Fordham Journal of Corporate & Financial Law

Volume 17 | Issue 4 Article 5

2012

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Cover Page Footnote

Marilyn Blumberg Cane, Professor of Law, Shepard Broad Law Center, Nova Southeastern University. B.A. Cornell University, J.D. Boston College. Professor Cane has written extensively on the subjects of securities, banking and corporate finance law. Professor Cane especially acknowledges the excellent work of Adam Shamir in connection with this paper overall, and Tomas Jodar in connection with his insights on the European Union. Adam Shamir, J.D., Shepard Broad Law Center, Nova Southeastern University, May 2012; B.A. University of Florida. Adam wishes to thank his friends and family for all of their encouragement and support. Adam extends special recognition to Professor Marilyn Cane for her continued guidance and motivation. Tomás Jódar Cobo, J.D., Shepard Broad Law Center, Nova Southeastern University, May 2012; J.D. Universidad de Barcelona 2010 and LL.M in International Economic Law and Policy, 2010.

VOLUME XVII 2012 NUMBER 4

FORDHAM
JOURNAL OF
CORPORATE & FINANCIAL LAW

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BELOW INVESTMENT GRADE AND ABOVE THE LAW: A PAST, PRESENT AND FUTURE LOOK AT THE ACCOUNTABILITY OF CREDIT RATING AGENCIES

Marilyn Blumberg Cane[*]
Adam Shamir[**]
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ABSTRACT

"Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies" by Professor Marilyn Blumberg Cane, co-authored with Adam Shamir and Tomas Jodar is a timely and comprehensive Article focusing on the responsibility, and lack thereof, of credit rating agencies ("CRAs"). The Article is titled "below investment grade" due to the shoddy performance of the CRAs in light of their key role in the financial crisis of 2007-08. It is also titled "above the law" because of the CRAs' lack of accountability due to regulatory sleight of hand and the CRAs' almost completely successful defense against liability to bondholders through the invocation of the freedom of speech under the First Amendment.

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* Marilyn Blumberg Cane, Professor of Law, Shepard Broad Law Center, Nova Southeastern University. B.A. Cornell University, J.D. Boston College. Professor Cane has written extensively on the subjects of securities, banking and corporate finance law. Professor Cane especially acknowledges the excellent work of Adam Shamir in connection with this paper overall, and Tomas Jodar in connection with his insights on the European Union.
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This Article covers the evolution of the credit rating industry, in particular, the noteworthy shift from the purchaser-subscriber to issuer-pays model. It then describes the history of SEC CRA regulatory measures, most notably the adoption of SEC Rule 436(g), adopted in 1982, which specifically eliminated liability for the big CRAs (Moody's, Standard & Poor's, Fitch's and Duff and Phelps) as "experts" under Sections 7 and 11 of the Securities Act of 1933.[1] This Article then covers the Credit Rating Agency Reform Act of 2006 and the adoption of SEC Rule 17g-5, in so far as they attempted to control conflicts of interest within CRAs.[2] This Article next turns to the freedom of speech as a defense effectively used by CRAs, although the United States Supreme Court has yet to address this issue directly.[3] The thrust of the CRAs' argument is that their ratings are simply their expression of their opinion, akin to a review of a restaurant or editorial column.[4] There is much irony in this as many regulated financial players, such as banks and insurance companies, are required to comply with governmental rules that mandate them to invest in "investment grade securities," a "blessing" conferred only by the privately owned CRAs.

Next, this Article dissects provisions regarding CRAs in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which among many other things, reads "Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933 shall have no force or effect."[5] As the reader will see, this provision has not been enforced by the SEC, whereas in what could only be seen as a game of hard ball, the CRAs won notwithstanding the Act. For completeness, this Article then turns to the European approach of CRA regulation, including the creation of the European Securities and Markets Authority in January 2011.[6]

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1. Christopher Keller & Michael Stocker, *Reining in the Credit Ratings Industry*, N.Y.L.J., Jan. 11, 2010, at 1.
2. 17 C.F.R. § 240.17g-5(a) (2010).
3. Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 85 (Yasuyuki Fuchita & Robert E. Litan eds., 2006).
4. David Segal, *A Matter of Opinion?*, N.Y. TIMES, July 19, 2009, at BU1, http://www.nytimes.com/2009/07/19/business/19floyd.html?pagewanted=all.
5. Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, § 939G, 124 Stat. 1376, 1889 (2010).
6. Dorothee Fischer-Appelt, *The European Securities and Markets Authority: The Beginnings of a Powerful European Securities Authority?*, LAW & FIN. MKTS. REV., Jan. 2011, at 21, *available at* http://meetings.abanet.org/webupload/commupload

This Article concludes by suggesting, at a minimum, that CRAs be subject to accountability, and that some formal, financially neutral body conduct a periodic assessment rating the performance of the CRAs.

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INTRODUCTION

"There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful," said journalist Thomas Friedman regarding the undeniable power of Credit Rating Agencies ("CRAs").[7] In light of the August 5, 2011 downgrade of the United States' long-term federal debt by major credit rating agency Standard and Poor's, Mr. Friedman's words ring truer than ever.[8]

CRAs have not always enjoyed such a commanding status, and have evolved considerably to become the market-shaping giants they are today.[9] Millions of investors across the world rely on rating agencies to help assess the creditworthiness of particular financial instruments.[10] While these agencies perform a vital function for the financial community, many individuals, investors, and organizations heavily criticize the rating agencies, notably for their role in the 2007-2008 sub-prime mortgage crisis.[11] CRAs have been blasted for their shoddy performance in rating various structured financial instruments, raising several questions regarding the accuracy of their ratings and the integrity of the process as a whole.[12]

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7. *The NewsHour with Jim Lehrer: Interview with Thomas L. Friedman* (PBS television broadcast Feb. 13, 1996).

8. Binyamin Applebaum & Eric Dash, *S.& P. Downgrades Debt Rating of U.S. for the First Time*, N.Y. TIMES, Aug. 5, 2011, at A1.

9. Kevin Voigt, *Explainer: The Power of Credit Rating Agencies*, CNN (July 15, 2011, 1:53 PM), http://edition.cnn.com/2011/BUSINESS/07/15/credit.ratings.agen ncy.explain/index.html.

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

11. U.S. SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 1 (2008), http://www.se c.gov/news/studies/2008/craexamination070808.pdf [hereinafter SEC SUMMARY REPORT].

12. *Id.* at 2.

Moreover, certain rating agencies had long been exempt from accountability as experts for the ratings that they issue.[13] Under former Rule 436(g) of the Securities Act of 1933, rating agencies labeled Nationally Recognized Statistical Rating Organizations ("NRSROs") enjoyed an exemption from legal accountability as experts when their ratings were used in connection with a registered offering.[14] Many people condemned this exemption for effectively shielding rating agencies from accountability, while others considered the exemption to be essential for the availability of quality ratings.[15]

Under Section 11(b)(3)(B) of the Securities Act of 1933, experts (such as engineers, appraisers, or auditors) who have consented to be named as having prepared or certified any part of a registration statement have liability to persons acquiring securities in registered offerings, unless the expert shall sustain the burden of proof that said expert "had, after reasonable investigation, reasonable ground to believe, and did believe" that the expert's statements were "true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements not misleading."[16] In other words, experts named in the registration statements have a statutory due diligence defense.

Notwithstanding, the NRSROs were exempt from even this liability under Rule 436(g).[17] When Congress sought to remove the added insulation from liability of Rule 436(g), the NRSROs played hardball.[18] If they were to be held accountable for their ratings, upon which many investors rely, indeed, upon which some institutions must rely as their investments must be "investment grade"—a "blessing" conferred by the NRSROs, by statute or regulation—they would take the ball and go

13. Keller & Stocker, *supra* note 1, at 1.

14. *Id.*

15. Tracy Alloway, *Why Repealing 436(g)Violates the First Amendment and Other Rating Agency Guff*, FINANCIAL TIMES (July 22, 2010, 1:45 PM), http://ftalphaville.ft.com/blog/2010/07/22/294666/why-repealing-rule-436g-violates-the-first-amendment-and-other-rating-agency-guff/.

16. Securities Act of 1933, 15 U.S.C. § 77k(b)(3)(B) (2010).

17. Adoption of Integrated Disclosure System, 47 Fed. Reg. 11,380, 11,391.

18. *See* SEC Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, Exchange Act Release No. 33-9071 (proposed Oct. 15, 2009), *available at available at* http://www.sec.gov/rules/concept/2009/33-9071.pdf [hereinafter SEC 2009 Concept Release].

home.[19] They would refuse to accept section 11 liability notwithstanding what Congress decreed.[20]

Despite many half-hearted attempts to regulate CRAs by the SEC over the years and most significantly, as discussed below, by Congress in its enactment of Dodd-Frank,[21] the SEC has been roundly criticized in its dealings with the CRAs.[22] In the New York Times "Fair Game" column entitled "Hey, S.E.C., That Escape Hatch Is Still Open," Gretchen Morgenson wrote:

> But since Dodd-Frank passed, Congress's noble attempt to protect investors from misconduct by ratings agencies has been thwarted by, of all things, the Securities & Exchange Commission. The S.E.C., which calls itself "the investor's advocate," is quietly allowing the raters to escape this accountability.
>
> When Dodd-Frank became law last July, it required that ratings agencies assigning grades to asset-backed securities be subject to expert liability from that moment on. This opened the agencies to lawsuits from investors, a policing mechanism that law firms and accountants have contended with for years. The agencies responded by refusing to allow their ratings to be disclosed in asset-backed securities deals. As a result, the market for these instruments froze on July 22.
>
> The S.E.C. quickly issued a "no action" letter, indicating that it would not bring enforcement actions against issuers that did not disclose ratings in prospectuses. This removed the expert-liability

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19. *Id.*; STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 102 (Comm. Print 2002) (hereinafter *Watchdogs*).

20. Anusha Shrivastava, Bond Sale? Don't Quote Us, Request Credit Firms, WALL ST. J. (July 21, 2010), http://online.wsj.com/article/SB10001424052748704723604575379650414337676.html; Alain Sherter, *As Obama Enacts Financial Reform, Credit Rating Agencies Fight to Remain Above the Law*, CBSNEWS (July 21, 2010), http://www.cbsnews.com/8301-505123_162-43546702/as-obama-enacts-financial-reform-credit-rating-agencies-fight-to-remain-above-the-law/.

21. *See generally* Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

22. Robert Schmidt & Jesse Hamilton, *SEC 'Capacity Gap' Risks Oversight Lapses as Regulator's Targets Multiply*, BLOOMBERG (Mar. 7, 2011 12:00 AM), http://www.bloomberg.com/news/2011-03-07/sec-capacity-gap-risks-oversight-lapses-as-regulator-s-targets-multiply.html.

> threat for the ratings agencies, and the market began operating again.[23]

Recognizing rating agencies' historical benefit of privilege without the burden of responsibility, Morgenson further writes:

> Unfortunately, the S.E.C.'s actions appear to continue the decades of special treatment bestowed upon the credit raters. Among the perquisites enjoyed by established credit raters is protection from competition, since regulators were required to approve new entrants to the business. Regulators have also sanctioned the agencies' ratings by embedding them into the investment process: financial institutions post less capital against securities rated at or above a certain level, for example, and investment managers at insurance companies and mutual funds are allowed to buy only securities receiving certain grades.
>
> This is a recipe for disaster. Given that ratings were required and the firms had limited competition, they had little incentive to assess securities aggressively or properly. Their assessments of mortgage securities were singularly off-base, causing hundreds of billions in losses among investors who had relied on ratings.
>
> That the S.E.C.'s move strengthens the ratings agencies' protection from investor lawsuits, which runs counter to the intention of Dodd-Frank, is also disturbing. Moody's and Standard & Poor's have argued successfully for years that their grades are opinions and subject to the same First Amendment protections that journalists receive. This position has made lawsuits against the raters exceedingly difficult to mount, a problem that Dodd-Frank was supposed to fix.[24]

Finally, Morgenson concludes that the SEC's efforts have been counterproductive to the legislative intent of Dodd-Frank:

> I[t] is certainly important that the S.E.C. work to eliminate references to ratings in the investment arena, and to reduce investor reliance on them. But Congress couldn't have been clearer in its intent of holding the agencies accountable. That the S.E.C. is undermining that goal is absurd in the extreme.[25]

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23. Gretchen Morgenson, *Hey, S.E.C., That Escape Hatch is Still Open*, N.Y. TIMES, Mar. 6, 2011, at BU1.

24. *Id.*

25. *Id.*

The Morgenson column was spurred by a letter written by Massachusetts Attorney General Martha Coakley to SEC Chairman Mary Shapiro on March 1, 2011.[26] That letter was in response to two no action letters issued by the SEC's Division of Corporate finance to Ford Motor Credit in 2010.[27] Attorney General Coakley's letter states:

> These [no action] letters state that the Division will not recommend enforcement action if issuers of asset-backed securities ("ABS") do not comply with the ratings disclosure requirements of Regulation AB, and thus fail to secure for investors the duty of competence mandated by Section 11 of the Securities Act. Since last July, many issuers have registered asset-backed securities without the required ratings disclosure and consents by rating agencies to Section 11 liability.
>
> As a matter of policy, we believe that creating a duty of competence for rating agencies under Section 11 is a good thing. We believe that Congress rescinded the rating agencies' exemption from liability with the expectation that this would result in rating agency liability. While the Commission, in its prosecutorial discretion, may decide it will not bring enforcement action in a given area, we are concerned about the no-action letters for two reasons. First, we believe the SEC's decision to take no action in this area undermines recent Congressional reform and is inconsistent with Congressional intent. Second, the Commission's no-action letters to Ford Motor Credit have resulted in significant uncertainty for both governmental actors and private parties. Legally, no-action letters are expressions of enforcement policy. In practice, they are public statements by SEC staff often taken to imply legal interpretations and administrative action they do not contain. Yet the Commission's exercise of prosecutorial discretion does not affect whether SEC regulations and the federal securities laws are being violated. We urge the Commission to enforce Regulation AB in its entirety, in particular with regard to the prospectus disclosure of ratings, as well as to clarify the duties of issuers.[28]

Attorney General Coakley concludes her letter by stating:

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26. *See* Letter from Martha Coakley, Attorney General of Massachusetts, to Mary Schapiro, Secretary, Securities and Exchange Commission (Mar. 1, 2011) [hereinafter *Coakley Letter*], *available at* http://www.mass.gov/Cago/docs/press/2011_03_07_sec_letter_attachment1.PDF.

27. *Id.*

28. *Id.* at 1-2.

