FROM AAA TO F: HOW THE CREDIT RATING AGENCIES FAILED AMERICA AND WHAT CAN BE DONE TO PROTECT INVESTORS

Abstract: In the fallout from the current economic crises, many have struggled to determine what went wrong. One factor contributing to the massive combustion of the U.S. financial markets (and thus the economy as a whole) was investors' heavy reliance on inaccurate, inflated credit ratings. Because of the long entrenchment of credit ratings in the regulatory structure and, perhaps more significantly, in the investment culture, reducing the reliance on those ratings is unlikely. This Note summarizes the increased reliance on credit rating agencies and credit ratings in the regulatory structure and examines some suggested models for reform. It argues that present reform efforts, however, address superficial flaws in the regulatory structure and fail to confront the real issues that undermine the validity of credit ratings. This Note proposes a model for regulating credit rating agencies in a manner akin to the regulation of broker-dealers, through a self-regulatory organization. It argues that the SEC should seek to ensure the transparency and integrity of the markets by facilitating, through regulatory requirements, the formation of a self-regulatory organization with oversight of and responsibility for credit rating agencies.

> *This financial crisis was not inevitable . . . . [O]ur regulations lagged behind changes in our markets—and too often, regulators failed to use the authority that they had to protect consumers, markets and the economy.*
>
> —President Barack Obama[1]

Introduction

On the afternoon of Friday, March 14, 2008, Moody's Investors Services and Standard & Poor's both announced they were downgrading the ratings of the renowned investment bank, Bear Stearns.[2] By Sunday evening, just two days later, officials from the U.S. Department

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[1] President Barack Obama, Remarks by the President After Regulatory Reform Meeting (Feb. 25, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-after-regulatory-reform-meeting/.

[2] Dakin Campbell, *Bear Gets Double Downgrade*, Bond Buyer, Mar., 17, 2008, http://www.bondbuyer.com/article.html?id=20080314V6C1I6IB.

of the Treasury and the Federal Reserve Board stepped in to negotiate the sale of Bear Stearns, one of the world's largest investment banks, to JP Morgan Chase.[3] Bear Stearns, which less than two years prior held assets of $350.4 billion and total capital of $66.7 billion, sold for a meager $1.2 billion by the end of the month.[4] Thus was the inglorious end to an eighty-five year-old Wall Street institution that had weathered serious economic downtimes from the Great Depression to the credit crunch of the 1970s.[5]

Although Bear Stearns' collapse was stunning, it was merely a preview to the financial crisis that ensued, a crisis that has been marked by the evaporation of Wall Street's most venerable institutions and the erosion of the national and international economies.[6] As the country continues to reel from the crisis, the discourse has inevitably turned toward assigning blame.[7] Many parties share in the responsibility for creating the toxic brew that brought about the financial collapse and subsequent economic crisis. The nation's credit rating agencies, however, are and will remain on the receiving end of much of the finger pointing.[8]

The criticisms currently pointed at the credit rating agencies, and those entities charged with regulating them, are remarkably similar to the criticisms those parties faced following the collapse of energy-giant Enron just six years earlier.[9] Enron declared bankruptcy days after hav-

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[3] John Waggoner & David Lynch, *Red Flags in Bear Stearns' Collapse*, USA TODAY, Mar. 17, 2008, at 1A.

[4] THE BEAR STEARNS COS., 2006 SUMMARY ANNUAL REPORT exhibit 13, 45 (2007); Landon Thomas, Jr. & Eric Dash, *Seeking Fast Deal, JPMorgan Quintuples Bear Stearns Bid*, N.Y. TIMES, Mar. 25, 2008, at C1.

[5] Andrew Ross Sorkin, *JP Morgan Pays $2 a Share for Bear Stearns*, N.Y. TIMES, Mar. 17, 2008, http://www.nytimes.com/2008/03/17/business/17bear.html.

[6] *See* Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES, Sept. 15, 2008, http://www.nytimes.com/2008/09/15/business/15lehman.html?_r=1&scp=1&sq=lehman%20brothers%20merrill%20lynch&st=cse. The September 2008 collapse of Lehman Brothers and the sale of Merrill Lynch are further examples of the pervasiveness of the crisis. *See id.*

[7] *See* Marie Leone, *Subprime Slam: SEC Exposes Rating Agency Faults*, CFO.COM, July 8, 2008, http://www.cfo.com/article.cfm/11699984?f=related (last visited Sept. 18, 2009); *Twenty-five People to Blame for the Financial Crisis*, TIME.COM, http://www.time.com/time/specials/packages/article/0,28804,1877351_1878509,00.html (last visited Sept. 18, 2009).

[8] *See, e.g.*, Thomas Frank, *The "Market" Isn't So Wise After All*, WALL ST. J., Dec. 31, 2008, at A7; Leone, *supra* note 7; Gretchen Morgenson, *Credit Rating Agency Heads Grilled by Lawmakers*, N.Y. TIMES, Oct. 22, 2008, http://www.nytimes.com/2008/10/23/business/economy/23rating.html?scp=1&sq=credit%20rating%20agencies&st=cse.

[9] *Compare* Leone, *supra* note 7 (discussing the SEC's scrutiny of credit rating agency actions in light of the subprime mortgage crisis), *with* Edward Wyatt, *Enron's Many Strands: Warning Signs; Credit Agencies Waited Months to Voice Doubts About Enron*, N.Y. TIMES, Feb. 8,

ing its credit rating downgraded.[10] The common thread between these two events is the backlash they prompted against the credit rating agencies responsible for assessing the risks of financial products and debtors.[11] Then, as now, the government took action to improve regulatory oversight of the credit rating agencies in the hopes that future financial crises could be avoided.[12]

Part I of this Note provides a brief history of credit rating agencies and the regulatory regime governing them.[13] It then explains how the products of rating agencies (the ratings themselves) have become increasingly integrated into governmental oversight of the financial markets while oversight of the rating agencies themselves has remained stagnant.[14] Part II looks at the regulation of the market in the current financial crisis.[15] Part III examines several of the proposed reforms in the regulation of rating agencies and examines the advantages and disadvantages of those models.[16] This part considers proposals by market participants and observers, as well as recent actions by the SEC and several congressional committees.[17] Part IV argues that the best approach to effectively regulating credit rating agencies and their work product is balancing the oversight authority of the SEC with the expertise of market-participants through a self-regulatory organization modeled on the self-regulatory organization currently overseeing broker-dealers.[18]

I. Regulating the Credit Rating Agencies: A Brief History

Before 2009, the regulation of credit rating agencies arose almost exclusively from the process of achieving the designation of a Nationally Recognized Statistical Ratings Organization ("NRSRO").[19] Because

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2002, at C1 (discussing the failure of the credit rating agencies to respond to weaknesses in Enron's finances).

[10] *See* Wyatt, *supra* note 9.

[11] *See* Morgenson, *supra* note 8; Wyatt, *supra* note 9.

[12] *See* Fraud Enforcement and Recovery Act, Pub. L. No. 111-21, 123 Stat. 1616 (2009); Michael L. Siegel, *Corporate America Fights Back: The Battle over Waiver of the Attorney-Client Privilege*, 49 B.C. L. Rev. 1, 2–3 (2008) (discussing remedial actions taken by Congress and the Department of Justice after the illegal activity at Enron came to light).

[13] *See infra* notes 19–99 and accompanying text.

[14] *See infra* notes 69–99 and accompanying text.

[15] *See infra* notes 100–146 and accompanying text.

[16] *See infra* notes 147–204 and accompanying text.

[17] *See infra* notes 147–204 and accompanying text.

[18] *See infra* notes 205–224 and accompanying text.

[19] U.S. Sec. and Exch. Comm'n, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets: As Required by Section

federal regulations provide incentives for broker-dealers to hold debt that has received an investment-grade rating from at least two NRSROs and some regulated investors are limited to investing in securities rated investment-grade, obtaining this designation can be very valuable and profitable to any credit rating agency.[20]

Thus, the role of the credit rating agencies and the regulatory structures that govern those agencies have evolved significantly since their inception in the early twentieth century, and this can only be expected to continue in light of the current economic crisis and the controversy surrounding the rating agencies' role.[21]

A. *The Historical Role of Credit Rating Agencies*

A credit rating agency is a person or organization that issues credit ratings for a reasonable fee; uses a quantitative or qualitative model, or both, to determine credit ratings; and receives fees from issuers, investors, or other market participants, or a combination thereof.[22] These agencies rate debt instruments and companies on a scale ranging from AAA, the highest rating, to junk bonds, the lowest, though each credit rating agency uses its own set of symbols.[23] The ratings are significant for two reasons: (1) many entities, such as pension plans or other government-regulated investment groups, are restricted to purchasing products that are rated investment grade[24] by a NRSRO; and (2) ratings

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702(B) OF THE SARBANES-OXLEY ACT OF 2002, at 5 (2004) [hereinafter REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES].

