Section 933(b): Nimble Private Regulation of the Capital Market Gatekeepers

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I. INTRODUCTION

Leading up to and during the financial crisis of 2007-08, inaccurate ratings from credit rating agencies contributed to systemic risk mismanagement by investors in asset-backed securities, which fueled an asset bubble and led to the collapse of asset prices and capital markets. These inaccurate ratings stemmed from a toxic mixture of factors—conflicts of interest, underresourcing, flawed models, information asymmetry, and a reduction in the need to maintain reputational capital.

Generally, credit rating agencies have been relied upon by both institutional and individual investors, as well as regulators, to play a gatekeeper role in financial markets, specifically in capital markets. Many credit rating thresholds are actually written into various state

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and federal financial regulations and programs. Simply put, markets and governmental entities rely on the accuracy of ratings provided by the credit rating agencies.

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was signed into law.1 Dodd-Frank totals 849 pages, with nineteen pages devoted exclusively to the cause of “Improvements to the Regulation of Credit Rating Agencies” in Title IX, Subtitle C.2 Of those nineteen pages, dealing with myriad regulations, duties, and mandated studies, one provision—containing a total of 185 words—stands out.

This 185-word provision, section 933(b) of Dodd-Frank, lowers the pleading requirement in class action lawsuits against credit rating agencies and is the focus of this Note.3 This Note argues that section 933(b) of Dodd-Frank is indispensible to advancing the cause of credit rating agency reform due to its: (1) conduciveness to countercyclical implementation; and (2) empowerment of innovative private attorneys general, which are independent from the whims of federal budgetary constraints, agency capture, and political meddling.

However, section 933(b) is not perfect, and it must be supplemented by excising National Statistical Ratings Organization references from various laws, thus restoring the incentive for rating agencies to gain and maintain reputational capital—a process thankfully set into motion by sections 939 and 939A of Dodd-Frank.

II. General Role and Importance of Credit Rating Agencies

Since the turn of the nineteenth century, “credit rating agencies have acted as ‘gatekeepers’ to the financial markets by providing assessments of the creditworthiness [(that is, risk of default)] of financial instruments.”4 The two largest credit rating agencies are Moody’s Investors Service (Moody’s) and Standard & Poor’s (S&P), which each control approximately 40% of the $4 billion credit rating market.5 The remainder of the market is divided among Fitch Ratings (Fitch) and other credit rating agencies.6 And the market is a

2. Id. § 931–939H (codified at 15 U.S.C. § 78o-7 (Supp. IV 2010)).
3. Id. § 933 (codified at 15 U.S.C. § 78u-4(b)(2)).
6. Id.
highly lucrative one, with operating margins averaging 53% from 2000 to 2007.\textsuperscript{7}

The general scales used by Moody’s, S&P, and Fitch are quite similar,\textsuperscript{8} and the S&P scale will be used in this Note to discuss ratings. Ratings from AAA to BBB are referred to as investment grade, while ratings of BB and lower are referred to as noninvestment grade, speculative, high yield,\textsuperscript{9} or junk.\textsuperscript{10}

Market demand for credit ratings exists for a host of reasons. First, there is an information asymmetry between instrument issuers and investors.\textsuperscript{11} Issuers possess the information regarding the likelihood of instrument default.\textsuperscript{12} Second, there is a high cost for individual investors of evaluating instrument creditworthiness.\textsuperscript{13} Third, there is an incentive for issuers to exaggerate the quality of their products.\textsuperscript{14} Therefore, credit rating agencies are relied upon as “gatekeepers” by individual and institutional investors and “are central to capital formation, investor confidence, and the efficient performance of the United States economy.”\textsuperscript{15}

Credit rating agencies are also relied upon by financial regulators\textsuperscript{16} due to the agencies’ roles as Nationally Recognized Statistical Rating Organizations (NRSROs).\textsuperscript{17} NRSROs came into existence in 1975 when the Securities and Exchange Commission (SEC) adopted Rule 15c3-1 (pertaining to capital requirements for broker-dealers) and issued no-action letters to Moody’s, S&P, and Fitch, recognizing each as an NRSRO and thus allowing the broker-dealers who held


\textsuperscript{10} Anatomy of a Financial Collapse, supra note 7, at 27.

\textsuperscript{11} See Caleb Deats, Note, Talk That Isn’t Cheap: Does the First Amendment Protect Credit Rating Agencies’ Faulty Methodologies from Regulation?, 110 COLUM. L. REV. 1818, 1824-25 (2010).

\textsuperscript{12} See id.

\textsuperscript{13} Id. at 1824.

\textsuperscript{14} See id. at 1829.


\textsuperscript{16} Id.

paper that was rated investment-grade by two of the new NRSROs to deduct less when computing net capital.18

There are now ten credit rating agencies designated by the SEC as NRSROs19 and “hundreds of rules, releases, and regulations” pertaining to “securities, pension, banking, real estate, and insurance regulation” incorporating the NRSRO designation.20 For example, state law permits Florida’s public pension fund to invest without limitation in “negotiable certificates of deposit . . . of prime quality of the highest letter and numerical ratings as provided for by at least one nationally recognized statistical rating organization.”21