> We ask the Commission to enforce Regulation AB in its entirety and in a manner consistent with the intent of the Dodd-Frank Act. Although we are aware that the rating agencies declined to participate in the securitization markets for the day of July 22, 2010, we believe that the SEC should let the market set rating agency pricing reflecting the Section 11 duty of competence. Calculating risk of loss is the business of the rating agencies.[29]

I. THE CREDIT RATINGS INDUSTRY

A credit rating agency is an organization that uses various models to rate debt instruments and companies on a proprietary scale, typically ranging from AAA premium ratings to junk bond ratings.[30] CRAs "help lenders pierce the fog of asymmetric information that surrounds lending relationships. . . . [and] help borrowers (and their credit qualities) emerge from that same fog."[31]

The origin of CRAs lies in the desire of investors to be able to evaluate the creditworthiness of a particular instrument without relying on the biased representations made by its seller.[32] Investors took satisfaction in the independence of CRAs, which charged subscription fees to the investing community in exchange for access to the valuable ratings.[33] John Moody, who founded Moody's Investor Services, is credited as a pioneer in the development of credit ratings in the early twentieth century.[34] Moody's issued its first ratings in 1909.[35]

A. THE ISSUER-PAYS BUSINESS MODEL

Investors who sought advice on the likelihood of default of corporate bonds flocked to Moody's and other rating agencies, buying subscriptions to access the valuable information.[36] However, the

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29. *Id.* at 10.

30. Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can be Done to Protect Investors*, 50 B.C. L. REV. 1275, 1279 (2009).

31. Lawrence J. White, The Credit Rating Industry: An Industrial Organization Analysis 4 (Feb. 12, 2001) (unpublished manuscript), *available at* http://www.stern.nyu.edu/eco/wkpapers/workingpapers01/01-02White.pdf.

32. Keller & Stocker, *supra* note 1.

33. *Id.*

34. Mulligan, *supra* note 30, at 1279.

35. White, *supra* note 31, at 8.

36. Mulligan, *supra* note 30, at 1279.

evolution of capital markets made the subscriber-paid business model less profitable, and rating agencies instead directed their services toward the issuers of securities in an "issuer-pays" business model.[37] As the market evolved, investors began to demand that new issues of securities retain at least one credit rating.[38] Since issuers were increasingly expected to issue rated securities, the rating agencies realized that their service was better catered to the issuers than individual investors.[39] Further, agencies faced difficulties in keeping their ratings away from non-subscribers, so subscribers quickly became reluctant to continue paying for ratings that increasingly became public information.[40] Another factor that led to the issuer-pays model was that securities had grown more complex, and agencies needed more resources than subscription fees alone were generating.[41]

In the United States, the largest rating agencies are Standard and Poor's, Moody's Investor Services, and Fitch.[42] It is estimated that Standard and Poor's is responsible for issuing about half of all credit ratings, and the "big three" combined issue approximately ninety-eight percent of all ratings.[43] Each major CRA in the United States derives most of its revenue from contracts with securities issuers to rate their securities.[44] Issuers of securities typically provide rating agencies with confidential or nonpublic information about their businesses and securities.[45] The agencies use this information to craft a creditworthiness assessment, and then make their opinion publicly available.[46]

This "issuer-pays" business model creates an inherent conflict of interest between CRAs and the issuers of the securities that CRAs are being paid to rate.[47] The major rating agencies generally downplay the significance of this conflict, and claim that their reputations are far too valuable for them to succumb to any inherent biases in their business

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37. *Id.*
38. Timothy E. Lynch, *supra* note 10, at 239.
39. *Id.*
40. *Id.*
41. *Id.*
42. Mulligan, *supra* note 30, at 1279.
43. *Id.*
44. Lynch, *supra* note 10, at 234.
45. *Id.* at 237.
46. *Id.*
47. *Id.* at 235.

model.[48] Sometimes rating agencies disclose the methodologies they use to calculate a credit rating, but they often provide only a basic rationale of the credit analysis, leaving much of the justification for a rating to be questioned.[49]

II. History of SEC Rating Agency Reform

A. Expert Accountability

Two important laws that relate to the legal accountability of experts, and potentially credit rating agencies, are Sections 7 and 11 of the Securities Act of 1933.[50] Section 7 requires the written consent of any expert who has helped prepare or certify a registration statement.[51]

> If any accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement, the written consent of such person shall be filed with the registration statement.[52]

Section 11 of the Act details the liability of an expert who has made untrue affirmations on a registration statement, and affords a cause of action to those who are misled by false statements.[53]

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity, in any court of competent jurisdiction, sue . . . every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the

48. *Id.*
49. *Id.* at 238.
50. *See* Securities Act of 1933, 15 U.S.C. §§ 77g, 77k (2010).
51. *See id.* § 77g(a).
52. *Id.*
53. *See id.* § 77k(a)(4).

> statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him . . . .[54]

If CRAs are considered "experts" under Section 7, their written consent would be required in order for a registration statement to disclose their rating.[55] Denoting the agencies as experts would also mean that they could be sued for issuing a misleading rating that was disclosed as part of a registration statement under Section 11.[56] According to the SEC, the purpose of Section 11 was to subject anyone with a direct role in a registered offering to a more rigorous standard of liability, assuring accurate disclosure regarding securities.[57]

The potential for liability has led credit rating agencies to label their ratings as opinions rather than "expert" advice.[58] They believe their ratings are analogous to other published opinions, such as editorials or restaurant reviews.[59] As such, CRAs frequently utilize the "personhood" of corporations in conjunction with the First Amendment protection of freedom of speech as a defense against legal claims.[60] Standard & Poor's is so serious about this defense that it hired the legendary Floyd Abrams, a veteran in the freedom of speech arena.[61] A major issue arises when agencies regard their ratings as mere opinions, while at the same time major market participants are continuously encouraged and sometimes even obligated to utilize rating agencies.[62] This creates an "unavoidable reliance on the agencies and a financial market characterized by a commingling of institutions."[63]

54. *Id.*

55. Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, 17 C.F.R. pt. 220, 4-5 (proposed Oct. 15, 2009), *available at* www.sec.gov/rules/concept/2009/33-9071.pdf [hereinafter SEC 2009 Concept Release].

56. *Id.* at 2-3.

57. *Id.* The SEC also notes that Section 11 afforded investors additional protection from barriers to recovery under certain common law fraud requirements. *Id.*

58. Parisa Haghshenas, Note, *Obstacles to Credit Rating Agencies First Amendment Defense in Light of Abu Dhabi*, 8 FIRST AMEND. L. REV. 452, 453 (2010).

59. *Id.*

60. *Id.*

61. Segal, *supra* note 4, at BU1.

62. Haghshenas, *supra* note 58, at 453.

63. *Id.*

B. NATIONALLY RECOGNIZED STATISTICAL RATINGS ORGANIZATIONS

Ratings issued by CRAs are significant for two reasons: (1) investors rely on them for an assessment of a product or company's creditworthiness, and (2) many entities are limited to purchasing products rated "investment grade" by Nationally Recognized Statistical Ratings Organizations.[64] The origin of the "NRSRO" designation began in 1975, but the history of the concept dates further back.[65]

Our financial system and capital markets have shown that major interruptions in the flow of capital, such as institutional insolvencies, create huge losses for investors holding a stake in those institutions.[66] Since 1931, the United States "safety-and-soundness" regulation of financial institutions has progressed with the goal of protecting investors from losses arising from insolvencies, while also preserving the stability of the banking system.[67] With so much money riding on financial institutions and the riskiness of the various assets they hold, regulators sought to limit that risk by specifying which assets institutions like banks could hold.[68] This was done by either prohibiting institutions from holding securities below a specified grade or by setting minimum capital requirements for holding certain securities pursuant to their ratings.[69] These requirements created a specific demand for creditworthiness ratings.[70] However, the question of whose ratings could be used for regulatory purposes remained unanswered until 1975.[71]

In 1975, the SEC revised its Net Capital Rule by applying it to broker-dealers in order to ensure that they had enough "liquid assets to meet their obligations to their investors and creditors."[72] Broker-dealers were required to maintain net capital over some calculated amount.[73] A broker-dealer calculating this minimum amount could deduct the "percentages of the market value of their securities from their total net

64. *See* Mulligan, *supra* note 30, at 1278-79.
65. *See* White, *supra* note 31, at 23.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.* at 24.
71. *Id.*
72. Net Capital Rule, 17 C.F.R. § 240.15c3-1 (1976).
73. *Id.*

worth."[74] Under the 1975 revisions, banks could base their capital requirements on the ratings of the securities they held, and certain securities were subjected to lower margin requirements if at least two NRSROs rated them as investment grade.[75] In specifying rating requirements, the SEC was next faced with the question of whose ratings could be used, which it answered by creating the NRSRO designation.[76]

Unfortunately, the SEC did not define or clarify the term "NRSRO" at that time.[77] The SEC also neglected to specify how a normal rating agency could ascend to NRSRO status.[78] Even without an "NRSRO" definition, it was certainly understood that Moody's, Standard & Poor's, and Fitch would fall under this select class of CRAs.[79] Recognition by the SEC as an NRSRO is important because most ratings-dependent regulations make reference to only those select few agencies designated by the SEC as NRSROs.[80] In setting its margin requirements on the basis of ratings issued by CRAs, the SEC cemented the rating agencies' role in U.S. financial markets.[81]

C. EARLY REFORM OF RATING DISCLOSURE REQUIREMENTS

In 1977, the SEC issued a concept release seeking comment on whether it should allow, encourage, or require corporate debt security ratings to be disclosed on registration statements and prospectuses.[82] Traditionally, the SEC did not permit such disclosure in reports filed with the Commission, but several factors led to consideration of whether its stance should change.[83] These factors include recommendations from the staff, letters from the public, literature by security professionals, and

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74. Mulligan, *supra* note 30, at 1281.
75. *Id.*
76. White, *supra* note 31, at 24.
77. Mulligan, *supra* note 30, at 1281.
78. *Id.*
79. White, *supra* note 31, at 24 n.45.
80. Lynch, *supra* note 10, at 245.
81. Mulligan, *supra* note 30, at 1281.
82. Disclosure of Security Ratings, 42 Fed. Reg. 58,414, 58,414 (proposed Nov. 9, 1977).
83. *Id.*

its own experience in administering securities laws.[84] The SEC was merely seeking comments on its proposal, and did not publish any new guidelines in this release.[85]

The 1977 release acknowledged that security ratings are frequently used in the investing community, and that reliance on ratings was widespread in the securities markets.[86] The SEC noted that ratings already play a pivotal role in its Net Capital Rule, whereby certain "haircut" deductions were permitted on short-term commercial paper that is recognized as "investment grade" by at least two NRSROs.[87] One of the SEC's inquiries in the 1977 release was whether "an entity issuing a security rating [is] the type of person referred to in Section 7 of the Securities Act of 1933 whose consent is required to be filed by the issuer of the security."[88] It sought comment regarding the potential costs or burdens associated with obtaining CRAs' consent for the disclosure of ratings.[89] The SEC also inquired about the impact that could result "from a rating entity being subject to Section 11 under the Securities Act of 1933, with respect to its rating being disclosed in a prospectus[.]"[90] Additionally, it sought comment on "additional disclosure concerning the nature of a rating and the manner in which it is obtained," specifically when ratings are included in filed documents.[91] Among the additional disclosure proposals was one that would require disclosure of "the fact that the agency was paid a fee for the rating," offering an early glimpse into the conflict of interest issue.[92]

The fifty-five comments in response to the 1977 release generally opposed CRA consent requirements under Section 7 and liability as experts under Section 11.[93] It was argued that applying Section 7 and 11 to CRAs would slow down the timetable of the registration process and would increase the cost of ratings due to the uncertain scope of CRA

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84. *Id.*

85. *Id.* at 58,415.

86. *Id.* at 58,414.

87. *Id.* at 58,414 n.4. At this time, the term "investment grade" referred to a non-convertible debt or preferred security that at least one NRSRO has rated within one of its four highest rating categories.

88. *Id.* at 58,415.

89. *Id.*

90. *Id.*

91. *Id.*

92. *See id.* at 58,414.

93. *See* SEC 2009 Concept Release, *supra* note 55, at 7.

liability.[94] The NRSROs in existence in 1977 also declared that they would decline to provide consent to be named in the registration statement if it became a requirement.[95]

Four years later in 1981, the SEC formally announced its shift in policy, permitting the voluntary disclosure of credit ratings in registration statements.[96] The 1981 release set forth two major proposals. The first was to amend the Securities Act of 1933, to "permit disclosure of security ratings of debt securities, convertible debt securities or preferred stock assigned by a rating organization in certain communications deemed not to be a prospectus."[97]

The second proposal would have eliminated the required consent of NRSROs under Section 7, and would have exempted an NRSRO from civil liability as an expert under Section 11 when its rating was used as part of a registration statement.[98]

> [The second proposal] would add a new subparagraph (g) to Rule 436 under the Securities Act . . . to provide that a security rating is not a part of a registration statement prepared or certified by a person or a report or valuation prepared or certified by a person within the meaning of Sections 7 and 11 of the Securities Act.[99]

The SEC noted several factors leading to this proposal.[100] First, if NRSROs refused to provide consent then there would ultimately be zero disclosure of credit ratings, even if permitted by the SEC.[101] As a result, 436(g) was proposed by the SEC "in order to make its new policy position on disclosure of credit ratings meaningful."[102] Next, responses to the 1977 release stated that procuring acquiring agencies' consent under Section 7 would prove to be troublesome and time-consuming.[103] A rating organization would not likely consent, until it could fully

94. *Id.* at 7-8.
95. *Id.* at 8.
96. Disclosure of Security Ratings in Registration Statements, 46 Fed. Reg. 42,024, 42,024 (proposed Aug. 18. 1981).
97. *Id.*
98. *Id.* at 42,024-25.
99. *Id.* at 42,024.
100. *Id.* at 42,027.
101. SEC 2009 Concept Release, *supra* note 55, at 8.
102. *Id.* at 8-9.
103. Disclosure of Security Ratings in Registration Statements, 46 Fed. Reg. 42,024, 42,027 (proposed Aug. 18, 1981).

ensure that its rating was based on all of the information in the registration statement if at all.[104] If Section 7 written consent became a requirement, NRSROs would have increased involvement with the content and timing of a registration statement, which "would inject the rating organization into the registration process as a participant, not as an objective evaluator, thus lessening its independence from the issuer."[105] Another reason for proposing 436(g) was that the prospect of liability under Section 11 would lead rating agencies to issue ratings solely on the basis of quantifiable data rather than informal subjective factors, lessening the quality of ratings.[106] This change would be damaging to the ratings process.[107] The uncertain scope of Section 11 liability would also lead NRSROs to raise their fees, which would be detrimental to newer or smaller issuers of securities facing higher costs.[108] The SEC believed it could circumvent these issues by permitting disclosure of ratings in registration statements without requiring agencies' consent, which would give investors direct access to the ratings.[109] The proposed exemptions would only apply to rating agencies who were NRSROs under the Net Capital Rule.[110]

The SEC justified the proposed exemptions by noting that rating organizations could already be subject to liability under select anti-fraud provisions of the federal securities laws, and thus 436(g) would serve to further hold NRSROs to the highest professional standards.[111] Additionally, the Investment Advisers Act of 1940 gave the SEC some jurisdiction over rating agencies.[112] Section 206 of the Investment Advisers Act of 1940 authorizes the SEC to "define and prescribe means reasonably designed to prevent, such acts, practices, and courses of

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104. *Id.*

105. *See also id.* at 42,028. "As previously discussed, the Commission is taking this action, in part, because it is concerned about the practical problems that were raised by the commentators, particularly the possible interference with the rating process and the possible difficulty in obtaining rating organization consents." *Id.*

106. *Id.* at 42,027.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.* at 42,028.