[20] *See id.* at 6–7 ("Although the Commission originated the use of the term 'NRSRO' in regulation, ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts.").

[21] *See id.* at 6.

[22] U.S. SEC. AND EXCH. COMM'N, OVERSIGHT OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS: A SMALL ENTITY COMPLIANCE GUIDE, *available at* http://www.sec.gov/divisions/marketreg/tmcompliance/nrsro-secg.htm (last visited Sept. 18, 2009).

[23] *See* FITCH RATINGS, DEFINITIONS OF RATINGS AND OTHER SCALES 5–6 (2009), *available at* http://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf; MOODY'S INVESTORS SERVICE, MOODY'S RATING SYMBOLS & DEFINITIONS 8 (2008), *available at* http://v2.moodys.com/moodys/cust/research/MDCdocs/29/2006600000424852.pdf?frameOfRef=corporate; STANDARD & POOR'S, STANDARD & POOR'S RATINGS DEFINITIONS 4–11 (2009), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/Ratings_Definitons_Update.pdf.

[24] Net Capital Rule, 17 C.F.R. § 240.15c3-1 (2008). An investment-grade rating is a rating that reflects a higher opinion on the creditworthiness of debtor or obligation being rating. Investment-grade ratings are rated BBB and higher, while non-investment grade credit ratings are BB and below. *See* U.S. Sec. and Exch. Comm'n., Credit Rating Agen-

impact the marketplace because investors rely on them as an accurate reflection of the creditworthiness of the product or company.[25] It is important to note, however, that these ratings are merely opinions as to the creditworthiness of the entity or the financial product at a particular point in time.[26]

Credit ratings were developed in the early twentieth century by John Moody, founder of Moody's Investor Services.[27] The purpose of publishing ratings was to provide investors with information about the quality of corporate bonds.[28] Early rating agencies profited by selling their ratings to potential investors seeking information about the perceived likelihood of default.[29] When the changing nature of capital markets rendered this practice no longer profitable, rating agencies began selling their services to the debt issuers themselves, relying on their reputations to give their voices credibility.[30]

The most well-known rating agencies in the United States are Moody's Investor Services, Standard and Poor's, and Fitch.[31] Standard & Poor's issues nearly half of all credit ratings and together with Moody's and Fitch, the so-called "Big Three" issue ninety-eight percent of the total ratings.[32]

The Big Three rating agencies dominated the field early on by being designated as NRSROs by the Securities and Exchange Commission

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cies—NRSROs, http://www.sec.gov/answers/nrsro.htm (last visited Sept. 18, 2009) [hereinafter Credit Rating Agencies—NRSROs].

25 STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 76 (Comm. Print 2002).

26 *See In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 511 F. Supp. 2d 742, 815–19 (S.D. Tex. 2005) (holding that in the case of Enron, the national credit rating agencies were entitled to first amendment protection against lender's claims regarding negligent misrepresentation of debtor's creditworthiness). The court in *In re Enron* found that credit rating agencies have a qualified protection under the First Amendment. *See id.* at 819 ("[T]his Court will not assume blanket protection for the Credit Agency ratings, but will consider any First Amendment protection for credit rating reports as qualified and will scrutinize the facts alleged according to standards and heightened pleading requirements developed by courts to determine whether . . . [the plaintiff] has stated a claim that is not precluded by First Amendment protection."); *see also* REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 5.

27 *See* Moody's History: A Century of Market Leadership, http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=history (last visited Sept. 18, 2009).

28 *See id.*

29 *See id.*

30 *See id.*

31 *See* Kathleen L. Casey, Comm'r, U.S. Sec. and Exch. Comm'n, Remarks at the Commission Open Meeting (Dec. 3, 2008), *available at* http://www.sec.gov/news/speech/2008/spch120308klc.htm#P23_2884.

32 *Id.*

("SEC" or "the Commission") in 1975.[33] An NRSRO is a credit rating agency that is registered with the SEC.[34] In recent history, the regulation of credit rating agencies has arisen almost exclusively from the process of achieving the designation of a NRSRO.[35] In practice, the SEC designated a rating agency as an NRSRO by issuing a no-action letter; once issued, the designation was not formally reviewed at any interval, though it could be revoked.[36]

The process of reviewing NRSROs was fairly informal and the standards considered by the SEC for granting the no-action letter were opaque.[37] Generally, the staff of the SEC's Division of Market Regulation reviewed the rating agency's business using discretionary guidelines; its primary consideration was the national recognition of the agency as an issuer of credible and reliable ratings by the predominant users of securities ratings.[38] Additional considerations included organizational structure, financial resources, rating procedures, and internal controls.[39] Upon making its determination, the only result was the Commission staff's issuance of the no-action letter stating it would not recommend that the Commission take enforcement action if broker-dealers relied on ratings from that rating agency in applying the Net Capital Rule.[40]

At present, the SEC has designated ten rating agencies as NRSROs: A.M. Best Company, Inc.; DBRS Ltd.; Egan-Jones Rating Company; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; LACE Financial Corp.; Moody's Investor Service, Inc.; Rating and Investment Information, Inc.; Realpoint LLC; and Standard & Poor's Rating Services.[41]

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[33] Lawrence J. White, The Credit Rating Industry: An Industrial Organization Analysis 11 (Feb. 12, 2001) (unpublished manuscript, *available at* http://www.stern.nyu.edu/eco/wkpapers/workingpapers01/01-02White.pdf).

[34] Credit Rating Agencies—NRSROs, *supra* note 24.

[35] CONG. RESEARCH SERV., 109TH CONG., CREDIT RATING AGENCY REFORM ACT OF 2006, at 3 (Comm. Print 2006) [hereinafter CRS Report].

[36] *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, 62 Fed. Reg. 68,018, 68,019 (proposed Dec. 30, 1997) (to be codified at 17 C.F.R. pt. 240) (not acted upon); CRS REPORT, *supra* note 35, at 3.

[37] CRS Report, *supra* note 35, at 3.

[38] Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, 62 Fed. Reg. at 68,019.

[39] *Id.*

[40] *Id.*; *see infra* notes 42–68 and accompanying text (discussing the Net Capital Rule).

[41] Credit Rating Agencies—NRSROs, *supra* note 24.

B. *The Net Capital Rule: Regulatory Integration of the NRSRO Designation*

The first appearance of the term NRSRO was in the Commission's 1975 revisions to the Net Capital Rule.[42] The Net Capital Rule, Rule 15c3-1, seeks to ensure that broker-dealers have sufficient "liquid assets to meet their obligations to their investors and creditors."[43] The Rule requires broker-dealers to maintain net capital over some specified amount.[44] In calculating the minimum net capital, broker-dealers deduct percentages of the market value of their securities from their total net worth.[45] Taking such actions are a way of protecting against fluctuations in the prices of broker-dealers' proprietary positions.[46]

The 1975 revisions to the rule permitted banks to base their capital requirements on the quality of the securities they held by subjecting them to lower margin requirements if those securities were rated investment grade by at least two NRSROs.[47] In revising the Net Capital Rule, however, the SEC did not define the term NRSRO nor did it indicate how rating agencies would achieve the designation.[48] In setting margin requirements based on the ratings of private ratings agencies, the SEC formalized the role of rating agencies in U.S. financial markets.[49] The Commission outsourced its regulatory responsibilities to these nongovernmental actors without providing any guidance or many discreet requirements.[50]

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[42] Net Capital Rule, 17 C.F.R. § 240.15c3-1 (1976).

[43] Michael P. Jamroz, *The Net Capital Rule*, 47 Bus. L. 863, 863 (1991–1992). This Note provides only a superficial discussion of the intricacies of the Net Capital Rule. Michael Jamroz, a former branch chief of the Division of Market Regulation at the SEC, offers a detailed analysis of the rule and the implications for investment practices. *See generally id.*

[44] *Id.* at 866.

[45] 17 C.F.R. § 240.15c3-1; *see also* REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 6.

[46] *See* 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E) (haircuts for commercial paper rated in one of the highest three categories by at least two NRSROs); *id.* § 240.15c3-1(c)(2)(vi)(F) (haircuts for noncovertible debt securities rated in one of the highest four categories by at least two NRSROs); *id.* § 240.15c3-1(c)(2)(vi)(H) (haircuts for cumulative, nonconvertable preferred stock rated in one of the highest four categories by at least two NRSROs); *see also* Nationally Recognized Statistical Rating Organizations, Release Nos. 33-7085, 34-34616, IC-20508, 59 Fed. Reg. 46,314, 46,314 n.2 (proposed Sept. 7, 1994); Jamroz, *supra* note 43, at 863–65.

