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Ratings Reform: The Good, The Bad, and The Ugly

John C. Coffee Jr.

Columbia Law School, jcoffee@law.columbia.edu

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John C. Coffee Jr.

Columbia Law School, American Academy of Arts & Sciences and ECGI

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Law Working Paper N°.162/2010

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Abstract

Both in Europe and in the United States, major steps have been taken to render credit rating agencies more accountable. But do these steps address the causes of the debacle in the subprime mortgage market that triggered the 2008-2009 crisis? Surveying the latest evidence on how and why credit ratings became inflated, this paper argues that conflicts of interest cannot be purged on a piecemeal basis. The fundamental choice is between (1) implementing a “subscriber pays” model that compels rating agencies to compete for the favor of investors, not issuers, and (2) seeking to deemphasize or eliminate the role of credit ratings to reduce the licensing power of rating agencies. Although it strongly favors the first option over the second, it also recognizes that the “public goods” nature of ratings makes it unlikely that a “subscriber pays” system will develop on its own without regulatory interventions. Thus, it considers how best to encourage the development of a modified system under which the investor would choose and the issuer/deal arranger would pay for the initial rating on structured finance transactions.

Keywords: credit rating, Dodd-Frank Act, public good, European Commission

JEL Classifications: G18, G28, G29, G38, K22

John C. Coffee Jr
Columbia Law School
435 West 116th Street
New York, NY 10027
United States
phone: 212-854-2833, fax: 212-854-7946
e-mail: jcoffee@law.columbia.edu

Ratings Reform: A Policy Primer on Proposed, Pending and Possible Credit Rating Reforms

by John C. Coffee, Jr. *

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

Beyond the recognition that the CRAs failed and that their efforts and performance were compromised by serious conflicts of interest, little consensus exists, particularly among academics, on the shape of reform. Numerous reforms have been proposed by numerous champions, but fundamental disagreements divide even the most trenchant critics of the CRAs. Many view the CRAs as gatekeepers possessing

* John C. Coffee, Jr. is the Adolf A. Berle Professor of Law at Columbia University Law School and Director of its Center on Corporate Governance.

¹ Reflecting this consensus, the Group of Twenty (G20) announced in April, 2009 their agreement on the need for “more effective oversight of the activities of Credit Rating Agencies.” See Global Plan Annex: Declaration on Strengthening the Financial System Statement Issued by the G20 Leaders, April 2, 2009, London.

² For the finding that the ratings on structured finance products were highly inaccurate, see Joshua D. Coval, Jacob W. Jurek, and Erik Stafford, Economic Catastrophe Bonds, 99 *Amer. Eco. Rev.* 628 (2009); see also Joshua D. Coval, Jacob W. Jurek, and Erik Stafford, The Economics of Structured Finance, 23 *J. Econ. Persp.* 3 (2009). For criticisms of the rating process and practices such as ratings shopping, see Efraim Benmelech and Jennifer Dlugosz, The Alchemy of CDO Credit Ratings, 56 *J. of Monetary Economics* 617 (2009).

³ See John Patrick Hunt, Credit Rating Agencies and the “Worldwide” Credit Crisis: The Limits of Reputation, the Insufficiency of Reform and A Proposal for Improvement, (available at <http://ssrn.com/abstract=1267625>) at 12.

reputational capital that they pledge to generate investors confidence in their ratings.⁴ From this “reputational capital” perspective, conflicts of interest become the principal problem, as the CRAs may willingly (even cynically) sacrifice some reputational capital for enhanced revenues, at least so long as barriers to entry remain high and their legal liability stays low. From a different perspective, however, the CRAs are viewed less as informational intermediaries (or “gatekeepers”) and more as holders of regulatory licenses that enabled them to exploit their quasi-governmental power for self-interested purposes.⁵ Some even doubt that the market needs credit rating agencies, believing that their role could and should be replaced by alternative mechanisms, including greater reliance on credit spreads.

Thus, while those who start from the “gatekeeper” perspective tend to favor reforms aimed at reducing conflicts of interest (either by increasing CRA liability or restricting the issuer’s ability to choose the rating agency), those who take the “regulatory license” perspective favor deregulation that ends the need for regulated financial institutions to obtain investment grade ratings before investing. This tension was evident in the drafting of the U.S.’s recent financial reform legislation – the Dodd-Frank Act – which largely straddles this gap. But if the deregulatory approach is taken, it leads to a further problem: How should financial institutions (such as money market funds) be regulated once it is acknowledged that in competitive markets these firms may be under

⁴ For a statement of this view (and a recognition of its limits), see John C. Coffee, Jr., *GATEKEEPERS: The Professions and Corporate Governance* (Oxford University Press 2006).

⁵ The leading proponent of this view that ratings-dependent regulation should be dismantled is Professor Frank Partnoy. See Frank Partnoy, *The Siskel & Ebert of Financial Markets?: Two Thumbs Down for the Rating Agencies*, 77 Wash. U. L. W. 619 (1999); see also Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis*, (available at <http://ssrn.com/abstract=1430653>).

pressure to take on excessive risk in order to obtain above-market returns? Can regulators define “creditworthy” investments with sufficient precision to enable them to end their current reliance on credit ratings?

The choice is fundamental. Although it is desirable to discourage unthinking reliance by investors on credit ratings, the implications of any mandatory downsizing of the role of the CRAs (beyond that which will naturally occur in a market dissatisfied with their performance) are uncertain. For some industries (such as housing finance) that depend upon asset-backed securitizations, access to capital may depend upon ratings that are credible, because “do-it-yourself” financial analysis of opaque debt instruments is simply not feasible for most financial institutions. Also, if the current reliance on investment grade credit ratings were ended, the manner by which sensitive financial institutions (most notably, money market funds) should be regulated remains unresolved. Are they to be given carte blanche to invest in any form of debt security? If not, can state and federal regulators define credit worthiness in comprehensible and comprehensive terms? Deficient as the CRAs have been, it is not obvious that governmental agencies can do much better, either at promulgating required standards of creditworthiness or in providing their own credit ratings.

Agreement, does, however, exist on one score: all want increased competition among CRAs. But, as will be seen, the impact of increased competition is problematic; it can encourage ratings arbitrage, as issuers pressure competing rating agencies to relax their standards. In any event, a feasible path to increased competition from the current starting point of oligopoly is far from obvious. The barriers to entry into this field are likely to remain forbiddingly high. Quite simply, the “Catch 22” for new entrants is that it

is nearly impossible to obtain clients without a track record for reliable ratings and such a track record is difficult to generate unless one first has clients. Thus, to generate competition, some governmental intervention appears necessary. Possible such responses include: (1) authorizing an independent body to select the rating agency; (2) mandating (and thereby effectively subsidizing) a “subscriber pays” model for ratings; and (3) creating a governmental rating agency to issue ratings (much like the TVA was created in the United States as a check on the monopoly power of private utilities). Evaluating these options and the defining the regulatory objectives of enhanced oversight will be a focus of this paper.

After a brief review of the latest empirical evidence on the failure of the CRAs, this paper will argue that the conflict inherent in the dominant “issuer pays” business model and the concentrated character of the CRA market require an interlinked solution that either (1) divorces issuer payment of the CRA from issuer selection of the CRA, or (2) encourages (and implicitly subsidizes) an alternative “subscriber pays” market for ratings.

Unlike more thorough-going critics of the CRAs, this article recognizes (as does a recent study by the staff of the New York Federal Reserve Bank⁶) that the CRAs do provide valuable information that strongly influences the cost of capital. At least in the case of complex and opaque debt securities (such as collateralized debt obligations or “CDOs”), “do-it-yourself” credit analysis, even by relatively sophisticated institutional investors, is no more feasible than “do-it-yourself” brain surgery. Thus, reform of the CRAs is to be preferred over free market solutions that permit anyone to issue credit

⁶ See Adam Ashcraft, Paul Goldsmith-Pinkham, and James Vickery, “MBS Ratings and the Mortgage Credit Boom” (Staff Report No. 449, May, 2010).

ratings and anyone to rely on them. That premise appears also to be shared by the U.S. Congress, Canada, and the EU Commission, which have all recently introduced systems for the mandatory registration and oversight of CRAs. Nonetheless, some downsizing of the mandatory role of credit ratings may be part of a balanced policy approach.

Because this paper covers European as well as U.S. developments, it must be underscored at the outset that context counts – particularly in two critical respects. First, the institutional culture and regulatory options available in the U.S. and Europe differ. The United States characteristically relies on private enforcement and civil litigation to deter wrongdoing, and the recent U.S. legislation continues this tradition. These litigation options are less relied upon in Europe, where the class action and contingent fee are not generally recognized and where “white collar” criminal enforcement is less common. Public enforcement and regulatory negotiation tend to be the favored levers in Europe. Similarly, Europe has not accorded the credit rating agencies the same de facto regulatory power as the United States has, with the result that downsizing their regulatory role may be a less important objective in Europe.

Second, the failure of the CRAs was almost uniquely with respect to structured financial products. Similar problems have not characterized the ratings of corporate bonds. Arguably, the necessary reforms can be safely limited to the lucrative and opaque context of structured finance. As next discussed, the conflicts were stronger and the prospects for ratings arbitrage greater in the case of structured finance.

