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Rating the Raters: Restoring Confidence and Accountability in Credit Rating Agencies

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RATING THE RATERS: RESTORING CONFIDENCE AND ACCOUNTABILITY IN CREDIT RATING AGENCIES

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The recent financial crisis has caused long-term damage and lasting effects to the global financial system. Credit rating agencies contributed to the boom by giving their highest ratings to poorly understood new financial instruments. During this time, they lacked accountability or oversight, and they suffered from intense conflicts of interest. The U.S. and E.U. have recently enhanced regulatory power in this area, but they should explore additional options at both the international and national level, including adopting an international advisory board or creating public rating agencies.

"From 2000 to 2007, Moody's rated 45,000 mortgage securities as AAA. In the beginning of [2010], there were six U.S. companies with that rating. In 2006, it gave its stamp of approval to some 30 such securities each and every working day. The results were disastrous. None of what happened was an act of God. The greatest tragedy would be to accept the idea that no one could have seen this crisis coming and thus, nothing could have been done. If we accept this notion, it will happen again."[1]

"Everything was investment grade. It didn't really matter."[2]

"[N]obody gives a straight answer about anything around here . . . . [H]ow about we come out with new [rating criteria] and actually have clear cut parameters on what the hell we are supposed to do."[3]

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1 Phil Angelides, Chairman, Fin. Crisis Inquiry Comm'n, Press Event on the Release of the Final Report of the Fin. Crisis Inquiry Comm'n 4–5 (Jan. 27, 2010), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-news/2011-01-27-FCIC-Press-Conference-Transcript.pdf.

2 *Hearing on Wall Street and the Financial Crisis: The Role of Credit Rating Agencies Before the Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs*, 111th Cong. Ex.1b (2010).

3 *Id.* at Ex.1c.

I. INTRODUCTION

These are tumultuous times for global financial markets. In 2007 and 2008, severe financial disruptions nearly collapsed the global economy and caused a worldwide crisis. In the wake of the crisis, millions of individuals found themselves unemployed, and trillions of dollars of wealth had evaporated.[4] Many believe that the crisis was avoidable and was caused by widespread failures in financial regulation.[5] Thus, policymakers and regulators worldwide now confront the formidable challenge of restoring confidence in markets and formulating long-term responses to the crisis.

The past few years bore witness to countless reports and studies that sought to identify and analyze potential sources of the crisis.[6] Most conclude that, in part, credit rating agencies (CRAs) played a role in and exacerbated the crisis.[7] Studies focus primarily on the ratings that CRAs assigned to the many of the exotic financial instruments at the heart of the recent crisis: asset-backed securities, collateralized debt obligations, credit

4 *See* FINANCIAL CRISIS INQUIRY COMMISSION, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xv–xvi (2011) [hereinafter FCIC REPORT] (noting that in the U.S., the effects included the unemployment of twenty-six million Americans and the loss of $11 trillion of household wealth).

5 *Id.* at xvii.

6 *See, e.g.*, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (2011) [hereinafter WALL STREET REPORT]; FCIC REPORT, *supra* note 4.

7 *See* FCIC REPORT, *supra* note 4, at xxv (concluding that CRAs were "essential cogs in the wheel of financial destruction" whose ratings "help[ed] the market soar" and later "wreaked havoc across markets and firms."). "So matters stood in 2007, when the machine that had been humming so smoothly and so lucratively slipped a gear, and then another, and another—and then seized up entirely." *Id.* at 212.

default swaps, and structured investment vehicles.[8] While investments with the highest ratings (AAA or Aaa) have traditionally defaulted at only a 1% rate, these complex, novel instruments—many of which enjoyed AAA or Aaa ratings before the crisis—defaulted or lost value at an alarming rate.[9] The result was "a loss of investor confidence in the value of the AAA rating, in the holdings of major U.S. financial institutions, and even in the viability of U.S. financial markets."[10]

The vast majority of ratings worldwide come from the three largest CRAs: Moody's Corporation, Standard & Poor's (S&P), and Fitch Ratings (collectively, the "Big Three").[11] These three companies have, for some time, dominated the credit rating industry.[12] Thus, the Big Three are at the center of the inquiry into CRA regulation and are the focus of this Note. Part II highlights some recurring criticisms leveled against the CRAs in recent years, especially against the Big Three. Part III reviews domestic and foreign approaches to CRA oversight in the wake of the recent crisis. Part IV presents alternative regulatory structures that could help restore worldwide confidence and accountability in CRAs.

