2014

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COMPETITION POLICY INTERNATIONAL

CPI Antitrust Chronicle
January 2014 (2)

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I. INTRODUCTION

In a 2007 memorandum, Raymond McDaniel, the Chairman and CEO of Moody's Corp., described competition among credit-rating agencies in a way that should give antitrust lawyers pause:

> Ideally, competition would be primarily on the basis of ratings quality, with a second component of price and a third component of service. . . . The real problem is not that the market . . . underweights ratings quality but rather that, in some sectors, it actually penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating. Unchecked, competition on this basis can place the entire financial system at risk. It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution.[2]

The basic claim here—that there are fundamental problems with competition in the credit-rating business if we care about ratings accuracy—is supported by financial research. Bo Becker and Todd Milbourn have provided evidence that the entry of Fitch as a third credit-rating agency in the market actually led to less accurate ratings.[3] More specifically, increases in Fitch's market share were associated with decreases in rating quality, including both higher ratings and less correlation between ratings and actual bond yields.

Of course, this is a failure of competition only if we view the goal of competition as producing accurate ratings. If the goal of competition among credit-rating agencies is to make them serve the needs of their customers, competition appears to be working. The customers who pay for ratings are the issuers of securities and, as McDaniel describes above, those issuers want higher ratings, not more accurate ratings.

II. VIEWING THE CREDIT-RATING AGENCY MARKET THROUGH AN ANTITRUST LENS

My purpose in this essay is to suggest that the mismatch between competition and ratings accuracy is less surprising if we view the credit-rating agency market through a different lens than is typically used. My suggestion begins from the underlying structure of the credit-rating market. Although issuers pay agencies for ratings, the underlying transaction that motivates the production of ratings is the sale of securities by issuers to purchasers. In that transaction, the

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[1] Professor of Law, Fordham University School of Law. I benefited from helpful comments by Harry First, Richard Squire, and Chris Sagers, none of whom should be taken to agree with the views expressed here.

[2] Memorandum from Raymond McDaniel to Raymond McDaniel, Oct. 21, 2007, *available at* http://oversight-archive.waxman.house.gov/documents/20081022111050.pdf.

[3] Bo Becker& Todd Milbourn, *Reputation and competition: evidence from the credit-rating industry*, Harv. Bus. Sch. Working Paper, 09-051 (Feb. 12, 2009).

credit-rating agencies stand between the sellers and buyers as information intermediaries.[4] This structure resembles that of other intermediary arrangements, like financial auditing or certifications like those of Underwriters Laboratories, and it shares at least some of the characteristics of two-sided markets. However, there is no accepted antitrust analysis either for information intermediaries or, despite a burgeoning economic literature, for two-sided markets.[5]

Nevertheless, this sort of market structure, involving a seller of a good, an intermediate provider of information about that good, and buyers, is present in another context that is a frequent subject of antitrust scrutiny: vertical distribution restraints. There are of course differences in the two contexts, but there are also significant similarities, which makes looking at credit-rating agencies as part of a vertical distribution system a worthwhile exercise.

A. Structural Similarities with RPM and Other Distribution Restraints

The typical dealer in a vertical distribution case does not, of course, provide *only* information. It typically delivers the actual products that are the subject of the information as well. But we can separate the two functions and consider them individually. Some of a dealer's margin serves to compensate it for its actual distribution services (the cost of maintaining inventory, delivery personnel, etc.), some perhaps for service costs, and some for promotional, or informational, services. In securities markets, the distribution services are performed by underwriters or banks, which also perform some of the promotional services. But the credit-rating agencies' services can be viewed as promotional, too, just as we view the informational services of dealers in typical product distribution chains.

The arguments about why credit-rating agencies may provide too-favorable ratings generally focus on the payment structure in the credit-rating agency market. Most credit-rating agencies, and all of the three dominant ones, are paid for their services by the issuers of the products they are rating. In that, too, they resemble dealers in production distribution chains. Those dealers are sometimes compensated directly by the producers of the products they sell, but even when they are not, the justification for resale-price maintenance ("RPM") and other distribution restraints imposed by producers is that those restraints provide dealers with sufficient margins to promote the manufacturers' products. That is, the distribution restraints are a means of compensating dealers for promotional services.