Part I: What Went Wrong?: A Summary of the Criticisms and the Recent Evidence

Although the following criticisms overlap, each involves a different aspect of the problem:

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

The rapid deterioration in credit quality associated with subprime mortgages is shown by the following table:⁷

Exhibit A

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

As it shows, “low document” loans (or “liars’ loans” in the U.S. parlance) almost doubled over a five year period and came to represent the majority of subprime loans. Moreover, adjustable rate mortgages (or “teaser” loans with initially low interest rates that later

⁷ Jennifer E. Bethel, Allen Ferrell & Gang Hu, Law & Economic Issues in Subprime Litigation, Harvard John Olin Center for Law, Economics, and Business Discussion Paper No. 612 (March 2008). A more recent study by the staff of the Federal Reserve Bank of New York finds that the percentage of “low/no-doc mortgages” in subprime mortgage securitizations rose from 24.8% in 2001 to 46% in 2006 and 45.1% in 2007. Similarly, the percentage of “interest-only” mortgages in subprime mortgage deals rose from 0% in 2001 to 21% in 2006 (and then declined to 16.4% in 2007). Although these changes are slightly less stark, this same study found that on “Alt-A deals” (which are slightly more creditworthy than subprime mortgages), “low/no-doc” loans rose from 66.3% in 2001 to 79.3% in 2007, and “interest-only” loans rose from 0.4% in 2001 to 62.3% in 2007 – an even more dramatic transition. See Adam Ashcraft, Paul Goldsmith-Pinkham, James Vickery, “MBS Ratings and the Mortgage Credit Boom,” (FRBNY Staff Report No. 449, May 2010). Thus, from both sources, the same picture emerges of an extraordinary deterioration in creditworthiness over a brief period.

steeply climbed) grew to over 91% of all such loans. Interest-only loans (which imply that the borrower could not afford to amortize the principal on the loan) rose to nearly 23% of such loans by 2006. But ratings did not change to reflect these trends.

In overview, the securitization process seems to have led to lax screening by loan originators. One study finds that the highest rates of default occurred on loans sold by the loan originator to an unaffiliated financial firm,⁸ and another finds that a loan portfolio that was securitized was 20% more likely to default than a similar portfolio that was not securitized.⁹ The implication seems obvious: loan originators dumped their weaker loans on investment banks that were seeking to assemble quickly loan portfolios for securitizations.

These trends, particularly the absence of adequate documentation, should have been evident to the CRAs. Why were they oblivious? Here, three distinctive facts about changes in the structured finance market over the last decade need regulatory attention. First, as structured financed issuances overtook corporate debt issuances (by around 2002), the nature of the CRA's clientele changed. When the CRAs principally rated corporate bonds, no one client accounted for 1% of their business (because even large corporations went to the bond market only intermittently). But as structured finance became the CRAs' principal profit center, the rating agencies faced a limited number of large investment banks that brought deals to them on a continuing basis (and thus could threaten to take a substantial volume of business elsewhere, if dissatisfied). The high

⁸ Atif Mian and Amir Sufi, The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis, NBER Working Paper No. W13936 (April 2008).

⁹ B. Keys, T. Mukherjee, A. Seru, & V. Vig., Did Securitization Lead to Lax Screening? Evidence from Subprime Loans, 2001-2006, (available at <http://ssrn.com/abstract=2093137>).

level of concentration in the market for subprime mortgage securitizations is shown by Exhibit B below:

Exhibit B

MBS Underwriters in 2007: A Very Concentrated Market

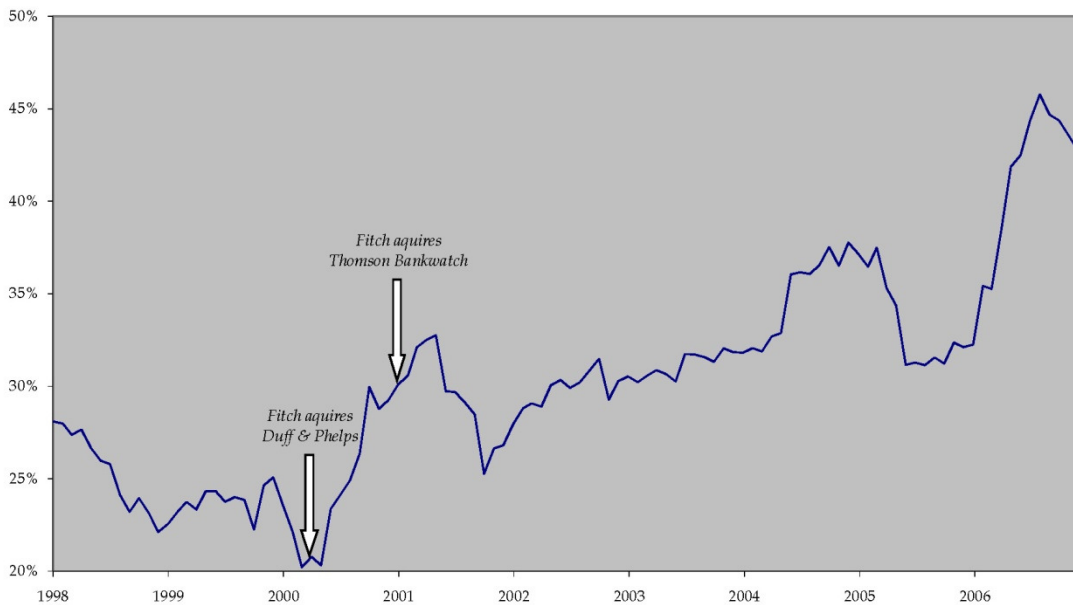
| Rank | Book Runner | Number of Offerings | Market Share | Proceed Amount + Overallotment Sold in US (\$mill) |
|-------------|--------------------------------|----------------------------|---------------------|---|
| 1 | Lehman Brothers | 120 | 10.80% | \$100,109 |
| 2 | Bear Stearns & Co., Inc. |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

As this table shows, the top six underwriters listed above controlled over 50% of this market, and the top dozen accounted for over 80%. As a result, they possessed the ability to threaten credibly that they would take their business elsewhere – a threat that the rating agencies had not previously experienced. In recent testimony before a U.S. Senate Committee, a former Managing Director of Moody’s with responsibility for supervising their subprime mortgage ratings testified that it was well understood within Moody’s that even a small loss of market share would result in a manager’s termination.¹⁰

¹⁰ See Statement of Eric Kolchinsky before the Senate Permanent Subcommittee on Investigations, April 23, 2010 at 1-3.

This development was exacerbated by the second major change occurring in this market in the decade prior to 2008: namely, heightened competition among the CRAs, caused by the rise of Fitch Ratings. As Becker and Milbourn have shown,¹¹ Fitch's monthly share of U.S. credit ratings between 1998 and 2006 rose from a low of 20% in 2000 to a peak of 45% in 2006:

Figure 1.
Fitch monthly market share of credit ratings (U.S. issuers)
12 month moving average 1998 - 2006



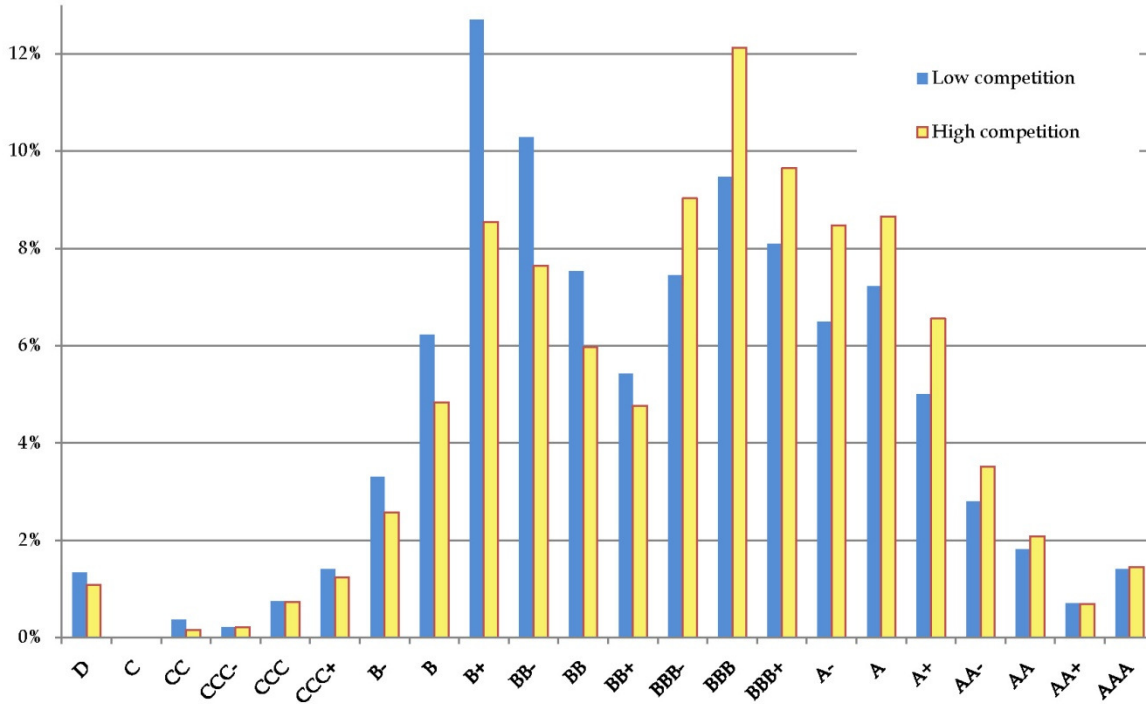
This sharp rise was the consequence of a series of acquisitions of smaller rating agencies (Duff & Phelps and Thomson Bankwatch) that Fitch's new parent undertook in 2000 as part of a strategy to build up Fitch's market share.

For many commentators, competition is exactly what the market for credit ratings needed. But Becker and Milbourne find that it in fact led to a significant inflation in ratings. As the following diagram shows, the percentage of investment grade ratings went

¹¹ Bo Becker and Todd Milbourn, Reputation and Competition: Evidence from the Credit Rating Industry, HBS Finance Working Paper 09-051 (2008).

up with greater competition, and the percentage of non-investment ratings went down – in both cases for every rating:

Figure 2.
Firm credit ratings distribution: high and low competition in the credit rating industry



By no means does this data truly prove that competition cannot work, but the shift from a duopoly to a three-way oligopoly appears to have challenged both Moody’s and S&P. A recent Congressional hearing featured former employees of the CRAs who testified that their firm’s culture changed around 2000, and the loss of even a small percentage of market share produced pressure from within the firm to relax rating standards.¹²

The third secular change that adversely affected CRA performance was the sharp reduction after 2000 in factual verification and due diligence. Factual verification of the creditworthiness of securitized mortgages largely disappeared after 2000, as investment

¹² See Statement of Eric Kolchinsky, supra note 10.

banks and deal arrangers ceased to pay for such activities, and CRAs did not insist on their continuation. Although this development will be discussed in more detail later, it appears to have been driven less by the desire to economize on expenses than by a desire to suppress the “red flags” that factual investigations would uncover about the deterioration in credit quality in the subprime mortgage field.