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8 An asset-backed security is a "financial security backed by a loan, lease or receivable[] against assets other than real estate and mortgage-backed securities." *Asset-Backed Security-ABS*, INVESTOPEDIA, http://www.investopedia.com/terms/a/asset-backedsecurity.asp (last visited Mar. 20, 2012). A collateralized debt obligation is a "security backed by a pool of bonds, loans and other assets." *Collateralized Debt Obligation*, INVESTOPEDIA, http://www.investopedia.com/terms/c/cdo.asp (last visited Mar. 20, 2012). A credit default swap is "a swap designed to transfer the credit exposure of fixed income products between parties." *Credit Default Swap,* INVESTOPEDIA, http://www.investopedia.com/terms/c/credit defaultswap.asp (last visited Mar. 20, 2012). A structured investment vehicle is "a pool of investment assets that attempts to profit from credit spreads between short-term debt and long-term structured finance products. . . ." *Structured Investment Vehicle*, INVESTOPEDIA, http://www.investopedia.com/terms/s/structured-investment-vehicle.asp (last visited Mar. 20, 2012).

9 WALL STREET REPORT, *supra* note 6, at 243.

10 *Id.*

11 *See* HOWARD DAVIES & DAVID GREEN, GLOBAL FINANCIAL REGULATION: THE ESSENTIAL GUIDE 68 (2008).

12 *Id.* Although CRAs play a central role in today's economy, they come from relatively humble beginnings. The use of credit ratings for market securities began in 1909 when John Moody first published *Moody's Analysis of Railroad Investments* to rate railroad stocks and bonds. *Moody's History: A Century of Market Leadership*, MOODY'S CORP., http://v3.moodys.com/Pages/atc00 1.aspx (last visited Mar. 20, 2012). John Fitch founded the Fitch Publishing Company in 1913, and Poor's Publishing rated its first corporate bond in 1922. *See About Us of Fitch Ratings*, FITCH GROUP, http://www.fitchratings.com/web/en/dynamic/about-us/about-us.jsp (last visited Feb. 10, 2012); *see also A History of Standard & Poor's*, STANDARD & POOR'S, http://www.standardandpoors.com/about-sp/timeline/en/us/ (last visited Mar. 20, 2012).

II. THE CURRENT SYSTEM'S FLAWS

Academics, politicians, and others have repeatedly criticized CRAs, especially the Big Three, in the wake of the recent financial crisis. Their complaints generally relate to (1) the intense conflicts of interest that pervade the industry-standard "issuer-pays" model used by CRAs; (2) the lack of accountability that CRAs face regarding rating errors and the market turmoil that they create; and (3) the immense power that CRAs wield as a result of the deep connection between their work and banking, real estate, and insurance laws. This Section examines these problems.

A. *The "Issuer-Pays" Model*

Historically, CRAs operated under a "subscriber-pays" model, earning their revenues from paid subscribers.[13] When a CRA rated a bond or a company, the CRA would not freely publish the credit rating that it assigned to the investment.[14] Rather, investors paid a monthly fee to gain access to lists of credit ratings of major companies and important bonds.[15]

By the 1970s, however, CRAs (including the Big Three) experienced revenue shortfalls and began searching for alternative sources of revenue.[16] They determined that they could substantially increase profits by shifting to an "issuer-pays" compensation model, which has now become an industry standard.[17] Under the issuer-pays model, companies—not paid subscribers—themselves seek ratings and pay for the CRA services.[18]

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13 *See* Carol Ann Frost, *Credit Rating Agencies in Capital Markets: A Review of Research Evidence on Selected Criticisms of the Agencies*, 22 J. ACCT., AUDITING, & FIN. 469, 478 (2007) (stating that the paid subscription model was employed until the 1970s).

14 *See id.* at 478–79.

15 *See id.* at 479.

16 *See id.* at 478–79 (concluding that another factor affecting the shift away from the subscription fee model was the advent of low-cost copy machines that enabled groups of subscribers to free-ride the system with a single subscription).

17 *See id.* at 479 (noting that the principal credit agencies began the trend towards the "issuer-pays "model).

18 *See id.* (briefly describing the model and exploring related conflict of interest issues). Today, the Big Three adhere to the issuer-pays model, and there are only a few subscriber-based companies, such as the Egan-Jones Rating Co. and Rapid Ratings International. These companies currently play a very minor role in the market. *See* EGAN-JONES RATING CO., http://www.egan-jones.com/ (last visited Mar. 20, 2012); *About Us*, RAPID RATINGS INTERNATIONAL, http://www.rapidratings.com (last visited Mar. 20, 2012). Despite their minor role, the 2008 financial crisis sharpened interest in these enterprises. *Reforming Credit Rating Agencies: Hearing Before H. Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises*, 111th Cong. 76 (2009) (statement of James H. Gellert, Chairman and CEO, Rapid Ratings International, Inc.), *available at* http://financialservices.house.gov/media/file/hearings/111/82.pdf.

Supporters of the issuer-pays model contend that the Big Three have implemented adequate measures to prevent or eliminate conflicts of interest.[19] They also argue that the issuer-pays model increases the public's access to information and ultimately lowers investment costs.[20] Nonetheless, it is widely believed that the issuer-pays system creates unacceptable conflicts of interest in the rating industry.

