Using Unsolicited Ratings To Regulate The Credit Rating Agencies

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Abstract

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KEYWORDS: Investing, Corporate Law, Finance, Regulation, Dodd-Frank, Credit Rating Agencies

*J.D. Candidate, Fordham University School of Law, 2013; B.A., Adelphi University, 2010. I would like to thank my advisor, Professor Caroline Gentile, for her assistance and guidance in writing this Note. Most importantly, I would like to thank my family for their love and perpetual support.
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ABSTRACT

Unsolicited ratings have long been overlooked in the investment landscape and issuer pay models. Although Congress has lost its confidence in the credit rating agencies’ reputation theory and is now considering a semi-closed market as the only viable solution to the conflict of interest problem, financial scholars have proposed the Inequality model using unsolicited ratings and focusing on a reputational theory that could lead to more stringent rating standards. This Note argues that it is possible to achieve the Inequality for unsolicited ratings by utilizing the already required disclosures and making a few enhancements. This Note proposes that this will in turn improve accuracy and combat the conflict of interest problem without deviating from free market principles.

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INTRODUCTION

Four years after the 2008 financial crisis, the United States economy is still recovering and fingers are being pointed at the credit rating agencies (“CRAs”) and the issuer pay model for their role in the economic collapse.\(^1\) Many question how CRAs can honestly evaluate entities that are paying their bills.\(^2\) Congress and many academics have rejected the long propounded reputation theory, which holds that the mere threat of a loss of reputation curtails CRAs bad behavior, and justifies little to no regulation within the industry.\(^3\) Yet, reversing the current approach to an investor-pay model is also inadequate for the task

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of evaluating the credit risk in the modern economy. Congress and the Securities and Exchange Commission ("SEC") have attempted to fix issuer pay problems through the Credit Rating Agency Reform Act of 2006 ("CRARA" or "Credit Reform Act")\(^5\) and Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")\(^6\) by bringing CRAs within the SEC’s regulatory purview, requiring extensive disclosures, and changing the hiring process for ratings to an assignment system.\(^7\)

Even prior to the investor-pay or issuer pay models, the very first publication by Moody’s Investors Services ("Moody’s") was a book of unsolicited ratings prepared by Moody’s without compensation from issuers, providing information on issuers for the marketplace.\(^8\) The practice of issuing unsolicited ratings has persisted under both models,\(^9\) but in the last fifteen years, unsolicited ratings have lost their popularity and were not mentioned or used in either the CRARA or Dodd-Frank. Fulghieri, Strobl, and Xia ("Fulghieri") proposed a rational expectation model to identify the circumstances in which unsolicited ratings would lead to more stringent or less stringent ratings standards.\(^10\) In forming this rational expectation model, Fulghieri and his colleagues considered both the positive and negative incentives of CRAs, focusing on reputational theory, and concluded that if the long-term reputational costs of inaccurate rating are higher than the short-term gains (the "Inequality"\(^11\)), CRAs will issue accurate ratings, including for unsolicited ratings.\(^12\)

This Note will argue that within the context of unsolicited ratings, the rejected reputational theory will produce accurate and beneficial

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4. Richard Cantor & Frank Packer, The Credit Rating Industry, FED. RES. BANK N.Y. Q. REV., Summer-Fall 1994, at 4, available at http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n2article1.pdf (discussing the rapid growth in size and subject matter for CRAs after the switch to the issuer pay model which could not have been possible under the investor pay model).


7. See infra Part II.B for a discussion of the Dodd-Frank reforms.


9. Id. at 5.


12. See id. at 26.
ratings if the Inequality is achieved. This Note will employ the principles expressed by the Inequality to examine the source of the problems that have plagued the credit rating industry and those who rely on it throughout the last decade.\footnote{See infra Part I.B for a discussion of the Enron bankruptcy and the 2008 Financial Crisis.} In addition, this Note will identify ways that unsolicited ratings will help alleviate these issues, and evaluate the extent to which new proposed reforms, including Dodd-Frank, succeed in minimizing the harmful effects of the short-term gains CRAs derive from unsolicited ratings while maximizing the positive influence of the long-term reputational costs CRAs suffer as a result of inaccuracies in ratings.

Part I discusses the history of CRAs and the reputational difficulties that plagued CRAs as a consequence of the Enron bankruptcy and the 2008 financial crisis. Part II considers how CRARA and Dodd-Frank tried to solve these problems and explores unsolicited ratings in the context of the Inequality. Part III identifies the conditions necessary to make the Inequality hold true in the market for corporate bonds, the impact of Dodd-Frank, and the next steps that must be taken.

\section*{I. Rating Agencies: History and the Crises}

CRAs, a product of the industrial age, were developed to provide investors with much needed information for making investing more manageable in a rapidly growing technological world.\footnote{See Cantor & Packer, supra note 4, at 1–2.} These agencies took complex data and combined it to produce a single neat symbol.\footnote{Frank Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies, 77 WASH. U. L.Q. 619, 638–39 (1999). A CRA, after analyzing all the available data on a certain bond, instrument, or organization, will provide its opinion on the likelihood that the issuer will default on its obligations. See id. at 641. CRA’s opinion is reflected on both ordinal (A,B,C) and cardinal (AAA, AA, A) scales. Id. at 642. However, there are two general categories: “investment grade” (i.e. AAA–BBB) and speculative or not investment grade (BB–D). SEC. & EXCH. COMM’N., REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS AS REQUIRED BY SECTION 702(b) OF THE SARBANES-OXLEY ACT OF 2002, at 25 (2003) [hereinafter SEC CRA REPORT], available at http://www.sec.gov/news/studies/creditratingreport0103.pdf. A triple “A” rating, whether a Moody’s AAA or an S&P Aaa, implies an “extremely strong capacity” to satisfy the debt commitment. See STANDARD & POOR’S FINANCIAL SERVICES, L.L.C., STANDARD & POOR’S RATINGS DEFINITIONS (June 22, 2012), available at http://www.standardandpoors.com/fi/srd/defs2.htm.}
In 1909, John Moody, inspired by mercantile rating agencies, took the next step and provided security ratings for railroad bonds in a single book.\textsuperscript{16} Moody’s was soon joined by Standard & Poor’s (“S&P”) in 1916 and Fitch Publishing Company in 1924.\textsuperscript{17} Moody’s initial publication contained only unsolicited ratings, and in the first half of the twentieth century, all CRAs operated on a pure investor paid subscription model.\textsuperscript{18}

It was not until 1970, when Penn Central defaulted on $82 million in commercial paper, that CRAs began to transition to the issuer paid model.\textsuperscript{19} This shift allowed CRAs to eliminate the free rider effect that discouraged new investor subscriptions,\textsuperscript{20} raise funds that would allow for greater information gathering,\textsuperscript{21} and gain access to non-public company information from obligor participation.\textsuperscript{22} Today, CRAs charge based on the size and complexity of the rated security, although it is typically two to three basis points of a bond’s face amount at issuance.\textsuperscript{23} The switch in the financial models allowed S&P and Moody’s to expand internationally and grow exponentially in size, as well as increase the number and types of rated securities.\textsuperscript{24}

Over the years, CRAs have become an integral part of the financial system, having been incorporated into the regulation of the markets and

\begin{itemize}
\item Partnoy, \textit{supra} note 15, at 638.
\item See id. at 639.
\item See id. at 640; see also Cantor & Packer, \textit{supra} note 4, at 4.
\item Cantor & Packer, \textit{supra} note 4, at 4.
\item As the quantity and size of the commercial paper market increased in the 1960s, CRAs began having difficulties keeping up with the amount of securities they needed to rate given the limited funds that a subscription would produce. Cantor & Packer, \textit{supra} note 4, at 4.
\item Lynch, \textit{supra} note 3, at 239–40. The issuer pay model does provide an advantage in that CRAs are privy to private company information and are able to issue their rating before a bond is issued. See id. at 242–43. Prior to the 1930s, ratings were announced after the bond was issued and could only affect the secondary market for the bond. See Partnoy, \textit{supra} note 15, at 643.
\item See Partnoy, \textit{supra} note 15, at 652–53.
\item See id. at 648–49. In the span of 20 years, the staff at S&P and Moody’s grew from less than 50 to 1,200-1,700. \textit{Id}.
\end{itemize}
securities at both the Federal and state levels.\textsuperscript{25} In 1975, the government provided the classification of nationally recognized statistical rating organization ("NRSRO") to those CRAs whose ratings could be used for regulatory purposes in an effort to differentiate between the upstart CRAs and those that met government standards.\textsuperscript{26} Frank Partnoy, a law professor at the University of San Diego and one of the earliest and well-known critics of CRAs, described NRSROs as grantors of regulatory licenses and "gatekeepers of the bond market" because their ratings made compliance with regulations simpler and cheaper for both issuers and investors.\textsuperscript{27} Even without their regulatory role, NRSROs are important to an issuer of corporate bonds. The issuer asks one or more NRSROs to rate their bonds, and the rating, which reflects the rate of default, correlates with the issuer's cost of capital.\textsuperscript{28} A higher assigned rating means more liquidity, lower cost of capital, and a wider potential investor pool (e.g., mutual funds and insurance companies) for the issuer.\textsuperscript{29}

A. ENRON AND THE FINANCIAL CRISIS OF 2008

In theory, NRSROs are meant to be unbiased experts of companies and securities;\textsuperscript{30} however, the past decade has brought to light significant flaws in both the quality of the ratings and the business

The number of outstanding rated bonds expanded from about 5,500 in 1975 to approximately 20,000 domestic bond issuers and 1,200 international by 1995. \textit{Id.}


26. SEC CRA REPORT, supra note 15, at 5–6. While the label "NRSRO" was created in 1975, it was not until 1997 that the government attempted to officially define NRSROs, though it did not act on the proposed rule. \textit{Id.} Additionally, until 2006, NRSRO status would be informally granted in a "no-action" letter. \textit{Id.}

27. Partnoy, supra note 15, at 681–82. A significant part of the NRSRO reform in Dodd-Frank was to remove the regulatory reliance on rating. See Dodd-Frank Act, Pub. L. No. 111-203, § 939, 124 Stat. 1376, 1885 (2010).