111. *Id.*

112. *Id.* At the time of the proposal for Rule 436(g), NRSROs were generally required to register as investment advisers. The Credit Rating Agency Reform Act of 2006 provides an exclusion from the Advisers Act for NRSROs.

business as are fraudulent, deceptive, or manipulative."[113] Therefore, if improper issuance of security ratings would become a problem, the SEC believed that Section 206 would give it authority to regulate such behavior.[114]

D. THE ADOPTION OF RULE 436(G) AND BEYOND

In 1982, the SEC formally adopted several important proposals.[115] A majority of responses to the 1977 and 1981 proposals were in favor of permitting voluntary disclosure of credit ratings and an exemption for NRSROs from Sections 7 and 11 of the Securities Act.[116] The 1982 release affirmed the adoption of the Rule 436(g) exemption for NRSROs.[117]

> The Commission continues to believe that ratings should be permitted to be disclosed in Commission filings . . . and that it is appropriate to exempt NRSROs from Section 11 liability if their ratings are included in Securities Act registration statements. Accordingly, the Commission today is affirming its new policy and adopting the proposed amendments to Rules 436 and 134.[118]

At that time, the organizations recognized as NRSROs under the Net Capital Rule were Standard & Poor's Corporation, Moody's Investor Services, Inc., Fitch Investors Services, and Duff and Phelps, Inc.[119]

Non-NRSROs were not afforded the privilege of exemption, and any disclosure of their ratings in a registration statement would require their written consent and could potentially expose them to civil liability as experts.[120] The Commission acknowledged that several commentators

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113. Disclosure of Security Ratings in Registration Statements, 46 Fed. Reg. at 42,028.

114. *Id.*

115. *See* Adoption of Integrated Disclosure System, 47 Fed. Reg. 11,380, 11,380 (proposed Mar. 16, 1982).

116. *See id.* at 11,391.

117. *Id.*

118. *Id.*

119. *Id.* at 11,392 n.54.

120. SEC 2009 Concept Release, *supra* note 55, at 10 ("While an NRSRO would not be required to provide a consent if its rating was disclosed in a registration statement pursuant to Rule 436(g), '[a]ny non-NRSRO non-NRSRO rating organization

criticized the Net Capital Rule for lacking any specific definition of the NRSRO term and also for its lack of guidance on how to qualify as an NRSRO.[121] The SEC responded by declaring that it was "not aware of any substantial burden being imposed on rating organizations that are not NRSROs due to any absence of guidance in this area."[122]

The 1982 release clarified that the voluntary disclosure of security ratings was not limited to only Securities Act registration statements, but also applied to certain Exchange Act of 1934 filings.[123] Security ratings could also be included in tombstone advertisements.[124]

The SEC then published some considerations for disclosing a security rating in a registration statement.[125] The registrant should first consider disclosing every other publicly available ranking assigned by an NRSRO that substantially differs from the disclosed rating.[126] A registrant should also consider providing additional information regarding the characteristics of security ratings, making clear the source of the rating so that investors can obtain more information.[127] When a rating is included in a registration statement, but the rating changes prior to the effectiveness of the statement, a registrant should consider amending it to disclose the rating change.[128] The SEC opted to include only a list of things that a registrant "should consider," rather than establishing concrete disclosure requirements.[129]

In 1986, the SEC proposed to extend the exemptions of 436(g) to include NRSRO ratings of money market funds.[130] The policies of the 1982 release did extend to preferred stock equity securities, but not other types of equity securities such as money market fund shares.[131] Therefore, it was proposed that exempting money market fund ratings from Section 7 and 11 of the Securities Act was a "logical extension" of

must furnish a consent and take on expert liability under the Securities Act if its rating is included in the registration statement and prospectus.'").

121. *Id.* at 11,392 n.54.

122. *Id.* at 11,392.

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. Disclosure of Security Ratings by Money Market Funds, 51 Fed. Reg. 9,838, 9,838 (proposed Mar. 21, 1986).

131. *Id.*

its action in adopting Rule 436(g).[132] The proposal would permit a money market fund with an NRSRO rating to disclose that rating without obtaining the NRSRO's consent before using it in a registration statement.[133] The 1986 proposal was never put into action, and Rule 436(g) was not amended to include money market fund ratings.[134]

In 1994, the SEC published a proposal that would mandate the disclosure of security ratings in cases where a rating is obtained by or on behalf of an issuer.[135] An issuer would also be required to discuss the scope of the rating and disclose any subsequent material changes to the security rating.[136] The SEC's 1994 proposal was intended to "improve the quality and timeliness of security ratings disclosures . . . in prospectuses and periodic reports, and to reduce the potential for market misunderstanding and confusion over the scope and meaning of security ratings."[137] The SEC felt compelled to propose mandatory disclosure requirements because the scope and meaning of security ratings had become more variable while disclosure requirements had remained the same.[138] Until 1994, the SEC had not seen a "pressing need" for mandatory disclosure, but proposed it at that time because the securities market had evolved to include many more types of securities, such as complex mortgage and asset-backed securities and other structured financial instruments.[139] Notwithstanding these market developments, the SEC had enacted few changes to its ratings disclosure policies.[140]

The 1994 release also solicited comments on whether the SEC should continue to distinguish between NRSROs and Non-NRSROs for the purpose of Rule 436(g) exemptions.[141] It also inquired as to whether Rule 436(g) should extend to Non-NRSROs, and whether the exemption for NRSROs should be rescinded completely.[142] The SEC wanted to discourage "rating shopping," whereby a company could avoid

132. *Id.* at 9,839.
133. *Id.*
134. SEC 2009 Concept Release, *supra* note 55, at 9.
135. Disclosure of Security Ratings, 59 Fed. Reg. 46,304, 46,304 (proposed Sept. 7, 1994).
136. *Id.*
137. *Id.*
138. *Id.* at 46,305.
139. *Id.*
140. *Id.* at 46,306.
141. *Id.* at 46,308.
142. *Id.*

disclosure of negative unsolicited ratings while only disclosing favorable solicited ratings.[143] The Commission also sought comments regarding the scope of information that should be disclosed alongside a security rating, and offered several of its own proposals to help remedy any potential investor confusion.[144]

Comments in response to the 1994 proposal generally opposed the exposure of NRSROs and CRAs to Section 11 liability under the Securities Act.[145] Among the commentators were Moody's and Fitch Investors Service, who defended security ratings as mere "expressions of opinion about risk," alleging that Section 11 liability would violate the First Amendment rights of NRSROs.[146] They added that the potential for liability could reduce or even eliminate the disclosure of security ratings.[147] The SEC ultimately did not act on its 1994 proposals.[148]

In 2002, months after the corporate giant Enron declared bankruptcy, the Senate Committee on Governmental Affairs held various hearings regarding the corporation's finances.[149] It subsequently produced a detailed report, urging "increased oversight for these rating agencies in order to ensure that the public's trust in these firms is well-placed."[150] Since the term "NRSRO" appeared in 1975, the Committee found that no less than eight federal statutes, forty-seven federal regulations, and over one hundred state laws and regulations made benchmark references to NRSROs.[151] While they were generally related to banking and securities, other regulations making reference to NRSROs dealt with education, transportation and even telecommunications.[152]

A 2005 SEC proposal sought to define the term NRSRO in order to recognize certain agencies that the SEC could rely on in formulating its regulations.[153] However, due to concerns from Congress that the

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143. *Id.* at 46,309.
144. *Id.* at 46,310-11.
145. SEC 2009 Concept Release, *supra* note 55, at 10.
146. *Id.* at 10-11.
147. *Id.* at 11.
148. *Id.*
149. *Watchdogs*, *supra* note 19, at 1.
150. *Id.* at 6.
151. *Id.* at 102.
152. *Id.*
153. Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. 21,306, 21,310 (proposed Apr. 25, 2005); Mulligan, *supra* note 30, at 1285.

Commission lacked the specific authority to oversee the credit rating industry in this manner, the 2005 proposal was never adopted.[154]

Proposals were also made in 2008 to amend Rule 436(g),[155] and in 2009 to rescind 436(g),[156] discussed in the sections below.

1. The Credit Rating Agency Reform Act of 2006

In the wake of the economic collapse of numerous large and well-rated companies, Congress enacted The Credit Rating Agency Reform Act of 2006.[157] The preamble to the Act expresses its goal, "[t]o improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry."[158]

The Act finally offered credit rating agencies the ability to ascend to NRSRO status by registering with the SEC and providing certain information.[159] The required information includes statistics regarding short and long-term performance, procedures used to determine credit ratings, policies implemented by the applicant to prevent the misuse of nonpublic information, and whether the applicant has procedures in place for addressing conflicts of interest.[160] To qualify, a CRA must be in business for at least three years preceding its application.[161] The Act gives the SEC "exclusive authority to enforce the provisions" regarding NRSROs,[162] and allows it to amend or review the regulations in furtherance of the objectives of the Act.[163]

The ability to register with the SEC would allow more agencies to earn the NRSRO designation, consequently fostering increased competition in the ratings industry.[164] Disclosure requirements were set

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154. Mulligan, *supra* note 30, at 1286.

155. Security Ratings, 73 Fed. Reg. 40,106, 40,114 (proposed July 11, 2008).

156. SEC 2009 Concept Release, *supra* note 55, at 3.

157. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified as amended in scattered sections of 15 U.S.C.); Lynch, *supra* note 10, at 267-68.

158. *Id.*

159. 15 U.S.C. § 78o-7 (2006).

160. *Id.*. § 78o-7(a)(1)(B).

161. *Id.* § 78o-7(a)(1)(C)(iv)(II).

162. *Id.* § 78o-7(c).

163. *Id.* § 78o-7(n)(1).

164. Paul Lasell Bonewitz, *Implications of Reputation Economics on Regulatory Reform of the Credit Rating Industry*, 1 WM. & MARY BUS. L. REV. 391, 420 (2010).

in order to increase transparency, which "allows investors to develop informed opinions and facilitates accountability."[165]

The Act also sets forth several provisions regarding the conflict of interest issue.[166] NRSROs were required to enact policies for eliminating potential conflicts of interest:

> Each nationally recognized statistical rating organization shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of the business of such nationally recognized statistical rating organization and affiliated persons and affiliated companies thereof, to address and manage any conflicts of interest that can arise from such business.[167]

The SEC was given the authority to issue the final rules regarding the management and disclosure of conflicts of interest.[168] Types of conflicts that the SEC could regulate include the manner in which an NRSRO is paid by the issuer for ratings, NRSROs' providing advisory and consulting services to issuers, and close business and financial relationships with issuers or their affiliates.[169] It is worth noting that under the Act, NRSROs must only abide by their own set of procedures and methodologies that they develop, and the SEC is prohibited from regulating the actual procedures or methodologies of any agency.[170]

A final provision in the Act calls for a study to be conducted in order to identify how the Act impacts the quality of credit ratings, financial markets, competition among rating agencies, the NRSRO

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165. *Id.* The author makes several noteworthy assertions about the scope of the Credit Rating Agency Reform Act of 2006, and the potential for achieving its objectives:

> [C]ompetition, accountability, and transparency will lead to accuracy only if NRSROs are more concerned with preserving their reputation for accuracy than they are with serving issuers' regulatory need for investment grade ratings. If, on the other hand, the regulatory value of ratings dominates their informational value or the reputation mechanism otherwise fails, the Act will do little to promote rating accuracy. . . . Competition among NRSROs will promote accuracy only to the extent that their clients, the issuers, demand accuracy.

Id. at 422.

166. *See* 15 U.S.C. § 78o-7(h).

167. *Id.* § 78o-7(h)(1).

168. *Id.* § 78o-7(h)(2).

169. *Id.*

170. Bonewitz, *supra* note 164, at 421.

registration process, and conflicts of interest by NRSROs.[171] This provision delegated the study to the Comptroller General of the United States, and requires the report to be submitted within three to four years of the enactment of the Act.[172]

2. Proposals in 2008 and 2009

In 2008, the SEC simultaneously published three releases proposing changes to security ratings and NRSROs.[173] The proposals were set forth in furtherance of the Act.[174]

In its June 16 release, the SEC proposed two initiatives targeted at reducing conflicts of interest, increasing competition among rating agencies, and improving investors' understanding of the risks associated with structured finance products.[175] The rulemaking initiatives addressed "concerns about the integrity of the credit rating procedures . . . of NRSROs in light of the role they played in determining the security ratings for securities that were the subject of the recent turmoil in the credit markets."[176]

In its July 11 release, the SEC contemplated whether its inclusion of security rating requirements in many of its forms and rules had effectively affixed an "official seal of approval" on the use of security ratings.[177] It believed that this sort of approval was undermining the quality of investors' own analysis and due diligence, consequently leading to undue reliance on security ratings issued by NRSROs.[178] Prior to this proposal, eligible issuers could only use Short Forms S-3 and F-3 for asset-backed securities if they met certain rating requirements, specifically if the securities were rated "investment grade" by NRSROs.[179] In an attempt to reduce reliance on credit ratings, the SEC proposed new requirements for Short Form S-3 and F-3, which were based on a minimum denomination amount rather than security

171. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 7, 120 Stat. 1327, 1338 (2006).
172. *Id.* § 7, 120 Stat. at 1339.
173. Security Ratings, 73 Fed. Reg. 40,106, 40,106 (proposed July 11, 2008).
174. *Id.*
175. *Id.* at 40,106-07.
176. *Id.* at 40,107.
177. *Id.*
178. *Id.*
179. *Id.* at 40,111.

ratings.[180] Under the proposal, an issuer utilizing Short Forms S-3 and F-3 to register primary offerings of non-convertible securities for cash could only do so if it has issued over $1 billion in non-convertible securities for cash, as of sixty days prior to filing the registration statement.[181] The SEC also sought comment on whether there exists an alternative definition of "investment grade debt securities" that did not incorporate NRSRO ratings and would still adequately relate short-form registration to the recognition of a widespread marketplace following.[182] The SEC ultimately did not act on its 2008 proposals.[183]

As the significance of credit ratings increased, the SEC sought to provide more protection to investors by contemplating the rescission of Rule 436(g) in 2009.[184] It was concerned that its original bases for distinguishing between NRSROs and Non-NRSROs with regard to Section 11 liability were no longer sufficient.[185]

> [W]e are now exploring whether Rule 436(g) is still appropriate in light of the growth and development of the credit rating industry and investors' use of credit ratings. We are mindful of the potential significant impact that rescinding Rule 436(g) could have on registrants, NRSROs and other credit rating agencies, investors and

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180. *Id.*
181. *Id.*
182. *Id.* at 40,112.
183. SEC 2009 Concept Release, *supra* note 55, at 12.
184. *Id.* at 4.
185. *Id.* at 3.

