical for investors to undertake the joint action needed to achieve the desired result. In either case, market incentives would not produce high-quality ratings.

A third possibility is that contractual quality guarantees are not used because of characteristics of the rating market (such as lack of competition and conflicts of interest) that policymakers are working to change. If so, a contractual system of quality guarantees might be expected to emerge and obviate the regulatory “disclose or disgorge” system over time.

VI. CONCLUSION

Fear of losing reputational capital is not likely to constrain credit rating agencies from issuing low-quality ratings on novel products, principally because they have no reputation in this type of product rating to lose. In this context, the dominant academic view of rating agencies, which underlies most reform efforts—including all such efforts that have actually gone into effect—is therefore likely to be wrong. Accordingly, reform efforts to date are fundamentally limited in their ability to bring about high-quality ratings for novel financial products. This issue is critical in light of the fact that innovation has become a fundamental and persistent feature of financial markets.

Under the apparently correct assumption that agencies have some knowledge of the quality of their ratings, rating quality could be improved by adopting a rule requiring a rating agency to either (a) disclose that it believes that its ratings on a new product is of low quality, or (b) disgorge profits derived from selling ratings on new products that turn out to be of poor quality. This proposal directly addresses the problem with ratings on novel financial instruments, is more likely to be effective than the SEC’s proposed grab bag of new rules, and is less intrusive than other direct interventions in the rating market.