29. \textit{See} id. at 247.

30. WATCHDOGS REPORT, supra note 25, at 52 (stating that the public expects CRAs to be "unbiased and accurate assessors of various companies' financial conditions").
model of NRSROs. Enron first shocked the investment community in 2001 with its bankruptcy, and then in 2008, the subprime mortgage crisis threatened the entire global economy. Center stage in the midst of these crises was NRSROs.

1. Enron

On December 2, 2001 Enron filed for bankruptcy. A mere four days earlier, Enron’s ratings by all “big three” CRAs were still above investment grade. Investigations after the fact revealed plenty of early signs of impending doom that NRSROs should have noticed. The warnings started in early October when Enron informed the agencies of a $1 billion write-down of after-tax income and a $1.2 billion shareholder equity reduction. Further signs included an SEC investigation into several partnerships of Enron’s CFO designed to hide the company’s losses and debts; the $500 million earning restatement that Enron issued on November 8th; and the $690 million demand obligations that S&P downgrades triggered that Enron hid from the


32. Id.

33. Claire A. Hill, Rating Agencies Behaving Badly: The Case of Enron, 35 Conn. L. Rev. 1145, 1149 (2003). Enron was not the only corporation that collapsed in the early 2000s; it was closely followed by other companies in deep financial problems. Notably, WorldCom caused another round of criticism of CRAs for yet again failing to timely lower WorldCom’s rating to reflect its financial troubles and pending bankruptcy. See Marie Leone, Bush Signs Rating Agency Reform Act, CFO.COM (Oct. 2, 2006), www.cfo.com/article.cfm/7991492/c_7989907=TodayInFinance_Inside.


35. See Hill, supra note 33, at 1149. While Enron was above investment grade until November 28, 2001, the company was downgraded by all three agencies starting from October 25th and teetered a notch above junk most of November. WATCHDOGS REPORT, supra note 25, at 85–88.


37. WATCHDOGS REPORT, supra note 25, at 85.

38. Id. at 86.

39. Id. at 88.
agencies until its quarterly filings on November 19th.\textsuperscript{40} The agencies tried to shift part of the blame on Enron for providing false and misleading information;\textsuperscript{41} however, the investigating Senate Committee found that CRAs’ efforts “fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance.”\textsuperscript{42} The Enron credit ratings were solicited, the ratings were not maintained solely based on public information, and all three agencies had open lines of communications with Enron staff, which the issuer pay model allows.\textsuperscript{43} The main problems were an insufficient review of company materials, the lack of diligent investigations into emerging problems, a focus on short-term rather than long-term creditworthiness, blindly accepting Enron’s officers’ words, a lack of inquisitiveness, and the agencies’ lack of accountability.\textsuperscript{44}

\textbf{2. Financial Crisis of 2008}

The Enron scandal paled in comparison to the financial crisis of 2008.\textsuperscript{45} The catalyst of the debacle was the high-risk mortgage lending at the height of the housing bubble where mortgages would be sold off, packaged in pools, and underwritten for investors to purchase.\textsuperscript{46} Since these mortgaged-backed securities were sold into the private market and not guaranteed by the government, investors demanded ratings for the pools, a task which fell to NRSROs.\textsuperscript{47} At the height of the bubble, the ratings provided by NRSROs were greatly overinflated\textsuperscript{48} and NRSROs’

\begin{itemize}
\item \textsuperscript{40} Id.
\item \textsuperscript{41} Id. at 120.
\item \textsuperscript{42} Id. at 90.
\item \textsuperscript{43} See id.
\item \textsuperscript{44} Id. at 90–98.
\item \textsuperscript{47} Kia Dennis, \textit{The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis}, 63 U. MIAMI L. REV. 1111, 1121–22 (2009).
agents would directly advise the issuers on how certain pool attributes would affect a rating, prior to actually establishing a rating. CRAs issued ratings for tens of thousands of United States residential mortgaged-back securities (RMBS) and collateralized debt obligations (CDOs). Most of these securities were rated investment grade (many AAA), despite being backed by high risk loans. Even when homeowners began defaulting on their subprime mortgages in 2006, CRAs did not heed these signs and continued issuing investment grade ratings. Finally, in July of 2007, CRAs began downgrading thousands of their ratings for RMBS and CDOs in a very short period of time. Overall, about 90% of RMBS originally rated AAA in 2006 and 2007 were downgraded to junk status. This sudden change forced banks, insurance companies, and pension funds, whose regulatory requirements obligated them to hold only highly-rated investments, to sell. The RMBS and CDO markets froze and collapsed in a matter of months.


50. Wall Street and the Financial Crisis Report, supra note 48, at 6. While bonds are debt obligations of the issuer for a given amount which is paid out by the issuer, RMBS and CDOs are significantly more complex because they are actually a securitization of pools of someone else’s debt. Before an RMBS is formed, an originator enters into a mortgage contract. *Id.* at 649. The originator then sells a pool of these mortgages (or some other income producing assets) to a special purpose vehicle (“SPV”), which issues securities in that pool to investors. *Id.* The income received from the mortgage payments of the RMBSs are divided to provide the principal and interest payments of the RMBS. *Id.* CDOs are formed in a manner similar to RMBSs, but the securities (and the payouts) are two-tiered. *Id.* When rating an RMBS or a CDO, NRSRO must look at all the underlying debt obligations in the pool to estimate the chance of default.

51. See supra note 15 for an explanation of rating categories.


53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*
The last decade has shredded the image of CRAs as unbiased specialists there to help investors.68 Instead, as a managing director of Moody’s admitted, “[c]ombined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both.”69 While the outcome might not necessarily point to incompetence, the critics, the Senatorial Subcommittee, and SEC all found glaring errors in the running of CRAs.70 The most severe criticisms have been the lack of regulation, conflicts of interest that led to inflated ratings and regulatory arbitrage, and rate shopping.71

1. Lack of Regulation

The initial problem affecting CRA performance was that there was no regulatory system for CRAs.62 Until 1997, there was no official definition for NRSROs even though the term has been used since 1975.63 It was only in 2006 that a formal system was established for granting a company the status of NRSRO,64 even though there were more than 100 laws that used NRSRO ratings as a benchmark at the time.65 It was not until after the Enron debacle that the government started considering regulating NRSROs, though the question of to what extent still lacks an answer.66

58. See generally WATCHDOGS REPORT, supra note 25, at 115–25.
59. WALL STREET AND THE FINANCIAL CRISIS REPORT, supra note 48, at 245.
60. See generally id. at 243–317.
62. See infra Part II.A.
63. See supra note 26 and accompanying text.
65. See WATCHDOGS REPORT, supra note 25, at 104.
66. While both the CRARA and the Dodd-Frank Act provided the SEC with certain powers to regulate the registration of NRSROs, neither act gave the SEC the ability to regulate content of a rating since that would infringe on CRAs’ First Amendment rights. See infra Part II.A.
2. Conflict of Interest

Another large problem contributing to the downfall of Enron and the Financial Crisis was the number of complications born of the issuer pay model. There is a glaring conflict of interest when the entity being rated pays the rating institution. Both the SEC and the Senate reports highlighted the increased chance of inflated ratings. Since a higher rating could allow an issuer to have a lower cost of capital and a wider investment pool, the issuer is interested in obtaining the highest possible rating. The issuer is also interested in maintaining the highest rating to avoid a decline in its liquidity and the triggering of rating-based clauses in their contracts. CRAs, as private for-profit companies, need to satisfy their customers, but that obligation conflicts with their primary purpose of providing information about bonds and issuers to investors. Additionally, there are regulatory advantages that an investment grade rating can secure. A rating could reduce the administrative and legal costs in filing an S-3 rather than an S-1 with the SEC or open the security to a pool of large institutional investors like money market mutual funds, pension funds, and insurance companies who are restricted by regulations in the type of securities they may hold.