[47] Nationally Recognized Statistical Rating Organizations, 59 Fed. Reg. at 46,314; *see also* REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 6; Jamroz, *supra* note 43, at 16–17 & n.5.

[48] *See* Nationally Recognized Statistical Rating Organizations, 59 Fed. Reg. at 46,314–17.

[49] *See* Net Capital Rule, 17 C.F.R. § 240.15c3-1 (2008).

[50] *See id.*; *see also* Frank Partnoy, *Historical Perspectives on the Financial Crisis: Ivar Kreuger, the Credit-Rating Agencies, and Two Theories About the Function, and Dysfunction, of Markets*, 26

Perhaps in recognition of their cession of authority, the SEC proposed to define the term NRSRO in 1997.[51] The proposal arose out of the SEC's 1994 Concept Release ("Concept Release").[52] In the Concept Release, the Commission sought comments on "the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for designating and monitoring the activities of NRSROs."[53] The SEC pointed out that it had not defined the term NRSRO for the purposes of the Net Capital Rule, and, since 1975, had used the term in other regulations while generally stating that it should have the same meaning as under the Net Capital Rule.[54] Additionally, the SEC recognized that concern had arisen over the lack of oversight over the NRSROs' functions.[55]

After soliciting comments, the Commission promulgated a proposed rule that sought to amend the Net Capital Rule to define NRSRO, as well as lay out specific criteria for rating agencies to achieve the designation.[56] At the time, the SEC considered amending the rule in part because of an ever increasing reliance on the term NRSRO in state and federal regulation.[57] Indeed, in the proposed rule, the SEC pointed to Congress's use of the term in the Secondary Mortgage Market Enhancement Act of 1984 to define, in part, mortgage related securities.[58] The SEC has used the term NRSRO and relied on the use of the term in the Net Capital Rule, in regulations adopted pursuant to the Securities Act of 1933, the Exchange Act, and the Investment Company Act.[59] Moreover, Congress has relied on the ratings of NRSROs

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YALE J. ON REG. 431, 432, 438–40 (2009) (discussing how regulatory reliance on credit rating agencies began during the Great Depression and noting that regulators "delegate[ed] responsibility to credit-rating agencies").

[51] Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, 62 Fed. Reg. 68,018, 68,020–21 (proposed Dec. 30, 1997) (to be codified at 17 C.F.R. pt. 240) (not acted upon).

[52] *Id.* at 68,020.

[53] *Id.*

[54] *Id.*

[55] REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 11.

[56] *Id.* at 12.

[57] *Id.* at 6.

[58] *Id.* at 7–8 (citing Pub. L. 98-440, § 101, 98 Stat. 1689 (1984) (codified as amended at 15 U.S.C. § 78c(a)(41) (1988))).

[59] REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 6–7.

> For example, Rule 2a-7 under the Investment Company Act of 1940 limits money market funds to investing in only high quality short-term instruments, and NRSRO ratings are used as benchmarks for establishing minimum quality

when defining "mortgage-backed securities," requiring that "such securities be rated in one of the two highest rating categories by at least one NRSRO."[60]

The 1997 Proposed Rule would have required credit rating agencies to meet the following criteria to be eligible for the NRSRO designation: (1) national recognition; (2) adequate staffing, financial resources, and organizational structure; (3) use of systemic rating procedures that are designed to ensure credible and accurate ratings; (4) extent of contacts between agencies and the management of the issuers; and (5) internal control procedures to prevent misuse of nonpublic information and compliance with such procedures.[61] These requirements are quite similar to the criteria the Commission applied in its informal process for issuing no-action letters.[62] The Proposed Rule would have required rating agencies seeking NRSRO status to register as an investment advisor under the Investment Advisors Act of 1940.[63] Additionally, the proposed rule would have set into the regulatory regime a process for recognizing and designating a rating agency as an NRSRO and would have required designated agencies to report material changes under the definition to the SEC.[64] Furthermore, the proposal sought comments from stakeholders about whether or not NRSROs' fee structures should be regulated, whether ratings should be made publically available, and whether there were ways to use statistical models for determining credit risk of specific financial instruments that could be used in place of NRSRO credit ratings.[65]

> investment standards. . . . In addition, . . . offerings of certain nonconvertable debt, preferred securities, and asset-backed securities that are rated investment grade by at least one NRSRO can be registered on . . . the Commission's "short-form" registration statement—without the issuer satisfying a minimum public float test.

Id. at 7.

[60] Id. at 7–8.

[61] Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, 62 Fed. Reg. 68,018, 68,020 (proposed Dec. 30, 1997) (to be codified at 17 C.F.R. pt. 240) (not acted upon).

[62] *Id.*; REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 13.

[63] Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, 62 Fed. Reg. at 68,020–21.

[64] *Id.* at 68,019; REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 13.

[65] Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, 62 Fed. Reg. at 68,021–23; REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 13–15. It is worth noting that the Proposed Rule would have all but guaranteed the existing NRSROs continued status because the new guidelines relied

Ultimately, the SEC chose not to act on its proposed rule.[66] In a 2003 Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, the SEC cited concerns regarding "the standards defining the term 'NRSRO,' and the initiation of broad-based Commission and Congressional reviews of credit rating agencies," as its reason for declining to act on the Proposed Rule.[67] Specifically, the Commission observed that most market participants and observers were opposed to the idea of regulatory oversight of NRSROs where such oversight might "interfere with a rating agency's credit rating process or rating judgments."[68]

C. *The Enron Effect*

After the Commission's inaction in the late 1990s, their oversight of the credit rating agencies came under attack again in 2001.[69] Late that year, energy giant Enron declared bankruptcy a mere four days after having its credit rating downgraded by the NRSROs Moody's, Standard & Poor's, and Fitch.[70] Investors, Congress, and the public reacted with frustration and anger at the ratings agencies' delay in downgrading Enron's credit rating despite warnings of trouble within the firm.[71] In October of the following year, the Senate Committee on Governmental Affairs held hearings on the public- and private-sector overseers of Enron's finances.[72] The Committee subsequently issued a detailed report entitled, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs, which recommended increased oversight for the rating agencies.[73]

The Committee's report noted, futher, that since the first use of the term NRSRO in 1975, eight federal statutes, forty-seven federal regulations, and more than one hundred state laws and regulations had

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heavily on the existing procedure in informing the structure and reasoning for issuing a no-action letter. *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, 62 Fed. Reg. at 68,019–24.

[66] JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 291–92 (2006).

[67] REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 15.

[68] *Id.* at 12.

[69] *Id.* 16–18.

[70] Wyatt, *supra* note 9.

[71] *Id.*

[72] STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 1 (Comm. Print 2002).

[73] *Id.* at 98–99.

been written with reference to or reliance on NRSRO credit ratings.[74] While government reliance on credit ratings as a regulatory touchstone was increasing, reliability of the ratings themselves was declining.[75]

1. SEC Efforts to Regulate in a Post-Enron Environment

In addition to Congress's study, the Commission conducted its own inquiry into the role and function of the credit rating agencies pursuant to the Sarbanes-Oxley Act of 2002.[76] In its report, the SEC announced its intent to issue proposed rules in response to its findings.[77] On April 25, 2005, the SEC published a proposed rule to define the term NRSRO.[78] The goal of the definition was to identify credit rating agencies whose ratings would be reliable such that the Commission could confidently rely on those ratings when using them to underpin regulations.[79] To that end, the proposed rule defined the term NRSRO as:

> [A]n entity that (i) issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings . . . ; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the

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[74] *Id.* at 79.

[75] *Turmoil in the U.S. Credit Markets: The Role of the Credit Rating Agencies, Hearing Before the Senate Committee on Banking, Housing and Urban Affairs*, 110th Cong. 5 (2008) [hereinafter *Turmoil in the U.S. Credit Markets*] (statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School).

[76] *See* REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES, *supra* note 19, at 3.

[77] *Id.* at 1.

[78] Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. 21,306 (proposed April 25, 2005) (to be codified at 17 C.F.R. pt. 240) (not acted upon). The Proposed Rule reflected issues raised in the Commission's 2003 Concept Release. *See* Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Release Nos. 33-8236, 34-47972, 68 Fed. Reg. 35,258, 35,259–64 (June 12, 2003); *see also* Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. at 21,306, 21,309-22. The rule, however, pertains only to defining the term NRSRO and does not consider the other issues raised by the 2003 Concept Release. *See* Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, 68 Fed. Reg. 35,258; Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. at 21,306, 21,310-19.

[79] Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. at 21,310.

> misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.[80]

The 2005 Proposed Rule was not adopted by the SEC because of congressional concern that the Commission's statutory authority did not extend to overseeing the credit rating agency industry.[81] The potential gap in statutory authority arises from the indirect nature of the SEC's oversight of NRSROs' designation. Once a credit rating agency has applied to the SEC, the SEC agrees not to take action against broker-dealers that rely on those credit ratings in adhering to regulatory requirements.[82] Because issuers will purchase credit ratings from NRSROs in order to facilitate investment from broker-dealers who must adhere to SEC requirements, the regulation of the NRSRO is intended to be a method by which the SEC regulates broker-dealers, not the NRSROs themselves.[83] This gives rise to concern that the SEC has uncertain authority to conduct further oversight of NRSROs or to look deeply at the inner workings of the agencies themselves.[84]

2. Seeking Statutory Authority

In light of the SEC's perceived lack of statutory authority, as well as its own qualms about the role of NRSROs, Congress enacted the Credit Rating Agency Reform Act ("CRA Reform Act").[85] In the Act's findings, Congress recognized the national importance of credit rating agencies, acknowledged that the oversight of credit rating agencies served the compelling interest of investor protection, and observed that the Commission required additional statutory authority to oversee the agencies.[86]

The CRA Reform Act addressed these concerns in several ways. First, it amended the Securities Exchange Act of 1934 to provide statutory definitions for the terms "credit rating," "credit rating agency,"

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[80] *Id.*

[81] *See* 123 Cong. Rec. E1957 (daily ed. Sept. 27, 2006) (statement of Rep. Fitzpatrick) (citing Carroll, *infra* note 84, at 5).

[82] *See supra* notes 33-41 and accompanying text.

[83] *See* Nationally Recognized Statistical Rating Organizations, 59 Fed. Reg. at 46,314; *see also* Report on the Role and Function of Credit Rating Agencies, *supra* note 19, at 6; Jamroz, *supra* note 43, at 16–17 & n.5.

[84] Brian Carroll, *Enron Scandals Spur Proposed Credit Rating Legislation*, Legal Intelligencer, Sept. 25, 2005, at 5.

[85] Credit Rating Agency Reform Act of 2006, 15 U.S.C.A. §§ 78a, 78o-7 (West Supp. 2008).

[86] *Id.*

"nationally recognized statistical rating organization," "person associated with a nationally recognized statistical rating organization," and "qualified institutional buyer," thereby intending to address the Commission's informal and indeterminate approach to NRSROs.[87]

The CRA Reform Act further added Section 15E to the Securities Exchange Act to set out procedures for registration of NRSROs.[88] In an effort to increase transparency, the Act called for rating agencies seeking the treatment of an NRSRO to provide information regarding credit ratings performance; the procedures and methodologies for determining ratings; policies to prevent misuse of nonpublic information; organizational structure of the agency; whether or not the agency has a code of ethics; conflicts of interest relating to the issuance of ratings; categories of products that the agency seeks registration to rate; information about the largest issuers and subscribers, by net revenue, using the agencies' services; and other information.[89] Finally, the CRA Reform Act calls on the SEC to "amend or revise [its] rules and regulations . . . as necessary or appropriate in the public interest or for the protection of investors."[90] This gives the Commission further authority to oversee the credit rating agencies in an effort to protect investors and the public.[91]

3. The SEC Takes Action

Armed with the necessary statutory authority, in 2007 the SEC implemented new rules under the CRA Reform Act.[92] The 2007 rules applied the requirements Congress set out for achieving recognition as an NRSRO in the CRA Reform Act on an ongoing basis through continual disclosures.[93] The rules required agencies seeking designation as an NRSRO to disclose their procedures and methodologies for assigning

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[87] *Id.* The CRA Reform Act defines an NRSRO as a credit rating agency that has been in business for at least the three consecutive years prior to its application; issues credit ratings certified by qualified institutional buyers in one ore more of a number of categories; and is registered as an NRSRO under Section 15E of the Securities Exchange Act. *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.* §§ 78a, 78o-7(n)(2)(B).

[91] *See* CRA Reform Act, 15 U.S.C.A. §§ 78a, 78o-7(n)(2)(B).

[92] Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 17 C.F.R. §§ 240, 249b (2007). In 2007, seven credit rating agencies registered with the SEC as NRSROs. Press Release, U.S. Sec. and Exch. Comm'n, Seven Credit Rating Agencies Registered with the SEC as Nationally Recognized Statistical Rating Organizations (Sept. 24, 2007), http://www.sec.gov/news/press/2007/2007-199.htm (last visited Sept. 23, 2009) [hereinafter Seven Credit Rating Agencies].

[93] 17 C.F.R. §§ 240, 249b.

ratings.[94] Additionally, the agencies that obtained the designation as NRSROs were required to disclose to the public specific performance measurement statistics including historical downgrades and default rates.[95] In addition to being certified annually, this information had to be updated should it become materially inaccurate.[96]

Like the CRA Reform Act, the motivation for the SEC's regulations was improving transparency of the credit rating process. This philosophy, which underscores federal securities law, "is premised upon the belief that, so long as there is full and accurate disclosure of all material information by a covered company, the investing public will have sufficient information upon which to make its investment decisions."[97] This notion is itself based on a primary presumption that the NRSROs will engage in better practices when subjected to public scrutiny.[98] Thus, it fails to account for market influences that cannot be mitigated through good-faith efforts on the part of the credit rating agencies; these influences have become the biggest crisis facing rating agencies in capital markets—high volumes of incredibly sophisticated, complex financial products that cannot, or at least have not, been rated with the same measure of accuracy as other types of financial products.[99]

II. Regulating the Credit Rating Agencies in the Current Financial Crisis

Despite the regulatory response to the Enron crisis, the credit rating agencies found themselves amidst controversy again when, in 2008, many subprime residential mortgage-backed securities ("RMBS") began to default and were subjected to rating downgrades.[100] Although many participants share responsibility for the crumbling financial mar-

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[94] *Id.*; Seven Credit Rating Agencies, *supra* note 92.

[95] 17 C.F.R. §§ 240, 249b.

[96] Erik Sirri, Dir., Div. of Market Reg., U.S. Sec. and Exch. Comm'n, Remarks Before the SEC Open Meeting: Final Rules Implementing the Credit Rating Agency Reform Act of 2006 (May 23, 2007), *available at* http://www.sec.gov/news/speech/2007/spch052307ers.htm.

[97] CRS Report, supra note 35, at 5.

[98] *See id.*

[99] *See Turmoil in the U.S. Credit Markets, supra* note 75, at 4–10 (statement of Professor John C. Coffee, Jr.); Roman Frydman et al., *We Must Not Rely Only on the Rosiest Ratings*, Fin. Times, (Oct. 19, 2008) http://www.ft.com/ (search "Rely Only on the Rosiest Ratings"; then following hyperlink with title); *see also* CRS Report, supra note 35, at 5.

[100] President's Working Group on Fin. Markets, Policy Statement on Financial Market Developments 2 (2008), *available at* http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf [hereinafter PWG March Policy Statement].

ket, regulators have cited credit ratings in general and credit rating agencies in particular, as having failed the marketplace.[101]

A. *Downgrading Credit Ratings in the Current Crisis*

Despite the reforms made to the regulation of capital markets in the early part of the decade, the current turmoil in the financial markets has left regulators and government entities struggling to determine what went wrong and why.[102] Indeed, the President's Working Group on Financial Markets ("President's Working Group") has considered the issue at length and drawn several conclusions.[103] They point out that investors were relying "excessively on credit ratings, which contributed to [the investors'] complacency about the risks they were assuming in pursuit of higher returns."[104] This stemmed, in large part, from the increasingly complex products in the financial industry, which in turn, forced investors to rely more heavily on the assessment of the "experts."[105] The credit ratings produced by credit rating agencies, however, were not as reliable, and thus were more likely to default than in previous years.[106] For example, a study by financial economists showed that the five-year cumulative default rate on corporate bonds rated "Baa" by Moody's between 1983 and 2005 was 2.2%, but the rate between 1994 and 2005 on collateralized debt obligations comparably rated was 24%.[107] Thus, when corporate bonds and collateralized debt obligations received identical ratings, those ratings represented vastly different

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[101] *Id.* at 1.

[102] *See id.* at i, 1

[103] *See* PWG March Policy Statement, *supra* note 100, at 1 (noting the principle causes of the crisis in the financial markets); PRESIDENT'S WORKING GROUP ON FIN. MARKETS, PROGRESS UPDATE ON MARCH POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 1–6 (2008), *available at* http://www.ustreas.gov/press/releases/reports/q4progress%20update.pdf [hereinafter PWG October Policy Statement].