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

The foregoing discussion has emphasized the significance of conflicts of interest in the rating process. But how did these conflicts actually impact the rating process? Here, the real question is: why were risky subprime mortgages able to be rated investment grade (and, more specifically, AAA) when they were collected into portfolios? The initial answer, of course, involves tranching and elaborate subordination. In theory, collateralized debt obligations (“CDOs”) received AAA ratings, because rating agencies concluded that sufficient debt obligations had been subordinated to the senior tranche to justify rating that senior tranche AAA. In light of their subsequent failure, however, the question becomes: was the level of subordination sufficient? Here, a recent 2010 study by Griffin and Tang of 916 CDOs issued between January 1997 and December 2007 finds that the CRAs did not follow a consistent policy or valuation model with respect to subordination, but rather regularly made “adjustments” on subjective grounds.¹³ Although these adjustments could be either positive or negative, 84% of these adjustments were in fact positive, and these adjustments increased the size of the top-rated AAA tranche by “an additional 12.1% of the AAA at the time of issue.”¹⁴ These

¹³ See John M. Griffin and Dragon Yongjun Tang, Did Subjectivity Play A Role in CDO Credit Ratings?, (available at <http://ssrn.com/abstract=1364933>) (2009).

¹⁴ Id. at 4.

discretionary adjustments, they find, “explain why CDO tranches are large and similar in size despite varying CDO structures.”¹⁵ Less surprisingly, they further find that the amount of the adjustment was positively correlated with future downgrades. In short, the evidence shows not that the CRAs’ valuation models were wrong, but that they were systematically overridden in a manner that increased the size of AAA tranches.

The degree to which CRAs overrode their own models to increase the size of the senior tranche that could now be rated AAA appears both extraordinary and largely based on discretionary upward adjustments. Griffin and Tang report that “only 1.4% of AAA CDOs closed between January 1997 and March 2007 met the rating agency’s reported AAA default standard,”¹⁶ with the rest falling short. Ultimately, they “estimate that the AAA tranches would have been rated BBB on average” and that the aggregate overvaluation of the CDOs in their sample of 916 CDOs was \$86.22 billion.¹⁷

In making these discretionary adjustments, the CRAs appear to have been acquiescing in the desires of the investment banks that engineered these securitizations. By increasing the size of the AAA tranche, the rating agencies made the CDO both more valuable and, at least as important, easier to sell (as lower rated tranches could only be sold to a much smaller audience). Hull estimates that often as much as “\$90 of AAA-rated securities [were] ultimately created from each \$100 of subprime mortgages.”¹⁸ Because subprime borrowers are by definition poor credit risks, he estimates that the typical subprime borrower “would at best be rated BBB” and thus, he finds, it was highly

¹⁵ Id.

¹⁶ Id.

¹⁷ Id. at 5.

¹⁸ John Hull, Credit Ratings and the Securitization of Subprime Mortgages, (Paper presented at the Federal Reserve Bank of Atlanta 2010 Financial Markets Conference, “Up from the Ashes: The Financial System After the Crisis,” May 11, 2010) at 4-5.

unlikely that any financial alchemy could generate \$90 of AAA-rated instruments from \$100 of BBB-rated mortgages.¹⁹

The conclusions reached by Griffin and Tang have recently been expressly confirmed by an even larger study by the staff of the New York Federal Reserve Bank.²⁰ Using a uniquely large data set that covered 60,000 MBS securities issued between 2001-2007, or “nearly 90% of the deals issued during this period,”²¹ they find that risk-adjusted subordination declined “significantly between the start of 2005 and 2007”²²; as a result, a greater percentage of the total offering was rated AAA. Their most striking finding is that “deals with a high share of low- and no-documentation loans (“low doc”) perform disproportionately poorly, even relative to other types of risky deals” – implying to them that these loans were not rated conservatively enough on an ex ante basis.²³ Unlike other studies, they do not find a steady decline from 2001 to 2007, but rather a sudden decline in 2005 to 2007, when a record number of deals came to market and when (in their view) the reputational costs of error became modest in relation to the expected profits to the ratings agency.

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

¹⁹ Id. at 4-5. In fact, on the typical “Alt-A deal,” the earlier noted Federal Reserve Bank study finds that, over the period from 2001 to 2007, \$100 of “Alt-A” mortgages generated on average approximately \$93.1 of AAA-rated CDO debt securities. See Ashcroft, Goldsmith-Pinkham and Vickery, *supra* note 7, at Table 3.

²⁰ See Ashcroft, Goldsmith-Pinkham, and Vickery, *supra* note 7, at 31.

²¹ Id. at 2.

²² Id. at 3.

²³ Id. at 3-4.

the AAA-rated tranche represented over 93% of the securities in the CDO pool over the same period.²⁴

This willingness of the ratings agencies to tolerate “thin” subordination and award AAA ratings to top-heavy securitization structures transcended the special field of subprime mortgages. In the related field of commercial mortgage-backed securitizations (“CMBS”), there was no general decline in the quality of the collateral (as there was in the case of residential mortgages), and the rate of default on such loans did not increase appreciably. Thus, ratings should have remained relatively reliable. Yet, studying a comprehensive sample of CMBS transactions from 1996 to 2008, Stanton and Wallace find that the CMBS market collapsed during the 2008-2009 financial crisis because ratings agencies permitted subordination levels to be reduced by issuers until they provided insufficient protection for the supposedly safe senior tranches.²⁵ This finding uncercuts the argument of the ratings agencies that they were blindsided by sudden changes in the subprime mortgage arena. To the contrary, the rating agencies appear to have tolerated thin subordination across a variety of contexts, as issuers and underwriters pressured them to compete.

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

Unlike auditors, securities analysts, attorneys, investment banks and other financial gatekeepers, CRAs do not conduct factual verification with respect to the

²⁴ Id. at Table 3.

²⁵ See Richard Stanton and Nancy Wallace, “CMBS Subordination, Ratings Inflation and the Crisis of 2007-2009,” NBER Working Paper No. 16206 (July 2010) (available at <http://ssrn.com/abstract=1648006>).

information on which their valuation models rely.²⁶ While accountants are quite literally “bean counters” and security analysts contact all possible sources of information (customers, suppliers, rivals) to obtain information about an issuer, CRAs simply disclose that they are relying on information supplied to them by others. The problem, of course, is that no model, however well designed, can outperform its informational inputs; unverified data results in the well-known “GIGO Effect” – Garbage In, Garbage Out.

Due diligence did, however, use to be part of the process. Prior to 2000, the ratings agencies usually had a generally reliable source of information about the quality of the collateral in securitization pools. During this period prior to 2000, investment banks outsourced the task of due diligence on asset-backed securitizations to specialized “due diligence” firms. These firms (of which Clayton Holdings, Inc. was probably the best known) would send squads of loan reviewers to sample the loans in a portfolio to be purchased from a financial institution or loan originator, checking credit scores and documentation. Although this sampling fell well short of an audit, it could identify the likely percentage of “problem” loans in the portfolio. But the intensity of this due diligence review declined after 2000. The Los Angeles Times quotes the CEO of Clayton Holdings to the effect that:

“Early in the decade, a securities firm might have asked Clayton to review 25% to 40% of the sub-prime loans in a pool, compared with typically 10% in 2006...”²⁷

²⁶ For this conclusion, see U.S. Securities and Exchange Commission, “Summary Report of Issues Identified in the Commission’s Staff’s Examination of Select Credit Rating Agencies” (July 2008) at p. 18 (noting that CRAs “did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated.”).

²⁷ See E. Scott Reckard, “Sub-Prime mortgage watchdogs kept on leash; loan checkers say their warnings of risk were met with indifference,” Los Angeles Times, March 17, 2008 at C-1.

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

“By contrast, loan buyers who kept the mortgages as an investment instead of packaging them into securities would have 50% to 100% of the loans examined, Bohan President Mark Hughes said.”²⁸

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

The actual “due diligence” personnel employed by these firms also told the above-quoted Los Angeles Times reporter that supervisors in these firms would often change documentation in order to avoid “red-flagging mortgages.” These employees also report regularly encountering inflated documentation and “liar’s loans,” but, even when they rejected loans, “loan buyers often bought the rejected mortgages anyway.”²⁹ In short, even when the watchdog barked, no one at the investment banks truly paid attention, and no one told the rating agencies.

All these elements converge to support a classic “moral hazard” story: those who did not expect to hold these loans for long invested increasingly less in investigating their creditworthiness and indeed repressed adverse information by ceasing to inquire. Concomitantly, they began to subordinate less of the portfolio in riskier tranches in order to increase the size of the more valuable top-rated tranche. The bottom line then appears to be that an “originate and distribute” business model does lead to lax screening and deceptively below average loan portfolios.

²⁸ Id.

²⁹ Id.

Other critiques of the CRAs have also been convincingly made: (1) they were slow to revise their ratings or downgrade securities; (2) they tend to “herd” or converge over time on a common rating (probably because a common error does not result in unique reputational damage);³⁰ and (3) they did not adequately disclose their valuation models. But these critiques, while probably valid, had less to do with the 2008 financial crisis and so will receive less attention.

Part II: The Debate Over Possible Reforms:
Where to Place Society’s Bets

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

A. Developments Over the Last Five Years.

1. The United States. In both the United States and Europe, credit rating agencies were not directly regulated for most of their existence. On the statutory level, this changed only in 2006 in the United States, and prospective changes have only been proposed this year in Europe. However, although the CRAs were not regulated, many

³⁰ See Andre Gutler, Lead-Lag Relationships and Rating Convergence Among Credit Rating Agencies, (European Bus. Sch. Research Paper No. 09-14, 2009) (available at <http://ssrn.com/abstract=1488164>) (finding that Moody’s closely tracks S&P upgrades, but not its downgrades). Such “upside” herding only cannot be attributed to a quantitative model, but appears discretionary.

institutional investors were. In the United States, banking and financial regulators have long required institutional investors and broker dealers to obtain ratings for debt securities they wished to hold in their portfolios in order to enable prudential-based regulation to distinguish safe investments from speculative ones. Beginning in 1975, the SEC required that such ratings be issued by “nationally recognized statistical rating organizations” (“NRSROs”).³¹ Effectively, this NRSRO requirement meant that rating agencies not so designated by the SEC could not issue ratings on which institutions and broker-dealers could rely for these regulatory purposes. CRAs excluded from the “NRSRO” club were thus prejudiced because their ratings carried a lesser value.