68. See generally Lynn Bai, On Regulating Conflicts of Interest in the Credit Rating Industry, 13 N.Y.U. J. LEGIS. & PUB. POL’Y 253 (2010) (explaining additional conflicts of interest on the agent level where the actual employee has a conflict of interest or the agency has an additional interest in having the issuer purchase ancillary services).
69. WALL STREET AND THE FINANCIAL CRISIS REPORT, supra note 48, at 243.
70. See supra notes 28–29 and accompanying text.
71. WALL STREET AND THE FINANCIAL CRISIS REPORT, supra note 48, at 273.
72. Id. For the perfect example of ratings affecting private contracts and securities post-issuance, consider how the S&P downgrade of Enron triggered a clause in Enron’s contracts resulting in a $690 million payout to the investor. See WATCHDOGS REPORT, supra note 25, at 88.
73. See Lynch, supra note 3, at 246–47.
76. See Lynch, supra note 3, at 246.
3. Rate Shopping

Congress and the SEC are also worried about rating shopping by issuers.\textsuperscript{77} Under the current system, the issuer approaches several CRAs to receive a preliminary rating, and ultimately chooses which to pay to issue the official rating.\textsuperscript{78} Even though the rating industry is an oligopoly,\textsuperscript{79} issuers are able to choose from whom to solicit ratings, and would logically choose the agency that gives the highest rating. That places external pressure on CRAs to provide a higher rating than warranted.\textsuperscript{80} This was especially worrisome during the financial crisis because a select few arrangers underwrote very large quantities of CDOs and RMBSs.\textsuperscript{81} As such, losing these large investors as clients could significantly affect profits at the CRAs.\textsuperscript{82}

Issuers are more likely to select NRSROs that have provided favorable ratings for their securities in the past, and therefore may be more likely to inflate their ratings in the future.\textsuperscript{83} The relationship is stronger with the more complex and longer maturity bonds because that is where the rating discrepancy among CRAs is greatest.\textsuperscript{84} Issuers with short-term debt who are on the verge of the regulatory minimums\textsuperscript{85} are more likely to shop around and solicit just one qualified rating.\textsuperscript{86} This

\textsuperscript{77} See \textit{Wall Street and the Financial Crisis Report}, supra note 48, at 244; see also Bai, \textit{supra} note 68, at 263.

\textsuperscript{78} See Bai, \textit{supra} note 68, at 263.

\textsuperscript{79} See Darcy, \textit{supra} note 49, at 641 ("Moody’s reported that its market share [for structured finance products] declined from 75% to 25% when it increased its rating standards.")

\textsuperscript{80} See id. at 641–42.

\textsuperscript{81} Darcy, \textit{supra} note 49, at 639–40. Rate shopping does not just apply to complex structured products. Recent research has found strong indications that rate shopping is also prevalent in the corporate bond market. See generally Mathias Kronlund, \textit{Best Face Forward: Does Ratings Shopping Distort Observed Bond Ratings?} (Univ. of Chicago, Working Paper, 2011), available at http://www2.lse.ac.uk/fmg/events/capitalMarket/CMW15M_Kronlund_BestFaceForward.pdf.

\textsuperscript{82} Darcy, \textit{supra} note 49, at 639–40

\textsuperscript{83} See id. at 34.

\textsuperscript{84} See id.

\textsuperscript{85} “Regulatory minimum” refers to the Rule 2a-7 of the Investment Company Act of 1940, which limits securities that a mutual fund may hold to those that have a certain rating. Id. at 4 (citing 17 C.F.R. § 270.2a-7 (2012)).

\textsuperscript{86} See id. at 22. Kronlund focused on Rule 2a-7, under the Investment Company Act of 1940, which states that if more than one rating is obtained, then the second
strategy of shopping around could have two effects: the inflated ratings could be used to fool investors and to commit regulatory arbitrage.87

The traditional defense to the conflict of interest and rate shopping problems tainting the issuer pay model was the reputational capital model.88 Regulators and investors value credit ratings because they are supposed to be unbiased third-party evaluations meant to bridge the informational asymmetry between the issuers and investors.89 CRAs’ continued success depends on their reputations: if the investors do not trust the accuracy of their ratings, that agency’s ratings would be devalued and unsolicited.90 The reputational theory provides the basis for the notion that the markets and CRAs will regulate their honesty and accuracy themselves.91 In a pre-CRARA study, Federal Reserve staff found that reputational theory can effectively control conflicts of interest in the bond market.92 One of the significant motives of CRAs when issuing a rating is to maintain their reputation.93 An advisor is only as good as his advice and CRAs are exposed to reputational worries;94 however, both Enron and the 2008 Financial Crisis provide enough ammunition to question whether reputational constraints alone are enough to curb NRSROs’ conflicts.95

highest rating is considered for the purposes of the rule. Id. (citing 17 C.F.R. § 270.2a-7 (2012)).

87. See id. at 27. Kronlund found that investors are cognizant of rate shopping and try to compensate through higher yields but was unable to conclude whether or not they are perfectly able to adjust for the bias. Id.

88. John Patrick Hunt, Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, 2009 COLUM. BUS. L. REV. 109, 127.

89. See id. at 158–59.

90. See id.

91. See id.; Steven L. Schwarcz, Private Ordering of Public Markets: The Rating Agency Paradox, 2002 U. ILL. L. REV. 1, 26 (“Rating agencies are already motivated to provide accurate and efficient ratings because their profitability is directly tied to reputation.”).


93. Lynch, supra note 3, at 252.

94. Schwarcz, supra note 91, at 14.

95. See Dennis, supra note 47; Lynch, supra note 3.
II. THE ATTEMPTED SOLUTIONS AND THE OMission OF UNSOLICITED RATINGS

Following Enron and the Financial Crisis of 2008, Congress turned its attention to the unregulated business of CRAs.96 The failure to accurately rate and timely modify ratings contributed to trillion dollar losses.97 In response, Congress passed CRARA and Dodd-Frank;98 however, neither of these pieces of legislation included unsolicited ratings because the utility of such ratings was uncertain.99 One recent proposal by Fulghieri recognizes that unsolicited ratings will only be accurate—and therefore beneficial to the market—when certain factors hold true in the Inequality.100

A. CREDIT RATING AGENCY REFORM ACT OF 2006 AND THE DODD-FRANK WALL STREET REFORM ACT OF 2010

CRARA regulates the CRAs and provides the SEC with oversight powers;101 however, before CRARA was even fully in effect, the United States was in another crisis—the Financial Crisis of 2008.102 Dodd-Frank was meant to fix the additional defects in NRSROs highlighted by the Financial Crisis.103

1. Credit Rating Agency Reform Act of 2006

Although CRAs advocated for continued reliance on the reputational theory and no regulation,104 Congress disagreed and CRARA added Section 15E to the Exchange Act of 1934.105 It was the

96. WATCHDOGS REPORT, supra note 25, at 123.
97. See Hill, supra note 33, at 1149; see also WALL STREET AND THE FINANCIAL CRISIS REPORT, supra note 48, at 6.
100. See Fulghieri, Strobl & Xia, supra note 10.
102. See supra Part I.A.2.
103. Murdock, supra note 3, at 1305–06.
104. WATCHDOGS REPORT, supra note 25, at 123.
first major piece of legislation that gave the SEC oversight power of
NRSROs.106 The Credit Reform Act set out the qualifications and
registration procedure for NRSROs. 107 In the application for
registration, the applicant CRA is required to reveal a wealth of
information about its performance and processes.108 The CRA has to
provide data on their credit rating performance measurements over the
short-term (one year), mid-term (three year), and long-term (ten year)
periods.109 Additionally, potential NRSROs are required to detail the
procedures and methodologies used in determining credit ratings.110 An
applicant also has to reveal any conflict of interest it faces relating to the
issuance of credit ratings so that the public is informed of any inherent
problems in the rating process.111 After registration, each NRSRO must
annually file with the SEC the same form with updated data, and certify
its accuracy.112 In July 2007, the SEC promulgated the rules that would
govern NRSROs.113

106. 15 U.S.C. § 78o-7(c) (2006). The Act gives the SEC the authority to regulate
NRSRO registration, organization, and procedure. However, the SEC is still not
authorized to “regulate the substance of credit ratings or the procedures and
methodologies by which any nationally recognized statistical rating organization
determines credit ratings.” Id. § 78o-7(c)(2).
107. Id.
108. Id. § 78o-7(a)(1)(B).
109. Performance is measured by how the assigned grade (and the risk of default)
matches to the actual defaults in the grade. The SEC has implemented the performance
disclosure through Exhibit 1 of Form NRSRO. See Application for Registration as a
Nationally Recognized Statistical Rating Organization (Form NRSRO), available at
www.sec.gov/about/forms/formnrsro.pdf. For each class of credit rating, NRSRO must
provide statistical performance in terms of default and transition rates. Id. But see Lynn
Bai, The Performance Disclosures of Credit Rating Agencies: Are They Effective
default and transition rates are adequate, choosing instead to look at fallen angel ratios
(securities that began as investment grade but in the period, fell to junk or defaulted),
rating change ratios, and large rating change ratios, which can reveal unstable or
inadequate ratings).
111. Id. In addition to requiring disclosures, the Credit Reform Act gave the SEC
the power to regulate the procedures that NRSROs were required to enact to control
conflict of interest problems, which the SEC did by prescribing a requirement for
establishing NRSRO policies and compliance officers. See id. § 78o-7(h); see also Bai,
supra note 109, at 47.
113. Bai, supra note 109, at 48.
2. Dodd-Frank Wall Street Reform Act of 2010