> Section 11 of the Securities Act imposes liability on various parties who are involved in the preparation of registration statements filed under the Securities Act. Section 11 was enacted so that those persons with a direct role in a registered offering would be subject to a rigorous standard of liability to assure that disclosure regarding securities is accurate. . . . Section 11 provides that an expert may be held liable if, when the registration statement became effective, the part of the registration statement purporting to be made on his or her authority contained an untrue statement of material fact or omitted to state a material fact necessary to make the statements therein not misleading, unless he can establish that he had, after reasonable investigation, reasonable grounds to believe and did believe at the time such part of the registration statement became effective, that the statements in the registration statement were true . . . Under Section 11, persons other than the issuer may be able to assert as a defense to Section 11 liability that they relied upon an expert that consented to be named in the registration statement (the "experts' defense").

Id. at 5.

> the financial markets in general, and we seek comment on any burdens or benefits that may result.[186]

The SEC's scrutiny of Rule 436(g) was based on four primary factors.[187] First, it believed that the underlying rationale behind Rule 436(g) was no longer sufficient to continue to allow NRSROs to be exempt from Section 11 in light of its recent mandatory disclosure requirements.[188] When the SEC first permitted voluntary disclosure of security ratings in registration statements in the 1980s, it believed that eliminating the Section 7 consent and Section 11 liability requirements for NRSROs would effectively promote the use of security ratings, thereby making its policy more meaningful.[189] If the SEC were to adopt its 2008 proposals mandating the disclosure of security ratings, it would "no longer need to provide a means to encourage disclosure about credit ratings," making the rationale of 436(g) inapplicable.[190] Another underlying reason for enacting 436(g) was that CRAs were already subject to liability under the Investment Advisers Act of 1940, which the SEC believed would provide sufficient investor protection against faulty security ratings.[191] Since the Act provides an exemption for NRSROs from the Investment Advisers Act of 1940, this protection also no longer applies.[192]

The second reason for proposing the rescission of 436(g) was the contention that investors rely on credit rating agencies as experts when their ratings are used to sell securities, and as such it could be appropriate to apply the SEC's liability scheme for experts onto NRSROs.[193] "In our view, NRSROs represent themselves to registrants and investors as experts at analyzing credit and risk," thus the SEC felt that rating agencies should be treated as experts.[194] Although NRSROs generally believe that their ratings are mere "opinions" on risk, the SEC notes that investors also rely on the opinions of other professionals, and

186. *Id.* at 4.
187. *Id.* at 13.
188. *Id.* at 14.
189. *Id.*
190. *Id.*
191. *Id.* at 14-15.
192. *Id.* at 15; Disclosure of Security Ratings in Registration Statements, 46 Fed. Reg. 42,024, 42,028 (proposed Aug 18, 1981).
193. SEC 2009 Concept Release, *supra* note 55, at 15.
194. *Id.*

those opinions are still subject to Section 7 and 11 of the Securities Act.[195] If NRSROs and CRAs are issuing expert opinions, the SEC saw no reason why they should not be treated as experts under the Securities Act.[196]

The third reason given for potentially repealing 436(g) was that exposure to the risk of liability under Section 11 would foster an improvement in the quality of credit ratings and enhance NRSROs' accountability.[197] Eliminating the protective shield of Rule 436(g) would encourage NRSROs and CRAs to improve the quality of their ratings in order to reduce their potential liability.[198]

The Commission's final reason was that the distinction between NRSROs and Non-NRSROs could create "competitive disadvantages" and lead to high barriers of entry into the credit ratings industry.[199] Non-NRSROs would likely face higher costs than NRSROs because of their potential risk for liability.[200] The Commission notes that despite NRSROs' past unwillingness to be subject to liability, the core of the CRA business model remains to be the issuance of credit ratings.[201] Due to their importance to NRSRO revenues, it is unlikely that agencies would cease to issue credit ratings in the face of potential liability.[202]

III. THE CONTROVERSIAL ROLE OF RATING AGENCIES IN GOVERNMENT AND BUSINESS

As self-established authorities on creditworthiness, both the accurate and inaccurate opinions of credit rating agencies may be thought of too highly by investors, notably when dealing with complex structured financial products.[203] After the United States economic

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195. *Id.* at 15-16. Examples of other professional opinions that investors rely on include legal opinions, valuation opinions, fairness opinions, and audit reports.

196. *Id.* at 16.

197. *Id.* at 16.

198. SEC 2009 Concept Release, *supra* note 55, at 16. The Commission acknowledged that the potential for liability could undermine competition in the credit ratings industry because certain agencies may exit the industry to avoid liability, and because new entrants in the ratings market may reconsider their choice in light of Section 11 liability.

199. *Id.* at 17.

200. *Id.*

201. *Id.* at 19.

202. *See id.*

203. *See* Lynch, *supra* note 10, at 234, 284-85.

collapse of 2007-2008, the excessive packaging and sale of sub-prime mortgages was largely to blame.[204] This occurrence and its subsequent economic impact left many questions to be answered, including why so many investors chose to invest in our housing market during a housing bubble.[205] While some of the blame for the sub-prime mortgage crisis lies with uninformed homeowners and unethical loan originators who gave out mortgages to those who lacked the creditworthiness to make timely payments, the major CRAs in America also played a large role in the crisis.[206] The heavy investment in structured financial instruments such as mortgage-backed securities can be traced back, in part, to the improper ratings given to those securities by Moody's, Standard and Poor's, and Fitch Ratings.[207] "Investor appetites" for mortgage-backed securities and other collateralized debt obligations were fueled by NRSROs, whose inflated ratings characterized certain investments as less risky than they really were.[208] As investor reliance on credit ratings increased, the level of due diligence and individual analysis of credit risks decreased, and credit ratings soon became substitutes—rather than supplements—for internal creditworthiness analysis.[209]

Performance of top-rated structured securities steadily decreased, prompting ratings downgrades for the complex financial instruments.[210] Unfortunately for investors, it was too late. The delayed timing of the rating agencies in downgrading certain ratings raised several questions about the overall accuracy and integrity of the credit rating process.[211] The sub-prime mortgage crisis revealed only a glimpse of the powerful and influential role of rating agencies in government and business.[212]

Further cementing the hegemonic role of CRAs in the global economy is the value of the services they provide to both investors and securities issuers.[213] For example, investors with limited access to research and analytical tools rely heavily on CRAs for making credit

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204. *See id*. at 231, 258.
205. *Id.* at 233.
206. *Id.* at 233-34.
207. *Id.* at 234.
208. Lynch, *supra* note 10, at 234.
209. *Id*.
210. SEC SUMMARY REPORT, *supra* note 11, at 2.
211. *Id.*
212. Lynch, *supra* note 10, at 236.
213. *Id.* at 240-41.

evaluations in an efficient manner.[214] When investors need not use their own energy, time, and money to research every investment opportunity, efficiency increases and overall costs of investing decreases.[215] Additionally, CRAs are given access to nonpublic information unavailable to most investors, contributing to their value in the investment community.[216] An issuer of securities that have been rated by a major CRA also benefits through lower costs of capital.[217] An investor considering a purchase of debt securities would be more inclined to do so if the securities were rated, because the investor would not be burdened with having to fully evaluate their creditworthiness.[218] This becomes particularly true when the securities involved are of a complex nature, such as mortgage-backed securities and collateralized debt obligations.[219]

A. CONFLICT OF INTEREST ISSUE

The continuing chain of financial scandals as of late has brought significant attention to conflicts of interest between credit rating agencies and securities issuers.[220] The process of issuers paying agencies for their own ratings creates an inherent conflict of interest.[221] This conflict is aggravated by the fact that CRAs typically offer consulting services to issuers on how to maintain or improve their ratings.[222] Despite the inherent flaws in the issuer-pays model, CRAs claim that they manage their conflicts of interest through internal processes.[223]

On its face, the close-contact relationship between rating agencies and issuers allows the agencies to make the most accurate judgments in calculating ratings while also ensuring that the issuer client is

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214. *Id.*
215. *Id.* at 241.
216. *Id.* at 242.
217. *Id.* at 241.
218. *Id.*
219. *Id.* at 242.
220. Daniel M. Covitz & Paul Harrison, *Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate* 2 (Fed. Reserve Bd., Paper No. 2003-68, 2003), *available at* http://ssrn.com/abstract=512402.
221. *Id.* at 6.
222. *Id.*
223. *Id.* at 2.

satisfied.[224] "But, as with a hostage that eventually sympathizes with his or her captors, with close contact comes the potential for an issuer to cloud the judgment of a CRA."[225] The ability of issuers to persuade CRAs to give them favorable ratings—or delay ratings downgrades—will be strong as long as issuers continue to pay for their own ratings.[226]

The potential for conflicts of interest is exacerbated by the complexity of structured financial products such as collateralized debt obligations and residential mortgage-backed securities.[227] In the process of rating a traditional financial instrument, an issuer of securities has little room to improve its creditworthiness and risk characteristics prior to being rated.[228] However, in the arena of structured finance, rating agencies play an active role in shaping the architecture of structured products.[229] "In practice, [issuers] will routinely use [CRAs'] publicly available models to pre-structure deals and subsequently engage in a process that is 'iterative and interactive,' informing the issuer of the requirements to attain desired ratings in different tranches and largely defining the requirements of the structures to achieve target ratings."[230] Typically, an issuer will propose certain structures of seniority within each tranche with the objective of achieving a favorable credit rating.[231] The development of models for rating collateralized debt obligations allowed issuers to reconfigure assets that were previously rated below investment grade into tranches offering higher yields at less of a credit risk.[232] The rating agency, now playing an advisory role, indicates to the issuer whether the assets and structures will attain favorable ratings

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224. Milosz Gudzowski, Comment, *Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency*, 2010 COLUM. BUS. L. REV. 245, 257 (2010).

225. *Id.*

226. *Id.*

227. Joseph Mason & Joshua Rosner, *Where did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* 13 (May 14, 2007) (unpublished manuscript), *available at* http:// www.riskandinsurance.com/userpdfs/MasonRosner2.pdf.

228. *Id.* at 13.

229. *Id.*

230. *Id.* (quoting *Taiwan Ratings*, http://www.taiwanratings.com/en/criteria/SF _ratingprocess.asp (last visited Nov. 4, 2010)).

231. Letter from John R. Rutherford, to Nancy M. Morris, Sec'y, Sec. & Exch. Comm'n (Mar. 8, 2007), *available at* http://www.sec.gov/comments/s7-04-07/s70407-17.pdf.

232. Mason & Rosner, *supra* note 227, at 17.

pursuant to the agency's methodologies.[233] This immerses rating agencies into the structuring process of a deal, leaving an open door for conflicts of interest.[234]

Given the complexity of these financial instruments, the CRAs' role in assessing the creditworthiness at each level is essential to the sale and distribution of the financial instruments.[235] A favorable rating seems to dictate how marketable a given structure will be to investors, further increasing market reliance on credit ratings.[236] Therefore, it could be said that an agency's rating is "essential" to the issuer's ability to sell its assets.[237] With the balance of power in favor of CRAs, which are in a position to influence an issuer's overall ability to sell securities, the need for objective ratings becomes even more apparent.[238]

Conflicts of interest can occur throughout the ratings process from beginning to end.[239] For example, below are a few "pressure points" in the process that are susceptible to such conflicts:

> At the initial contact between the issuer and/or its investment bank in soliciting a rating. In the application by the issuer of the agency's rating model and assessment of an issue's rating-sensitivity to changes in the structure of the offering and discussions with agency staff.
>
> During meetings between the agency's staff and corporate management of government officials and the assembly of both public and private information.

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233. *Id.*
234. *Id.* at 13.
235. *Id.* at 14.
236. *Id.*
237. Mason & Rosner, *supra* note 227, at 14. Mason & Rosner question whether the characteristic of being in control of a security's marketability is sufficient to categorize credit rating agencies as underwriters:

> According to the 1933 Securities Act the term "underwriter" includes "any person who . . . has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking . . . ." It seems plausible there may be a basis for argument that they have participated in the underwriting.

Id. (quoting Securities Act of 1933, 15 U.S.C. § 77b(a)(11) (2006)).
238. *See id.*
239. ROY C. SMITH & INGO WALTER, RATING AGENCIES: IS THERE AN AGENCY ISSUE?, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 289, 309 (Richard M. Levich et al. eds., 2002).

> During the preparation of a recommendation to the rating committee, and during the committee meeting leading to the rating to be assigned.
>
> During the comment period made available to the issuer between the preliminary assignment of a rating and its publication. Following rating reviews which place an issuer on a "watch list" for possible re-rating—usually negative, stable or positive—after there has been an unexpected material change in the issuer's fundamentals and announcement that a rating review is in process.[240]

In the ordinary course of business, other key sources of conflicts of interest at the *individual* level include: ownership of securities by CRA analysts who participate in the ratings process for those securities; serving as directors, officers, or employees at entities they rate; maintaining business relations that are beyond the scope of ordinary business; receiving gifts from issuers who are subject to a CRA's rating; and CRA compensation contingent on revenues generated from debt issuers subject to a CRA's rating.[241] At the *credit rating agency level*, conflict of interest sources include: CRA affiliation with the issuer or underwriter of securities; rendering ancillary services to rated entities; and issuer payments to CRAs for providing ratings under an issuer-paid business model.[242]

1. Conflicts of Interest and Reputation

How is the reputation of the major rating agencies affected by conflicts of interest? NRSROs have consistently cited the importance of their business reputation as a key incentive for avoiding conflicts of interest.[243] Disciplinary action against a rating agency by the SEC could severely impair the ability of the agency to attain future business and revenue.[244] If a CRA is deemed to have violated legal or professional standards, serious doubt would be cast on the credibility of its past and future ratings.[245] Further, in a global economy where the name of a rating agency signifies the quality of its ratings, violations of conflicts of

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240. *Id.*

241. Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 15 N.Y.U. J. LEGIS. & PUB. POL'Y 253, 272 (2010).

242. *Id.* at 277.

243. *Id.* at 310.