Curiously, the SEC never officially defined the term “NRSRO,” nor did it establish formal criteria governing admission to the NRSRO club. Instead, the SEC’s staff used a vaguer and ultimately question-begging test that looked to whether an applicant was “nationally recognized by the professional users of ratings in the United States as an issuer of credible and reliable ratings.”³² Between 1975 and 2006, the SEC generally refused to confer the NRSRO designation on most credit rating applicants, apparently because it feared that new and “fly-by-night” rating agencies would be more generous in awarding investment grade ratings and thereby lead a race to the bottom.

The SEC’s conservatism in approving new NRSROs drew criticism (particularly from excluded firms). Equally important, in the wake of the Enron, WorldCom and related corporate scandals in the 2001-2002 period, the existing NRSROs became politically vulnerable when they had clearly failed to detect approaching financial

³¹ For a fuller background, see John C. Coffee, Jr., *GATEKEEPERS: The Professions and Corporate Governance* (2006) at 293-297.

³² See U.S. Securities and Exchange Commission, *Report on the Role and Function of Credit Rating Agencies In the Operation of the Securities Markets* (2003) at 9.

disasters (the often-cited illustration is that none of the NRSROs downgraded Enron until a day or two before its bankruptcy). Following a series of critical studies, Congress enacted the Credit Rating Agency Reform Act of 2006, which created an objective registration framework that sought to both facilitate entry by new agencies into the NRSRO market and to mandate greater accountability by existing NRSROs. Although the 2006 Act did authorize broad rule-making by the SEC to restrict conflicts of interest, it expressly denied the SEC the power to “regulate the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings.”³³ This compromise under which the SEC can restrict conflicts of interest, require disclosure, and monitor performance, but not regulate the methodologies or models by which ratings are determined reflected a Congressional view that the SEC lacked the expertise to prescribe models to the CRAs, but could evaluate the consistency of application by each CRA. This compromise will remain in force even under the currently pending legislation passed by the two houses of the U.S. Congress.

Pursuant to the powers granted it by the 2006 Act, the SEC has promulgated a series of rules to (1) govern the registration procedure; (2) provide detailed disclosure as to the experience with the ratings issued by each NRSRO rating agency, (3) regulate conflicts of interest, and (4) encourage competition. Probably the most noteworthy of these rules is Rule 17g-5, which expressly prohibits some seven types of conflicts of interest.³⁴ Even more importantly, Rule 17g-5 was amended in 2009 to create an “equal access” obligation. Under it, when an NRSRO is hired by an issuer or other arranger to

³³ See Section 15E(c)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-7(c)(2).

³⁴ These seven prohibited conflicts (all set forth in Rule 17g-5(c)) are ably discussed in Lynn Bai, On Regulating Conflict of Interests in the Credit Rating Industry, 13 N.Y.U. J. Legis. & Pub. Pol’y _ (forthcoming in 2010). See also 17 C.F.R. Section 240.17g-5(c).

determine an initial credit rating for a structured finance product, it must make available the information it receives from the issuer or arranger to other NRSROs (but not to the public generally) in order to enable them to issue their own ratings.³⁵ The intent of this “equal access” rule is to encourage competition by allowing potential competitors to obtain the same information given by the issuer to the CRA that it hires. In short, although this rule is based on the SEC’s power to regulate conflicts of interest, its primary intent is to foster competition.

Pursuant to the 2006 Act, the SEC has been required to admit any NRSRO applicant that can make an adequate showing of competence, and the SEC has in fact expanded the number of NRSROs to ten (with several applications pending that are likely to be successful). Still, the Big Three (Moody’s, Standard & Poor’s and Fitch Ratings) have remained dominant (with the new CRAs largely focusing on specialized market niches or rating foreign firms based in their own jurisdiction). This result suggests that the regulatory power assigned to the Big Three by the NRSRO system does not truly explain their market dominance. Even during the 1975-2006 period, a few new entrants were admitted by the SEC to the NRSRO club, but they were unable to compete successfully (and were acquired by the Big Three). Uniquely, Fitch Ratings did become competitive with Moody’s and S&P, but it had specialized in structured finance and thereby had acquired a competitive headstart over its rivals (Moody’s was in fact slow to enter the structured finance field). Overall, this pattern suggests that there are important “first mover” advantages because reputational capital is hard to acquire and goes to the first firms in the field. If licensing power alone could explain the dominance of the Big

³⁵ See Securities Exchange Act Release No. 34-61050 (November 23, 2009), 2009 SEC LEXIS 3798.

Three, then the newer members of the SEC's "NRSRO Club" would have joined and shared in their oligopoly.

2. Europe. In comparison to the United States, Europe has traditionally not regulated CRAs. Following the Enron scandal in 2001, the Committee of European Securities Regulators ("CESR") conducted a study for the European Union Commission (the "Commission") that ultimately concluded that legislation was not necessary to regulate the CRAs. Instead, the Commission relied on a Code of Conduct developed by the International Organization of Securities Commissions ("IOSCO") to ensure the accountability of the CRAs. The Commission designated CESR the responsibility of monitoring compliance with this Code and instructed CESR to report to the Commission annually. In 2006, after the first such report from CESR, the Commission again concluded that, although it saw problems with the performance of the CRAs, these problems were not sufficient to require legislation.³⁶

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

Well established as the "comply or explain" model was in Europe, the 2008 financial crisis has caused Europe to abandon it in the case of the CRAs in favor of a mandatory system of registration and administrative supervision. The process began in 2009, when the European Parliament adopted a "Proposal by the European Commission

³⁶ For a general overview, see Stephane Rousseau, "Regulating the Credit Rating Agencies After the Financial Crisis: The Long and Winding Road Toward Accountability" (available at <http://ssrn.com/abstract=1456708> (2009)).

for a Regulation on Credit Rating Agencies.”³⁷ This initial regulation introduced the principle of mandatory registration for credit rating agencies operating in Europe, but it was not then clear who would supervise the CRAs. Then, on June 2, 2010, the European Commission proposed a revision to this regulation to create a pan-European body – the European Security Markets Authority (or “ESMA”) – that would be given exclusive supervisory authority over credit rating agencies registered in Europe.³⁸ Backstopping this supervision would be new powers given to the ESMA to investigate, impose fines, and suspend or terminate a CRA’s license. The proposal requires approval by the European Parliament and member governments, but it is particularly noteworthy in that it would represent the initial pan-European body with day-to-day regulatory authority over the securities markets.

In some important respects, the EU Regulation resembles the SEC’s approach, both in the requirement of registration and in a common “equal access” rule intended to promote competition. The ESMA, however, would have marginally greater authority than the SEC, because it would be empowered to evaluate the methodologies and procedures used by the CRA to rate securities. Under the proposed EU Regulation, CRAs must periodically review their methodologies, adopt reasonable measures to assure the reliability of the information relied upon by their models, and ensure that their employees are adequately trained and have appropriate knowledge and experience. In general, the EU Regulation is framed in broad and non-specific terms and at this stage focuses more

³⁷ See Regulation 1060/2009, OJL 302, 17.11.2009, p. 1.

³⁸ For overviews of this proposal, see James Kanter, “EU seeks oversight of rating agencies,” *The International Herald Tribune*, June 3, 2010, at p. 15; “EC waves big stick, rival at rating agencies,” *The Australian*, June 4, 2010, at p. 28.

on establishing a framework for supervision than on mandating specific prophylactic rules.

3. The New Convergence. As a result of the EU Regulation, recent amendments to the IOSCO Code of Conduct, and the SEC's rules, the U.S. and Europe seem to be converging. Both SEC Rule 17g-5 and the IOSCO Code seek to reduce conflicts of interest by (1) barring an NRSRO or similar European CRA from issuing a rating with respect to an obligor or security where it has advised or consulted on the design or structuring of the security,³⁹ and (2) prohibiting an analyst who participates in the rating determination from negotiating the fee that the issuer or arranger pays for it.⁴⁰ The first prohibition is designed to discourage the provision of consulting services to issuers by rating agencies, and seems modeled on similar prohibitions in the Sarbanes-Oxley Act that precluded auditing firms from providing defined consulting services to audit clients for fear that the provision of such services would exacerbate conflicts of interest; the second prohibition on analyst involvement in fee negotiations similarly seeks to protect the professional independence of the analyst (much as the "global settlement" reached by U.S. regulators in 2002 with the major investment banks sought to distance securities analysts from any involvement in marketing activities). Building on the IOSCO Code of Conduct, the EU Regulation would similarly bar a rating agency from providing consulting or advisory services to a client whose securities it is rating.

³⁹ SEC Rule 17g-5(c)(5) bars an NRSRO issuer from issuing or maintaining a rating where it (or any associated person) "made recommendations about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security." See 17 C.F.R. Section 240.17g-5(c)(5) (2009).

⁴⁰ SEC Rule 17g-5(c)(6) prohibits an NRSRO from issuing or maintaining a credit rating "where the fee paid for the rating was negotiated, discussed or arranged by a person within the NRSRO who has responsibility for participating in, determining or approving credit ratings . . ." See 17 C.F.R. Section 240.17g-5(c)(6) (2009).