Detractors contend that CRAs fail to operate objectively because the issuer-pays system provides incentives for them to attract clients by offering high—but often inaccurate—ratings.[21] A Senate report notes that former Moody's and S&P employees have stated that before the crisis, "gaining market share, increasing revenues, and pleasing investment bankers . . . assumed a higher priority than issuing accurate [] credit ratings."[22] Indeed, at that time relationships with issuers and investment banks took on a higher priority than high quality research.[23] Internal e-mails suggest that managers at the Big Three were willing to adjust rating criteria to enhance their market share.[24] Likewise, a 2010 U.S. Senate investigation confirmed that investment banks hired from the ranks of former CRA employees based on those individuals' knowledge of how to structure deals to secure the highest credit ratings.[25]

Another conflict of interest arises when a CRA not only rates a client's credit, but also provides additional ancillary consulting services.[26] These ancillary services typically include, among other things, services such as scoring models, systems support, and empirical data reports.[27]

[19] *See* WALL STREET REPORT, *supra* note 6, at 273 (stating that CRAs assured Congress of their ability to manage conflicts of interest, although market pressures undermined the process and quality of credit ratings).

[20] Roopa Kudva, *Issuer-Pays Model Ensures Ratings are Available to the Entire Market*, ECON. TIMES (INDIA) (Oct. 22, 2010), *available at* http://articles.economictimes.indiatimes.com/2010-05-06/news/27585572_1_rating-agencies-downgrades-issuer.

[21] WALL STREET REPORT, *supra* note 6, at 272.

[22] *Id.* at 273.

[23] *Id.* at 274.

[24] *Hearing on Wall Street and the Financial Crisis*, *supra* note 2, Ex.1b.

[25] *See* Rich Blake, *Sleeping with the Enemy – Rating Agency Conflicts Surface*, ABCNEWS (Apr. 27, 2010), http://abcnews.go.com/Business/ratings-agencies-chiefly-sp-moodys-fitch-fire-bed/story?id=10481484. Unfortunately, this is a longstanding practice. Clifford L. Alexander, the former chairman of Moody's, spent 19 years on the board of MCI Communications Corp. and later WorldCom, resigning a mere six months prior to the latter's historic bankruptcy scandal. *See* Alec Klein, *Moody's Board Members Have Ties to Clients*, WASH. POST, Nov. 22, 2004, at A09, *available at* http://www.washingtonpost.com/wp-dyn/articles/A3057-2004Nov21.html.

[26] *See* Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 70 (Robert E. Litan & Yasuyuki Fuchita eds., 2006).

[27] *Id.*

Admittedly, the CRAs' consulting services are miniscule compared with their credit rating lines of business.[28] However, it is questionable whether a CRA can be an unbiased, objective observer under these circumstances.

B. Little Accountability for Error

Another complaint about the Big Three is that the justice system does not hold them accountable when they issue erroneous ratings, even when they downgrade a company shortly before it declares bankruptcy.

Suits against CRAs regarding erroneous ratings have typically failed at the earliest stages of litigation.[29] Plaintiffs see their suits dismissed because, among other things, CRAs enjoy extensive First Amendment free-speech protection for those ratings that are freely distributed and widely available to the public.[30] The result is an "actual malice" standard that few plaintiffs can prove before discovery.[31] Courts tend to apply this standard when the defendant CRA failed to issue a downgrade until shortly before the client's bankruptcy, as illustrated by the bankruptcies of Orange County, CA and the now-defunct Enron Corporation.[32]

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[28] *See, e.g.*, Moody's Corp., Annual Report (Form 10-K) (Mar. 1, 2010). In 2009, Moody's received 71% of its revenues ($413.6 million) from issuer subscriptions to its "Research, Data, and Analytics" line of business, which provides credit ratings, industry studies, and economic commentary. *Id.* In comparison, it received only about 25% ($145.1 million) from selling risk management software and about 4% ($20.8 million) from professional services such as personnel training. *Id.* Although the 71% number has declined from previous years, credit ratings consistently are the largest portion of the firm's revenues. *Id.*

[29] *See, e.g.*, County of Orange v. McGraw Hill Co., 245 B.R. 151 (C.D. Cal. 1999); *In re* Enron Corp. Sec., 511 F. Supp. 2d 742 (S.D. Tex. 2005).