One final difference in the two markets is that RPM and other vertical restraints are often specifically included in the contract between the producer and dealer, making the application of Sherman Act § 1 straightforward. With credit-rating agencies, there is no comparable contractual "restraint of trade" beyond the payment from the issuer to the credit-rating agency. That may make § 1 inapplicable, but the point here is not so much to suggest a legal treatment for credit-rating agencies as to suggest an analogy to help understand the market.

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[4] An excellent review of credit-rating agencies, focusing specifically on this intermediary function, is Thomas J. Fitzpatrick, IV & Chris Sagers, *Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations*, 61 ADMIN. L. REV. 557 (2009).

[5] *Cf.* Pola Karolczyk, *Product Certification – the next big standard-setting debate*, Kluwer Competition Law Blog (Mar. 14, 2013) *available at* http://kluwercompetitionlawblog.com/2013/03/14/product-certification-the-next-big-standard-setting-debate/.

The effects of RPM, of course, need not be imposed through an agreement, either. Those effects are often produced unilaterally, avoiding § 1 as permitted by *United States v. Colgate Co.*,[6] through announcements of the pricing policy and subsequent unilateral refusals to sell to dealers that do not follow it. Somewhat similarly, securities issuers sometimes engage in "rating shopping" by going from one credit-rating agency to another until the desired rating is obtained.[7] The key point is that the incentives in both contexts are similar, so the analogy may provide some useful insight into both arrangements.

B. Do Similar Structures Imply Similar Anticompetitive Harm?

One might object that even if the structures of the two markets are similar, the potential anticompetitive harms are not. The harm of RPM is generally viewed as higher prices, but for credit-rating agencies the harm is inaccurate ratings. The harm of RPM is not high prices in some absolute sense, though, but high prices in comparison to the value received or, equivalently, services of lower quality than the prices justify.

Similarly, inaccurate credit ratings are low-quality products that do not justify the prices that investors pay for them, indirectly, though securities prices. In either case, harm can be caused by the provision of inaccurate information, and, in either case, the reason is that the seller, whether the producer of a good or the issuer of a security, may be more interested in selling than informing.

One of the more thorough expositions of this issue in the distribution context has been presented by Warren Grimes, who describes how providing dealers with a high margin can induce them to provide misleading information to consumers in order to induce sales. His summary could equally well be applied to credit-rating agencies, substituting "security" for "brand," "issuer" for "producer," and "credit-rating agency" for "dealer":

> [B]rand promotion can be anticompetitive if it leads a consumer to make less competitive choices than the purchaser would otherwise make. . . .
>
> . . . Consumers can grasp the self-interest that motivates producer brand promotion. In dealer brand promotion, self-interest can be hidden--consumers may be unaware that a dealer benefits by selling one brand over another. Moreover, although both producers and dealers may occasionally dispense inaccurate information, dealer promotion abuses are often more difficult to monitor and control.[8]

If we accept the fundamental similarity of these two markets, what are the implications for antitrust treatment of credit-rating agencies? It is currently unclear what antitrust approach, if any, should apply to credit-rating agencies.[9] Although it is unlikely that we would apply the law of distribution restraints, even if we could bring credit-rating agency arrangements under § 1—

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[6] 250 U.S. 300 (1919).

[7] *See* Rosa M. Abrantes-Metz, *Is There Misdiagnosis in the Market for Credit Ratings*? 11(2) CPI ANTITRUST CHRON., (Nov. 2013).

[8] Warren S. Grimes, *Spiff, Polish, and Consumer Demand Quality: Vertical Price Restraints Revisited*, 80 CAL. L. REV. 815, 818 (1992).

[9] *See* Nicolas Petit & Norman Neyrinck, *Credit Rating Agencies and Competition Law*, 8(2) CPI ANTITRUST CHRON., (Aug. 2011).

perhaps by viewing the contractual payment by issuers to credit-rating agencies as sufficient to establish a contractual restraint of trade—it is still worth considering the application of distribution law, simply as a thought experiment.

C. Using Leegin to Assess Credit-rating Agencies

As suggested above, the payment arrangements for credit-rating agencies would seem to make RPM, rather than nonprice restraints, the closer distribution analogy. In the Supreme Court's latest word on RPM, *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*,[10] the Court set out several pro-competitive justifications for RPM and several market characteristics that could give rise to concern.