The President's Working Group on Financial Markets was established by Executive Order in 1988 in response to the market crisis of 1987. *See* Exec. Order No. 12,631, 53 Fed. Reg. 9421, 9421 (Mar. 22, 1988); Nathaniel C. Nash, *Stock-Fall Study Gets Chairman*, N.Y. TIMES, Mar. 24, 1988, at D13 ("[T]he President's interagency committee . . . seeks to produce a unified series of White House recommendations on how to avoid another stock market crash."). It is chaired by the Secretary of the Treasury, and its members include the Chairman of the Board of Governors of the Federal Reserve, the Chairman of the SEC, and the Chairman of the Commodity Futures Trading Commission. Exec. Order No. 12,631, 53 Fed. Reg. at 9421.

[104] PWG March Policy Statement, *supra* note 100, at 2.

[105] *Id.*

[106] *Id.*

[107] *Turmoil in the U.S. Credit Markets*, *supra* note 75, at 5 (statement of Professor John C. Coffee, Jr.).

opinions of creditworthiness.[108] Because financial products were becoming increasingly complex, the relative risk associated with a particular credit rating increased.[109] Investor behavior, however, was not correspondingly more prudent, and it is rational to conclude that investors imputed the relative risk to the rating itself, rather than the product itself.[110]

The trouble materialized when confidence in credit ratings on some products, namely subprime RMBS, began to erode. The seeds of doubt sown, confidence fell in the entire asset-backed commercial paper market because the NRSROs issued extensive downgrades even on newly rated securities.[111] Downgrading newly rated securities sends the message to the market and to investors that these securities, and perhaps others, were not effectively rated from the outset.[112] Such messages can only serve to create additional anxiety, an emotion that does not contribute to growing capital markets.[113]

B. *Recommendations in Light of the Downgradings*

In response to the market crises, the President's Working Group issued many recommendations.[114] These recommendations include improving the integrity and transparency of the credit rating agencies' processes and practices and taking steps to ensure that the world's financial institutions manage risk more effectively.[115] Specifically, the President's Working Group recommends that credit rating agencies disclose the nature of the qualitative reviews they perform on originators; require the underwriters of asset-backed securities to disclose the due diligence performed on the underlying assets; manage conflicts of interest; assist investors in understanding credit ratings by making public information regarding their rating methodologies; employ different models for rating structured products from corporate and municipal securities; make rating performance statistics available; and more effectively monitor and update ratings.[116]

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108 *See id.*
109 *See id.*
110 *See* PWG March Policy Statement, *supra* note 100, at 2.
111 *See id.*
112 *See id.*
113 *See id.*
114 *Id.* at 3.
115 *Id.*
116 PWG March Policy Statement, *supra* note 100, at 4–5.

In addition to proposing reforms of the credit rating agencies' processes, the President's Working Group examined the way investors understand and act based on ratings.[117] They found that,

> [i]n particular, many investors seem to treat a credit rating as a "sufficient statistic" for the full range of risks associated with an instrument, when, in fact, credit ratings are assessments of creditworthiness, and not of liquidity, market, or other risks. Some investors also relied exclusively on ratings for valuation purposes.[118]

To address this issue, the President's Working Group suggested that investors, particularly those overseen by government entities, should be required to seek out better information about the risk characteristics of the products they purchase and, further, that those investors develop independent understandings of the risk characteristics of their portfolios.[119] This knowledge would supplement the credit ratings issued by the NRSROs.[120]

C. *Recent SEC Action*

Following the report of the President's Working Group, the Commission issued a series of proposed rules to overhaul the NRSROs and credit ratings generally.[121] In three proposed rules, the SEC addressed conflicts of interest that arise when issuers pay for ratings; required NRSROs to distinguish ratings by using different symbols for different types of products or disclosing the differences between the ratings; sought to educate investors on the limits and purposes of credit ratings; and removed the NRSRO term from some SEC rules and forms.[122]

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[117] *Id.* at 12–14.

[118] *Id.* at 12.

[119] *Id.* at 13.

[120] *Id.*

[121] References to Ratings of NRSROs, 73 Fed. Reg. 40,124 (proposed July 11, 2008); Security Ratings, 73 Fed. Reg. 40,106 (proposed July 11, 2008); Proposed Rules for NRSROs, 73 Fed. Reg. 36,212 (proposed June 25, 2008).

[122] References to Ratings of NRSROs, 73 Fed. Reg. at 40,124 (proposing the amendment of "five rules under the Investment Company Act of 1940 and the Investment Advisors Act of 1940 that rely on NRSRO ratings"); Security Ratings, 73 Fed. Reg. at 40,106 (proposing to "replace rule and form requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 that rely on security ratings . . . with alternative requirements"); Proposed Rules for NRSROs, 73 Fed. Reg. at 36,212 (seeking to impose additional requirements on NRSROs).

Among the proposed regulatory amendments by the SEC is a rule to "require that as a condition to the NRSRO rating a structured finance product[,] the information provided to the NRSRO and used by the NRSRO in determining the credit rating would need to be disclosed through a means designed to provide reasonably broad dissemination of the information."[123] This effort would serve the SEC's goal of increasing transparency and accountability while clarifying for investors the nature and limitations of credit ratings.[124] Investors' reliance on credit ratings is a key concern of the SEC, and the express purpose of at least some of the regulatory changes is to "reduce undue reliance on credit ratings and result in improvements in the analysis that underlies investment decisions."[125]

Additionally, the SEC proposed a rule to replace rule and form requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 that rely on NRSRO ratings of securities with alternative requirements.[126] This would decrease the regulatory reliance on rating agency ratings.[127] The proposed rule points out that "the Commission is considering whether the inclusion of requirements related to security ratings in its rules and forms has, in effect, placed an 'official seal of approval' on ratings that could adversely affect the quality of due diligence and investment analysis."[128] The SEC first began evaluating whether or not it overly relied on credit ratings for regulatory purposes in a 2003 Concept Release; while it did not take any action on that Release, the Commission subsequently adopted rules that did not rely on investment grade ratings.[129]

Shortly after the SEC announced these new regulations, Chairman Christopher Cox testified before the Senate Committee on Banking, Housing and Urban Affairs about the steps the Commission had taken in light of the developing financial crisis.[130] Chairman Cox highlighted the Commission's newly acquired authority under the CRA Reform Act

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[123] Proposed Rule for NRSROs, 73 Fed. Reg. at 36,219.

[124] *Recent Developments in U.S. Financial Markets and Regulatory Responses Before the Senate Committee on Banking, Housing and Urban Affairs*, 110th Cong. (2008) (statement of Christopher Cox, Chairman, U.S. Sec. and Exch. Comm'n), *available at* http://www.sec.gov/news/testimony/2008/ts071508cc.htm.

[125] References to Ratings of NRSROs, 73 Fed. Reg. at 40,125.

[126] Security Ratings, 73 Fed. Reg. at 40,106.

[127] *See id.*

[128] *Id.* at 40,107.

[129] *Id.* at 40,108.

[130] *Recent Developments in U.S. Financial Markets and Regulatory Responses Before the Senate Committee on Banking, Housing and Urban Affairs*, *supra* note 124 (statement of Christopher Cox, Chairman, U.S. Sec. and Exch. Comm'n).

to investigate and regulate credit rating agencies.[131] In investigating, Cox indicated that the SEC found serious problems with the three major credit rating agencies, including a deficiency in disclosures to the public, problems with the rating processes, and lack of attention to conflicts of interest.[132] In his testimony, the Chairman noted that "[e]ven before these new rules take effect, the [credit rating agencies] themselves have committed to the SEC that they will make changes in their own procedures. Each of the firms [the SEC] recently examined has agreed to take remedial measures as recommended in [its] report."[133] The Chairman further indicated that the SEC would be following up with the credit rating agencies cited in the report to determine whether they complied with the recommendations and would begin examinations of the other registered NRSROs.[134]

The SEC considered several of the proposed rules at a meeting on December 3, 2008.[135] At that time, the SEC approved final rule changes concerning public disclosure of NRSROs' ratings performance and methodologies, recordkeeping requirements, and conflicts of interest.[136] The Commission also approved a rule to amend the instructions to Form NRSRO to require enhanced disclosures by NRSROs and by applicants for registration as NRSROs.[137] The enhanced disclosures include the provision of transition statistics for each asset class of credit ratings for which the NRSRO is registering; the degree of verification agencies conduct on the underlying assets when generating a rating; the role of the quality of the originator in determining a rating; and information regarding surveillance of products once a rating has been

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[131] *Id.*

[132] STAFF OF THE OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, U.S. SEC. AND EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMM. STAFF'S EXAMINATION OF SELECT CREDIT RATING AGENCIES 3 (2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf; *see also Recent Developments in U.S. Financial Markets and Regulatory Responses Before the Senate Committee on Banking, Housing and Urban Affairs*, *supra* note 124 (statement of Christopher Cox, Chairman, U.S. Sec. and Exch. Comm'n).