The Dodd-Frank Act aimed to address the many problems of the Financial Crisis, and Title IX specifically focused on NRSROs. Among the many changes instituted by Dodd-Frank was the purging of the use of the credit ratings from all federal laws, and a requirement that NRSROs develop internal control structures. While the aforementioned changes are significant, the most relevant features of Dodd-Frank were the Franken-Wicker Proposal (the 15E(w) Amendment), which has yet to be adopted, and the new disclosure requirements, which were expanded to create transparency in the rating process. Dodd-Frank and the proposed regulations address two types of disclosure: those which must accompany each individual rating and general disclosures about the performance of NRSRO itself.

a. The Disclosures for Each Rating

Each new or modified rating on a particular security must be accompanied by a disclosure form that is clear, informative, public, comparable to other NRSROs, and must include performance information over a range of years and a variety of credit ratings. To combat the problem of opaque models that were identified in the Senate Report following the financial crisis, NRSROs are required to disclose

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115. Id. § 939, 124 Stat. at 1885.
116. Id. § 932(a)(3), 124 Stat. at 1873.
119. Dodd-Frank Act, sec. 932(a)(8), § 15E(q), 124 Stat. at 1878. The SEC shall make rules that require disclosure on each initial rating and any subsequent changes “for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different nationally recognized statistical rating organizations.” Id.
120. Id.
122. See WATCHDOGS REPORT, supra note 25, at 245.
methodologies as well as qualitative and quantitative information. In terms of qualitative information, NRSROs must disclose the following with each rating: 1) the main assumptions and principles used in their procedures and methodologies; 2) potential limitation and excluded risk of the ratings; 3) information on the uncertainty of the rating and any limits on the scope or reliability of the available data; 4) to what extent third party due diligence services have been used; 5) a description of the data about the issuer that was used; 6) an assessment of the quality of the information available; and 7) any information relating to a conflict of interest. In addition to the extensive qualitative information, NRSROs must also provide the following quantitative information: 1) the measure of potential volatility of the rating; 2) the historical performance of the rating and the probability of default along with the expected loss in a default event; and 3) the sensitivity of the rating to the assumptions made in the rating process.

b. The New Form NRSRO

In addition to making the reports accompanying individual ratings, Dodd-Frank calls for annual certification of the same qualities through Form NRSRO. Under the Credit Reform Act, Exhibit 1 of Form NRSRO requires each agency to provide performance statistics—specifically transition and default rates—for each class of securities for the past one, three, and ten years. The SEC has noted that since the Form’s instructions do not provide for a specific methodology or limit the type of information included, NRSROs used different techniques to produce ratings, came up with their own ways of presenting the data, and generally varied in the manner of their disclosure. In an effort to make Exhibit 1 disclosures more uniform and understandable, the SEC has proposed a standard matrix for Exhibit 1. However, two years

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123. Dodd-Frank Act, sec. 932(a)(8), § 15E(s), 124 Stat. at 1879.
124. Id.
125. Id.
127. See Form NRSRO, supra note 109.
129. Id. Below is a sample matrix that would be included with the proposed instructions:
after Dodd-Frank and a year after the publication of the proposed rules, the SEC still has not adopted a final rule.130

c. 15E(w) Amendment

The 15E(w) Amendment was proposed to address conflicts of interest and rate shopping for complex structured products.131 Its goal was to create the Credit Rating Agency Board (“the Board”), a self-regulating organization that would assign NRSROs to rate new structured products rather than having the issuer pick the agency.132 Any issuer seeking an initial rating of a structured finance product would apply to the Board and the Board would select a NRSRO from a pool of qualified agencies to produce the rating.133 To become part of this pool of agencies, NRSROs would have to submit an application to the Board to be considered a “qualified NRSRO” (“QNRSRO”).134 The Board would review each QNRSRO’s performance annually, and future

<table>
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<tr>
<th>Credit Rating Scale</th>
<th># Of Ratings Outstanding as of 12/31/2000</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
<th>CC</th>
<th>C</th>
<th>Default</th>
<th>Paid Off</th>
<th>Withdrawn (other)</th>
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<td>4%</td>
<td>1%</td>
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<tr>
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<td>8%</td>
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<tr>
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<td>2%</td>
<td>18%</td>
</tr>
<tr>
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<td>6%</td>
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</tr>
</tbody>
</table>

131. Bai, supra note 109, at 49.
133. Id. at 28,287–88.
assignment by the Board would depend on this past performance. Rather than adopting the amendment immediately, Section 939F of Dodd-Frank calls for an SEC study and a recommendation on the feasibility of the 15E(w) Amendment or some other similar system.

Based on the directive of Section 939F, the SEC issued a solicitation for comment on the 15E(w) amendment, as well as five alternatives to the 15E(w) Amendment. Of note is the option for the maintenance and expansion of Rule 17g-5—the equal access rule.

Rule 17g-5, promulgated pursuant to § 17 of the Exchange Act, requires that if a hired NRSRO has a conflict of interest when rating a structured finance product, it must make the information available and accessible to other non-hired NRSROs on a password protected website. The rule limits non-hired NRSROs' access by providing that they may not utilize the website more than ten times a year. If greater admittance is desired, the individual NRSRO must issue and maintain a credit rating for at least ten percent of all securities whose information is viewed. The program’s purpose is to encourage unsolicited ratings. In the above-mentioned solicitation for comment, the SEC inquired if

135. Id. at 28,291.
138. Id.
139. Id. at 28,275. Other options include the investor-owned credit rating agency model, stand-alone model, the designation model, and the user-pay model.
140. 17 C.F.R. § 240.17g-5(b) (2012).
141. Id. Conflicts of interest include: 1) being paid by the issuer, underwriter, or obligor for the security that they will issue, underwrite, or be obligors for, 2) being paid for additional ancillary services, 3) being paid by persons for subscriptions who will use the rating to comply or obtain statutory or regulatory benefits or own investments which could be beneficially or adversely affected by credit ratings; 4) having NRSRO employees own securities in the issuer or have more than an arms-length relationship with issuer, 5) being a broker or dealer who is in the business of underwriting securities and is associated with NRSRO. Id.
142. Id. § 240.17g-5(a)(3). For purposes of the requirement, complex financial products include all securities or money market instruments issued by an asset pool or as part of an asset-backed or mortgage-backed securities transaction. Id.
143. Id. § 240.17g-5.
144. Id. § 240.17g-5(a)(3)(ii)(B).
145. Id.
the existing Rule 17g-5 program, with possible modifications, is an adequate model to curb the conflicts of interest.147

The SEC published the results of their study in December 2012, which mainly featured a summary of all the submitted comments.148 The SEC study did not reach an ultimate decision but rather recommended the formation of a roundtable for further study.149 While academics supported the adoption of Amendment 15E(w) as the only workable solution to the conflict of interest problem, the top three NRSROs and the majority of commentators took the position that Amendment 15E(w) was unworkable, against public policy, too costly, and would decimate the competition among NRSROs.150 Instead, they expressed the belief that a modified and enhanced Rule 17g-5 is a viable alternative solution because the disclosure that would accompany unsolicited ratings and unsolicited comments151 would be sufficient to control the conflict of interest.152 As commentators pointed out, if any version of the 15E(w) Amendment is accepted, it would mean unprecedented government interference into a private industry and an assault on the self-regulation and the reputational theory that has guided the CRA industry since its inception.153

149. Id. at 73.
150. See id. at 30–52 (reporting that a majority of commentators found that the 15E(w) Amendment has problems of moral hazard, feasibility, independence, accountability, reduction of competition, transparency, and market acceptance).
151. Unsolicited comments are opinion letters issued by various NRSROs regarding a specific security and the rating that the hired NRSRO provided. See Comment Letter from Richard M. Whiting, Exec. Dir. & Gen. Counsel, The Fin. Servs. Roundtable, to Elizabeth M. Murphy, Sec’y, Sec. Exch. Comm’n 18 (Sept. 13, 2011), available at http://www.sec.gov/comments/4-629/4629-16.pdf. Unlike unsolicited ratings, comments are less expensive feedback for the non-hired NRSROs since they do not necessitate the regulatory compliance and the post rating monitoring that official ratings would require. Id. Quite a few of such unsolicited comments have been issued since the implementation of Rule 17g-5. Id.
152. See SEC Assigned Credit Ratings Study, supra note 148, at 55–56.
153. Id. at 33, 36–37. As a comparison, the greatest blame from the Enron scandal fell on the public accounting firms. In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002). The accounting firms, blamed for the Enron scandal, also faced conflicts of interest on both the individual employee level (through
B. THE ROLE OF UNSOLICITED RATINGS IN THE NEW REFORM SCHEME

While NRSROs were brought into the regulatory fold in 2006, there was little mention of unsolicited ratings since they slowly faded from practice in the late 1990s. At the turn of the century, there was confusion as to whether unsolicited ratings were tools of blackmail or a market check, since it was possible to abuse the unsolicited rating process. In analyzing these dual motives for unsolicited ratings, Fulghieri and his colleagues recognized that in the state of the Inequality, unsolicited ratings would have a positive impact.