The pro-competitive justifications center on free-riding. The idea, as is well known, is that dealers will not provide services or promotional efforts if other dealers can undercut their prices, making it impossible to profit from the provision of the services and promotion. However, this justification is not present with credit-rating agencies because they receive payment directly from issuers, not from sales of the securities. In the same way, courts in distribution cases have held that the free-riding rationale does not apply where dealers are paid directly by producers for their services.[11]

With respect to what the *Leegin* Court called "economic dangers," the Court listed three factors that could create concern: (i) the number of producers using the challenged practice, (ii) whether the practice originated with dealers rather than the producer, and (iii) whether the producer or dealer had market power.

1. Overall Market Coverage

To determine whether the practice is widespread in the market, we need to consider what "the practice" is. The most likely candidate seems to be the issuer-pays model,[12] and that model constitutes almost 100 percent of the market. Thus, to the extent that the current model injures purchasers of securities, they will find it difficult to avoid it. Although there are a few subscriber-pays credit-rating agencies, the dominance of Moody's, S&P, and Fitch is generally accepted, and they all use the issuer-pays model. This *Leegin* factor thus provides reason for concern.

2. Source of Practice

Furthermore, the switch from a subscriber-pays model to an issuer-pays one in the 1970s was arguably prompted by the credit-rating agencies, which *Leegin* suggests should raise concerns. But the reason usually offered for the change is the improvement in photocopying technology that allowed a rating report, upon being issued to a paying subscriber, to be copied for other potential subscribers. In other words, the goal was not to exploit the credit-rating agencies' power, which was the concern of *Leegin*, but simply to ensure compensation for rating services. Therefore, this factor does not seem significant here.

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[10] 551 U.S. 877 (2007)

[11] *See* Toys "R" Us, Inc. v. Federal Trade Commission, 221 F.3d 928 (7th Cir. 2000); General Leaseways, Inc. v. National Truck Leasing Association, 744 F.28 588 (7th Cir. 1984).

[12] Rating shopping would be another possibility, but even if no shopping occurred in a particular instance, the threat of such shopping would likely be present, at least unless there are issuers that have a reputation for never engaging in it.

3. Market Power

The question of the market power of the dealers and producers—or credit-rating agencies and issuers—is the most interesting one. The "big three" credit-rating agencies collectively have approximately a 95 percent market share, and the share of the two larger ones, Moody's and S&P, is about 80 percent. These shares are even more significant because an issuer will often obtain ratings from two agencies. Although there is no formal obstacle to an issuer using one of the smaller agencies,[13] including a subscriber-pays agency, the share of the big three appears not to be eroding, even as the number of smaller agencies has increased.

Turning to consider the power of issuers, the securities market is probably one of the least concentrated markets in existence. There are thousands of securities, and they all provide the same thing, financial returns, so there is in one sense little product differentiation. In another sense, though, the issuance of some forms of securities may actually be quite concentrated. Rosa Abrantes-Metz has argued in this journal that "[t]he structured finance market is characterized by a few large financial institutions who issue these securities and who have the market power to possibly influence credit-rating agencies to at least adopt more liberal analytics—if not outright compromise them."[14] The power she is suggesting is not, however, power over purchasers of securities but power over credit-rating agencies. *Leegin*, in contrast, was referring to power over the ultimate buyers, because without power over them, the ability of the producer and the intermediate dealer to exploit those buyers would be limited.

The power, if any, of a securities issuer or a credit-rating agency over securities purchasers does not likely originate in market share of the security or the agency. Instead, the likely source of power for securities issuers is the difficulty for potential purchasers of evaluating the quality of the security or its rating. It is this difficulty of evaluating securities that has created the demand for credit-rating agencies, but the evaluation of ratings quality poses the same problems as does the evaluation of the securities themselves. As Becker and Milbourn say, "[t]he quality of individual ratings is hard to assess for the investors and regulators who rely on them."[15] And if buyers cannot assess the quality of the goods they are buying, sellers may be able to price them supracompetitively, *i.e.*, exercise market power.[16]

Although this may not be the sort of market power that the *Leegin* Court had in mind (though notably it did not refer to market share), it is exactly the sort of power that could cause competitive problems in this context. Market power, after all, turns on the ability and incentives of competitors to prevent anticompetitive conduct. Credit-rating agencies have not had a history of pointing out flaws in their competitors' ratings and, even if they did, it is not clear that

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[13] *But see* OECD, Competition and Credit Rating Agencies 6, DAF/COMP(2010)29, Oct. 5, 2010, http://www.oecd.org/regreform/sectors/46825342.pdf (describing the credit-rating agency market, somewhat implausibly, as a natural oligopoly).