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

Given this high level of convergence (albeit with fewer mandatory rules or enforcement mechanisms in Europe), the important questions become: (1) What important topics have not yet been addressed?; and (2) Are there areas in which Europe and the U.S. do not agree? One obvious example of the latter is the reported plan of the European Commission to establish a regional European rating agency to compete with the Big Three.⁴¹ No similar idea has been proposed in the U.S. At least in part, this proposal appears attributable to the fact that Moody’s and S&P are American firms and, perhaps even more, to the action of the Big Three in recently downgrading European sovereign debt (most notably that of Greece) in a manner that was perceived to have exacerbated the recent European financial crisis in 2010.

In addition, although some conflicts of interest have been addressed, neither the SEC nor the EU Commission has yet addressed the “issuer pays” business model of the CRAs or the highly concentrated character of the CRA market. The next section surveys these areas.

B. An Overview of the Choices Not Yet Faced

⁴¹ See sources cited supra at note 38.

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

A. Litigation and Deterrence-Based Reforms.

Consistent with the U.S.'s preferences to rely on liability-based reforms, the U.S. House of Representatives passed legislation in December, 2009, which contained a provision subjecting CRAs to liability for gross negligence. Section 6003(c) of H.R. 4173 provided that a purchaser of a rated security "shall have the right to recover for damages if the process of determining the credit rating was (1) grossly negligent, based on the facts and circumstances at the time the rating was issued, and (2) a substantial factor in the economic loss suffered by the investor." Differing markedly from the antifraud provisions in the Securities Exchange Act of 1934 (which generally require the plaintiff to plead and prove a fraudulent intent on the part of the defendant), this provision would have made it far easier for plaintiffs to sue a rating agency than to sue the issuer or underwriter of the security. In 1995, as a protection against "frivolous" litigation, the Private Securities Litigation Reform Act (or "PSLRA") adopted strict pleading rules that required a plaintiff in a securities fraud action to plead facts with particularity that "give rise to a strong inference of fraud" before it can obtain discovery. These rules would have been effectively inapplicable to a negligence-based action against a CRA and thus would have tilted the playing field substantially toward the plaintiff. Unusual as it is to hold a secondary participant legally responsible under a more relaxed and pro-plaintiff standard than the issuer, the House provision clearly reflected the Congressional (and public)

anger at the rating agencies, who seem to many to have been the gatekeepers that failed the worst during the 2008-2009 financial crisis.

Ultimately, the U.S. Congress declined to adopt the House's negligence standard and instead opted for the liability provision in the later passed Senate Bill. The Senate Bill (whose liability provision was drafted initially by this author and is later discussed in more detail) used a more traditional antifraud standard. Essentially, the Senate Bill coupled a fraud-based standard with a safe harbor that becomes applicable when the CRA conducts or obtains factual verification of the key elements in its ratings model. Thus, the Senate Bill's goal was more focused on encouraging due diligence than imposing damages.

Although the Dodd-Frank Act expressly enhances the liability of the CRAs, a Constitutional question mark still hangs over this area that could nullify this new liability provision. Some judicial decisions in the U.S. have viewed credit ratings as expressions of opinion protected by the First Amendment.⁴² The case law in the United States is currently divided on this question,⁴³ and no authoritative answer is possible until the Supreme Court addresses the issue.

Still, from a policy perspective, does negligence-based liability make sense? Although the case for enhanced liability may be strong, three distinct policy reasons suggest that a liberalized negligence standard is ill-advised. First, a negligence standard

⁴² For such holdings, see Jefferson County School District No. R-1 v. Moody's Investor's Services, Inc., 175 F.3d 848, 852-856 (10th Cir. 1999); In re Enron Corp. Securities Derivative & "ERISA" Litigation, 511 F. Supp. 2d 742, 752 (S.D. Tex. 2005).

⁴³ Some recent decisions have refused to find the First Amendment applicable to ratings on structured finance products, because in the view of these courts no issue of public concern that merited First Amendment protection arises in the rating of the debt of a "special purpose entity" that was to be sold only to a limited group of institutional investors. See Abu Dhabi Commerical Bank v. Morgan Stanley & Co., Inc., 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

could easily bankrupt the CRAs, as a single case could produce a billion dollar (or greater) judgment. Second, the threat of a negligence standard could lead the CRAs to withdraw from rating risky structured finance products (and similarly chill new entrants from entering this field). Indeed, if the CRAs were to cease to rate structured finance products because of this standard, housing finance in the U.S. might remain paralyzed. Third, and most importantly, the appropriate legislative goal should be deterrence, not compensation. Given that trillions of dollars in structured finance products have been marketed globally, there is no realistic possibility that the credit rating agencies could fund meaningful compensation to most their victims. Their pockets are simply not deep enough to cover even a small percentage of the losses associated with structured finance.

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

B. Employee Compensation-Based Reforms.

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

Although logical in theory, these compensation-based proposals encounter overwhelming practical difficulties. Rating fees cannot easily be placed in escrow for the life of the bond without creating severe liquidity problems for the ratings agency. Equally important, if the rating proves inflated, the issuer who paid the CRA for that rating should hardly be entitled to a seeming windfall profit by enabling it to recapture its fee. Only the injured investor deserves any repayment, and it wants restitution of its loss, not a mere clawback of the rating agency's fees. Clawbacks directed at employees and former employees may also be difficult to enforce – particularly years after the inaccurate rating

was issued. Nor is it clear that the CRA should be entitled to a clawback from its own analysts. Indeed, if the inflated rating was the result of pressure by the rating agency on its employee (backed up by the implicit threat of dismissal if the employee lost “market share”), then arming the employer with a right to “clawback” the employee’s compensation rewards the principal culprit. In any event, employees who are motivated to inflate ratings by fear of demotion or dismissal are unlikely to find the distant threat of a clawback in future years sufficient to offset fully the shorter-term pressure.

Subtler variations on compensation formulas can be imagined. Listokin and Talbleson have suggested that rating fees should be paid to the CRA in the rated securities in order that the cost of the overvaluation of the rate securities would fall on the rating agency.⁴⁴ Clever as this idea is in principle, it would not work if the rating agency could immediately sell the debt securities before their misrating was discovered. If it cannot, it must hold a sizable portfolio of securities with resulting liquidity and legal problems.⁴⁵ Also, if the rating fee was a basis point (or less) of the deal size, this system would involve the issuance of small amounts of debt securities (and in odd denominations) to the rating agency. It is inefficient to hold or trade small quantities of a large number of illiquid debt securities (as the CRA would incur disproportionate brokerage fees).

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

The most obvious conflict of interest that potentially undercuts the credit rating agency’s independence and objectivity is the simple fact that the issuer pays the rating

⁴⁴ See Yair Listokin and Benjamin Talbleson, “If You Migrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation,” 27 Yale J. on Reg. 91 (2010).

⁴⁵ For example, the CRA might become an “inadvertent” investment company under the Investment Company Act of 1940.

agency's fee. At some point in the mid-1970s, the credit rating agencies shifted to this business model after finding that they could be no more than marginally profitable operating on a subscription basis under which investors paid for their ratings.⁴⁶

Obvious as the conflict in an "issuer pays" model is, two points must be immediately made about the realism of seeking to eliminate it: (1) Most financial gatekeepers – auditors, law firms, investment banks – operate under a similar model under which the issuer pays their fees; and (2) A "subscriber pays" model may be doomed to failure by the "public goods" nature of ratings. Because the rating agency cannot effectively prevent the communication of its ratings to non-paying investors once it discloses its ratings to its clients, it cannot capture the full value of the financial information that it creates. For example, a subscriber may leak the rating information to another institutional investor, possibly in return for some reciprocal favor (including disclosure of the rating issued by some other rating agency). As a result, free riders will inevitably acquire and rely on the information without compensating the creator – in effect, the standard "non-excludibility" criterion that defines a public good. Indeed, some have argued that the principal CRAs encountered this free riding problem in the early 1970s, which lead them to shift to the "issuer pays" model.⁴⁷

Thus, the more feasible response to the conflict of interest inherent in the "issuer pays" model may to permit the issuer to pay for the rating, but not to select the rater. This strategy would also respond to the independent problem of "rating shopping," under

⁴⁶ See Coffee, *GATEKEEPERS: The Professions and Corporate Governance* (2006) at 295-296.

⁴⁷ Professor Lawrence White has suggested that this shift was attributable to the rating agency's inability to keep their ratings secret – in effect, their ratings became "public goods." Information technology – the xerox, the fax machine, etc. – made it possible by the 1970s to easily distribute ratings that were revealed by the ratings agency only to the initial subscriber.

which issuers seek preliminary ratings and then choose the agency giving it the highest preliminary rating to issue the final rating.

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

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

Ultimately, the Franken Amendment was watered down in the final revisions of the Dodd-Frank Act so that the SEC must first conduct a study of the feasibility of its approach. Following that study (which must be conducted within two years of the Act’s passage), the SEC is authorized to adopt the equivalent of, or a variant on, the Franken Amendment.⁴⁸ In short, this proposal remains very much on the table for discussion and modification.

⁴⁸ See Section 939F of the Dodd-Frank Act.

2. Encouraging a “Subscriber Pays” Model: Another way to avoid issuer domination of the rating determination would be to require institutional investors to obtain their own ratings (and from a rating agency not retained by the issuer or underwriters) before they could purchase the debt securities. The issuer would also remain free to hire its own rating agency, but each institutional investor would need to obtain its own independent rating. The goal of this approach is to spur the growth of a “subscriber pays” market. Its key premise is that a “subscriber pays” market will not develop on its own (as it clearly has not to date) so long as investors are free to rely on an “issuer-paid” rating. Some reformers would go even further and seek to mandate or encourage the formation of investor owned rating agencies on the premise that they would be bias free.⁴⁹ Still, this belief that institutions will form their own ratings agencies probably posits a stronger investor interest in ratings reform than it is realistic to assume most institutions have. Nonetheless, even if institutions will resist expending funds on ratings, groups of institutions presumably might economize on their fees under a mandatory “subscriber pays” system by jointly hiring an independent rating agency at a discounted “wholesale” price. Thus, the costs to them are not prohibitive.