[133] *See also Recent Developments in U.S. Financial Markets and Regulatory Responses Before the Senate Committee on Banking, Housing and Urban Affairs*, *supra* note 124 (statement of Christopher Cox, Chairman, U.S. Sec. and Exch. Comm'n).

[134] *Id.*

[135] *Id.*; Press Release, U.S. Sec. and Exch. Comm'n, SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies (Dec. 3, 2008), http://www.sec.gov/news/press/2008/2008-284.htm (last visited Sept. 18, 2009).

[136] *Id.*

[137] Press Release, U.S. Sec. and Exch. Comm'n, Fact Sheet from the Open Meeting of the U.S. Securities and Exchange Commission (Dec. 3, 2008), http://www.sec.gov/news/press/2008/nrsrofactsheet-120308.htm (last visited Sept. 18, 2009).

assigned. Theoretically, this will increase transparency of NRSROs' processes and allow the SEC to monitor the quality of the work being performed.[138]

Additionally, the final rules impose several new record keeping requirements on NRSROs and require an annual report to the SEC detailing the number of credit rating actions for each class of security taken in the fiscal year.[139] Finally, the SEC added three new prohibited conflicts to prevent NRSROs from rating products or having individuals participate in the rating of products where a conflict of interest exists.[140] These conflicts include prohibiting an NRSRO from issuing a rating with respect to an obligor or security where the NRSRO made recommendations to the issuer about its corporate or legal structure, assets, liabilities, or activities; prohibiting a person within an NRSRO who participates in determining credit ratings or developing methodologies from also participating in fee discussions; and, perhaps obviously, prohibiting NRSRO credit analysts from receiving gifts valued at an excess of twenty-five dollars from the issuer of the product being rated.[141]

In addition to approving the final rules, the SEC proposed an amendment to require NRSROs to disclose ratings history information for all of their current issuer-paid credit ratings in a downloadable format.[142] They also re-proposed an amendment that would prohibit an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer, sponsor, or underwriter unless the information the NRSRO receives from the issuer, sponsor, or underwriter is made available to other NRSROs.[143] Furthermore, the Commission declined to act on two of the releases published in July, namely, the proposal regarding enhanced disclosure and explanation of ratings and ratings' products to investors, and the proposal relating to the SEC's regulatory reliance on NRSRO ratings.[144]

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[138] *Id.*

[139] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6456, 6456–57 (Feb. 9, 2009) (to be codified at 17 CFR pts. 240 and 249b).

[140] *Id.* at 6465–66.

[141] *Id.* at 6456.

[142] *Id.*; Fact Sheet from the Open Meeting of the U.S. Securities and Exchange Commission, *supra* note 137.

[143] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. at 6456; Fact Sheet from the Open Meeting of the U.S. Securities and Exchange Commission, *supra* note 137. This rule comes closest to reflecting the proposal outlined in Part IV below. *See infra* notes 205–224 and accompanying text.

[144] Casey, *supra* note 31.

The final rules and these additional actions were put on hold when the Obama administration took office, pursuant to a review by the agency head appointed by President Obama.[145] After a review, the rules were endorsed by the SEC (now headed by Chairman Mary Schapiro), were published on February 9, 2009; and took effect on April 10, 2009.[146]

III. Others' Proposals for Reform and The Merits of Those Proposals

Criticisms of the credit rating agencies are plentiful, especially in the current financial climate where the impact has spread far beyond Wall Street to blight the economy as a whole.[147] Such criticism, however, is not unique to the current crisis.[148] In addition to proposals for reform from the regulators and other government entities, market observers have also participated in the debate.[149] This Part will discuss those suggestions for reform. Such suggestions include increasing the number of NRSROs; eliminating or loosening the NRSRO designation; increasing liability for credit rating agencies; increasing regulation of rating procedures and methodology; and reorganizing the issuer-based payment structure to eliminate the "pay for rating" potential.[150]

A. *Suggestions Within the Current Regulatory Framework*

1. Increasing the Number of NRSROs

Increasing competition amongst rating agencies through the regulatory structure is frequently cited as a promising reform to the rating agency marketplace.[151] Indeed, the SEC's action to expand the number of agencies designated as NRSROs suggests that government regulators

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[145] Memorandum from Rahm Emmanuel, Assistant to the President and Chief of Staff, to Heads of Executive Dep'ts and Agencies (Jan. 20, 2009) (*available at* http://www.sec.gov/news/press/2009/2009-11.htm). President Obama's designee to chair the SEC, Mary Schapiro, was sworn in on January 27, 2009. Press Release, U.S. Sec. and Exch. Comm'n, Mary Schapiro Sworn in as Chairman of SEC (Jan. 27, 2009).

[146] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. at 6456.

[147] *See, e.g.*, Frydman et. al., *supra* note 99; Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping?*, N.Y. Times, Dec. 7, 2008, at A1.

[148] *See* Wyatt, *supra* note 9.

[149] *See, e.g.*, Coffee, *supra* note 66; Frydman et. al., *supra* note 99; Morgenson, *supra* note 147; Partnoy, *supra* note 50.

[150] *See infra* notes 151–204 and accompanying text.

[151] *See* Claire H. Hill, *Regulating the Ratings Agencies*, 82 Wash. U. L.Q. 43, 83–84 (2004).

support the notion that more players in the marketplace could be beneficial.[152] A key failure of ratings agencies is that they are notoriously slow at providing updated information after the initial rating and are hesitant to do so.[153] Furthermore, once a credit rating agency is recognized as an NRSRO, institutional entrenchment and market forces further impede competition.[154] New competitors could improve upon the current agencies' performances by providing better ongoing monitoring, which might improve the overall quality of ratings.[155] In increasing the number of ratings agencies that the SEC designates as NRSROs, the market could become more specialized as agencies would work in particular industries; this, in and of itself, would improve the quality of ratings through increased expertise.[156]

Two concerns are typical amongst critics of increased competition.[157] The first is that increased competition will result in issuers being able to shop for better ratings, degrading the value of the rating as an indicator of credit-worthiness.[158] The second concern is that new competitors will have difficulty challenging the dominance of Moody's and Standard & Poor's because credit rating agencies rely heavily on large infrastructures, credibility, and expertise.[159] Essentially, the primary issue is that quality will suffer because newer agencies will lack the very knowledge and skill sets that make ratings valuable.[160] Or, in the alternative, that building up the reputation necessary to be viable in the market does not result merely from being recognized as an NRSRO.[161]

2. Increased Civil Liability for Credit Rating Agencies

A second proposal that might serve to increase the accountability of the rating agencies and, theoretically, the quality of their work is allowing for increased litigation and legal liability as a check against the rating agencies' power.[162] The courts largely come down on the side of

[152] *See, e.g.*, Seven Credit Rating Agencies, *supra* note 92.

[153] COFFEE, *supra* note 66, at 302; Morgenson, *supra* note 147.

[154] Hill, *supra* note 151, at 83–84.

[155] *Id.*

[156] *Id.* at 85.

[157] COFFEE, *supra* note 66, at 299–300.

[158] *Id.*

[159] *Id.* at 302.

[160] *Id.*

[161] *Id.*

[162] *Id.* at 302–03; *see also* Rating Accountability and Transparency Act of 2009, S. 1073, 111th Cong. § 4 (2009). The Rating Accountability and Transparency Act, introduced by Senator Jack Reed (D R.I.), provides for suits against NRSROs where the organization

the rating agencies in these civil disputes, affording them protection under the First Amendment.[163] Furthermore, the U.S. Court of Appeals for the Seventh Circuit has set a tone regarding the role of credit ratings with respect to investors of credit ratings when it determined that reliance on a credit rating was "unreasonable."[164] As a result, the ratings agencies have two safe havens from civil liability.[165]

Although litigation, or an omnipresent threat of litigation, might incentivize rating agencies to review ratings more vigorously, scholars agree that litigation should ultimately be a recourse only in cases with a strong inference of fraud.[166] The disadvantages of increased liability are the potential for less-accurate ratings, increases in the cost of services, and disproportionate remedies for liability.[167] Furthermore, ratings are inherently subjective, and increased scrutiny would result in a plethora of lawsuits for basic rating activities like downgrades.[168] Indeed, increased litigation may be more detrimental than beneficial toward achieving the overall goal of a better credit rating regulatory regime.[169] Thus, the promise of reform would be limited in scope, and flaws in ratings are more likely to result from incompetence than fraudulence.[170]

3. Restoring the Principal-Agent Relationship

Restoring the principal-agent relationship would require potential investors or subscribers to pay for ratings, rather than issuers.[171] The restoration of this relationship could be facilitated if the SEC took steps to increase recognition of NRSROs that use a subscriber-based model.[172] An examination of the credit rating agency, Egan Jones

knowingly or recklessly engaged in substandard practices in evaluating credit risk. *See* S. 1073, § 4.