244. *Id.*

245. *Id.*

interest "destroy the perceived value of having a rating from the agency that granted it."[246] Moody's has stated that its success is contingent upon maintaining its professional reputation and coveted brand name.[247] Another reputation-related factor is that misleading ratings would entice securities issuers to seek ratings from competitors.[248] Investors would discount the value of credit ratings issued by any CRA with a reputation for bias and seek out more CRAs.[249]

Notwithstanding the discussion above, the high barriers to entry in the credit ratings industry and the "two-rating norm" in many markets diminish the significance of reputation as an incentive against conflicts of interest because there is not as much competition between the firms.[250] The two-rating norm describes the typical practice of obtaining ratings from two different agencies for each issue.[251] Since this entails that the first two rating agencies need not compete against one another, the CRA market has been said to be a "partner monopoly" consisting of Moody's and S&P.[252] The Credit Rating Reform Act of 2006 attempted to reduce the barriers of entry by announcing procedures for achieving NRSRO status.[253] NRSRO designation can be seen as a barrier, given that only NRSRO-issued ratings carry official weight with the SEC.[254]

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246. SMITH & WALTER, *supra* note 239, at 310.

247. *Id.* at 311.

248. *Id.*

249. Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L.J. 617, 637-38 (2006).

250. *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*, 2009 COLUM. BUS. L. REV. 109, 131-33 (2009).

251. *See id.* at 132.

252. *Id.*; *see also* Letter from Sean J. Egan & W. Bruce Jones, Egan-Jones Ratings Co. to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (Nov. 10, 2002), *available at* http://www.sec.gov/news/extra/credrate/eganjones2.htm.

The phrase "partner monopoly" is explained in terms of the noncompetitive relationship between Moody's and S&P. In the case of most US corporate ratings and an increasing number of structured finance transactions, S&P and Moody's are the only firms used. The industry could more accurately be described as a "partner monopoly," a term used by U.S. Department of Justice personnel. A partner monopoly differs from an oligopoly in the sense that the two firms share the market whereby the gain in revenues by one firm does not reduce the revenues of the second firm. Since two ratings are normally needed for the issuance of bonds, the gains of Moody's do not come at the expense of S&P and vice versa. *Id*.

253. Hunt, *supra* note 250, at 133-34.

254. *Id.*

The SEC has since continued its attempt to foster competition in the ratings agency,[255] however it remains clear that the big three firms are here to stay.

In the arena of structured financial instruments, reputation plays even less of a role because they have been rated by CRAs for a short amount of time relative to more traditional debt instruments.[256] As such, investors may not necessarily associate imperfect ratings for CDOs with the performance of traditional securities.[257] Since these structured products are so complex, most investors lack the ability to independently value them to determine their true creditworthiness, further clouding their judgment of a CRA's reputation.[258]

2. SEC Rule 17g-5

The SEC promulgated Conflicts of Interest Rule, 17 C.F.R. § 240.17g-5 (2012) ("Rule 17g-5") to further control conflicts of interest within CRAs.[259] Enhanced disclosure is at the root of Rule 17g-5, which prohibits NRSROs from some conflicts of interest unless they are disclosed,[260] expressly prohibits other conflicts,[261] and requires rating agencies to establish, maintain, and enforce procedures to address such conflicts.[262]

Provisions relating to the maintenance of an internet website: Rule 17g-5 utilizes the free flow of information made possible by the internet in order to ensure full disclosure of conflicts of interest as well as material non-public information that is useful to other rating agencies and the SEC.[263] The complexity of structured debt securities led the SEC to set more stringent disclosure requirements for credit ratings, including requiring NRSROs to maintain a password-protected website detailing the information provided by issuers, sponsors, or underwriters to the

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255. *See id.* at 135.
256. *See* Mason & Rosner, *supra* note 227, at 10.
257. Hunt, *supra* note 250, at 172.
258. *See* TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS 2 (2008), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf [hereinafter IOSCO Report].
259. 17 C.F.R. § 240.17g-5(a) (2012).
260. *Id.* § 240.17g-5(a)(1).
261. *See id.* § 240.17g-5(c).
262. *Id.* § 240.17g-5(a)(2).
263. *See id.* § 240.17g-5(a)(3)(i).

CRAs.[264] The internet website provisions apply to NRSROs that rate securities or money market instruments issued by an asset pool or as part of asset-backed or mortgage-backed securities that are paid for by the issuer.[265] This is significant because the SEC formally recognizes the inherent conflicts of the "issuer-pays" business model that has been utilized by the major rating agencies for decades.[266]

The requisite information to be made available on the website includes a list of each security for which a CRA is in the process of generating an initial credit rating, details regarding the type of security, the name of the issuer, the dates involved in the rating process, and the specific internet address where the information above can be accessed.[267] More specifically, Rule 17g-5(a)(iii)(C) requires the issuer, sponsor, or underwriter to:

> Post . . . all information the issuer, sponsor, or underwriter provides to the [NRSRO], or contracts with a third party to provide to the [NRSRO], for the purpose of determining the initial credit rating for the security . . . including information about the characteristics of the assets underlying or referenced by the security . . . and the legal structure of the security . . . at the same time such information is provided to the [NRSRO]; and Post . . . all information the issuer, sponsor, or underwriter provides to the [NRSRO] . . . for the purpose of undertaking credit rating surveillance on the security . . . including information about the characteristics and performance of the assets underlying or referenced by the security . . . at the same time such information is provided to the [NRSRO].[268]

Provisions relating to certified access to the internet website: The NRSRO must provide free and unlimited access to the website to any other NRSRO which signs a certification stating that the information will be kept confidential and treated as material nonpublic information, addressing security concerns.[269] In order to gain website access via certification, the NRSRO providing the certification must have "[d]etermined and maintained credit ratings for at least 10% of the issued securities . . . for which it accessed information . . . in the calendar year prior to the year covered by the certification, if it accessed

264. *Id*.
265. *Id.* § 240.17g-5(b)(9).
266. *Id.*
267. *Id.* § 240.17g-5(a)(3)(i).
268. *Id.* § 240.17g-5(a)(3)(iii)(C), (D).
269. *Id.* § 240.17g-5(e).

such information for 10 or more issued securities or money market instruments."[270] Alternatively, a certification may indicate that the NRSRO providing the certification has not accessed the information ten or more times in the recently ended calendar year.[271] This basically means that NRSROs who are given access to this information are either constantly using it to rate securities, or barely using it at all.

In addition to requiring certification from other NRSROs, a rating agency must also seek certain written representations from the issuers of the securities under Rule 17g-5.[272] Each issuer, sponsor, or underwriter of the securities must furnish the NRSRO with a written representation that it will present the information on the website in a manner that designates which information can be relied upon in making creditworthiness assessments.[273] The issuer must also indicate that it will provide access to the password-protected website to any NRSRO meeting the above certification requirements.[274]

Provisions regarding types of conflicts that must be disclosed: Rule 17g-5(b) enumerates nine specific conflicts of interest which are prohibited unless they are disclosed.[275] A CRA must disclose when it has been paid by issuers, underwriters, or obligors to determine credit ratings of securities or money market instruments.[276] A CRA must also disclose whether it is being paid for additional services beyond normal credit rating determinations.[277] Payments to CRAs for subscriptions to access or receive credit ratings by persons who may use the ratings to comply with and obtain benefits or relief under statutes and regulations utilizing the term "nationally recognized statistical rating organization" must be disclosed.[278] The same is true where the persons purchasing the subscriptions may own investments or have entered into transactions that could be impacted by a specific CRA's credit rating.[279] Full conflict

270. *Id.* § 240.17g-5(a)(3)(ii)(A).
271. *Id.* § 240.17g-5(a)(3)(ii)(B).
272. *Id.* § 240.17g-5(a)(3)(iii).
273. *Id.* § 240.17g-5(a)(3)(i).
274. *Id.* § 240.17g-5(a)(3)(iii)(B)(1), (2).
275. *See id.* § 240.17g-5(b). The conflicts of interest must be disclosed "in Exhibit 6 to Form NRSRO in accordance with section 15E(1)(1)(B)(vi) of the Act . . . and § 240.17g-1." *Id.* § 240.17g-5(a)(1).
276. *Id.* § 240.17g-5(b)(1), (2).
277. *Id.* § 240.17g-5(b)(3).
278. *Id.* § 240.17g-5(b)(4).
279. *Id.* § 240.17g-5(b)(5).

disclosure is also required where a credit rating has been set forth for a security issued by an asset pool or as part of any ABS or MBS transaction which was paid for by the issuer, sponsor, or underwriter.[280]

Ownership of securities rated by an NRSRO by persons within the NRSRO is also prohibited unless disclosed.[281] Rule 17g-5 defines "person within an NRSRO" as "a nationally recognized statistical rating organization, its credit rating affiliates identified on Form NRSRO, and any partner, officer, director, branch manager, and employee of the [NRSRO] or its credit rating affiliates (or any person occupying a similar status or performing similar functions)."[282] These provisions target the close interpersonal relationships that can arise between NRSROs and issuers, which are a breeding ground for conflicts of interest. For example, direct ownership interests in issuers, obligors, and the securities themselves by persons within the NRSRO are a listed conflict of interest.[283] Further, relationships beyond an "arms length ordinary course of business relationship" between NRSRO employees and issuers subject to a credit rating by the NRSRO are conflicts.[284] A person associated with an NRSRO who is a broker or dealer in the business of underwriting securities must also disclose that fact.[285] A final catch-all provision is listed as the tenth enumerated conflict within this category, and requires disclosure of any other conflict of interest that is material to the NRSRO.[286]

Provisions regarding types of conflicts that are absolutely prohibited: While some NRSRO conflicts are permissible if disclosed, those listed under Rule 17g-5(c) are expressly prohibited.[287] An NRSRO cannot issue or maintain a credit rating that has been solicited by a person that has provided 10% (or greater) of the NRSRO's total net revenue in the most recently ended fiscal year.[288] This would prevent an issuer from being able to easily solicit favorable ratings for securities on

280. *Id.* § 240.17g-5(b)(9).
281. *Id.* § 240.17g-5(b)(6).
282. *Id.* § 240.17g-5(d).
283. *Id.* § 240.17g-5(b)(6).
284. *Id.* § 240.17g-5(b)(7). These conflicts have not been expressly prohibited due to the difficulty of defining the boundaries of relationships in the ordinary course of business. This is more of a case-by-case determination. Bai, *supra* note 241, at 274.
285. 17 C.F.R. § 240.17g-5(b)(8).
286. *Id.* § 240.17g-5(b)(10).
287. *Id.* § 240.17g-5(c).
288. *Id.* § 240.17g-5(c)(1).

the basis of generating a large portion of the NRSRO's total revenue. It is also prohibited to issue or maintain a credit rating to a person (excluding sovereign nations) where the NRSRO, including any analysts who participated in determining the rating or were responsible for approving it, directly owns securities or other interests in the person subject to the credit rating.[289] Ownership of a security can directly skew analysts' objectivity when making determinations that can favorably or adversely impact the security's value.[290] Further, issuing ratings where a credit analyst—or someone responsible for approving ratings—serves as an officer or director of the entity being rated is not permitted.[291] NRSROs are precluded from issuing ratings with respect to any person associated with the NRSRO[292] as the market derives little value from credit ratings issued by agencies having a direct affiliation with underwriters or issuers.

Where an NRSRO or a person associated with it has "made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security," the NRSRO may not issue or maintain a credit rating for that obligor or security.[293] This reflects belief by the SEC that an NRSRO cannot maintain an objective viewpoint when it essentially rates its own work.[294] Rule 17g-5(c) also forbids a rating from being issued where the same person is involved in both the credit rating determination process and the fee negotiation process within the NRSRO.[295] This is intended to keep the people who negotiate fees insulated from those who are directly involved in the rating process, to defeat the possibility of giving more favorable treatment to certain high-paying issuers.[296] Lastly, anyone within an NRSRO involved in the determination, monitoring, or approval of a credit rating is forbidden from receiving gifts exceeding $25.00,

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289. *Id.* § 240.17g-5(c)(2).

290. *See id.* Indeed, it is easy to see how ownership of a security would provide a financial incentive for inflating its credit rating.

291. *Id.* § 240.17g-5(c)(4).

292. *Id.* § 240.17g-5(c)(3).

293. *Id.* § 240.17g-5(c)(5).

294. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342, 74 Fed. Reg. 6,456, 6,465 (Feb. 9, 2009).

295. 17 C.F.R. § 240.17g-5(c)(6).

296. *See id.*

including entertainment, from the obligor, issuer, underwriter, or sponsor of the securities being rated.[297] The SEC intended here to target any potential undue influence arising from the exchange of gifts between issuers and rating agency analysts.[298]

Responses to Rule 17g-5: Throughout the process of creating Rule 17g-5, the SEC received several responses to its proposals, most generally supporting the disclosure requirements.[299] One commenter noted that these rules created a "level playing field" for the CRAs.[300] Another supporter believed that the heightened levels of disclosure would foster "true competition" in the industry.[301] Regarding the password protected internet website, one commenter stated that the requirements for NRSROs to maintain the website are not unduly burdensome on the agencies.[302] On the issue of whether the information on the NRSRO website would be sufficient to timely notify other NRSROs that the rating process has begun, one commenter suggested that the SEC requires non-hired NRSROs to be notified of new deals by e-mail, or that the Commission initiates a pilot project aimed at getting the information out to the non-hired NRSROs.[303] The Commission did not find this necessary, arguing that monitoring such a website would be simple and not overly time-consuming for non-hired NRSROs.[304]

Numerous comments also disfavored the Rule 17g-5 proposals. One commenter noted that these elevated disclosure requirements would impose heavy costs on small originators of structured debt instruments, causing them to abandon that market.[305] Another commenter stated that requiring such great disclosure creates an incentive for issuers to engage in ratings shopping, choosing the NRSRO that would demand the least amount of information in the rating process.[306] However, the SEC takes the view that its initiatives would remedy "ratings shopping by exposing

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297. *Id*.
298. Bai, *supra* note 241, at 276.
299. Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-61050, 74 Fed. Reg. 63,832, 63,843 (Dec. 4, 2009) [hereinafter Final NRSRO Rules].
300. *Id.* (quoting Riskmetrics Statement).
301. *Id.* (quoting Egan-Jones Statement).
302. *Id.* at 63,845 (quoting ABA Committee letter).
303. *Id.* (citing DBRS letter).
304. *Id*, at 63,846.
305. *Id.* at 63,843 (citing R&I letter).
306. *Id.* (citing Moody's letter).

an NRSRO that employed less conservative rating methodologies in order to gain business."[307] Further, the SEC proposals were believed to mitigate the potential effects of rating shopping, because non-hired NRSROs can nonetheless issue their own credit ratings.[308]

The SEC acknowledges that the nonpublic nature of certain information regarding structured finance products often results in a rating from only one or two NRSROs.[309] To combat this, Rule 17g-5 and its amendments are designed to make certain information more available to other NRSROs, which can provide a check on conflicts of interest and increase transparency.[310] By increasing the available credit ratings for a security, users are given more opinions on its creditworthiness.[311] Further, the SEC notes that "opening up the rating process to more NRSROs will make it easier for the hired NRSRO to resist [pressure from issuers] by increasing the likelihood that any steps taken to inappropriately favor the arranger could be exposed to the market through credit ratings issued by other NRSROs."[312]