3. The Government Utility Model: A last alternative is a government-created and managed rating agency, and the E.U. is currently considering such an approach on a regional basis. This “Governmental Utility Model” could be designed to be a check on the private market – much as the Tennessee Valley Authority (“TVA”) was created in the U.S. during the New Deal era as a check and yardstick by which to measure the

⁴⁹ For such a proposal, see Joseph Grundfest and Evgeniya E. Hochenberg, “Investor Owned and Controlled Rating Agencies: A Summary Introduction,” Rock Center for Corporate Governance Working Paper No. 66 (October 25, 2009) (available at <http://ssrn.com/abstract=1494527>).

performance of privately owned public utilities. That is, it would not be an exclusive rater, but investors would compare the Moody's or S&P rating against the governmental rating.

4. A Policy Evaluation. Each approach has its own advantages and disadvantages. Using the government (or its proxy) as the neutral party who selects the initial rating agency is simple and direct and should assure the independence of the chosen rater. More questionable, however, is whether the rating agency so chosen will have credibility. Conceivably, this approach potentially provides politicians with an enormous patronage system. How do we ensure that political loyalties and contributions do not influence the selection of the initial, government-appointed rating agency? The Franken Amendment provides that independent commissioners chosen by the SEC would perform this function, but it also permits its Credit Rating Agency Review Board to use either a lottery or a rotating assignment system. The sheer volume of initial ratings may compel such a mechanical approach because the Board may find it infeasible to make individualized decisions in every case.

Although random or rotation assignments might protect against political favoritism and probably would encourage new entrants to apply to become NRSROs (in the U.S. parlance) in order to obtain initial rating assignments, the problem with such a system is that it creates little incentive for rating agencies to compete based on the quality of their ratings. The participants simply do not need to win the favor of investors. In addition, the new entrants might charge inflated fees because they would not need to compete. Thus, if we are concerned about encouraging factual verification and due diligence, the participants under this system would have little incentive to invest in costly

research or conduct factual verification. Effectively, they might behave much like civil servants or tenured academics, placidly enjoying the quiet life.

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

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

The second alternative – i.e., requiring institutions to obtain a credit rating from the rating agency of their choice (provided that it was not also paid by the issuer) – has the key advantage of encouraging greater competition. New rating firms would enter this

market to compete for this business (probably on the accurate assumption that Moody's and S&P would remain committed to an "issuer pays" business model). Under such a "subscriber pays" system, the free rider problem would also diminish in its significance, because each substantial institutional investor would be required to hire a rating agency for its advice.⁵⁰ A market would thus be assured. Reputational capital would now count for something, and the rating agency might deliver a fuller report, not simply a two or three letter rating. Candidly, however, it must be recognized that investors are likely to resist having to pay themselves for a rating. Securities analysts have similarly found investors resistant to paying for investment advice. Although a "subscriber pays" model could be legally mandated, investors are likely to constitute a powerful political lobby against such a reform – at least so long as its costs fall on them.

Another danger in this model might be that some institutional investors would opt for the cheapest rating agency, which agency might in turn economize on its own efforts by simply conforming to the ratings provided by the "issuer paid" rating agency. Such "herding" is already common among both securities analysts and rating agencies.⁵¹

Given the political obstacles to imposing costs on investors, several possible variations can be imagined. One compromise would be to allow institutions to pass on the cost of ratings by seeking reimbursement of their rating fees from the issuer or deal arranger. At this point, the conflict of interest problem now re-enters by the back door (as underwriters might find ways to influence the choice of rating agency in return for

⁵⁰ A significant legal difficulty arises, however, with proposals to mandate behavior by investors. In general, the SEC and other securities regulators have no delegated power over investors as a group (but only selected institutions, such as mutual funds). Nor would it be politically easy to pass legislation requiring investors (or even institutional investors) to bear specified costs (such as the cost of a rating agency's rating).

⁵¹ See sources cited supra at note 30.

agreeing to reimburse those costs). Reimbursement of the rating fee need not be prohibited, but its permissibility should be clearly conditioned on the investor having an unfettered right to choose its own rating agency.

Another bolder alternative, proposed by Grundfest and Hochenberg, envisions that any issuer who purchases an NRSRO rating must also pay for a second rating from an “Investor Owned and Controlled Rating Agency” (or an “IOCRA”).⁵² Again, this seeks to subsidize a “subscriber-based” market. Still, the incentive of investors to form such subsidiaries or collectives seems doubtful, in part because institutional investors are often in active competition with each other and thus do not share information freely.

Absent the unlikely formation of such investor-owned rating agencies, the simpler approach is to allow (or require) issuers to pay for a second rating from an investor-chosen rating agency. But here the critical complication involves how investors are to choose such a second rating agency, as the issuer cannot reasonably be expected to pay for the choice of each investor when this might require it to retain numerous rating agencies. One feasible answer to this problem would be to instruct the governmental board that selects the rater under the first option discussed above to poll institutional investors and select the rater preferred by the most institutions (possibly excluding the rating agency retained by the issuer). In effect, the Board would defer to the investors’ choice. This would not permit every institution its individual choice, but it would still induce rating agencies to compete for the investors’ favor. Now, the issuer could feasibly pay for the rating under this variant on the first alternative, but predictably better, or at

⁵² See Grundfest and Hochenberg, *supra* note 49.

least more attentive, services would be provided by rating agencies to investors under this approach.

Investors also have conflicts of interest that cannot be ignored. Some may choose a rating agency that gave inflated ratings in order to enable them to purchase risky securities with higher yields. In this light, an advantage of this last approach of an investor vote or poll is that it mitigates the danger that “fly by night” rating agencies would be chosen to deliver inflated ratings. Such a desire is plausible in individual cases because an NRSRO “investment grade” rating gives legal protection to the board and officers of a risk-preferring institutional investor in the event that a breach of fiduciary duty claim is raised against them following a costly default. A rating agency collectively chosen by a vote or poll of the institutions is thus preferable if we assume that the majority of institutions are prudent and only the minority are apt to behave as risk-preferrers.

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

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

This U.S. example is probably mirrored by equivalent European examples (for example, could a German "public" ratings agency easily downgrade Deutsche Bank or Volkswagen?). Indeed, the European Commission's interest in a European credit rating agency may have been triggered in part by the political outrage at the Big Three for downgrading Greece's sovereign debt. Some non-European editorialists have already recognized this episode as a classic case of "blaming the messenger."⁵³ The sad but simple truth is that politically accountable public bodies may find it more difficult to resist political pressure.

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

The one advantage of a Government Utility Approach is also a disadvantage of the "subscriber pays" model: those who do not pay are left in the dark by a "subscriber pays" model. Although this criticism has been raised by those skeptical of a "subscriber pays" model, the validity of this criticism probably depends on whether issuers and arrangers would continue to hire Moody's and S&P to deliver "issuer paid" ratings. If

⁵³ See Peter Hosking, "Brussels busy shooting the messenger," *The Australian*, June 4, 2010, p. 28.

they would, then the public would still have at least one publicly disclosed rating (which would likely be more accurate than today because of the competition from “private” ratings). In effect, no one is worse off under this system. Moreover, the need for public disclosure of ratings may depend on the extent of retail investor participation in the market, and generally retail investors simply do not participate in the market for structured finance products.

D. Reducing the Regulatory Power of Rating Agencies

Some believe that the basic error made by regulators was to grant ratings agencies a de facto regulatory role. In truth, this decision, which dates back to the 1930s in the U.S., was the product of the inability of financial regulators to define excessive risk themselves. Needing to prevent mutual funds, banks, investment banks, and pension funds and other collective investment vehicles from overinvesting in risky securities, U.S. financial regulators either (1) required these institutions to limit their debt investments to securities having an “investment grade” credit rating (or at least to keep the majority of their portfolio in such securities) or (2) applied a stern “haircut” (or writedown) to financial investments not having such a rating, thereby requiring investment and commercial banks to retain greater capital for regulatory purposes. Then, realizing that financial institutions could outflank these rules by turning to new “fly-by-night” credit rating agencies, the SEC adopted rules in the mid-1970s that created a small, select club of “Nationally Recognized Statistical Rating Agencies” (or “NRSROs”). Because only the ratings issued by these NRSRO agencies were to be considered by regulators in determining the “investment grade” status of debt securities, this last step gave the Big Three de facto regulatory power.

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

Critics assert that the NRSRO designation (and similar requirements for investment grade ratings adopted as early as the mid-1930s by the Comptroller of the Currency) gave the credit rating agencies de facto licensing power and thereby compelled investors to rely upon them for regulatory permission. Clearly, this outcome was not intended, as federal regulators were simply following the path of least resistance. For them, it would have been a regulatory nightmare to attempt to adopt comprehensive standards of creditworthiness. But intent is less important than effect, and these critics argue that regulatory licensing power became the principal barrier to entry that excluded new entrants. This is a doubtful claim for several reasons: First, the Big Three also dominate European ratings where they enjoy no similar licensing power. Second, because Moody's and S&P dominated the field since early in the 20th Century, well before the creation of NRSROs and similar regulatory rules, the claim that their licensing power explains their market dominance cannot explain their market power before the time that

they received any licensing power. Third, experience since 2006 shows that expanding the NRSRO club to ten firms has not eroded the dominance of the Big Three. Their supremacy thus seems more based on “first mover” advantages and the difficulty of entering the field without a proven track record. More likely, the initial firm to enter the field gains reputational capital over time, which creates a barrier to entry. If (as widely assumed) economies of scale characterize the production of financial information, the first entrant can operate more efficiently and exclude later entrants.

In this light, the more plausible hypothesis for the Big Three’s dominance is that sophisticated institutional investors relied on Moody’s and S&P because there was no one better to rely upon, even though they knew the conflicts latent in the “issuer-pays” model.⁵⁴ Still another possibility is that some institutional investors were actually content with rating inflation, as it allowed them to rationalize acquiring risky, but higher yield securities.