The regulation of NRSROs includes some SEC staples such as registration and disclosure, as well as some radically new proposals, but neither the Credit Reform Act nor the Dodd-Frank Act addresses the issue of unsolicited ratings. The subscriber pay model was the standard in the credit rating industry from their inception until the 1970s, and even in the 1990s, after switching to an issuer pay model, both Moody’s and S&P rated all SEC-registered domestic securities regardless of solicitation. However, after Jefferson County School District sued Moody’s over the unsolicited rating of its bonds in the late 1990s, claiming that the rating was retaliation for not hiring Moody’s to rate their security, the practice acquired a negative reputation. The issue of unsolicited ratings sparked an investigation by the Justice Department and the New York Attorney General, Eliot Spitzer.

lateral positions) and the company wide strata (through the purchase of ancillary services). Id. at 684. Yet, even after Enron, reporting companies still choose their own accounting firms even though the accounting sector is strictly regulated and overseen by the SEC and the Public Company Accounting Oversight Board. Sarbanes-Oxley Act, Pub. L. No. 107-204, § 702, 116 Stat. 745, 797 (2002).


155. See Cantor & Packer, supra note 4, at 4.

156. Id. at 5. S&P limited their policy to only domestic SEC registered securities while Moody’s would also issue unsolicited rating to both structured products and foreign bonds. Id.


Although both investigations did not lead to charges, Moody’s, S&P and Fitch abandoned mandatory policies of providing ratings for all securities.

Does that mean that unsolicited ratings are illegal tools in the hands of NRSROs? The SEC did not necessarily think so as demonstrated by its attempt to encourage unsolicited ratings for structured financial products in Rule 17g-5. Rule 17g-5 makes the issuance of unsolicited ratings for financial products possible and easier, and the SEC envisioned that they would act as a check on rate shopping by disseminating a true—or lower—rating that frustrates the very reason for shopping around. The ability of non-hired NRSROs to view the underlying data necessary to produce a rating would also produce more accurate ratings because under the new Rules 17g-5 and 17g-2, both investors and NRSROs have a greater insight into the methodologies of and any mistakes made by the hired NRSRO. According to the new rules, unsolicited ratings would alleviate rate shopping, increase


161. Fitch, which never adhered to a mandatory policy, uses the term “shadow rating” to refer to its unsolicited ratings that are based on largely public information. See Winnie P. H. Poon & Michael Firth, Are Unsolicited Credit Ratings Lower? International Evidence From Bank Ratings, 32 J. BUS. FIN. & ACCT. 1741, 1743–44 (2005).

162. Moody’s current policy states: “MIS’s publication of an unsolicited Credit Rating will be based, among other factors, on MIS’s assessment of the usefulness of the rating to the capital markets, and our determination that sufficient information is available to allow MIS to assign and maintain the rating.” Policy for Designating Unsolicited Credit Ratings in the European Union, MOODY’S INVESTORS SERVS., 1 (2011), available at www.moodys.com/designating_unsolicited_ratings_in_the_eu. S&P does not publish an official policy, but even as late as 2004, S&P did claim that it would assign a rating for all public corporate debt over $50 million. Hill, supra note 20, at 51. As for Fitch, they issue unsolicited ratings on a case by case basis. Id.


165. Id.
accuracy of ratings, and provide competition.\textsuperscript{166} However, commentators worried that the non-hired NRSROs would use unsolicited ratings as a threat by purposely producing a low rating; the SEC maintained that such ratings would be beneficial.\textsuperscript{167}

C. THE INEQUALITY

A big question remains: are unsolicited ratings a positive tool or a bullying technique against creditors?\textsuperscript{168} The government agencies seem divided between investigating the motivations behind unsolicited ratings on the one hand,\textsuperscript{169} and encouraging their use on the other.\textsuperscript{170} Fulghieri recently proposed a new theory.\textsuperscript{171} Taking into account CRAs’ ability to issue unsolicited ratings, their ability to misrepresent the issuer’s credit quality through false ratings, and their own reputational concerns, Fulghieri explains that a tension under the issuer-pay model exists because of the potential for short-term profits by producing an inflated rating and the long-term reputational loss that stems from said inflated rating.\textsuperscript{172} Extending the rationale to unsolicited ratings, providing unsolicited and inaccurate ratings—like those alleged in Jefferson County School District—acts as a forced incentive to the issuer to obtain a solicited rating.\textsuperscript{173} With this threat, CRAs can charge higher fees for the solicited favorable ratings and produce short-term profits.\textsuperscript{174} Economic theorists predict that issuers will pay additional fees up to the present value of the costs that an unfavorable bond rating would create.\textsuperscript{175} However, by issuing accurate ratings, CRAs can improve their

\begin{thebibliography}{99}
\bibitem{166} Id.
\bibitem{167} Id.
\bibitem{168} Soku Byoun, \textit{Information Content of Unsolicited Credit Ratings and Incentives of Rating Agencies: A Theory} 20 (Baylor University Working Paper, 2011), available at www.apfis.org/conference/2011/cafmFile/12-1.pdf (“Despite controversy surrounding unsolicited ratings, there has been little effort to understand the nature of unsolicited ratings.”).
\bibitem{169} See supra notes 158–60 and accompanying text for discussion of the DOJ investigation.
\bibitem{170} See supra notes 163–64 and accompanying text for a discussion of Rule 17g-5’s encouragement of unsolicited ratings.
\bibitem{171} See Fulghieri, Strobl & Xia, supra note 10, at 3–4.
\bibitem{172} See \textit{id.} at 2–3.
\bibitem{173} See \textit{id.} at 3.
\bibitem{174} See \textit{id.} at 3–4.
\bibitem{175} \textsc{Christopher R. Thomas & S. Charles Maurice}, \textsc{Managerial Economics} (9th ed. 2007), available at http://highered.mcgraw-hill.com/sites/0073402818/
reputation by demonstrating that they do not create inflated ratings, thereby achieving a long-term profit.176 Balancing these two conflicting motivations, Fulghieri provides that if short-term profits outweigh long-term losses, CRAs will have an incentive to use unsolicited ratings as a threat against issuers, leading to less stringent rating standards.177 Conversely, if short-term profits are smaller than long-term losses, CRAs will issue accurate ratings that produce more stringent rating standards and improve social welfare.178 In order to ensure that unsolicited ratings are beneficial to the market, short-term gains from threatening inaccurate ratings have to be smaller than the long-term losses from reputational theory: this is the Inequality.179

III. USING UNSOLICITED RATINGS FOR GOOD

In the last few years, Congress has given up on NRSROs self-regulation and has attempted to generate accuracy of ratings through disclosures and the 15E(w) Amendment.180 NRSROs have become integral to the United States financial system, and their inability to adequately control conflicts of interest and rate shopping carries steep consequences.181 NRSROs provide future predictions for both simple bonds and extremely complex products; Professor John Coffee even compared the task of rating complex financial products to brain

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176. See Fulghieri, Strobl & Xia, supra note 10, at 4.
177. See id.
178. See id. Social welfare will be improved by eliminating negative net present value (“NPV”) projects by issuers. Accurate credit ratings, which can better predict negative NPV projects by considering the chance of default, therefore increases social welfare. Id.
179. See id. at 30. The model provides a framework for analyzing the reforms in Dodd-Frank. In his work, Fulghieri also concludes that there is no downward bias for unsolicited ratings because in equilibrium, high-quality issuers acquire favorable solicited ratings whereas low-quality issuers would not bother seeking a solicited rating and would receive deserving low unsolicited ratings. See supra notes 168–73. The unsolicited ratings further reflect the incentive of CRAs to maximize profits through threats. See infra Part II.B. Fulghieri’s reasoning, in this respect ignores the motivations of the issuers that might produce an inflated solicited rating.
181. NRSROs were one of the main causes of the Financial Crisis of 2008. See Fin. CRISIS INQUIRY COMM’N, supra note 1, at xxv.
surgery.\textsuperscript{182} In such an intricate system, it is better for the market and the sophisticated players to control themselves rather than trying to impose a system such as the 15E(w) Amendment.\textsuperscript{183}

Unsolicited ratings can be a market mechanism in which the NRSROs will check and control each other by issuing accurate ratings that will frustrate rate shopping and curb the conflict of interest.\textsuperscript{184} The issuer does not pay CRAs issuing the unsolicited rating, so there are no incentives for the CRA to provide a better rating for the issuer in order to keep its business.\textsuperscript{185} Additionally, though the issuer can choose to shop around for the most favorable ratings,\textsuperscript{186} the unfavorable one will still be published and so the entire exercise of rate shopping becomes futile.\textsuperscript{187}

This positive result of unsolicited ratings can be achieved if the state of the Inequality holds true and the long term reputational costs of inaccurate unsolicited ratings outweigh the short-term gains from such inaccuracies.\textsuperscript{188} Section A will discuss how the Inequality can be achieved theoretically. Section B will consider how the Dodd-Frank disclosure requirements contribute to making the Inequality hold true and the problems that the 15E(w) Amendment pose to the Inequality. Section C will provide additional recommendations to the existing regulatory scheme which will promote the Inequality.