IV. ACCOUNTABILITY OF CREDIT RATING AGENCIES

A. FREEDOM OF SPEECH AS A DEFENSE

1. Introduction

Can a complex credit rating for a structured debt instrument calculated using advanced algorithms and methodologies be likened to a restaurant review in a newspaper? How about an editorial column? The major CRAs seem to think so.[313]

Faced with lawsuits by disgruntled investors seeking redress, major CRAs employ the shield of the First Amendment to defend claims of responsibility for losses and fraud.[314] Standard & Poor's, Fitch, and Moody's each awarded the best possible ratings to billions of dollars of structured debt products that tanked along with the collapse of the

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307. *Id.* at 63,844.
308. *Id.*
309. *Id*. at 63,844.
310. *Id.*
311. *Id.*
312. *Id.*
313. Segal, *supra* note 4.
314. *Id.*

United States housing market.[315] Since the collapse, major CRAs have had to explain why the debt of companies like Lehman Brothers and A.I.G. were given "the Wall Street equivalent of gold stars" prior to the collapse of Lehman and the rescue of A.I.G.[316] The skepticism toward misappropriated ratings dates further back, like in 2001, when NRSROs came under fire for delaying their recognition of Enron's creditworthiness deterioration.[317] Investors were never given an early warning and by waiting to act until the company's bond value fell hard and fast, NRSROs failed to properly anticipate Enron's financial issues.[318]

The Supreme Court of the United States has yet to specifically address whether credit ratings are protected speech pursuant to the First Amendment.[319] However, the Court offered some insight on the First Amendment issue in the case of *Dun & Bradstreet, Inc. v. Greenmoss*.[320] In *Greenmoss*, a defamation suit was brought on the basis of a false credit report.[321] The central issue was whether the defamatory statements were a matter of public concern, which would raise the requisite standard of proof to actual malice.[322] For matters of public concern, a plaintiff in a defamation suit must prove the defendant's "knowledge of falsity or reckless disregard for the truth" in order to meet the actual malice standard.[323] The Court in *Greenmoss* looked to the "content, form, and context" of the speech at issue, holding that the report was not a matter of public concern, and would not receive constitutional speech protection.[324] The report was available to only five subscribers and targeted a limited audience, factors which more resembled private speech in the Court's view.[325] Thus, when ratings are considered public in nature, the "actual malice" standard will be applied against the CRAs.[326] Moody's has stated that stripping First Amendment protection

315. *Id.*
316. *Id.*
317. Covitz & Harrison, *supra* note 220, at 3.
318. *Id.* at 4.
319. Partnoy, *supra* 3, at 59,85.
320. 472 U.S. 749 (1985).
321. *Id.* at 751-52.
322. *Id.* at 751.
323. *Id.*
324. *Id.* at 761, 763.
325. *Dun & Bradstreet, Inc.*, 472 U.S. at 762.
326. *In re* Pan Am Corp., 161 B.R. 577, 583-84 (S.D.N.Y. 1993).

from CRAs would impose damage on the financial service markets, emphasizing that credit ratings are matters of public concern.[327] Some courts have deemed credit ratings matters of public concern on the based on the increasing role of corporate debt in the stability of financial markets.[328]

2. Rating Agencies' Arguments for Freedom of Speech Protection

NRSROs contend that just as a journalist's expression of his or her opinion is protected speech under the First Amendment, their credit ratings are also opinions entitled to the same protection.[329] They have likened themselves to newspapers, because they too serve the public by "formulat[ing] opinions about those issuers and securities and broadly disseminat[ing] those opinions, which are of concern to the public."[330] They say this to receive the highest free speech standard of actual malice, requiring proof that a defendant acted "with knowledge that the statement was false or with reckless disregard for whether it was false or not."[331] Floyd Abrams, a famous First Amendment lawyer hired to defend S&P, stated that "the major similarity here is that both the newspaper and S&P are offering opinions on matters that people can and do disagree about."[332] In defense of allegations of fraud and false misrepresentation against S&P, Abrams contends that the law protects forward-looking statements so long as the NRSRO truly believed its own ratings.[333] Again relying on the analogy to editorials, Abrams claims that you cannot sue economists or meteorologists making predictions for the future, therefore you should not be able to sue an NRSRO, "[e]ven if those ratings are wrong, or the company did a lousy job, you can't bring a lawsuit against someone for offering forward-looking predictions."[334]

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327. *In re* Nat'l Century Fin. Enters., Inc., 580 F. Supp. 2d 630, 639 (S.D. Ohio 2008).
328. *In re* Enron Corp., 511 F. Supp. 2d 742, 818-19 (S.D. Tex. 2005).
329. Segal, *supra* note 4.
330. *In re* Enron Corp., 511 F. Supp. 2d at 810.
331. New York Times Co. v. Sullivan, 376 U.S. 254, 280 (1964).
332. Segal, *supra* note 4.
333. *Id.*
334. *Id.*

Rating agencies have successfully argued that investor reliance on their credit ratings is unreasonable.[335] They have been insistent that ratings are "not a recommendation to buy, sell, or hold any [securities] and may be subject to revision or withdrawal at any time," a disclaimer which is often attached to ratings.[336] The reliance argument is essential to NRSROs' constitutional defense, because where speech proposes a commercial transaction, it is considered "commercial speech" and constitutional protections for this speech are narrowed.[337] In a 2009 letter to the SEC, famous First Amendment attorney Laurence Tribe distinguishes credit ratings from promotional advertising, stating that "NRSRO ratings, by contrast, are independent evaluations that do not propose any transaction."[338] Tribe cites *Lowe v. SEC*,[339] which held that "expression of opinion about a commercial product" is a matter of public concern, extending First Amendment protections to "opinions" about marketable securities.[340] Applying this precedent, he agrees that a registration statement and prospectus can be considered commercial speech, but argues that this does not extend to an NRSRO's opinion about a security.[341]

> A credit rating concerns an economic subject, of course. But it is not an advertisement that seeks to encourage investors to purchase an instrument; it merely provides information to investors to enable them to evaluate whether or not to engage in a transaction. Literally countless articles in publications such as the *Wall Street Journal* and *Bloomberg* serve an indistinguishable function by providing still other information to potential investors. Indeed . . . NRSROs consistently state in their ratings that their opinions have a limited role and are *not* recommendations to purchase, sell, or hold securities. In this respect, a credit rating is "closely analogous to a

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335. Quinn v. McGraw-Hill Cos., 168 F.3d 331, 336 (7th Cir. 1999).

336. *Id*. at 333.

337. Cent. Hudson Gas & Elec. Corp. v. Public Serv. Comm'n, 447 U.S. 557, 562-63 (1980); *see also* Bolger v. Youngs Drug Prods Corp., 463 U.S. 60, 66-67 (1983); Virginia State Bd. Of Pharm. v. Va. Citizens Consumer Council, Inc., 425 U.S. 748, 762 (1976).

338. Letter from Laurence Tribe and Thomas Goldstein, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n, (Dec. 14, 2009), *available at* http://www.sec.gov/comments/s7-24-09/s72409-13.pdf [hereinafter *Tribe Letter*].

339. Lowe v. SEC, 472 U.S. 181 (1985).

340. *Id.* at 210 n.58 (citing Bose Corp. v. Consumers Union of U.S. Inc., 466 U.S. 485, 513 (1984)).

341. *Tribe letter*, *supra* note 338, at 6.

> restaurant or performance review, or a *Consumer Reports* article, in the context of the [investment markets]."[342]

Tribe further argues that extending Section 11 liability to NRSROs would subject them to strict liability for their ratings, leaving only the defense that the NRSRO was not negligent.[343] He contends that this level of liability unfairly shifts the burden of proof to NRSROs, who must prove they acted with due care, rather than the plaintiff having to prove the defendant's "actual malice" in typical proceedings regarding matters of public concern.[344] Facing "crushing liability" to the investing community, Tribe argues that "NRSROs rationally would often make the choice simply not to speak, to the great detriment of the public markets."[345]

It is also argued that a change in NRSROs' business models would do nothing to remedy the First Amendment liability issue.[346] Despite the inherent conflicts of the issuer-pays model, it is unrealistic to expect that NRSROs will be able to generate significant revenue by reverting to a subscriber-pays model.[347] Laurence Tribe notes significant changes in technology—such as photocopying and the internet—as reasons for why the subscriber-pays model is not feasible: it has become easier for non-subscribers to "free ride" on the issued rating information.[348] Further, a small investor base paying for subscriptions to ratings could not

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342. *Id.* (citing Commodity Trend Serv., Inc. v. CFTC, 149 F.3d 679, 686 (7th Cir. 1998)).

343. *Id.* at 8.

344. *Id.* at 9 (citing Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 244 (1986) (stating that pursuant to the First Amendment, plaintiffs are required to prove that defendants acted with actual malice by clear and convincing evidence)).

345. *Id.* at 10. In his letter to the SEC, Laurence Tribe further argues that not only may NRSROs be reluctant to issue credit ratings, but they may also distort their own ratings in order to avoid lawsuits by disgruntled investors, resulting in a chilling effect on speech.

> At best, NRSROs would face perverse incentives either to artificially inflate the assessment of risks, fearing investor suits when rated investments lose value, or to artificially discount those risks, fearing suits by issuers pointing fingers of blame at those who did not issue ratings favorable enough to permit them to succeed in the market. . . . The upshot would be ratings distorted to an unpredictable degree and in an unpredictable direction. But the entirely predictable result would be to render capital markets less informed and less efficient.

Tribe letter, *supra* note 338, at 11.

346. *Id.* at 19.

347. *Id.*

348. *Id.*

adequately cover the depth of analyses necessary to formulate and publish credit ratings.[349] The seven registered NRSROs utilizing the issuer-pays model account for about 99% of the total outstanding credit ratings issued by all ten registered NRSROs.[350] Forcing NRSROs to adopt the subscriber-pays model would further violate the First Amendment, Tribe says, because a speaker is entitled to protection for the speech itself as well as *how* the message is delivered.[351]

3. Arguments Against Freedom of Speech Protection

In a 2002 Enron report, the SEC stated that "credit rating agencies seem to be trying to walk a fine line between maintaining their enormous market power through both official and unofficial uses of their ratings, and insisting their ratings are purely their 'opinion.'"[352] Rating agencies have had to defend their "opinions" against numerous claims including common law fraud, negligent misrepresentation, negligence, breach of fiduciary duty, breach of contract, unjust enrichment, and aiding and abetting.[353] But are they really "opinions"?

The actual malice standard, consistently applied to NRSROs in court, lacks any objective reasonable person standard.[354] Under the lesser negligence standard, a rating agency could face liability for not investigating when a reasonable person would have investigated.[355] As long as the actual malice standard is applied to NRSROs, they cannot be

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349. *Id.*

350. Sec. & Exch. Comm'n, Annual Report on Nationally Recognized Statistical Rating Organizations: As Required by Section 6 of the Credit Rating Agency Reform Act of 2006, 6 (Jan. 2011), *available at* http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf.

351. *Tribe letter*, *supra* note 338, at 20 (citing Schneider v. New Jersey, 308 U.S. 147, 163 (1939)).

> It would turn this core First Amendment principle on its head to justify the imposition of strict liability (or even negligence-based liability) for NRSRO ratings – which are currently available without cost to the public at large – with the observation that NRSROs could in theory avoid such liability by selling their ratings to the narrow class of investors who might afford their substantial cost.

Id. at 22.

352. *Watchdogs*, *supra* note 19, at 123.

353. Abu Dhabi Com. Bank v. Morgan Stanley & Co. Inc., 651 F. Supp. 2d 155, 163 (S.D.N.Y. 2009).

354. *In re* Enron Corp. Sec., 511 F. Supp. 2d 742, 811 (S.D. Tex. 2005).

355. *Id.*

held liable for negligent misrepresentation.[356] Negligent misrepresentation, a state-specific tort, requires that plaintiffs "justifiably rely on the false information when the agency supplies it for the guidance of others in their business transaction and fails to exercise reasonable competence in obtaining or communicating the information."[357] However, as long as courts seek to protect ratings' public function by accepting a First Amendment defense, credit ratings will continue to be treated as opinions.

Several problems exist with the "opinions" defense. The main difference between credit ratings and a newspaper editorial or a weather forecast is that CRAs are paid by the companies they rate and know their ratings are being relied upon by investors. A meteorologist has no financial stake in telling the public "It's going to be sunny."[358] Meanwhile, rating agencies "get paid by the people who need a prediction of clear skies, and the customers can always ask a different forecaster if they don't hear what they like."[359] Furthermore, there are numerous statutes requiring institutions to rely on ratings by law.[360] This underscores the commercial importance of the ratings and elevates them above a weather forecast.[361]

Regarding the issue of fraud, S&P defends that it was just as surprised as everyone else when its ratings "didn't pan out."[362] However, that defense is questionable at best. The rating agencies likely had an idea that they were helping sell packaged loans that sub-prime mortgagors simply could not repay. That model of residential mortgage-backed securities revolved around the notion that housing prices would continue to rise annually by double digit percentages. This was an unrealistic expectation that NRSROs could have seen coming. With the poor creditworthiness of sub-prime mortgagors, it would be hard to convince most investors to purchase RMBS securities packaged with sub-prime mortgages. But S&P and others likely knew the extent of their own influence, realizing that issuing a favorable rating was a "golden ticket" for enabling the banks to sell these bundled loans in the

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356. *Id.*
357. Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. 341, 353 (2006).
358. Segal, *supra* note 4.
359. *Id.*
360. *Id.*; *Watchdogs*, *supra* note 19, at 102.
361. Segal, *supra* note 4.
362. *Id.*

secondary market. Credit ratings became a self-fulfilling prophecy. NRSROs profited handsomely by issuing ratings as high as AAA for securities that realistically amounted to junk bonds.[363] Issuing misleading ratings should have crippled rating agencies' client base and reputation. However, due to the success of their tissue-thin First Amendment defense, they remain economically strong and poised to repeat history. As one blogger writes, continued protection from liability—including on First Amendment grounds—is quite fallacious:

> The notion that credit agencies should be immune to prosecution when they are clearly complicit in fraud by awarding investment grades to investments that they knew were not investment grade is as daft as the notion that a con artist should be immune to prosecution because the mark should [have] known that it was a con.[364]

4. *Abu Dhabi and Future Accountability for Ratings*

Decided in 2009, *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*[365] departed from the traditional application of the First Amendment to rating agencies.[366] In *Abu Dhabi*, a class of institutional investors sought to recover financial losses originating from the liquidation of notes that were issued by an SIV, or structured investment vehicle.[367] Among the defendants were CRAs, a bank, and a placement agency.[368] The notes at issue were given top-notch ratings: Moody's and S&P both rated them "AAA."[369] The ratings were disclosed by Morgan Stanley in a SIV Information Memoranda issued to potential investors.[370] The SIV collapsed in 2007 during the credit crisis, as it became apparent that the subprime mortgages securing the rated notes

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363. *See* Jeannette Neumann and Jean Eaglesham, *SEC Eyes Ratings From S&P Regulators Scrutinize 'Dummy' Assets in Investments Marked as Triple-A*, WALL ST. J., Sept. 27, 2011, at C1. For example, in January of 2008, Moody's downgraded the CDO Delphinus from triple-A to junk status, with S&P doing the same in February.