[30] *See Approaches to Improving Credit Rating Agency Regulation: Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing*, 111th Cong. 4–6 (2009) (statement of Eugene Volokh, Gary T. Schwartz Professor of Law, Univ. of Cal. Los Angeles), *available at* www.house.gov/apps/list/hearing/financialsvcs_dem/volokh.pdf (noting that in addition to the fact that ratings are "issues of public concern" because they are widely available free of charge, ratings are not "commercial advertising," a designation given to business statements made for profit). The other major source of protection is the Securities Act of 1933, which bars suit against CRAs unless there is a showing of fraud. The statute does not provide similar protection to underwriters and accountants. *See* Jonathan S. Sack & Stephen M. Juris, *Rating Agencies: Civil Liability Past and Future*, 238 N.Y.L.J., no. 88, Nov. 5, 2007 at 2, *available at* http://www.maglaw.com/publications/data/00144/_res/id=sa_File1/07011070002Morvillo.pdf (citing 17 C.F.R. § 230.436(g)(1) (2007)). Lastly, CRAs can typically find refuge in industry standards and in plaintiffs' difficulty pleading causation. *See* Larry P. Ellsworth & Keith V. Porapaiboon, *Credit Rating Agencies in the Spotlight: A New Casualty of the Mortgage Meltdown*, 18 BUS. L. TODAY, no. 4, Mar.–Apr. 2009 at 35, *available at* http://www.jenner.com/system/assets/publications/1926/original/BLT_MA09_ellsworth.pdf?1314984199.

[31] Ellsworth & Porapaiboon, *supra* note 30; New York Times v. Sullivan, 276 U.S. 254 (1964).

[32] *McGraw Hill*, 245 B.R. at 153–54; *Enron*, 511 F. Supp. 2d at 810–11.

In 1994, Orange County lost $500 million from poorly performing bonds and subsequently declared bankruptcy.[33] The county filed a $2 billion suit against S&P regarding two groups of bonds, claiming that S&P failed to accurately assess the bonds' quality.[34] The court held that because the ratings were "matters of public concern," Orange County must show that S&P maliciously published the ratings.[35] Orange County could not do so, and the court granted summary judgment to S&P.[36] Similarly, in the wake of the 2001 Enron bankruptcy scandal, a Texas court applied the same free-speech protection to the Big Three's faulty credit ratings of that company.[37] The court held that the ratings were matters of public concern and were not published with actual malice, dismissing all charges against the CRAs.[38]

Congress enacted the Sarbanes-Oxley Act shortly after the Enron scandal.[39] While the Sarbanes-Oxley Act dramatically enhanced corporate accountability and insider trading laws, it did not significantly address the role of rating agencies in corporate scandals.[40] CRAs emerged relatively unscathed.

Recent court decisions, however, indicate that the CRAs' free-speech protections might be eroding.[41] Pension funds have filed many class action suits against CRAs since 2008, alleging that CRAs misrepresent the safety of bonds and then quickly downgrade them to below investment-

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33 *McGraw Hill*, 245 B.R. at 155.

34 *See id.* at 153–54 (claiming breach of contract and professional negligence by S&P). To be precise, Orange County actually sued McGraw Hill, the parent company of S&P. This Note refers to the company as "S&P" for consistency.

35 *Id.* at 155.

36 *Id.* Interestingly, for the second issuance of bonds, S&P settled the case for a mere $140,000 without admitting wrongdoing. The $140,000 figure was a small fraction of the total settlement that Orange County obtained from other financial companies that played other roles in the bankruptcy. *See* Michael B. Marois & William Selway, *Merrill Vies for Orange County Job a Decade After Bankruptcy*, BLOOMBERG (Apr. 20, 2005), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ataoEpOgwlRg (noting that other firms settled their liability in the case for a total of over $860 million, including a $400 million settlement by Merrill Lynch).

37 *Enron*, 511 F. Supp. 2d at 743.

38 *Id.* at 833–36.

39 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

40 *See* Brian Kim, *Sarbanes-Oxley Act*, 40 HARV. J. ON LEGIS. 235 (2003) (discussing the increased scrutiny placed on corporate management and the eventual passage of the Sarbanes-Oxley Act following the Enron bankruptcy).

41 *See* Claire A. Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. PITT. L. REV. 585, n.34 (2010) (describing recent suits brought by pension funds against the major CRAs for ratings errors).

grade status.[42] Many of these cases are still in their infancy, but unlike *Orange County* and *Enron*, courts have been hesitant to dismiss them before trial.

In a recent case against S&P and Moody's, a federal court held that the First Amendment does not protect CRAs' ratings of structured investment vehicles.[43] The court noted that the ratings provided to structured investment vehicles were not publicly circulated, but rather that S&P and Moody's only provided them to a select group of investors.[44] Similarly, a court refused to dismiss an ongoing $6 billion suit by the California Public Employees' Retirement System for the same reason.[45] While that case has not yet reached the trial stage, it appears likely that the plaintiffs will succeed on a negligence claim.[46]

C. *Connection Between Credit Ratings and Laws*

A final concern is the connection between credit ratings and substantive law, such as securities, banking, real estate, and insurance law.[47] Incorporating credit ratings into the law distinguishes between safe and unsafe investments, but it also conveys enormous power to existing CRAs, especially the Big Three.[48]

In 1975, the SEC introduced the concept of the Nationally Recognized Statistical Rating Organization (NRSRO) and mandated that any CRA referenced in a law must have the SEC's NRSRO blessing.[49]

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42 *See id.* (noting that one judge rejected the CRAs' traditional First Amendment free speech argument because the ratings were provided to a select group of institutional investors rather than the public at large).