A. ESTABLISHING THE INEQUALITY

Fulghieri provided the circumstances in which unsolicited ratings can lead to more accuracy and higher social welfare: when long-term reputational costs are greater than the short-term profits from purposely inaccurate ratings.\textsuperscript{189} The point drawn from the Inequality is not that the

\begin{footnotesize}

\begin{enumerate}
\item[(183)] For additional support to this argument in the context of complex financial products, \textit{see} SEC Assigned Credit Ratings Study, \textit{supra} note 148, at 56--57.
\item[(185)] For the discussion of conflicts of interests of solicited rating, \textit{see} supra Part I.B.2.
\item[(186)] \textit{See supra} Part I.B.3.
\item[(188)] Fulghieri, Strobl & Xia, \textit{supra} note 10, at 4.
\item[(189)] \textit{See supra} note 179 and accompanying text.
\end{enumerate}

\end{footnotesize}
reputational theory is futile, but rather that reputation is one factor to consider in the decision making process of NRSROs. Ultimately, regulators should not abandon reliance on the reputational theory or the free market, but manipulate the existing reputational motive to achieve the state propounded in the Inequality. This is especially true in the bond market where reputational concerns are stronger.

To make the Inequality work, regulators can increase the reputational costs and/or seek to depress the short-term profits. The difficulty with altering reputational costs is that they are both long term and hard to measure. To increase the value of one’s reputation, a regulator must bring the realization event closer to the present and set up a system where accuracy can be better evaluated. For profits from short-term threats, the entire cost comes from the effect that a lower unsolicited rating will have on a bond. The stronger the effect, the higher the cost of the bond will be to the issuer, and the more motivation the issuer will have to solicit a rating, even at a higher fee. While it is impossible to control the effect the issuance of the rating will have on the market, regulation can target CRA’s motive—the higher fee.

190. Fulghieri, Strobl & Xia, supra note 10, at 4; Lynch, supra note 3, at 252–53; Dennis, supra note 47, at 1132.
191. See Covitz & Harrison, supra note 92, at 2, 5.
192. See Fulghieri, Strobl & Xia, supra note 10, at 3-4 (analyzing how the weight of short-term profits or threats can affect the Inequality).
193. Lynch, supra note 3, at 287–88 (“Secondly, if benefits are to be derived from issuing unsolicited ratings, such benefits are likely to be realized only after a prolonged period—likely many years, if not a decade—of issuing such ratings.”).
194. Id. at 288 (“[P]atterns of accuracy (or inaccuracy) only reveal themselves over time, if at all, as enough debtors perform or default on their obligations, and such performance can be compared to the earlier ratings issued by a rating agency. Such prolonged periods also give NRSROs, whose ratings might be assessed and perhaps called into question by such unsolicited ratings, ample opportunity to seek short-term (and, indeed, medium-term) profits by issuing inaccurately high ratings. NRSROs issuing inaccurate ratings are simply unlikely to be ‘caught’ in the short-term.”).
195. See supra text accompanying notes 173–75.
196. See supra text accompanying notes 173–75.
197. Dennis, supra note 47, at 1133.
1. How to Measure Inaccuracy

In any bond rating situation, one of four scenarios is possible. The NRSRO: 1) provides an accurate rating and the issuer defaults; 2) provides an accurate rating and the issuer does not default; 3) provides an inaccurate rating and the issuer defaults; 4) provides an inaccurate rating but the issuer does not default.\(^{198}\) The only way to measure the performance of an NRSRO is by looking at the default of the issuer.\(^ {199}\) If Moody’s rates an issuer “Baa,” the fourth highest rating, it means that the issuer’s bond has some speculative characteristics.\(^{200}\) Statistically, Baa bonds have a less than six percent default rate in the long term.\(^ {201}\) However, when an issuer defaults on a specific security, it is still difficult to draw a conclusion as to the accuracy of the rating (at the time it was given) in light of the default.\(^ {202}\)

While it is impossible to identify each of the four scenarios, it is possible to identify trends.\(^ {203}\) Hypothetically, if the default percentage on Baa-rated corporate bonds suddenly increased from six to ten percent, or the fourth highest rating at other rating agencies only produced a two percent default rate (compared to Moody’s six percent rate), the apparent conclusion is that Moody’s rating process is flawed.\(^ {204}\) Prior to the Credit Reform Act, the only way investors could obtain performance data was to subscribe to a Moody’s or S&P report of their own performance statistics or calculate an appropriate default rate for each grade and asset type.\(^ {205}\) The Credit Reform Act requires each NRSRO to provide an annual certification under Form NRSRO, which

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199. Id.
203. Bai, supra note 109, at 60, 81 (providing matrices and regressions to evaluate performance based on default rates).
204. See id.
makes default rates publicly available for observers to monitor performance.206

2. Bringing the Future Closer to the Present

Just as it takes time for a rating agency’s reputation to improve,207 it takes time for a reputation to be ruined.208 For instance, it was not until 2007 that the inaccuracies in rating CDOs and RMBSs of the “big three” NRSROs were revealed; by this time, the NRSROs made billions off of the lucrative asset-backed securities.209 When S&P or Moody’s issue an inflated rating, the agency is cognizant that the rating underestimates the probability of default; however, the statistics on those facts may not be available for years.210 At the same time, a CRA that issues an accurate unsolicited rating will also not see the fruits of its labor until the relevant statistics become available.211

Until this point in the Note, reputation was discussed as a concept. The desired Inequality, however, is based on valuation.212 The question for NRSROs is how much reputational loss or gain in the future is worth today, which can be approximated using the NPV formula.213 Applying this formula to the decision-making process, an unsolicited rater will seek to ensure that the amount it spends today to rate a bond will be less than the probable future business that will result from the accuracy of its rating.214 That future amount must be discounted to the present value, and the greater the reputational gain from the accurate rating that

206. See supra notes 108–12 and accompanying text for all the information that must be provided in the initial NRSRO application and annual updates in the certification.
207. See Lynch, supra note 3, at 288.
208. The reputational consequences are the same for both the solicited and unsolicited rater. See supra Part II.C.
209. FIN. CRISIS INQUIRY COMM’N, supra note 1, at 149.
210. In the financial crisis of 2008, the problems did not become apparent until the teaser rate on the variable rate mortgages expired. See WATCHDOGS REPORT, supra note 25, at 90–98. For bonds, the default event can stretch all the way to maturity.
211. See Lynch, supra note 3, at 288.
212. Only cardinal numbers can produce a mathematical equation or, in this case, an inequality.
213. See 34 C.F.R. § 668.28(b) (2012). The NPV formula may be expressed as the sum of the discounted cash flows $C/(1+r)^t$ where “r” is the discount rate, “t” is the time, and “C” is the net cash flow for the time period (t). Id.
214. See id.
accrues, the less the present value will be worth.\footnote{215}{Assuming the cost of the rating is \( C_0 \), the payoff in the future from improved reputation is \( C_t \), the NPV formula would be \( \text{NPV} = -C_0 + \frac{C_t}{(1+r)^t} \). The longer the time period \( t \), the greater the denominator and the less the future gain will be worth.} A rational CRA will not undertake an unsolicited rating if its calculation produces a negative NPV.\footnote{216}{See Fulghieri, Strobl & Xia, supra note 10, at 4. The inverse logic will apply to a solicited CRA; it will calculate a present gain from an inflated rating and a future loss in reputation and if the calculation yields a positive NPV, CRA should provide an inflated rating.} The most effective solution is to decrease the time for the reputational effects to be recognized. This can be achieved by making NRSROs provide more statistics on their performances, specifically statistics covering various time periods.\footnote{217}{See Bai, supra note 109, at 51 (noting that new disclosure requirements are meant to increase reputational sanctions).} For instance, an issuer has a particularly strong interest in receiving an investment grade rating for borderline investment grade bonds,\footnote{218}{See Lynch, supra note 3, at 246.} and as such, NRSROs have more motivation to inflate the rating into the investment grade category.\footnote{219}{See id. at 247.} By making NRSROs provide information in staggered increments, investors can see where solicited NRSROs are inflating ratings and where they are more accurate due to the frequency of performance review and the three varying time periods used in the evaluations.\footnote{220}{Dodd-Frank Act, Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1878 (2010) (to be codified at 15 U.S.C. § 78o-7(q)) (requiring disclosure for the purpose of allowing more performance comparison between agencies).}

The Credit Reform Act established a system for shorter reflection periods. Under Form NRSRO, CRAs must provide transition and default rates for all outstanding ratings in one, three, and ten year increments.\footnote{221}{See Form NRSRO, supra note 109.} This system identifies default rates in the long and short terms.\footnote{222}{See, e.g., Moody’s Investors Service, Inc., Annual Certification of Form NRSRO 2011, supra note 201, at 71 ex.1; Standard & Poor’s Rating Services, Standard & Poor’s Form NRSRO: Exhibit 1, available at http://www.standardandpoors.com/ratings/form-nrsro/en/us.} Through this regulation, Congress has taken the first step to increasing the cost of reputation by bringing the realization event closer to the present.\footnote{223}{See supra notes 227 and 232.}
3. Lowering the Short-Term Profits

The short-term gains from inaccurate and threatening unsolicited ratings represent the other side of the Inequality equation. These lower unsolicited ratings can have costly effects for the issuer by increasing interest rates for their bonds, foiling regulatory compliance, or tripping a clause in an investment contract. Since unsolicited ratings have the power to hurt issuers, issuers may solicit ratings to avoid the lower, unsolicited ones. This dependence allows CRAs, especially the major three, to ask for a higher fee. Due to free market and free speech protections, regulation cannot affect either the issuance of the unsolicited rating or its effect on the market. Regulation may, however, try to curtail the higher fee motivation.