364. *Enablers of Fraud*, BADTUX THE SNARKY PENGUIN BLOG (Mar. 8, 2011), *available at* http://snarkypenguin.blogspot.com/2011/03/enablers-of-fraud.html.

365. Abu Dhabi Com. Bank v. Morgan Stanley & Co., Inc., 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

366. *Id.* at 175-76.

367. *Id.* at 163.

368. *Id.*

369. *Id.* at 165.

370. *Id.* at 165-66.

were of low quality and value.[371] Unable to repay the notes' senior debt when it was due, the SIV declared bankruptcy in August 2007.[372]

Plaintiffs' causes of action included common law fraud, negligent misrepresentation, negligence, breach of fiduciary duty, breach of contract, unjust enrichment, and aiding and abetting.[373] Predictably, the defendants filed a motion to dismiss for failure to state a claim upon which relief can be granted and for lack of subject matter jurisdiction.[374] The motion was granted in part and denied in part.[375] The importance of *Abu Dhabi* lies in U.S. District Judge Shira Scheindlin's denial of the motion to dismiss plaintiffs' claims against the CRAs and placement agency for fraud stemming from the SIV's credit rating.[376]

The defendant rating agencies contested that the misrepresentation claims were nonactionable due to the immunity of ratings pursuant to the First Amendment, and because the ratings were nonactionable opinions.[377] Rejecting this argument, the Court stated:

> It is well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an "actual malice" exception, from liability arising out of their issuance of ratings and reports because their ratings are considered matters of public concern. However, where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection. Here, plaintiffs have plainly alleged that the Cheyne SIV's ratings were never widely disseminated, but were provided instead in connection with a private placement to a select group of investors. Thus, the Rating Agencies' First Amendment argument is rejected.
>
> I also reject the argument that the Rating Agencies' ratings in this case are nonactionable opinions. "[A]n opinion may still be actionable if the speaker does not genuinely and reasonably believe it or if it is without basis in fact." For the reasons discussed below, plaintiffs have sufficiently pled that the Rating Agencies did not genuinely or reasonably believe that the ratings they assigned to the Rated Notes were accurate and had a basis in fact. As a result, the

371. *Id.* at 168.
372. *Id.*
373. *Id.*
374. *Id.* at 163-64.
375. *Id.* at 164.
376. *Id.* at 181.
377. *Id.* at 175.

> Rating Agencies' ratings were not mere opinions but rather actionable misrepresentations.[378]

The Court also rejected the defense that CRA disclaimers about the use of ratings should make the plaintiffs' misrepresentation claims nonactionable:

> For the same reasons, the disclaimers in the Information Memoranda that "[a] credit rating represents a Rating Agency's opinion regarding credit quality and is not a guarantee of performance or a recommendation to buy, sell or hold any securities," are unavailing and insufficient to protect the Rating Agencies from liability for promulgating misleading ratings. I conclude that plaintiffs have sufficiently alleged that the ratings issued by the Rating Agencies on the Rated Notes are actionable misstatements.[379]

The holding that the First Amendment applies only to statements by rating agencies issued to the general public[380] is a move in the right direction regarding increased liability for losses stemming from overrated securities. Where a statement is private or made to a select group of people, as in the ratings circulated to investors in *Abu Dhabi*, no such constitutional protection applies.[381] The court relies on *Dun & Bradstreet, Inc. v. Greenmoss*, noting that the ratings at issue were not a matter of public concern because they were only distributed to a limited group of investors.[382] Effects of *Abu Dhabi* will likely be felt in the structured finance arena because many RMBS and almost all CDOs are sold in private placements. The *Abu Dhabi* decision will have an expanding impact on liability in future fraud cases against CRAs.

If the First Amendment defense continues to hold up in court, the reputation of NRSROs is unlikely to be rehabilitated. Rather, the "opinion" defense will be perceived as a slick legal tactic, further exposing that rating agencies did not know much about what their own ratings meant.

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378. *Id.* at 175-76.
379. *Id.* at 176.
380. *Id.* at 175-76.
381. *Id.* at 175-76.
382. *Id.* at 176 n.120.

B. THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010

Congress issued a series of unprecedented regulations for CRAs with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[383] The Act seeks to increase transparency, impose guidelines for corporate governance, address conflicts of interest, and improve the ratings process overall.[384] It provides the SEC with greater power to oversee and enforce laws, and seeks to ease the ability of investors to bring civil suits against rating agencies.[385] Further, Dodd-Frank aims to reduce investor reliance on credit ratings by promoting use of broader criteria in evaluating credit quality.[386] The Act begins with a statement of its purpose:

> To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘‘too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.[387]

Under Section 931, titled "Improvements to the Regulation of Credit Rating Agencies," Congress identifies its findings regarding the role of CRAs:

> Because of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators, the activities and performances of credit rating agencies . . . are matters of national public interest, as credit rating agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy.
>
> Credit rating agencies . . . play a critical ‘‘gatekeeper’’ role in the debt market that is functionally similar to that of securities analysts,

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383. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

384. SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, THE DODD-FRANK ACT: COMMENTARY AND INSIGHTS 73 (2010), *available at* http://www.skadden.com/Cimages/sitefile/Skadden_Insights_Special_Edition_Dodd-Frank_Act1.pdf [hereinafter Dodd-Frank Commentary].

385. *Id.*

386. *Id.*

387. Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, § 931, 124 Stat. 1376.

> who evaluate the quality of securities in the equity market, and auditors, who review the financial statements of firms. Such role justifies a similar level of public oversight and accountability.
>
> Because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial ''gatekeepers'' do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers.
>
> In certain activities, particularly in advising arrangers of structured financial products on potential ratings of such products, credit rating agencies face conflicts of interest that need to be carefully monitored and that therefore should be addressed explicitly in legislation in order to give clearer authority to the Securities and Exchange Commission.
>
> In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.[388]

1. Corporate Governance and Conflicts of Interest

Pursuant to the Act, CRAs are required to establish and enforce internal controls governing the implementation of and adherence to their policies and procedures for determining credit ratings.[389] Annual internal controls reports shall be submitted to the Commission, which must describe the management's responsibility in maintaining the internal control structure and assess the effectiveness of the structures put in place.[390] In order to ensure the accuracy of ratings, the Act orders the Commission to set forth qualification standards for credit analysts to make certain that they meet the standards of training, experience, and competence necessary to produce accurate credit ratings.[391]

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388. *Id*. at 1872.
389. *Id.* § 932(a).
390. *Id.*
391. *Id.* § 936.

To avoid conflicts of interest, each NRSRO must maintain an independent board of directors, meaning that at least half (but not fewer than two) of the board members must be independent of the NRSRO.[392] The compensation for these independent board members cannot be linked to the NRSRO's business performance in order to ensure their independent judgment.[393] The Act further targets conflicts of interest by calling for the SEC to issue rules aimed at preventing sales and marketing considerations from influencing an NRSRO's production of credit ratings.[394] If the SEC finds (after a hearing) that an NRSRO has violated this rule, and the violation affected a rating, a credit rating agency could have its NRSRO status suspended or even revoked.[395] Additionally, rating agencies must retroactively address conflicts of interest by establishing policies targeted at ensuring that former NRSRO employees did not succumb to conflicts during their employment.[396] The agencies must conduct reviews to determine whether conflicts existed, and subsequently take necessary action to revise any rating improperly influenced by a former employee.[397]

How will the SEC administer these regulations and ensure their compliance? The Act calls for the creation of an Office of Credit Ratings, charged with promoting accuracy and preventing conflicts of interest.[398] The new Office of Credit Ratings is to be "staffed sufficiently to carry out fully the requirements of this section. The staff shall include persons with knowledge of and expertise in corporate, municipal, and structured debt finance."[399] The Office must conduct examinations of each NRSRO at least annually.[400] Annual reports are also to be made available to the public, detailing the Office's findings and subsequent responses by NRSROs to address "material regulatory deficiencies."[401] Congress further encourages the SEC to exercise its rulemaking authority in order to prevent conflicts of interest arising out of the provision of services to issuers unrelated to the actual issuance of credit

392. *Id.* § 932(a).
393. *Id*. at 1376.
394. *Id.* § 932(a).
395. *Id.*
396. *Id.* § 932(a)(4).
397. *Id.*
398. *Id*. at 1877.
399. *Id.*
400. *Id.*
401. *Id.*

ratings, such as consulting and advisory services.[402] Congress empowered the SEC with the ability to temporarily suspend or permanently revoke the NRSRO status of any NRSRO that "does not have adequate financial and managerial resources to consistently produce credit ratings with integrity."[403]

2. *Changes to the Credit Ratings Process*

The Dodd-Frank Act also addresses procedures and methodologies used by CRAs.[404] The Act charges the SEC with the task of issuing rules "for the protection of investors and in the public interest."[405] NRSROs are required to have their procedures and methodologies approved by their board.[406] Using a standardized form, rating agencies are required to publicly disclose certain information including their rating methodologies, the issuer's data used to calculate a rating, and underlying assumptions in order to increase transparency.[407] Additionally, issuers and underwriters of asset-backed securities shall disclose any findings from third-party due diligence reports the issuer has obtained.[408]

Congress also sought to increase transparency in the performance of credit ratings.[409] This is achieved by requiring public disclosure of information on initial ratings as well as subsequent changes to those ratings, allowing investors to evaluate an NRSRO's accuracy and also compare ratings performance among different NRSROs.[410] The Act also calls for NRSROs to consider credible and significant data from outside sources in calculating ratings, broadening the scope of ratings beyond issuer-provided data.[411]

Acknowledging the complexity of structured finance products, the Dodd-Frank Act tasks the SEC with conducting a study of the ratings process for structured products, conflicts of interest inherent in the

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402. *Id.* § 939H.
403. *Id*. at 1874.
404. *Id.* § 932(a)(8).
405. *Id.*
406. *Id.*
407. *Id.*
408. *Id.* at 1881.
409. *Id.* § 932(a)(8).
410. *Id.*
411. *Id.* § 935.

issuer-pay and subscriber-pay models, and other related issues.[412] No later than two years after the enactment of Dodd-Frank, the SEC is to submit its findings to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.[413] The SEC's report will also contain recommendations for changes necessary to implement the findings, whether regulatory or statutory.[414] Congress goes a step further by attempting to tackle "ratings shopping" in an unprecedented way, allowing the SEC to potentially change how a security's initial rating will be selected:

> After submission of the report under subsection (c), the Commission shall, by rule, as the Commission determines is necessary or appropriate in the public interest or for the protection of investors, establish a system for the assignment of [NRSROs] to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the [NRSRO] that will determine the initial credit ratings and monitor such credit ratings.[415]

3. *Increased Potential Liability*

As discussed earlier, one of the most significant laws concerning CRAs' liability was former Rule 436(g), which is formally repealed by the Dodd-Frank Act.[416] Section 939G of the Act reads "Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect."[417] This provision exposes CRAs to liability as experts under Section 11 of the Securities Act for consenting to the disclosure of their ratings in a registration statement.[418] It is likely that stripping 436(g) protection from rating agencies reflects the view of Congress that rating agencies act as experts and should face liability as such.

In Section 933, the Act applies the enforcement and penalty provisions of the Exchange Act onto rating agencies, allowing for civil

412. *Id.* § 939F(b).
413. *Id.* at 1889.
414. *Id.*
415. *Id.* § 939F(d).
416. *Id.* § 939G.
417. *Id.*
418. *Id.* at 1890.

suits against CRAs.[419] This effectively subjects rating agencies to the same penalty standards as public accountants and securities analysts.[420] Congress further exposes rating agencies to liability by altering certain culpability requirements for civil suits:

> The Act alters the pleading standards that were implemented by the Private Securities Litigation Reform Act of 1995 as applied to actions for money damages against rating agencies. Under the standards in place prior to the enactment of the Act, to survive a motion to dismiss a claim based on Rule 10b-5, a plaintiff had to allege facts giving rise to a "strong inference" that the defendant knowingly or recklessly made a material misstatement or omission. In the context of credit ratings, courts required plaintiffs to plead that the rating agency did not genuinely believe its opinions regarding credit quality or that the opinions lacked basis in fact. Plaintiffs were often unable to satisfy this pleading burden in actions against rating agencies. Under the Act, a pleading against a rating agency would satisfy the state-of-mind requirement if it alleges facts with particularity giving rise to a strong inference that the rating agency *knowingly* or *recklessly* "failed to conduct a reasonable investigation" of the factual elements relied upon in evaluating the credit risk of the rated security. The determination of what constitutes a "reasonable investigation" will be based on a court's consideration of the particular facts and circumstances.[421]

The Dodd-Frank Act also changes certain Exchange Act language to state that rating agencies must "file" their registration applications with the SEC, rather than "furnish" them, thereby subjecting agencies to Section 18 of the Exchange Act, which affords a civil remedy for misleading statements contained in certain documents filed with the SEC.[422]

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419. *Id.* § 933(a).

420. *Id.* Section 933(a) also notes that agencies' statements are not deemed forward-looking statements, excluding ratings from the certain safe harbor provisions of the Private Securities Litigation Reform Act of 1995:

> The enforcement and penalty provisions of this title shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws, and such statements shall not be deemed forward-looking statements for the purposes of section 21E.

Id.

421. Dodd-Frank Commentary, *supra* note 385, at 75 (emphasis added).

422. Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, § 932(a), 124 Stat. 1376, 1877 (2010).

Though the extent of rating agencies' future liability remains unclear, these provisions of Dodd-Frank at least recognize that NRSROs are part of our economic problem and must be held accountable for their statements. Congress has taken a step in the right direction by giving the SEC more power to regulate CRAs. By requiring additional disclosure to the public and removing NRSRO exemptions from expert liability, Congress is sending a message to the major CRAs: You are no longer untouchable, and should be liable for materially misleading or overstated credit ratings. How the Dodd-Frank Act will impact liability is largely contingent on the future success of rating agencies' First Amendment "opinion" defense. Congress has initiated the momentum and it is now up to the judicial system to follow through with heightened civil liability.