[14] Abrantes-Metz, *supra* note 7.

[15] Becker & Milbourn, *supra* note 3, at 1.

[16] If buyers are aware of this problem, then perhaps they will discount all quality ratings, and the sellers of high-quality products will not be able to charge the price that their products are worth. *See* George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). Indeed, one of Akerlof's examples is credit markets. The "lemons problem" has not, however, eliminated securities markets.

consumers would be able to judge between the competing claims, given their lack of knowledge about rating methodologies.

Competing issuers are also unlikely to effectively counter inaccurate information about another issuer's security, for at least two reasons. First, they may face the same informational problems as do potential purchasers, in that they are not likely to have access to private financial information about their competitor. Second, the competing issuers best positioned to assess securities are those offering similar securities and, to the extent that any creditworthiness problems arise not from issuer-specific information but from systematic issues, the competing issuers' pricing would suffer from emphasis on that information as well. Indeed, this problem is greater here than in most, though not all,[17] product markets, because producers of other sorts of products will often be quite willing to point out flaws in the products of their competitors.

The upshot, then, is that the market for credit-rating agencies, viewed by analogy to vertical distribution restraints, appears to present the competitive dangers *Leegin* saw in such restraints without offering the usual competitive benefits. That is not to say, of course, that those dangers cannot be overcome. Reputation effects and repeated purchases in reliance on ratings surely provide some constraints. But as the quotation from Raymond McDaniel at the beginning of this piece shows, these constraints may be very attenuated, or may even exacerbate the problem. Not all consumers, and maybe not even the majority of consumers, in this market have the goal of receiving high-quality information. That is true for distribution restraints as well as for the credit-rating market, but only the latter has societal implications important enough to have created widespread calls for a remedy.

III. CONCLUSION

It is not clear, though, what remedies would solve this problem, at least through antitrust law. In the credit-rating context, in contrast to typical distribution restraints, it may not be feasible to prohibit the "restraint," even if the restraint is accepted to be the issuer-pays model.

And, as described above, it is not clear that greater competition among credit-rating agencies would lessen the problem, just as it is not clear that a greater number of dealers would provide more beneficial promotional services in the usual distribution context. The fundamental problem is that when information affects purchasing decisions, sellers will always have incentives to distort the information purchasers receive, and it may often be possible to persuade information intermediaries to go along.[18]

Fortunately, the goal of this essay has not been to solve these problems but simply to highlight them by analogy to a familiar antitrust issue. The informational aspects of the credit-rating market are not fully captured by looking only at the transaction in which the services of the rating agencies are purchased by issuers. The same is true for other similar markets, yet many

[17] *Cf.* Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451, 474 (1992) ("Even if competitors had the relevant information, it is not clear that their interests would be advanced by providing such information to consumers.").

[18] For a somewhat polemical view of this danger, *see* Mark R. Patterson, *On the Impossibility of Information Intermediaries*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=276968 (July 2001).

cases involving information products, like the recent Bazaarvoice merger challenge,[19] focus only on that one side of the market.

Instead, it is important when assessing information intermediaries to consider the overall structure of the markets in which information is provided for the ultimate user of the information. It is important also to recognize that we might not find it satisfactory for those who pay for information to receive the information they want, when society would benefit from more accurate or useful information. In the end, information presents particular problems for competition, and antitrust law needs to develop new analytical techniques for these problems.

[19] The Department of Justice recent successfully challenged the merger of two providers of online "ratings and reviews platforms." The case focused almost exclusively on the market in which the two companies provide their platforms to commercial websites, *see* Memorandum Opinion, United States v. Bazaarvoice, Inc., No. 13-cv-00133 (filed Jan. 8, 2014), and said little about whether there might be effects on the information provided to consumers. Just as with credit-rating agencies, one wonders if there might be incentives for the platform providers to provide products that benefit their website customers at the expense of consumers. (For example, eBay used to make it difficult to read negative reviews on its website.) And one wonders, as with credit-rating agencies, whether those incentives would be greater or less with more competition among the platform providers. *Cf.* Complaint, United States v. Bazaarvoice, Inc., No. 13-cv-00133-WHO (filed Jan. 10, 2013), at ¶¶ 50-54 ("Bazaaarvoice and PowerReviews engaged in 'feature driven one-upmanship,' which drove both firms to innovate and develop new PRR platform features.").