One strategy to prevent the higher fees is to set an industry standard for issuer pay compensation. The standard can be set by a committee of representatives comprised of sophisticated investors and CRAs, and the rate may be based upon the interest rate borne by that bond—for example two basis points of a bond offering. This would prevent an increase in the price that the unsolicited rating threat might produce.

224. See Fulghieri, Strobl & Xia, supra note 10, at 3. For an example, see Jefferson Cnty. Sch. Dist. No. R-1 v. Moody’s Investor’s Servs., 175 F.3d 848 (10th Cir. 1999).
226. See supra notes 123–27 and accompanying text.
227. See WATCHDOGS REPORT, supra note 25, at 88. (discussing Enron’s triggered payout).
228. See Fulghieri, Strobl & Xia, supra note 10, at 4.
229. See id.
231. See Lynch, supra note 3, at 252–53.
233. Even with a standard price, an inaccurate unsolicited rating may still attract more business to CRA as the threat of the rating may entice the issuer to solicit multiple ratings. Fulghieri, Strobl & Xia, supra note 10, at 4. However, a review of the statistics makes the effectiveness of this strategy unlikely. In Jefferson County School District, the issuer solicited ratings from both S&P and Fitch but alienated Moody’s. See Jefferson Cnty. Sch. Dist. No. R-1 v. Moody’s Investor’s Servs., 175 F.3d 848,856 (10th Cir. 1999). At the time, the only accredited NRSROs were Moody’s, S&P, and Fitch. Bai, supra note 109, at 50. Currently, there are nine NRSROs, and Fitch has gained a larger percentage of the market share. Yet, even with the expanded number of NRSROs, 47.3 % of issuers still solicit ratings from only two agencies and only 28.9% of issuers solicit ratings from all three. Kronlund, supra note 81, at 32. It is uncertain
While the concept of setting a standard price for solicited ratings might be effective in curbing short-term profits from threats, it is a significant infringement into the free market system and private industry of credit ratings. Setting a standard price would require the creation of a board with regulatory power over NRSROs, and would restrict each NRSRO’s ability to adjust its fee based on the complexity and size of the offering. The SEC has always favored disclosure over direct influence into the free market, so this particular step should be considered with caution. Currently no regulatory system or proposals exist to set the standard price for issuing ratings.

**B. HOW DODD-FRANK AFFECTS THE INEQUALITY**

In Part A, there were three steps proposed to achieve a state where the value of reputation is greater than the profits from threatening an issuer: 1) establishing a system that better measures inaccurate ratings; 2) bringing the reputational realization event closer to the present; and 3) as a last resort, establishing a system of fixed prices for rating. The issue is how Dodd-Frank, whose provisions are still just going into effect, will contribute to the theoretical model. The two significant changes in Dodd-Frank are the disclosure requirements and the 15E(w) Amendment.

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235. See id.
237. The 1997 proposed rule that that suggested such a practice was never implemented. SEC CRA Report, supra note 15, at 12–14.
238. See supra Part III.A.
239. While not as popular, unsolicited ratings are still being issued, so the model Inequality is the deciding factor every time an NRSRO issues an unsolicited rating and even every time, an NRSRO is not ultimately selected by the issuer after doing the work, since it then has a choice to issue their already derived rating.
240. See supra Part II.A.2.
1. Disclosure Requirements

The recently implemented NRSRO application and annual certification required by CRARA should make it possible to spot the trends in inaccurate rating, measure performance, and make it easier to evaluate the reputation of NRSRO sooner by providing performance data through rating transition, as well as default rates in one, three, and ten year increments. However, Form NRSRO does not prescribe a particular technique to calculate the statistics, resulting in each NRSRO providing this information in its own way. Dodd-Frank tweaked the system by requiring that all reports for initial ratings be comparable, and the SEC proposes to extend that requirement via a revised Form NRSRO.

Another facet of Title IX disclosure changes is the new reports that must accompany every new rating issuance or modification. This will change the rating process drastically and dispel the days of opaque models. While the new disclosure requirements have not gone into effect, the exhaustive description of all the information needed creates an impression that size of rating reports will compare to that of an S-1 filing. However, the new disclosures will increase the actual cost of an unsolicited rating to NRSROs since the rules apply to all ratings, both solicited and unsolicited.

In this new report, NRSROs would have to discuss methodologies, assumptions, limitations, sources and descriptions of data, volatility of ratings, historical performances, expected probabilities and magnitudes of a default event, and sensitivity of the rating on assumptions. The purpose of the new requirements is to help the investor understand how the rating was determined, evaluate its accuracy, and compare

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242. See id.
243. See id.
245. See WALL STREET AND THE FINANCIAL CRISIS REPORT, supra note 48, at 245 (discussing the problem of opaque models).
246. See supra notes 123–25 and accompanying text.
248. See Dodd-Frank Act § 932, 124 Stat. at 1879 (to be codified at 15 U.S.C. § 78o-7(r)); see also supra notes 125–28 and accompanying text.
NRSROs. Such disclosures will allow sophisticated investors, like institutions, to better gauge the accuracy of a rating, but they will also provide an added advantage to CRAs issuing unsolicited ratings. As competitors, NRSROs will be able to better judge the quality and methodologies used for solicited ratings, and the competitor’s criticisms can be expressed in the form of an unsolicited rating. While this motive can only affect the investor post-issuance, it is still an internal market check against excesses and rating inflation. It will also allow for a better evaluation of NRSRO’s performance.

2. The 15E(w) Amendment

In accordance with § 939F of Dodd-Frank, the SEC conducted and published a study about reforming NRSROs’ approach to structured finance products. At the forefront of the study was the 15E(w) Amendment. In their reply to the request for comment, Senators Franken and Wickers, the proposers of the Amendment, explained their idea in greater depth. The result will be a semi-closed market where a Board would assign QNRSROs to provide an initial rating; the selection process would be based on the job’s size, complexity, and NRSRO’s

249. See Dodd-Frank Act § 932, 124 Stat. at 1878 (to be codified at 15 U.S.C. § 78o-7(q)(1)).
250. See Bai, supra note 109, at 51 (dual purposes of disclosure).
251. For an example, consider Fitch’s public criticisms of S&P and DBRS’ grading of triple AAA for $800 million of mortgage-backed securities, where Fitch’s rating were not solicited because of its more conservative assumptions. Nicole Bullock, Agencies at Odds Over New Ratings, FIN. TIMES (Apr. 8, 2012), available at www.ft.com/cms/s/0/66738d12-7f5b-11e1-a06e-00144feab49a.html.
253. See Bai, supra note 109, at 51 (the purpose of disclosure is to allow for better evaluation).
past accuracy. Depending on the version of the Amendment that will ultimately get adopted, the fee for such a job may be negotiated by the NRSRO or established by the Board. The issuer can solicit secondary and tertiary ratings after the initial rating. According to the Senators, this amendment would not affect unsolicited ratings. Even if that is true, the Senators did not address whether the Amendment would affect Rule 17g-5 disclosures. It is uncertain if the QNRSROs would still have the same conflict of interest, since under the current definition of conflicts of interest, it seems that even when assigned, they would qualify as issuer paid. If there were a conflict of interest, as defined by Rule 17g-5, QNRSROs would be obligated to post all the data on a website for other NRSROs to view. If the 17g-5 disclosures were affected, this would prevent, or at least severely compromise, NRSROs’ ability to issue unsolicited ratings in the field of structured financial products.