[163] *See In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 511 F. Supp. 2d 742, 816–17 (S.D. Tex. 2005) (holding that absent actual malice, national credit rating agencies are entitled to first amendment protection against lender's claims regarding negligent misrepresentation of debtor's creditworthiness).

[164] *See* Quinn v. McGraw-Hill Co., 168 F.3d 331, 336 (7th Cir. 1999) (holding that reliance on a credit rating was unreasonable). This is particularly ironic given the SEC's reliance on ratings as a de facto regulatory standard. *See id.*

[165] COFFEE, *supra* note 66, at 303.

[166] *Id.* at 304.

[167] *Id.* at 303.

[168] Hill, *supra* note 151, at 89.

[169] COFFEE, *supra* note 66, at 303; Hill, *supra* note 151, at 89.

[170] *See* Hill, *supra* note 151, at 7. *But see* Morgenson, *supra* note 147 (implying that negligence or indifference may be a significant cause of failed ratings).

[171] COFFEE, *supra* note 66, at 299.

[172] *Id.* at 299, 306.

(prior to its recognition as an NRSRO), provides a recent example of this system's potential in the marketplace.[173] Egan Jones charges subscribers rather than issuers for ratings.[174] As such, it seem more responsive to its constituencies' demands and changes ratings more quickly than the large rating agencies.[175] This has serious potential to minimize the systemic weaknesses of the rating agency market by making ratings more reflective of ongoing risk, rather than simply the creditworthiness at the time of the initial rating.[176]

Economic feasibility, however, is the central challenge to this proposal. Because the process of creating a credit rating requires manpower and technology, it is quite costly; to the issuer, unlike the investor, this investment is financially valuable because that issuer benefits from regulatory treatment and market credibility when it achieves a particular rating.[177] The economic benefits are far less direct when a potential investor or subscriber pays for a product to be rated without knowing that an investment grade rating, or a profitable investment, will result.[178] Furthermore, the very clear and concise nature of a rating (essentially a symbol consisting of one, two, or three letters) disseminated rapidly through the technology of the information age could easily result in subscribers sharing the information with non-paying entities, thereby undermining the profitability of the venture.[179] Finally, the expansion of NRSRO recognition to emphasize firms that are driven by subscribers would admittedly be a complete reordering of the system, and thus difficult to put into action from a policy perspective.[180]

B. *Other Models of Regulation in the Securities Industry*

1. Ending Regulatory Reliance

The one area where the SEC has been decidedly slower to act is in regard to the regulatory reliance on private market credit ratings, that is, to simply eliminate the mention of NRSROs in federal regulation.[181]

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[173] *See id.* at 299.

[174] *Id.*

[175] *Id.*

[176] *Id.* at 306.

[177] COFFEE, *supra* note 66, at 299.

[178] *See id.*

[179] *Id.* It is worth noting that empirical evidence from the Egan Jones study suggests this does not occur. *Id.*

[180] *Id.* at 347.

[181] Although there is some willingness to move away from a regulatory reliance on credit ratings, given the entrenchment of ratings and the role of credit rating agencies in

Any analysis of the regulatory structure governing rating agencies must begin with a discussion of the proper role for rating agencies in our marketplace; despite having proposed rules in the summer of 2008 regarding regulatory references to NRSROs, the SEC declined to act on the proposal at the December 2008 meeting.[182] In her statement at the December meeting, Commissioner Casey highlighted the importance of acting on those rules.[183] She noted that "[i]t is imperative that we remove the regulatory requirements that have served to elevate NRSRO ratings to a status that does not reflect the actual purpose and limitations of credit ratings."[184]

This theory is often considered because commentators believe issuers have come to rely on credit ratings solely for the purpose of achieving particular regulatory treatment.[185] This perception, known as the regulatory licensing view, holds that such ratings have little or no informational value and are simply a mechanism for affording favorable regulatory treatment.[186] It is argued that the ratings agencies benefited from deeming debt to be "in compliance"; thus, the central benefit of a rating to an issuer is not the rating itself but the favorable treatment that the government affords a product with that rating.[187]

The empirical evidence, however, does not support the conclusion that the sole purpose of obtaining an investment grade credit rating is the resultant regulatory treatment.[188] Although the regulatory implications associated with a particular credit rating can have an impact on the rating, this in and of itself cannot explain the value of ratings agencies.[189] In fact, issuers will generally purchase credit ratings from more than one agency, usually from the two large rating agencies, Moody's and Standard & Poor's.[190] From this, one could conclude that ending or decreasing regulatory reliance on credit ratings would not reduce

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both state and federal regulation, a full withdrawal is unlikely and infeasible. *See* Casey, *supra* note 31.

[182] *See id.*

[183] *Id.*

[184] *Id.* Commissioner Casey also discussed the importance of enhancing disclosures to investors in order to allow for better investment decisions. *Id.*

[185] Frank Partnoy, *The Paradox of Credit Ratings*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65, 66 (Richard M. Levich et. al. eds., 2002).

[186] *Id.*

[187] *Id.*

[188] Hill, *supra* note 151, at 65–67.

[189] *Id.* at 65–66.

[190] *Id.*; *see supra* note 20 and accompanying text.

investor's reliance on credit ratings, and those ratings would have less oversight if the NRSRO recognition were removed from regulation.[191]

2. The Self-Regulatory Organization

In considering modes of overseeing and regulating credit rating agencies, the SEC and Congress can look to archetypes from other aspects of the securities market.[192] Congress first recognized the value of self-regulation generally, and self-regulatory organizations in particular, in the Securities Exchange Act of 1934.[193] This recognition has been formalized in various aspects of the security industry; for example, brokers and dealers ("broker-dealers") are required to register as such with the SEC and *also* with a self-regulatory organization.[194]

Much like the economic turmoil of today, the stock market crash of 1929 led to efforts to improve the functioning of the securities industry. The efforts by industry groups, with the backing of government regulators, are particularly interesting.[195] Initially, these efforts involved industry associations, such as the Investment Bankers Conference (which replaced the Investment Bankers Code Committee), acting as national organizations with the purpose of proposing best practices for the industry.[196] In response to the establishment of these organizations, the Commission concluded that official legal status was required to effectively meet the goal of self-regulation.[197] Congress subsequently passed

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[191] *See id.*

[192] *See* Securities Exchange Act § 15(b)(8), 15 U.S.C § 78o-3 (2006). For a discussion of the requirements for broker-dealer registration, including registration with an SRO, see SEC. & EXCH. COMM'N, GUIDE TO BROKER-DEALER REGISTRATION (2008), *available at* http://www.sec.gov/divisions/marketreg/bdguide.htm.

> SROs assist the SEC in regulating the activities of broker-dealers. FINRA and the national securities exchanges are all SROs. . . . If a broker-dealer effects securities transactions other than on a national securities exchange of which it is a member . . . including any over-the-counter business, it must become a member of FINRA . . . .

Id.

[193] 15 U.S.C. § 78f.

[194] *Id.* § 78o-3.

[195] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 183–85 (3rd ed., Aspen 2003) (1982) (discussing the amendments to the Securities Exchange Act of 1934 that let to the creation of the National Association of Securities Dealers, the precursor to FINRA, among other reformatory efforts).

[196] *See id.* at 184–85. The Investment Bankers Conference and its predecessor were focused on the work of the over-the-counter securities dealers.

[197] *See id.*

the Maloney Act to create a statutory conceptualization of registered national securities association self-regulatory organizations.[198]

In promulgating a statutory framework to facilitate the establishment of self-regulatory organizations, Congress asserted that "it was distinctly preferable to rely on cooperative regulation, in which the task will be largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation."[199]

Congress, however, did not mandate private regulation at the expense of oversight by government regulators.[200] Instead, it "determined that the securities industry self-regulatory system would provide a workable balance between federal and industry regulation."[201] Regulating the day-to-day activities of the securities industry is extremely costly and inefficient.[202] Furthermore, the complexities of aspects of the securities industry, such as securities trading practices (and indeed, evaluating the creditworthiness of complex financial products) require regulatory oversight from parties with a comprehensive and sophisticated understanding of the industry.[203]

Although the character and physiology of self-regulatory organizations have evolved over the decades, the SEC and Congress recently reaffirmed self-regulatory organizations' place in the regulatory framework when they oversaw and approved the consolidation of the National Association of Securities Dealers and some regulatory functions of the New York Stock Exchange, two self-regulatory organizations of broker-dealers.[204]

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[198] 15 U.S.C. § 78o-3. The Maloney Act amended the Securities Exchange Act. *See id.*

[199] Concept Release Concerning Self Regulation, 69 Fed. Reg. 71,256, 71,257–58 (proposed Dec. 8, 2004) (internal quotation marks omitted) (citing S. REP. No. 94-75, at 7, 11 (1975)).