43 Abu Dhabi Commercial Bank v. Morgan Stanley, 651 F. Supp. 2d. 155 (S.D.N.Y. 2009).

44 *Id.*

45 *See* Alison Frankel, *No Free-Speech Protection for Rating Agencies…Again: CA Judge*, REUTERS (Jan. 13, 2012), http://blogs.reuters.com/alison-frankel/2012/01/13/no-free-speech-protection-for-rating-agencies-again-ca-judge/ (discussing the defendants' second failure to dismiss the case on free-speech grounds).

46 *See id.*

47 Partnoy, *supra* note 26, at 82.

48 *See* Kathleen L. Casey, Comm'r, U.S. Sec. and Exch. Comm'n, Remarks at The SEC Speaks in 2009: *In Search of Transparency, Accountability, and Competition: The Regulation of Credit Rating Agencies* (Feb. 6, 2009), *available at* http://www.sec.gov/news/speech/2009/spch020609klc.htm (addressing the unintended consequences of the regulatory use of ratings. Commissioner Casey describes the NRSRO requirement as "a valuable franchise for the large rating agencies [that] . . . innoculat[es] them from market competition.").

49 *See* Partnoy, *supra* note 26, at 64 (noting that the first NRSRO requirement was for the calculation of net capital requirements for broker-dealers).

Private institutions quickly followed suit and adopted NRSRO standards in their own contracts.[50]

The SEC issued no-action letters to applicant CRAs applying for NRSRO status on a case-by-case system until 2006, when the agency standardized the process.[51] That treatment created an oligopoly situation with high barriers to entry for small and new CRAs, which were unable to acquire NRSRO status because of a "Catch-22" in the NRSRO application process: a CRA needed to provide "generally accepted" ratings to become an NRSRO, but few bond-issuing companies would actually do business with CRAs that were not NRSROs.[52] Thus, the system centralized power in the largest CRAs, including the Big Three, and pushed small and new CRAs out of the industry.

III. RECENT DEVELOPMENTS

During the past decade, and especially following the recent financial crisis, policymakers worldwide have become cognizant of the issues described above and have imposed a variety of regulations upon CRAs. An examination of these oversight and accountability measures follows.

A. IOSCO's Voluntary Compliance Regime

The International Organization of Securities Commissions (IOSCO) sets standards for international securities markets and is the primary forum for the world's securities agencies.[53] IOSCO has broad jurisdiction and authority, and its members account for more than 95% of the world's securities markets.[54]

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50 RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 103 (Viral V. Acharya & Matthew Richardson eds., 2009).

51 *See The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing Before S. Comm. on Banking, Housing & Urban Affairs*, 110th Cong. (2007) (statement of Christopher Cox, Chairman, Securities and Exchange Commission) [hereinafter *Role and Impact of Credit Rating Agencies*], *available at* http://www.sec.gov/news/testimony/2007/ts092607cc.htm (describing the "no-action letter" process as one in which the SEC would review information and documents to determine "whether the [CRA] had achieved broad market acceptance for its ratings").

52 *See* Casey, *supra* note 48 (imploring the SEC to remove regulatory requirements in SEC rules as a means to eliminate overreliance on NRSRO ratings); *see also* Mark A. Calabria, *Did Deregulation Cause the Financial Crisis*, 31 CATO POL'Y REP. 7–8 (2009) (describing the unintended consequences of NRSRO registration requirements).

53 *IOSCO Historical Background*, IOSCO, http://www.iosco.org/about/index.cfm?section=background (last visited Mar. 20, 2012).

54 *Id.*

In 2003, IOSCO issued the Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO Code).[55] The IOSCO Code laid the groundwork for each jurisdiction to implement its own regulatory system, and its broad rules encourage widespread adoption by the CRAs' many member jurisdictions.[56] For example, the IOSCO Code does not require CRAs to adhere to a particular formula or methodology for their ratings, nor does it provide for a mechanism to sanction.[57] Instead, IOSCO left those decisions to the policymakers in its various member jurisdictions.