Based on the foregoing diagnosis, some reformers in the U.S. (and the editorial pages of the Wall Street Journal) have insisted on reducing the de facto regulatory power accorded NRSRO rating agencies. An amendment to the pending federal financial reform legislation, which was sponsored by Senator George LeMieux (R-Flo.), passed the U.S. Senate on May 14, 2010, with all Republican Senators (and many Democrats) voting for it. Incorporated into the final version of the Dodd-Frank Act, this provision deletes references in several federal statutes governing financial regulators that require

⁵⁴ Economists have in fact developed such a model that assumes that some investors are “naïve” and others sophisticated. Under it, naïve investors take the ratings at face value, while sophisticated investors realize they are unable to determine the accuracy of the rating. They conclude that the reputational cost may be low in an oligopolistic market where all the major actors inflate their ratings. See Patrick Bolton, Xavier Friexas & Joel Shapiro, *The Credit Rating Game* (NBER Working Paper No. 14712 (2009)).

“investment grade” ratings from NRSRO rating agencies. Instead, it instructs these regulators to adopt their own “standards of credit-worthiness.”

What will be the impact of this and similar provisions? Probably, they will have no more than marginal impact on the market position of the “Big Three” credit rating agencies – but for the fact that the current and pending federal financial statutes only seek to regulate NRSRO rating agencies. Thus, a possible strategic move for the Big Three may be to surrender their NRSRO status – and thereby avoid relatively demanding legislation that only applies to NRSROs. Indeed, the combined impact of the Franken Amendment and the LeMieux Amendment is to make the NRSRO status considerably more of a burden than a benefit for the Big Three. Under the Franken Amendment, by abandoning their NRSRO status, the Big Three would lose the ability to give the initial ratings to most “structured finance” issuers, but logically they might prefer to focus on marketing themselves to issuers as the providers of second opinions. Under the LeMieux Amendment, the Big Three will lose some of their so-called licensing power. Accordingly, when the burdens outweigh the benefits, it makes sense for them to abandon NRSRO status – if they can.⁵⁵

The idea that reducing the regulatory power of the ratings agencies is the key to reform is popular in academia. The idea is simple, sweeping, and requires no understanding of the institutional or regulatory context. In reality, however, reducing the role of the rating agencies will likely be a slow and confused process. This has been shown by the early experience under the Dodd-Frank Act. The Act overruled a long-

⁵⁵ A complicated legal issue surrounds whether existing NRSROs can deregister and in effect abandon their NRSRO license (now that it has reduced value). That issue is beyond the scope of this paper.

standing SEC rule (Rule 436(g))⁵⁶ that gave rating agencies an exemption from the liability that a statutory expert faces under Section 11 of the Securities Act of 1933. Under Section 11, an “expert” whose opinion is cited in a registration statement used in connection with a public offering of securities has presumptive liability for any material misstatement that it makes. Thus, if the stock price declines after the offering, the expert can be held liable for this price decline, unless it can prove that it was not negligent. The burden of proof is on the expert. Although this provision was principally intended to apply to auditors, the language of Section 11 clearly covers rating agencies as well, if the registration statement references their ratings. For many years, the SEC had effectively exempted rating agencies from Section 11 liability pursuant to Rule 436(g), which allowed the rating agencies to avoid consenting to becoming a statutory “expert.” Dissatisfied with the rating agencies performance, Congress ended this exemption in the Dodd-Frank Act and expressly overrode Rule 436(g).

What happened? Predictably, the rating agencies refused to consent and thus blocked their ratings from being referenced in registration statements (as they were entitled to do). At this point, issuers discovered that, in the case of asset-backed securitizations, the SEC’s rules required disclosure of the rating in the registration statement; thus, they could not comply without the rating agency’s consent. As a result, some offerings could not go forward.⁵⁷

⁵⁶ See 17 C.F.R. § 230.436(g). Technically, this rule permits the rating agency not to file a consent to the use of its rating in the prospectus. The significance of this elimination of its required consent is that an expert is liable under Section 11 only if it consents to be named as an expert in the registration statement.

⁵⁷ See Anusha Shrivastava and Fawn Johnson, “SEC Breaks Impasse With Rating Firms,” *The Wall Street Journal*, July 23, 2010 at C-1; Dennis Berman, “Note to Credit Raters: Evolve or Die,” *The Wall Street Journal*, July 27, 2010 at C-1.

For a brief time, the public debt markets froze, and offerings were delayed. In response, the SEC declared a six month moratorium on its rule requiring the disclosure of ratings in the registration statement in the hope that a compromise could be negotiated.⁵⁸

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

E. Encouraging Due Diligence

As noted earlier, rating agencies are unique among financial gatekeepers in not conducting factual verification. Obviously, factual verification would be costly, given the sheer volume of ratings that they issue. Still, there is an alternative to the rating agency doing its own factual verification: Rating agencies can instead require factual investigation by independent experts of the critical facts on which their models rely. As noted earlier, this had been the standard approach in rating structured finance products

⁵⁸ See “Statement by the SEC Staff: Statement Regarding the Registered Asset-Backed Securities Market” (July 22, 2010) (announcing a six months moratorium during which ratings need not be disclosed in the registration statement).

prior to 2000, as the investment banks and the rating agencies both relied on “due diligence” firms (such as Clayton Holdings and the Bohan Group) that were paid by the underwriters. However, as the housing bubble grew, investment banks cut off this flow of information, possibly because it might alert rating agencies to problems.

The pending financial reform legislation in the U.S. takes several steps by which to restore due diligence. NRSRO agencies are, for example, required by the Dodd-Frank Act to disclose in a mandated form that must accompany the publication of each credit rating a variety of factual information, including:

“(v) whether and to what extent third party due diligence services have been used by the nationally recognized statistical rating organization, a description of the information that such third party reviewed in conducting due diligence services, and a description of the findings or conclusions of such third party.”⁵⁹

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

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

“[I]t shall be sufficient for purposes of pleading any required state of mind in relation to such action that the complaint state with particularity facts

⁵⁹ See Section 932(s)(v) of S.3217.

giving rise to a strong inference that the credit rating agency knowingly or recklessly failed –

(1) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or

(2) to obtain reasonable verification of such factual information of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.”⁶⁰

This language (which was drafted by this author) in effect says that the rating agency must either conduct its own “reasonable investigation” or rely on an “independent” due diligence firm. If the rating agency does not, then particularized factual pleadings of this failure will enable the plaintiff to survive the defendant’s motion to dismiss. To be sure, the plaintiff would still have to show loss causation, reliance, scienter, and the other elements of a Rule 10b-5 cause of action,⁶¹ but a strong incentive arises to use a third party due diligence firm in this setting.

In Europe, the litigation lever is both less favored and less available as a means by which to influence the behavior of market actors. Still, European regulators could simply mandate the use of a third party, “due diligence” firm to conduct factual verifications, at least in the case of structured finance offerings. Both in Europe and the U.S., the use of a third party due diligence firm is likely to be preferred by the rating agencies to any requirement that it conduct its own due diligence, both because (1) the cost of the third party firm’s services can be directly passed on to the underwriters or deal arrangers, and (2) overlapping factual investigations by each rating agency are duplicative and

⁶⁰ See Section 933(b)(1)(B) of S.3217.

⁶¹ Potentially, the complete failure to conduct any factual due diligence or to receive seemingly reliable reports from independent third parties may show a reckless indifference to factual accuracy that also can demonstrate scienter, but this will depend on the facts and circumstances of individual cases.

inefficient. In a new and changed environment in which multiple rating agencies are likely to rate the same security, use of a third party expert spares society the costly and senseless duplication of requiring each rating agency to conduct a separate investigation of the same facts. Any such report provided by a third party expert should presumably fall within the earlier discussed “equal access” rule and so be accessible to all rating agencies.

F. Increasing Competition

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

A quicker route to robust competition might be to require institutional investors to obtain their own credit rating from an approved “subscriber pays” rating agency. This would subsidize a new market, without requiring the government to choose the rater. Nor could a “fly by night” rater that was ready to give inflated ratings to institutions desiring such ratings easily enter this market if the institutional investor were required to choose an NRSRO rating agency that met minimum governmental standards.

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

In response, the SEC has adopted Rule 17g-5, and Congress will similarly and more generally mandate “equal access” in its pending legislation. The EU Commission’s proposed rules take a similar approach. Issues, however, remain. The SEC’s rule requires the retained rating agency to release all data to other NRSRO agencies that request it, but does not require public disclosure. Under pending SEC rules, this data might be stored in a confidential, password-protected website to which requesting NRSRO agencies would be given access. Whatever the details, “equal access” seems a necessary precondition to greater competition.

G. Staleness Reforms

Much criticism has pointed out that rating agencies are slow to update their ratings or to downgrade them. One reason for this tendency is economic: there is today little, if any, revenue in downgrading a client’s rating and some risk of a loss of future business. One relevant response to this problem would be to require the issuer to enter into a multi-year contract with the rating agency to monitor the issuer’s rating for a

defined period after a rating's issuance. This pattern is already beginning to develop, but should be mandated. The issuer would be required to pay a "reasonable" annual fee for this service. If the initial rater were picked by a neutral body (such as the Credit Rating Agency Review Board), this reform seems promising. If not, a conflicted, "issuer-paid" rating firm will probably still be slow to downgrade.

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

H. Internal Governance

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

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

Many of these provisions seem to have been borrowed from the 2002 global settlement reached by the SEC, the New York State Attorney General, the NASD and other agencies with the securities industry regarding securities analysts. Debate continues over how effective that settlement has been, and the SEC recently (and unsuccessfully) attempted to drop as unnecessary some of the provisions in that settlement that precluded communications between analysts and investment bankers. Although there is evidence that senior executives at rating agencies placed pressure on their analysts, it is not clear that the provisions of Section 932 will stop this.

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

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

I. Administrative Registration

Consensus exists in both the U.S. and Europe that credit rating agencies should be registered with a government agency and subjected to its continuing oversight. To this extent, reliance on self-regulation and voluntary codes of conduct has been abandoned in Europe. In the U.S., pending legislation will create a new office within the SEC – the “Office of Credit Ratings” – to oversee credit rating agencies; it also requires annual

oversight of their internal controls and the consistency of their methodologies.⁶² Skeptics have doubted the efficacy of such efforts, because governmental agencies have little expertise in evaluating credit risk (and the SEC in particular has far less expertise in this area than do bank regulators, such as the FDIC and the Federal Reserve). Some fear that the tendency of bureaucratic regulators might be simply to focus on procedural regularity by the rating agency: Did it keep full and complete records?; Did it have a compliance officer; etc.?