[200] *Id.*

[201] *Id.* at 71,256.

[202] *Id.*

[203] *Id.*

[204] *Consolidation of NASD and the Regulatory Functions of the NYSE: Working Towards Improved Regulation Before the Subcom. on Securities, Ins., and Inv. of the S. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (2007). In July of 2007, the National Association of Securities Dealers and some of the regulatory functions of the New York Stock Exchange Member Regulation merged to form the Financial Industry Regulatory Authority ("FINRA"). About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/ (last visited Sept. 18, 2009).

IV. A New Approach to Regulating Credit Rating Agencies: The Credit Rating Agency Regulatory Authority

The SEC's current approach to reforming the regulation of credit rating agencies is the piece-meal adoption of the many suggestions posed by market participants and commentators.[205] According to former-Chairman Cox, the rules, "touch every aspect of the credit rating process—from conflicts of interest to publication of ratings methodologies, to disclosure of ratings track records. . . . [T]hese rules will address [serious deficiencies] so that investors and markets will have better information to guide investment decisions."[206] The rules the SEC has thus far acted to adopt make clearer the requirements any credit rating agency must meet to obtain the desired NRSRO recognition.[207] Part of that process has resulted in an expansion of the number of NRSROs in the market.[208]

Although it is unclear what direction the SEC will take under the chairmanship of Mary Schapiro, the SEC, at the urging of Congress and the White House, is expected to continue to address the role of credit rating agencies generally and NRSROs in particular in the financial markets.[209]

The rules that have recently been considered and promulgated, however, fail to address the root causes of the credit rating agencies' role in the current financial crisis.[210] Although it is good policy to regulate enforcement or limit the potential for conflicts of interest, these policies have a limited effect and likely would not have prevented the

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[205] *See supra* notes 100–146 and accompany text.

[206] Press Release, U.S. Sec. and Exch. Comm'n, SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies (Dec. 3, 2008), http://www.sec.gov/news/press/2008/2008-284.htm (last visited Sept. 18, 2009).

[207] *Id.*

[208] *See* Seven Credit Rating Agencies, *supra* note 92.

[209] *Schapiro Approved as New SEC Chairman*, DealBook: N.Y. Times Blog on Financial News, http://dealbook.blogs.nytimes.com/2009/01/23/schapiro-approved-as-new-sec-chairman/?scp=2&sq=mary%20schapiro&st=cse (Jan. 23, 2009, 7:39 EST).

[210] References to Ratings of NRSROs, 73 Fed. Reg. 40,124, 40,124 (proposed July 11, 2008) (proposing the amendment of "five rules under the Investment Company Act of 1940 and the Investment Advisors Act of 1940 that rely on NRSRO ratings"); Security Ratings, 73 Fed. Reg. 40,106, 40,106 (proposed July 11, 2008) (proposing to "replace rule and form requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 that rely on security ratings . . . with alternative requirements"); Proposed Rules for NRSROs, 73 Fed. Reg. 36,212, 36,212 (proposed June 25, 2008) (seeking to impose additional requirements on NRSROs).

current problem if the root of the problem was indeed the rapid development of increasingly complex and misunderstood securities.[211]

The key issue affecting credit ratings in the twenty-first century is the decline in the accuracy of the credit ratings produced by credit rating agencies.[212] In order to address this issue, the SEC and Congress should facilitate the establishment of a self-regulatory organization for credit rating agencies as a way to improve the quality of those ratings, which do play a vital role in helping investors (and issuers) make informed decisions in our capital markets.

In the same way that the Financial Industry Regulatory Authority ("FINRA") regulates and oversees broker dealers, an independent regulatory authority should regulate and oversee the work of rating agencies.[213] Their guidelines and activities would serve to supplement, not supplant, the necessary oversight of the SEC. Thus, the regulatory efforts undertaken by the SEC would remain in place, and additional oversight and enforcement would come from the credit rating agency self-regulatory organization.[214] The government should not be in the business of acting as an NRSRO, and trying to dictate the daily work of the rating agencies would be fiscally and politically irresponsible.

The statutory authority for recognizing a credit rating agency is drawn from the CRA Reform Act.[215] The CRA Reform Act gives the Commission authority to promulgate regulations that adhere to the Act's purpose of protecting investors and the public.[216] The SEC should, therefore, write regulations that require membership in a credit rating self-regulatory organization in order for a credit rating agency to obtain NRSRO recognition.[217] If, however, the Commission was concerned that it lacked the necessary authority to require credit

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211 *See* PWG October Policy Statement, *supra* note 103, at 14 ("The PWG will facilitate formation of a private-sector group (with representatives of investors, issuers, underwriters, and CRAs) to develop recommendations for further steps that the issuers, underwriters, CRAs, and policymakers could take to ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment.").

212 *See* PWG March Policy Statement, *supra* note 100, at 1 (concluding that flaws in the assessments of complex structured credit products contributed to the financial markets' distress); PWG October Policy Statement, *supra* note 103, at 14 (same).

213 FINRA, http://www.finra.org/ (last visited Sept. 18, 2009) (providing a thorough overview of FINRA's compliance, regulatory, education, and enforcement functions).

214 *Id.*

215 Credit Rating Agency Reform Act of 2006, 15 U.S.C.A. §§ 78a, 78o-7, Section 3(n)(2)(B) (2006).

216 *Id.*

217 *Id.* This, of course, would require the collective action of the NRSROs to create such a self-regulatory organization, but self-regulation is surely a more attractive option than the external control of the SEC.

rating agencies to register with a self-regulatory organization, it could ask Congress to amend the definition of NRSRO in the CRA Reform Act.[218] The amendment would add the registration requirement to the definition of NRSRO.[219]

A credit rating agency self-regulatory organization is a valuable weapon in the regulatory arsenal that can be achieved without the government incurring the monetary or political costs of becoming intricately involved in the credit rating process or trying to end reliance on credit ratings.[220] Much like FINRA, which is funded by collecting fees from member firms, a self-regulatory organization overseeing rating agencies could look to credit rating agencies to fund its operations through membership contributions.[221]

An obvious criticism of the self-regulatory organization approach is the potential for lax regulation by an organization with close ties to the industry it oversees.[222] Congress, however, recognizes that active participants in an industry can "bring down to bear on the problems of regulation a degree of expertise and, in many circumstances, expedition not expected of a necessarily more remote governmental agency."[223] Indeed, a credit rating agency self-regulatory organization would provide those agencies with a forum for facilitating the education of analysts, devising industry-wide best practices, and promulgating self-regulations.[224]

Conclusion

Credit rating agencies and ratings play an important role in the functioning of capital markets. Investors lack the expertise and resources to develop a thorough appreciation of the myriad of sophisticated financial products in which they seek to invest. As such, credit rating agencies have played an important role in the markets for nearly a century. In general, investors have stored a great deal of faith in the ratings produced by the three largest credit rating agencies, and this

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[218] *Id.* §§ 78a, 78o-7.

[219] *Id.*

[220] *See* Fin. Indus. Regulatory Auth., Regulatory Notice 08-07, Regulatory Pricing Proposal 1 (2008), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038008.pdf.

[221] *Id.*

[222] *See* 1961–1963 Special Study of Securities Markets, Securities and Exchange Commission, Report on Special Study of Securities Markets, H.R. Doc. No. 88-95 (1963).

[223] Concept Release Concerning Self Regulation, 69 Fed. Reg. 71,256, 71,258 n.37 (proposed Dec. 8, 2004).

[224] FINRA, http://www.finra.org/ (last visited Sept. 18, 2009) (providing a thorough overview of FINRA's compliance, regulatory, education, and enforcement functions).

trust largely has been validated by the SEC's similar reliance on the ratings of designated agencies in its regulatory constructions.

As the critics have suggested, the SEC has indicated it might take action to reduce reliance on NRSRO credit ratings by increasing investor understanding of the credit ratings and by reducing the regulatory reliance on those ratings. The SEC should seek to ensure the transparency and integrity of the markets by facilitating the formation of a self-regulatory organization with oversight of and responsibility for credit rating agencies. This self-regulatory organization and its regulations should work in concert with the Commission's own regulatory efforts. The responsibilities of such an organization could be varied but should include oversight of credit rating methodologies as well as auditing of the ratings processes applied to all financial products.

CAITLIN M. MULLIGAN