Framing the IOSCO Code broadly ensured wide adoption by CRAs.[58] Many rating agencies have adopted some or all of the IOSCO Code; the Big Three have adopted "substantial" portions.[59]

B. Regulation in the U.S.

Currently, two laws regulate CRAs in the U.S.: the Credit Rating Agency Reform Act of 2006 ("CRA Act"), which marked the first official regulation of CRAs in the U.S., and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[60]

The CRA Act defined the term "NRSRO" and standardized the NRSRO application process.[61] It also granted the SEC authority over CRA

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[55] Technical Comm., Int'l Org. of Sec. Comm'ns [IOSCO], *Code of Conduct Fundamentals for Credit Rating Agencies*, IOSCO Doc. No. IOSCOPD180 (2004) [hereinafter *IOSCO Code*], *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf (addressing three topics: (1) the quality and integrity of the rating process; (2) conflicts of interest; and (3) CRA responsibilities to the investing public and issuers). For background material regarding the IOSCO Code, see IOSCO, *Statement of Principles Regarding the Activities of Credit Rating Agencies*, IOSCO Doc. No. IOSCOPD151 (2003), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf (proposing four high-level objectives to address regarding CRAs: (1) the integrity of the rating process; (2) conflicts of interests; (3) transparency; and (4) confidential information).

[56] *See* External Credit Rating & Assessment Inst., *Regulation: IOSCO Code of Conduct*, ECRAI, http://www.ecrai.eu/en/regulation/iosco_code_of_conduct.php (last visited Mar. 20, 2012) (outlining the history and purposes furthered by the IOSCO Code); *IOSCO Code*, *supra* note 55.

[57] External Credit Rating & Assessment Inst., *supra* note 56.

[58] *See* IOSCO, *A Review of Implementation of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies*, at 5, IOSCO Doc. No. IOSCOPD 286 (2009), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD286.pdf ("Because the IOSCO CRA Code was designed for use by all CRAs, of all sizes and business models and operating under a variety of legal systems, this review is not limited to just the largest CRAs.").

[59] *Id.* at 6.

[60] Credit Rating Agency Reform Act of 2006, Pub. L. No. 109–291, 120 Stat. 1327 (2006) (codified at 15 U.S.C. § 78o–7 (2006)); Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) [hereinafter *Dodd-Frank Act*].

[61] Registration of Nationally Recognized Statistical Rating Organizations, Pub. L. No. 109–291, § 4(a), 120 Stat. 1329 (2006) (codified at 15 U.S.C. § 78o-7 (2006)) (amending the Securities Exchange Act of 1934 to include various disclosure requirements for NRSRO

recordkeeping requirements and reporting. As in the IOSCO Code, the SEC's new authority was limited to examinations, as the CRA Act explicitly restricted the SEC from overseeing the "substance . . . or the procedures and methodologies" of credit ratings.[62] Most CRAs supported the passage of the CRA Act because this limitation was present.[63]

The passage of the Dodd-Frank Act marked a sweeping change to financial law in the U.S.[64] It subjects CRAs to substantial new authority from the SEC's new "Office of Credit Ratings," which can fine noncompliant CRAs.[65] The Dodd-Frank Act also enables investors to sue CRAs for errors in ratings, and it forces CRAs to publish their history of correct and incorrect ratings.[66] It also enhances disclosure requirements regarding methodologies and track record of incorrect ratings.[67] Lastly, the Dodd-Frank Act addresses conflicts of interest for compliance officers and NRSRO board members, addresses the ties between ratings and laws, and enables the SEC to deregister NRSROs that frequently provide incorrect ratings.[68]

One notable feature about the Dodd-Frank Act is that it does not propose a government clearinghouse to randomly assign work to the various CRAs.[69] The Franken Amendment, drafted by Minnesota Senator Al

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applications, as well as requiring that all NRSRO application be made public by the applicant CRA); *id.* at § 2(4) (finding that oversight of CRAs "serves the compelling interest of investor protection").

62 *Id.* at 1332; *see also Role and Impact of Credit Rating Agencies*, *supra* note 51.

63 *See* FRANK PARTNOY, RETHINKING REGULATION OF CREDIT RATING AGENCIES: AN INSTITUTIONAL INVESTOR PERSPECTIVE 6 (2009), *available at* http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf (noting that the major CRAs approved of the CRA Act because it was so narrowly tailored).

64 *See generally Dodd-Frank Act*; SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP & AFFILIATES, THE DODD-FRANK ACT: COMMENTARY AND INSIGHTS (2010) (outlining the major highlights of the Dodd-Frank Act, including oversight and systemic risk, financial institutions, capital markets, corporate governance and compensation, and consumer issues). At the signing of the Dodd-Frank Act, President Obama stated that Congress overcame "the furious lobbying of an array of powerful interest groups." Pres. Barack Obama, Remarks by the President at Signing of Frank-Dodd Wall Street Reform and Consumer Protection Act (July 21, 2010), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act.

65 *Dodd-Frank Act* § 931-67; *see also* U.S. Sen. Comm. on Banking, Housing & Urban Affairs, *Dodd-Frank Wall Street Reform: Conference Summary*, http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (last visited Feb. 13, 2012) (providing a concise summary of the Dodd-Frank Act).

66 *Dodd-Frank Act* § 932.