4. Reducing Reliance on Credit Ratings

The Dodd-Frank Act seeks to reduce reliance on credit ratings by removing certain statutory references to phrases like "investment grade," and encourages institutional investors to utilize their own due diligence to eliminate sole reliance on ratings.[423] For example, benchmark references to credit ratings are altered in the Federal Deposit Insurance Act, Federal Housing Enterprises Financial Safety and Soundness Act of 1932, Investment Company Act of 1940, and the Securities Exchange Act of 1934.[424] Many of the changes replace the phrase "rated investment grade" or "rated in one of the two highest rating categories by at least one NRSRO" with "meets standards of creditworthiness as established by the Commission," leaving an open-ended standard that relies less on ratings.[425] Additionally, Section 939A of the Dodd-Frank Act calls for each federal agency to review the regulations they issue and modify regulations making benchmark references to credit ratings by removing those references and substituting the standard of credit-worthiness that each agency determines is appropriate for such regulations.[426] The Act sets a firm timeline of one year after the enactment of Section 939A for agencies to

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423. *Id.* § 939, 939A.
424. *Id.* § 939.
425. *See id.*
426. *Id.* § 939A.

conduct such a review.[427] Lastly, the Act removes the exemption for CRAs from Regulation FD regarding information that has been provided to the agencies.[428]

5. The SEC's Implementation of Dodd-Frank Provisions

After the passage of Dodd-Frank, how has the Commission adjusted its staffing and funding to accommodate its new power? According to an internal review conducted over several months by Boston Consulting Group, the SEC has been too slow to adapt:

> The U.S. Securities and Exchange Commission is short some 400 employees needed for the regulator to manage its current workload, according to a draft of a four-month internal review by Boston Consulting Group obtained by Bloomberg News. The review, required by the Dodd-Frank Act, backs the claim by SEC officials that the agency is underfunded and understaffed as it includes in its oversight derivatives, credit rating companies and municipal bonds. The study said staffing levels had been on a downward trend since 2005. To address the manpower shortage, Boston Consulting reportedly recommended shifting managers to front-line or support staff roles. The consulting firm also reportedly suggested hiring temporary workers. However, because of the House Republican cuts on federal spending to 2008 levels, a major budget hike for SEC to hire more workers has small chances of being approved.[429]

Unfortunately, the lack of resources at the SEC undermines the congressional objectives laid out in the Dodd-Frank Act and minimizes its potential impact on holding agencies more accountable for their ratings.[430] However, once the SEC is better equipped to handle the ratings industry, it is certain that the sweeping changes laid out in Dodd-Frank will be a push in the right direction for dealing with rating agencies. In the meantime, it remains unclear how stringent the SEC and Congress will be in enforcing Dodd-Frank provisions, but it is apparent that change needs to be made. Congress has laid the regulatory

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427. *Id*. at 1887.
428. *Id.* § 939B.
429. Robert Schmidt & Jesse Hamilton, *SEC 'Capacity Gap' Risks Oversight Lapses as Regulator's Targets Multiply*, BLOOMBERG (Mar. 7, 2011 12:00 AM), http://www.bloomberg.com/news/2011-03-07/sec-capacity-gap-risks-oversight-lapses-as-regulator-s-targets-multiply.html.
430. *Id.*

framework with the Dodd-Frank Act, and it is now up to the SEC to exercise its muscle to increase CRAs' transparency, accountability, and liability.

C. THE EUROPEAN APPROACH TO CREDIT RATING AGENCY REGULATION

Similar to the United States, Europe is facing the daunting task of regulating CRAs, but employing a different approach.[431] While the United States has enacted stringent corporate governance rules which seek to ensure full disclosure, the European Union ("EU") has instead opted to issue codes of ethics for its public companies.[432] Such public companies have the option of abiding by the code of ethics or disclosing the reasons why they have chosen to avoid compliance.[433] Further, US regulations target disclosure differently than EU regulations:

> By imposing corporate governance rules, the United States intends to regulate disclosure on the ''source,'' thus assuring that information is accurate. On the other side, by proposing codes of ethics under the disclose or explain rule, the European Union does not address the accuracy of the information itself, but widens the array of issues which have to be disclosed.[434]

The US issues sanctions for non-fulfillment of certain provisions by the operation of law.[435] The EU approach does not incorporate the law until a company decides to neither comply nor explain its non-compliance.[436]

EU rulemaking in this area involves a two-tiered approach: the "Winter Report" is the code of ethics at the EU level, while several codes/regulations are also implemented at the national level.[437] The Winter Report encompasses a variety of issues including capital formation, types of enterprises, and rules for investor protection and

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431. Miguel Lamo de Espinosa Abarca, *The Need for Substantive Regulation on Investor Protection and Corporate Governance in Europe: Does Europe Need a Sarbanes-Oxley?*, 19 J. INT'L BANKING L. REG. 419, 422 (2004).

432. *Id.*

433. *Id.*

434. *Id.*

435. *Id.*

436. *Id.*

437. *Id.*

corporate governance.[438] The report regards disclosure obligations as a paramount concern, under the assumption that increased disclosure protects market transparency.[439] Thus, its focus is "enhancing corporate governance disclosure requirements for listed companies."[440] The Winter Report acknowledges that disclosure is an area where self-regulation has been deficient.[441] The following recommendations are included in the Winter Report:

> A descriptive statement of corporate governance structure must be included in the annual accounts of the corporation. The statement should make reference to a particular national code on corporate governance (to be adopted by each Member State) and should specify the extent to which deviations exist. The Board of Directors will be responsible for any non-accuracies of such statement.
>
> Additional disclosure obligations on corporate governance (to be developed by each Member State) are established. Among others, information on corporate governance rules, remuneration of directors, compensation schemes, independence of directors and their qualifications should be disclosed. Additional disclosure obligations on corporate websites are also proposed.
>
> The role of independent directors in the board (as well as in audit, nomination, and remuneration committees) is revisited. The Winter Report recommends a minimum standard for independent board representation of 30 per cent (such a level is recommended to be higher than 50 per cent when there are dispersed shareholders).
>
> Additional rules on voting information and access to shareholder meetings are proposed. Responsibilities of institutional investors are revisited, mainly as regards their obligation to disclose investment policies and the exercise of voting rights.[442]

1. European Securities and Markets Authority

Effective January 1, 2011, the creation of a new regulatory body titled the European Securities and Markets Authority ("ESMA") is the

438. *Id.*
439. *Id.*
440. *Id.*
441. *Id.*
442. *Id.*

European Commission's most recent major financial reform.[443] The ESMA is part of a larger reform package that also includes formation of the European Banking Authority and the European Insurance and Occupational Pensions Authority.[444] Also created was a regulatory agency to monitor possible threats to the financial system, titled the European Systemic Risk Board ("ESRB").[445]

With these new agencies, the EU seeks to prevent future financial breakdowns like the most recent crisis. The European Parliament has given the ESMA the necessary power to effect change by designating the ESMA to take over the Committee of European Securities Regulators ("CESR"), and by requiring EU Member States to adopt legislative changes by December 31, 2011.[446] With an eye on efficiency, the EU Commission has integrated a review clause into the ESMA Regulation, which will require submitting reports every three years to address issues such as whether it is necessary to divide supervision into segmented agencies (banking, insurance, occupational pensions, securities and financial markets), whether it is beneficial to have each authority based in the same city, and whether it is necessary to delegate additional supervisory powers.[447]

Perhaps most striking about the ESMA is the unprecedented scope of its power, encompassing both lawmaking and supervisory roles. The ESMA's influence will be apparent in the financial markets from top to bottom. At the legislative stage, the ESMA can "develop drafts of binding regulat[ions] and implement[] technical standards . . . ."[448] At the enforcement stage, it can "adopt a binding decision addressed *directly* to a financial institution requiring it to take the necessary action . . . ."[449] Market participants are also offered a consultation process by the ESMA.[450] In the case of emergencies, the EU has empowered the ESMA to order that necessary actions be taken by individual EU Member States, subject to the Council's ultimate approval.[451] Beyond

443. Fischer-Appelt, *supra* note 6, at 21.
444. *Id.*
445. *Id.*
446. *Id.*
447. *Id.*
448. *Id.* at 21.
449. *Id.* at 21-22 (emphasis added).
450. *Id.* at 21.
451. *Id.* at 22.

the aforementioned powers, the ESMA can also mediate among national powers:

> ESMA will be able to impose legally binding mediation in cases of disagreements between national supervisors, and, if no agreement can be reached, within the relevant college of supervisors. Where a competent authority does not comply with ESMA's decision, ESMA may in certain cases directly impose supervisory decisions on the financial institution concerned. ESMA will also be able to intervene as a mediator at its own discretion.[452]

a. ESMA and Credit Rating Agencies

The latest changes in the regulation of CRAs provide the ESMA with significant oversight over the affairs of agencies all over the EU. By July 2011, the ESMA was in direct supervision of CRAs.[453] Known as "dawn raids," the ESMA can "conduct unannounced checks . . . at the premises of a CRA, impose fines and [ ] ensure that agencies evaluate the accuracy of their past ratings."[454] The element of surprise is likely to instill a sense of urgency into CRAs and cause them to remedy any potential doubts regarding the accuracy of their ratings. By July 2014, all CRAs must be checked by the ESMA.[455] It has the right to impose fines proportionate to the type of infringement and surrounding circumstances.[456] In addition to monetary sanctions, "ESMA will also have a number of other supervisory powers in cases of breach of the CRA Regulation, ranging from the temporary prohibition of issuing credit ratings to the withdrawal of the registration altogether."[457]

If that much power was to be given to a governmental agency in the United States, it could have a lasting impact on the accuracy of credit ratings. It remains unclear whether the Dodd Frank Act's creation of the Office of Credit Ratings will have the potential to effectuate change as it appears the ESMA does. Either way, we are on the right track in creating an independent agency to specifically address credit rating agency concerns.

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452. *Id.*
453. *Id*. at 23.
454. *Id.*
455. *Id.*
456. *Id.*
457. *Id.*

V. CONCLUSION

As Massachusetts Attorney General Martha Coakley correctly pointed out:

> The Dodd-Frank Act itself notes, in the findings of Section 931 (emphasis supplied):
>
> (4) Because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial 'gatekeepers' do, the activities of credit rating agencies are fundamentally commercial in character and *should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers,*
>
> (5) In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and Investors, which in turn adversely impacted the health of the economy in the United States and around the world. *Such inaccuracy necessitates increased accountability on the part of the credit rating agencies*.[458]

The SEC in its no-action letter response to Ford Motor Credit,[459] permitted the CRAs to bully not only the SEC, but to flout Congress, and the will of the people of the United States. In short, the CRAs said, if you will not play by the rules we want, we will take our ball and go home. What the CRAs want is simple. They want to have their cake and eat it too. They are, after all, above the law. They practically have no liability for their ratings.[460] According to them, their ratings are mere opinions, like Zagat's star ratings for a restaurant.[461] They have recruited

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458. *See Coakley Letter*, *supra* note 26.

459. Response from Katherine Hsu, Senior Counsel, Office of Chief Counsel Division of Corporation Finance, Sec. & Exch. Comm'n, http://www.sec.gov/divisions /corpfin/cf-noaction/2010/ford072210-1120.htm (last updated Nov. 23, 2010).

460. While former Rule 436(g) was in effect, rating agencies were legally exempt from liability. Now that it has been repealed, there are still numerous obstacles in the way of assigning liability to credit rating agencies, notably their successful First Amendment defense.

461. However, Zagat surveys are not paid for by the restaurants reviewed, whereas the CRAs are paid by the corporations whose securities they rate.

> Zagat Survey content is based on the collective opinions of a worldwide network of surveyors. The survey process begins with a local food expert who is hired to compile

among the most famous and revered First Amendment scholars to successfully defend their position.[462]

Recent history has shown that investors have relied on the CRA ratings to their detriment (hence, "below investment grade" in the title of this Article). Not only have they so relied, they (or their investment managers) have in many cases been *forced* to rely on CRA ratings when governing statutes or regulations require them to invest in "investment grade" securities.[463] "Investment grade" is a "benediction" that is conferred by the CRAs only.[464]

Keep in mind that Section 11(b)(3)(b) of the Securities Act does not create strict liability for experts, nor does it create liability for negligence for experts. To meet their due diligence defense, which is what auditors and other experts routinely do, CRA experts must merely prove that "as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, *after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, ...*"[465] In other words, they must act responsibly, knowing that investors will rely on their expert opinion. In 1933, the House Report concerning Section 11 of the Securities Act liability "throws upon originators of securities a duty of competence as well as innocence which the history of recent

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> a list of restaurants. Once the restaurants have been compiled and a survey is created for a specific location, the public is [notified] . . . Once the official voting drive is over reports are created that contain numerical ratings (for Food, Décor, Service and Cost) of the restaurants on the survey in several categories along with voter comments . . . Zagat Survey calls every establishment on the survey and fact checks information. **Establishments cannot pay to be included on a survey;** likewise Zagat Survey cannot guarantee that every restaurant on a survey will be included in the guide. All survey participants are eligible for a reward as a "thank you" for their input. A complimentary copy of the guide once it is published or a free subscription to ZAGAT.com is our way of thanking our loyal surveyors.

How the Zagat Survey Works, ZAGAT, http://www.zagatsmartbox.com/how-the-zagat-survey-works/ (last visited June 14, 2011) (emphasis added).

462. Segal, *supra* note 4.

463. *Watchdogs, supra* note 19, at 102.

464. *Credit Rating Agencies-NRSROs*, SEC (May 12, 2011), *available at* http://www.sec.gov/answers/nrsro.htm.

465. Securities Act of 1933, 15 U.S.C. § 77k(b)(3)(B) (2010) (emphasis added).

spectacular failures overwhelmingly justifies."[466] "Plus ca change, plus c'est la meme chose."[467]

Items 1103(a)(9) and 1120 of Regulation AB require disclosure of whether an issuance or sale of any class of offered asset-backed securities is conditioned on the assignment of a rating by one or more rating agencies. If so conditioned, those items require disclosure about the minimum credit rating that must be assigned and the identity of each rating agency. Item 1120 also requires a description of any arrangements to have such ratings monitored while the asset-backed securities are outstanding. With the abolition of Rule 436(g) and the imposition of Section 11 liability, perhaps the CRAs will do what most people thought they did—act competently and carefully. The world of asset-backed securities is complex, indeed too complex for the average investment advisor or manager to comprehend, never mind the average investor.[468] This means that investors are essentially increasingly forced to rely on CRAs as the information concerning these investments is simply too difficult to understand.

We believe that the CRAs should have expert liability under Section 11. This may mean that the markets will essentially flee the registration route, that is, the public offering route, altogether, as Section 11 applies only to registered offerings. Ultimately, the CRAs should be held accountable to market participants who justifiably rely upon their expertise. One suggestion is that there be created some formal, periodic assessment of how accurate the CRAs were in their ratings. In other words, somebody should rate the CRAs themselves, *i.e.*, rate the raters.

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466. LOUIS LOSS & JOEL SELIGMAN, 9 SECURITIES REGULATION 4267 (3d ed. 2004) (quoting H.R. REP. No. 85, 73d Cong., 1st Sess. 9 (1933)).

467. The more things change the more they are the same.

468. *See generally* Steven L Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211 (2009).