Still, empirical research, such as that earlier noted by Griffin and Tang,⁶³ has identified a strange pattern of discretionary upward adjustments that inflated the size of AAA-rated tranches in structured finance offerings. This is the type of pattern on which regulatory oversight should properly focus. Indeed, the SEC has begun to respond. In 2009, SEC Rule 17g-2(a)(2) was amended to require NRSROs (in the case only of structured finance products) to document the reasons for a deviation when a final credit rating materially deviates from the rating implied by the NRSRO's quantitative model.⁶⁴ Europe needs to adopt a similar rule, because it should be a priority for regulators on both sides of the Atlantic to monitor deviations by rating agencies from their quantitative valuation models and demand detailed justifications.

Conclusion

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

⁶² Most of these provisions are in Section 932 of S.3217 (the Senate Bill).

⁶³ See text and notes supra at notes 13 to 17.

⁶⁴ See 17 C.F.R. Sec. 240.17(g)-2(a)(2). Technically, this rule applies only when a quantitative model is a "substantial component" of the rating process.

First, an “issuer pays” business model invites the sacrifice of reputational capital in return for high current revenues.

Second, competition is good, except when it is bad. When CRAs compete for the favor of issuers, rather than for that of investors, ratings arbitrage results. Both in their indifference to “red flags” and their tolerance for “thin” subordination, the CRAs appear to have engaged in a continuing race to the bottom.

Third, in a bubbly market, no one, including investors, may have a strong interest in learning the truth. The process of ratings inflation continues until the short sellers realize that enormous profits can be made from betting against inflated ratings. Only a strong and highly motivated watchdog can offset this process of repression and self-delusion.

From this perspective, neither the SEC nor the European Commission has yet taken a significant step that is likely to spur the creation of a “subscriber pays” market for credit information. At most, the SEC and the EU Commission have endorsed an “equal access” rule that, if enforced, would preclude the most blatant form of issuer hostility to a “subscriber pays” model. But useful as the SEC’s Rule 17g-5 is, it is insufficient to jumpstart a “subscriber pays” market into existence. Instead, what is needed are incentives. Appropriate incentives could be created in a variety of ways. Rules could require investors or deal arrangers to obtain a second rating from a CRA selected by investors. In the United States, the Franken Amendment (whose ultimate fate must await a two year study by the SEC) does take an initial, but imperfect, step in this direction by severing the connection between issuer payment and issuer selection of the CRA. But the problem with the Franken Amendment is that it does nothing to encourage competition

among CRAs for the favor of investors (and thus to incentivize CRAs to conduct independent research or verification). If, however, the initial rater were chosen through a vote (or even a poll) of likely investors, then the nature of the competition would change, and the CRAs would need to compete for the favor of investors.

The Bad. The major alternative to administrative oversight is deregulation, which would be achieved by eliminating existing requirements for credit ratings. Although it would be desirable to make investors less reliant on credit ratings, it is doubtful that this can (or should) be achieved by a stroke of the statutory pen. Rapid deregulation will likely produce a few failures at money market funds and other sensitive financial institutions and the appearance of some “fly by night” rating agencies. Equally important, it is necessary to recognize that credit rating agencies can play a socially useful and economically efficient role as informational intermediaries.⁶⁵ They can do so precisely because specialization is efficient. Because structured finance products are complex and opaque and because the rate of innovation in the field is rapid, “do-it-yourself” credit analysis by even sophisticated institutional investors will be inefficient. Economies of scale characterize the production of financial information, and thus even a large institutional investor, if diversified, will not have the same broad range of expertise that a properly motivated CRA should have.

Moreover, even if large institutional investors could assemble similar expertise in-house, such an investment in an in-house capacity is essentially duplicative, as all these

⁶⁵ Empirical studies have documented the informational value of credit ratings and shown them to be independent of and additive to the informational value that can be derived from credit default swap prices. See Lars Norden & Martin Weber, The Comovement of Credit Default Swap, Bond and Stock Markets: An Empirical Analysis, (available at <http://ssrn.com/abstract=635981> (2004)).

institutions are essentially investing in the acquisition of similar information which they could more cheaply purchase from specialized firms. For these reasons, any campaign to abolish credit rating agencies or discourage their use would be misguided.

Nor is it realistic to attribute the dominance of the Big Three to their de facto regulatory licensing power. Their market dominance preceded the SEC's creation of NRSROs, characterizes Europe as well in the absence of any similar regulatory power, and has persisted in the U.S. even after the Credit Agency Reform Act of 2006, which effectively ended any legal basis for their predominance. Their oligopolistic position seems attributable instead to the high barriers to entry into this market, which require that a new firm acquire reputational capital before it can acquire clients. This is the critical "Catch 22" problem that impedes competition.

The Ugly. Worse yet, there is also a dark side to reform, as the creation of a governmental rating agency presents special dangers. Not only might such an agency be conflicted, but there is a more ominous danger that if private CRAs disagree with its rating analysis, the regulator might take their disagreement as evidence of a deficiency in the procedures or methodologies of the non-governmental CRAs. As anger against the CRAs mounts, the prospect of retaliation for politically incorrect ratings lurks in the background. Ironically, while the CRAs have been justly criticized in the U.S. for inflated ratings, they may face even greater hostility in Europe for downgrades that are perceived as excessive or premature.

The Prescription. How much regulation is needed? If the market incentivized CRAs to compete for the favor of investors, less regulation and oversight would be required. However, in the absence of such incentives, close regulatory oversight is

needed. On what should such oversight focus? The empirical research has identified a pattern of discretionary adjustments that CRAs made to inflate their ratings.

Unfortunately, the tendency of a bureaucratic regulator is more to focus on procedural regularity, record-keeping, and adequate staffing. Such procedurally-oriented bureaucratic oversight promises little benefit. Instead, upward adjustments and deviations from the CRA's normal valuation model should be the regulatory focus.

Precisely because the term "oversight" is vague and regulatory supervision can sometimes degenerate into bureaucratic nitpicking (or worse), a clear regulatory agenda needs to be specified for the new ESMA in its oversight of CRAs in Europe. As just noted, the first priority should be to focus on upward deviations or adjustments from the CRA's methodology, which methodology must be publicly disclosed, at least in the case of issuer-paid CRAs.⁶⁶ Briefly, ESMA's priorities should include:

- (1) implementation of a detailed "equal access" rule;
- (2) requiring multi-year fee contracts between the issuer and a rating agency hired or paid by the issuer so that follow-up monitoring of the initial rating is required;
- (3) a corresponding requirement that when a CRA changes its methodology, it must revise all existing ratings that would have been originally affected by that change within a defined period;

⁶⁶ As just discussed, SEC Rule 17g-2(a)(2), adopted only in 2009, requires NRSROs to document the reasons for a deviation from their quantitative valuation models. See text and note supra at note 64. SEC Rule 17g-1 also requires public disclosure by the CRA of the methodology that it uses to determine ratings, and such disclosure must be sufficiently detailed to provide users of the ratings with a clear understanding of the process used by the NRSRO.

- (4) the development of a publicly available ratings history for each CRA, enabling investors to see the subsequent history of its ratings, including all defaults and downgrades;⁶⁷
- (5) prohibition of certain clear conflicts of interest, including rating offerings on which the CRA consulted (i.e., “self-rating”);⁶⁸
- (6) a rule requiring the disclosure of any “preliminary” ratings to discourage rating shopping; and
- (7) encouraging the use of third party “due diligence” firms to assure factual verification.

Much is changing. In this flux, the optimist will see a growing consensus that closer regulation is both needed and gaining political support. The pessimist will sense instead that regulators may increasingly be ready to punish CRAs for politically sensitive ratings downgrades (either of a locally favored company or a sovereign debt where the effect is to destabilize the market or a currency). The practice of “blaming the messenger” for bad news is a tradition that has persisted for millennia. Unacceptable as the performance of the CRAs has been, the future could see them caught between Scylla and Charybdis: sued by investors in the United States for inflated ratings and disciplined by politically-motivated regulators in Europe for downgrades that destabilize markets or disfavor politically powerful local companies.

⁶⁷ SEC Rule 17g-2 already requires such rating histories to a limited extent. Under it, the CRA must disclose 10% of the ratings, chosen at random, for each class of ratings in which the NRSRO rating agency participated. Under a 2009 amendment to this rule, the 10% requirement increases to 100% for ratings issued after June 26, 2007. See 17 C.F.R. Section 240.17g-2 (2009).

⁶⁸ SEC Rule 17g-5 precludes an NRSRO issuer from issuing or maintaining a credit rating with respect to an issuer or obligor where it (or any associated person) “made recommendations . . . about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security.” See SEC Rule 17g-5(c)(5). See 17 C.F.R. Section 240.17g-5(c)(5) (2009).

Amidst all this change, one priority must be insisted upon: the failure to address the “issuer pays” business model, while addressing only more specific conflicts (such as those addressed by the “equal access” rule), amounts to re-arranging the deck chairs on the Titanic, while ignoring the gaping hole created by the iceberg. On both sides of the Atlantic, there should be a recognition that (1) the existing market for ratings failed, (2) voluntary self-regulation and reliance on the rating agency’s desire to protect its “reputational capital” is inadequate, and (3) incentives must be aligned so that the watchdog is motivated to watch carefully.

Although regulatory supervision can mitigate conflicts of interest, the intensity of such supervision always eases once “boom” times arrive again, and thus the cycle leads back to laxity. Because of the inevitability of this sine curve of regulatory intensity, the sounder course is to encourage a “subscriber pays” model that can compete with the “issuer pays” model. But because of the “public goods” nature of financial information, a “subscriber pays” (or “platform pays”) model will not arrive naturally, and regulatory interventions are necessary to prod it into existence. If we get the incentives right, relatively little regulation is needed. But if the incentives remain poorly aligned, it is unclear whether any level of regulation can ensure ratings accuracy.

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