67 *Id.*

68 *Id.*

69 John Hunt, *Senate Passes Tough Rating-Agency Amendments*, CREDIT RATING AGENCY LAW BLOG (May 13, 2010), http://ratingagencylawblog.wordpress.com/2010/05/13/franken-and-lemieux-amendments/.

Franken, presented this concern and proposed a randomized system intended to prevent companies from "shopping around" for favorable ratings.[70] However, the Senate referred the issue to an SEC study that could take several years to finish.[71] Based upon the intensely negative public reaction by the CRAs to the Franken Amendment, many speculate that rating-agency lobbyists had a hand in this decision.[72] Aside from this speculation, however, many observers believe that the passage of the Dodd-Frank Act is a bold, successful new step that will restore confidence in the financial system and in CRAs.[73]

The CRA and Dodd-Frank Acts have prompted significant changes in the ratings industry. In particular, the SEC's new ability to fine noncompliant CRAs will likely enhance adherence to SEC regulations.

C. Regulation in Europe

Until September 2009, CRAs operating in the E.U. did not report to any formal authority other than the voluntary IOSCO compliance regime.[74] At that time, the European Parliament adopted the Regulation on Credit Rating Agencies (E.U. Regulation), significantly surpassing IOSCO's voluntary baseline requirements.[75]

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70 *See* David M. Herszenhorn, *House-Senate Talks Drop New Rules for Credit Raters*, N.Y. TIMES, June 15, 2010, *available at* http://www.nytimes.com/2010/06/16/business/16regulate.html.

71 *See id.* (remarking that conference negotiations between the House and Senate removed the randomization requirement to study the conflict-of-interest issue).

72 *See* Ben Hallman, *Credit Rating Agencies Most Worried About Liability*, IWATCH NEWS (June 16, 2010), http://www.iwatchnews.org/2010/06/16/2645/credit-rating-agencies-most-worried-about-liability ("The industry is dominated by Moody's Corp., Standard & Poor's Financial Services, and Fitch Ratings Inc, which collectively spent more than $1 million on financial reform legislation-related lobbyists in the first three months of 2010, according to a Center analysis of lobbying data."). The rating agencies bristled at the Franken Amendment. An S&P spokesman advised that the amendment would reduce competition and innovation by "lead[ing] to more homogenized rating opinions and, ultimately, depriv[ing] investors of valuable, differentiated opinions on credit risk." Kevin Drawbaugh & Andy Sullivan, *Senate Wall Street Reform Bill Hits Credit Raters*, REUTERS (May 13, 2010), http://www.reuters.com/article/idUSWAT01445120100513.

73 *See* SKADDEN, ARPS ET AL., *supra* note 64.

74 *See* Siegfried Utzig, *The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective* 8 (Asian Dev. Bank Inst., Working Paper No. 188, 2010), *available at* http://www.adbi.org/files/2010.01.26.wp188.credit.rating.agencies.european.banking.pdf ("Before the outbreak of the financial crisis, the regulatory setup in Europe was based mainly on self-regulation within certain supervisory 'crash barriers' in the form of the IOSCO Code.").

75 *See* Council Regulation 1060/2009, 2009 O.J. (L 302) 1-31 (EC) (turning voluntary reporting into mandatory reporting); *see also Parliament Backs Tighter Rules for Rating Agencies*, EURACTIV (Apr. 24, 2009), http://www.euractiv.com/en/financial-services/parliament-backs-tighter-rules-rating-agencies/article-181579 (emphasizing that the E.U.

The E.U. Regulation is similar to U.S. regulation with respect to registration and recordkeeping requirements.[76] However, the E.U. Regulation also implicitly allows European regulators to impose methodological requirements upon CRAs.[77] Further, it implements an "endorsement or certification" restriction that requires foreign CRAs to either receive the endorsement of a domestic CRA or to become certified in that jurisdiction.[78] Due to this restriction, it is possible that fewer CRAs will operate in the E.U. going forward.

IV. ALTERNATIVE APPROACHES

As discussed above, regulators in the U.S. and the E.U. have begun to address industry problems. While it is still quite early to criticize either approach, this Section presents alternative solutions that regulators could adopt in lieu of or in addition to their current efforts. Two options are the creation of an international oversight and accountability board and the creation of publicly owned rating agencies.

A. International Oversight and Accountability Board

Credit rating agencies, issuers, and investors currently face the difficult challenge of navigating divergent regulatory systems. The Securities Industry and Financial Markets Association (SIFMA), through its Credit Rating Agency Task Force, suggested that creating an international oversight and accountability board could ameliorate this challenge.[79] SIFMA proposed that a well-respected international body could command

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Regulation imposes more stringent rules than the IOSCO guidelines upon CRAs). The E.U. made this decision based on advice from the Committee of European Securities Regulators (CESR) and the European Securities Market Expert Group (ESME). *Id.*

76 *See* Kristina St. Charles, Note, *Regulatory Imperialism: The Worldwide Export of European Regulatory Principles on Credit Rating Agencies*, 19 MINN. J. INT'L L. 399, 417 (2010) (listing the EU Regulation's detailed provisions).