The 15E(w) Amendment focuses on structured finance products, as they represent a major source of rate shopping and conflict of interest. Senators Franken and Wicker, assume that the new system will successfully accomplish four goals: (1) reducing the conflict of interest, (2) eliminating rate shopping for initial ratings, (3) rewarding accuracy, and (4) promoting competition. While it seems to resolve the issues at the heart of the most recent financial crisis, it offers no solution to the Enron scandal, which did not involve structured products. It also does

257. Id. at 3–4.
258. Id. at 7.
259. Id. at 4.
260. Id. (“The Franken-Wicker amendment applies only to initial ratings, and does not affect non-initial ratings or unsolicited ratings.”). However, unsolicited ratings operate in a free market system and restricting the market will affect NRSRO’s motives in providing unsolicited ratings – namely the desire to break into new markets or industries.
261. See generally id.
262. See supra note 142 and accompanying text.
263. Rule 17g-5 requires disclosure for all situations where the issuer pays for the rating and there is no exception for assigned ratings. 17 C.F.R. § 240.17g-5(a) (2012).
264. See supra Part II.B (discussing the necessity of requiring disclosure of non-public information for complex products in order to issue unsolicited ratings).
265. Comment Letter from Senators Al Franken & Roger Wicker, supra note 259, at 5.
266. Id. at 3.
267. See supra Part I.A.1.
not address rate shopping of corporate bond issuers.\textsuperscript{268} It simply provides a piecemeal solution to a systemic problem that extends to every rated security and does so by interfering with the free market.\textsuperscript{269} Overall, this amendment creates a scenario that prevents a repeat of the 2008 problem but does not necessarily set up a system where other future rating problems will be prevented.\textsuperscript{270}

This proposal does eliminate market competition and self-regulation through unsolicited ratings via Rule 17g-5 and the reputation theory.\textsuperscript{271} As commentators adamantly stressed, this is an extreme step.\textsuperscript{272} This Note advocates for a scheme where unsolicited ratings are accurate and beneficial to the social welfare, in such a way that the SEC can encourage its practice without fearing abuse by NRSROs.\textsuperscript{273} Additionally, the narrow application of the reputation theory to improve the state of unsolicited ratings demonstrates that it can be workable.

\section*{C. Additional Useful Regulations}

Both the Credit Reform Act and Dodd-Frank took strident steps toward a more transparent credit rating procedure.\textsuperscript{274} Slight adjustments are possible to reach the Inequality and increase the value of an NRSRO’s reputation. Form NRSRO requires disclosure of transition and default rates for three periods according to the ratings’ classes.\textsuperscript{275}

\begin{footnotesize}
\begin{enumerate}
\item[268.] See supra Part I.B.1.
\item[269.] See SEC Assigned Credit Ratings Study, supra note 148, at 48–51.
\item[270.] Another commentator has pointed that the 15E(w) Amendment is necessary because of the potential for NRSRO nullification. This is so because compliance is costly, yet the benefits of being an NRSRO have been reduced through the purging of NRSRO’s from federal statutes. Parsont, supra note 247, at 1020. By creating the QNRSRO pool, the Board would establish another elite club of raters with benefits that would entice NRSROs to comply with the more extensive regulations of the SEC and the Board. Id. Without this elite club, NRSROs might simply exit (stop registering with the SEC). Id. While this worry seems reasonable, it is highly speculative and downplays the solution of simply changing the law to make NRSRO registration necessary.
\item[271.] The 15E(w) Amendment creates a semi-closed market economy. Comment Letter from Senators Al Franken & Roger Wicker, supra note 259, at 3–4.
\item[272.] See SEC Assigned Credit Ratings Study, supra note 148, at 21, 30–52 (commentators arguing that existing provisions of Dodd-Frank would be enough to address the conflict of interest without the deeply flawed 15E(w) Amendment).
\item[273.] The changes required to encourage greater use of 17g-5 disclosures are outside the scope of this Note. For different solutions, see the letters submitted in response to the Solicitation of Comment, supra note 147 and accompanying text.
\item[274.] See supra Section III.B.
\item[275.] See Form NRSRO, supra note 111.
\end{enumerate}
\end{footnotesize}
This produces about 75–85 pages of matrices that a typical investor would probably not read.\textsuperscript{276} Ineffective disclosures serve no purpose, and buried disclosures are no disclosures at all. NRSROs need to provide information that is simple to understand and is not buried under eighty pages of statistics.\textsuperscript{277} The SEC adopted rules to make disclosures in an S-1 application effective, so it is reasonable to require the same thing for NRSRO reports, namely through a summary of important information in the beginning.\textsuperscript{278} The SEC has already recognized the need for standard, easy-to-follow matrices and has proposed changes to that effect.\textsuperscript{279} However, the SEC still has not finalized rules or implemented those changes.\textsuperscript{280}

The second alteration would be to highlight the risks and problems in the beginning of Exhibit 1 of Form NRSRO to inform an investor of the possible deficiencies. In a S-1, the issuer is required to list the risk factors right after the summary section.\textsuperscript{281} NRSROs should be required to do the same with their performance statistics and describe any problems or anomalies with the data.\textsuperscript{282} For example, part of the summary disclosure section can include the following hypothetical statement: “The default rates for asset back securities for the terms of one, three, and ten years have been higher than predicted by their ratings. The elevation can be traced back to the 2008 Financial Crisis.”\textsuperscript{283} These disclosures will draw the investor’s attention to any

\textsuperscript{276} Moody’s Investors Service, Inc., Annual Certification of Form NRSRO 2011, supra note 201, at 71 ex. 1; Standard & Poor’s Rating Services, Standard & Poor’s Form NRSRO: Exhibit 1, supra note 222.


\textsuperscript{279} See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 76 Fed. Reg. at 33,435; see also supra note 131 and accompanying matrix.

\textsuperscript{280} SEC Proposed Rules: 2011, supra note 130.

\textsuperscript{281} Form S-1, supra note 278.

\textsuperscript{282} The SEC requires that S-1 disclosures provide a “discussion of the most significant factors that make the offering speculative or risky.” 17 C.F.R. § 229.503(c) (2012).

\textsuperscript{283} Though provided hypothetically, the data from S&P and Moody’s does confirm the statement. Moody’s Investors Service, Inc., Annual Certification of Form
significant inaccuracies. The annual certifications should provide information specifically addressing the performance of unsolicited ratings, which would both differentiate solicited from unsolicited ratings, as well as make it easier to spot any misuses of unsolicited ratings. Given the abundance of the charts already included in Exhibit 1, the additional cost of compliance for inserting tables addressing unsolicited ratings should not be prohibitively high. Furthermore, the inclusion of the additional information would not just be beneficial for a better assessment of an NRSRO’s reputation; it would also encourage unsolicited ratings of structured financial products, a critical purpose of Rule 17g-5. The addition of the unsolicited ratings matrices would provide investors with the necessary performance and efficiency data to evaluate the effectiveness of the equal access rule.

**CONCLUSION**

Fulghieri and his colleagues address the confusion surrounding unsolicited ratings by forming the Inequality, which analyzes reputational effects and other profit making motives. The short-term gains of threats to the issuer are balanced against the long-term reputational costs of the rating agency. As long as the long-term reputational costs are higher than the short-term gains, CRAs will issue accurate ratings, which in turn benefits society. The benefits to the market can also be increased by making CRAs more transparent and by bringing the costs closer to the present. First, the more transparent the process, the easier it is for an investor to judge their accuracy and reputation. It would also be possible for other CRAs to use the in-depth information to act as a check on the solicited rating, something which would encourage and enable competition and self-regulation.

NRSRO 2011, supra note 201, at 71 ex.1; STANDARD & POOR’S RATING SERVICES, STANDARD & POOR’S FORM NRSRO: EXHIBIT 1, supra note 222.

284. Just as the S-1 disclosures would provide any significant factors that make the security risky. 17 C.F.R. § 229.503(c) (2012).


286. 17 C.F.R. § 240.17g-5(b) (2012).


288. Id.

289. See supra Part III.A.

290. See supra Part III.B.1.

291. See Xia & Strobl, supra note 252.
within the industry. Conveniently, the Credit Reform Act grants the SEC the power to regulate the required disclosure of methodologies. The other approach to highlighting a CRA’s reputation is to make the reputation effects more tangible in the foreseeable future. Since in the Inequality, the reputational effects are long-term, their long-term costs/gains have to be discounted to present value. If the realization of the reputation cost is sooner rather than later, the discounting for the firm would be less and the reputational worth would be higher. Alternatively, regulators can attempt to decrease the short-term profits from misuse of unsolicited rating by a standard industry wide fee system, thereby focusing on the increased fee motivation.

Dodd-Frank disclosure reforms greatly further the road to accurate unsolicited ratings by making NRSROs provide extensive reports of their methodologies, assumptions, due diligence, and data for every rating. This would allow investors and other NRSROs to better judge the accuracy of a particular rating, and make it easier to provide and justify an unsolicited rating for the same security. By providing unsolicited rating, competing NRSROs can both increase their reputation by producing better models, as well as criticize the models and core assumptions of the solicited NRSRO. Ultimately, this competition will benefit both the agencies and the investors by providing more accurate ratings overall and increasing the name and goodwill of previously small or unknown CRAs.

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292. Bai, supra note 109, at 51.
294. 34 C.F.R. § 668.28(b) (2012).
295. See supra Part III.B.2.
296. The potential downside is the increased regulatory expense of producing an unsolicited rating that may dissuade NRSROs from actually publishing their rating.
299. See supra Part II.B.
300. When the terms of the Inequality are fulfilled, unsolicited ratings will create a more stringent rating standard. Fulghieri, Strobl & Xia, supra note 10, at 4.