77 *See* Council Regulation 1060/2009, art. 8; *see also* St. Charles, *supra* note 76, at 425 (discussing the impact of the EU regulations on CRAs and international financing opportunities).

78 *See* Council Regulation 1060/2009, arts. 4–5 (providing procedures for issuance of credit ratings and guidelines for using credit ratings from agencies in third countries); *see also* Utzig, *supra* note 74, at 15–16 (describing the key points of the Regulation); St. Charles, *supra* note 76, at 419–27 (describing the endorsement and certification process in the EU); *Credit Rating Agencies*, EUROPA, http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_transactions_in_securities/mi0009_en.htm (last updated Sept. 2, 2011) (highlighting the methods to approve credit ratings issued outside of the EU).

79 SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, RECOMMENDATIONS OF THE SIFMA CREDIT RATING AGENCY TASK FORCE 11 (2008), *available at* http://www.sifma.org/news/news.aspx?id=6594.

oversight functions and that a wide array of investors, underwriters, and bond issuers could staff the advisory board.[80] The board would perform functions such as advising lawmakers and companies, developing CRA guidelines and best practices, and disclosing information.[81]

An oversight and accountability board could potentially have significant benefits over the current system. Standardizing the ratings process across jurisdictions would create economies of scale and would eliminate costly inter-jurisdictional analyses. It would also be easier for CRAs and investors to understand and adapt to the uniform framework. Bond issuers could benefit from lower fees as well.

This approach would have disadvantages as well, such as funding the board and persuading multiple countries to agree to a uniform plan. Each country would bring its own strategic considerations to the table, and compromising on details could prove difficult. For example, the U.S. would probably insist that it retain special authority over the Big Three, all of which are headquartered within its jurisdiction.

By the time that a permanent solution is agreed upon, the global financial situation could change entirely. However, it would be useful to begin multilateral discussions and explore in greater detail the opportunities that this proposal presents.

B. *Public Rating Agencies*

Another option exists at the national level: implementing public rating agencies to compete with the existing private rating agencies. Lawmakers in the E.U. considered this idea in 2010, when E.U. Internal Market Commissioner Michel Barnier suggested that creating an E.U. rating agency would increase competition among the Big Three.[82]

There would of course be significant difficulties and unintended consequences to this approach. For example, lawmakers would need to restrict political pressure from influencing the public CRA, and they would need to ensure that the public CRA is independent from its government regulators. Additionally, they would need to determine the cost-effectiveness of this approach.

With these challenges in mind, lawmakers should continue to explore the public CRA as a method to loosen the oligopoly status of the existing CRAs, especially the Big Three. While the expense to the public

[80] *Id.*

[81] *Id.* at 11–12 (describing the major functions such a board would conduct, including advising lawmakers, serving as a global forum for regulatory approaches, promoting consistent guidelines and best practices for CRAs, and disclosing information for the public).

[82] Kyle James, *E.U. Eyes Tougher Regulation for Credit Rating Agencies*, DEUTSCHE WELLE (Nov. 5, 2010), http://www.dw-world.de/dw/article/0,,6196208,00.html.

CRA approach may be significant, lawmakers should consider the price of another financial crisis. Ultimately, implementing this approach would require a deep examination of the role of the government in private markets.

V. CONCLUSION

The recent financial crisis has caused long-term damage and lasting effects to the global financial system. Credit rating agencies contributed to the crisis by giving their highest ratings to poorly understood new financial instruments. They played an enabling role in the boom of the housing market, and later, they exacerbated the financial meltdown by quickly downgrading investments worth billions to below investment-grade status. All the while, they lacked significant accountability and oversight and suffered from intense conflicts of interest.

Regulators in the U.S. and in the E.U. have begun to take action. In the U.S., the Credit Rating Agency Reform Act and the Dodd-Frank Act now address inappropriate CRA practices, and the SEC can now fine noncompliant CRAs. Multiple class action lawsuits are progressing to trial. In the E.U., European regulators now enjoy many of the same regulatory capabilities as their American counterparts, and they also have power over the methodologies that CRAs use.

Although lawmakers have already taken substantial steps, they could explore additional options at the international and national level. An international advisory board could promote uniformity and compliance across jurisdictions, and introducing public CRAs could increase competition in the marketplace and weaken the oligopoly that the Big Three currently enjoy.

Party politics, lobbyists and special interests must not dissuade legislators as they continue to address CRA practices. Regulators must vigilantly ensure that the investment community and the public maintain confidence in credit rating agencies. The international financial system survived the recent financial crisis, but it may not be able to survive another.