III. BACKGROUND: ROLE OF INACCURATE RATINGS IN THE FINANCIAL CRISIS

“The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval.”22

Beginning in the late 1990s and continuing into 2006, home prices nationwide rose 67%; home prices in some markets such as Miami, Phoenix, and Los Angeles more than doubled.23 This rise was sharply at odds with historical trends24 and was fueled by increased speculation in the housing market,25 as well as the proliferation of high-risk home loans,26 which were securitized (that is, bundled together into pools to which bonds were linked)27 by investment banks and sold to investors as residential mortgage-backed securities (RMBSs)28 and collateralized debt obligations (CDOs).29

19. Morrissey, supra note 5.
20. See Partnoy, supra note 17, at 690-91.
23. Id. at 5.
25. See Fin. Crisis Inquiry Comm’n, supra note 22, at 5.
27. See id. at 18.
28. Id. at 28.
29. Id. at 28-29. A CDO is a security linked to a pool of securities which has been purchased by a Special Purpose Entity. See Frank Partnoy & David A. Skeel, Jr., The Promise and Perils of Credit Derivatives, 75 U. Cin. L. Rev. 1019, 1027 (2007). The securities in the Special Purpose Entity have been combined and then been split into tranches of varying credit risk, to which the CDO securities are linked. Id. CDOs can be linked to pools of different types of securities, including RMBS. See Anatomy of a Financial Collapse, supra note 7, at 28. Additionally, synthetic CDOs exist, in which the long end of credit default swaps (CDS) make up the pool held by the Special Purpose Entity. See Partnoy & Skeel, supra, at 1028. A credit default swap is a two-sided contract
From 2004 to 2007, Moody’s and S&P greased the gears of the RMBS and CDO market by issuing “investment grade credit ratings for the vast majority of RMBS and CDO securities issued in the United States.”

During those years, roughly $2.5 trillion in RMBSs and $1.4 trillion in CDOs were issued by U.S. institutions. Without investment grade ratings, these products would have been much less marketable, as institutional investors would not have been allowed to purchase them.

By mid-2006, the U.S. housing market had peaked. “In late 2006, high risk mortgages began to go delinquent at an alarming rate.”

In July of 2007, after RMBSs and CDOs began incurring losses, Moody’s and S&P began a series of downgrades for thousands of RMBSs and CDOs, triggering a collapse in the price of, and market for, these assets.

These July downgrades marked a turning point “and perhaps more than any other single event triggered the beginning of the financial crisis.” A near-halt in many securitization markets began, leading to a crash in these markets, as investors lost confidence in underlying assets. By early 2008, losses in U.S. mortgage-backed securities reached an estimated $500 billion. By late 2008, the securitization of automobile loans, credit card receivables, and loans to small businesses had nearly ceased, the investment bank Lehman Brothers was bankrupt, and the U.S. economy had shed 3.6 million jobs. By 2010, over 90% of the subprime RMBSs issued in 2006 and 2007 that were originally rated AAA had been downgraded to junk status by Moody’s and S&P.

in which the parties bet on the default of a debt issuer. Id. at 1021-22. The holder of the long end of the CDS is paid a premium by the holder of the short end; if the debt issuer to which the CDS is linked defaults, the holder of the long end pays the holder of the short end. Id.

30. See ANATOMY OF A FINANCIAL COLLAPSE, supra note 7, at 243.
31. Id. at 8.
32. See id. at 243.
34. See ANATOMY OF A FINANCIAL COLLAPSE, supra note 7, at 243.
35. See id.
36. Id.
37. See FIN. CRISIS INQUIRY COMM’N, supra note 22, at 214.
39. See FIN. CRISIS INQUIRY COMM’N, supra note 22, at 214.
40. ANATOMY OF A FINANCIAL COLLAPSE, supra note 7, at 47.
41. FIN. CRISIS INQUIRY COMM’N, supra note 22, at 390.
42. Subprime is a term used to characterize higher-risk loans or borrowers. See ANATOMY OF A FINANCIAL COLLAPSE, supra note 7, at 19.
43. Id. at 31.
IV. PRIMARY CAUSES OF INACCURATE RATINGS

A. NRSRO Status Diminishes the Need for Reputational Capital

In theory, gatekeepers such as credit rating agencies depend on building up and maintaining their reputational capital, which is paramount to maintaining credibility and revenue. Reputational capital is essentially a reserve of good will which enables individuals and institutions to trust in a third-party gatekeeper for an assessment. “Absent other factors, the consumer of a product will purchase a rating if the expected benefit of the rating minus the actual cost of the rating is both positive and greater than the expected benefit of an independent investigation minus the actual cost of such an investigation.” According to the reputational capital theory, individual credit rating agencies will only survive and thrive if they are viewed as “accurate and reliable in assessing the credit risks of borrowers.”

The credit rating industry is oligopolistic, as it is overwhelmingly dominated by Moody’s and S&P, and the barriers to entry are quite high (at least to gain the all-important NRSRO designation). Additionally, Moody’s and S&P rarely rate the same bond differently, which one would expect if the two were in real competition for reputational capital. Rather, Moody’s and S&P have obtained regulatory licenses, due to their status as NRSROs, and can engage in the business of selling these licenses to issuers in the form of ratings, with less regard for gaining or maintaining reputational capital. Issuers have a great need for such NRSRO ratings, because their products are much less marketable without them. Many institutional purchasers are restricted, by various regulations and to varying degrees, in the amount of instruments not conferred top ratings by NRSROs that they can purchase or hold.

B. Conflicts of Interest

One glaring conflict of interest in the credit rating industry is the issuer-pays model, in which credit rating agencies are paid by the

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44. See John C. Coffee, Jr., Understanding Enron: “It’s About the Gatekeepers, Stupid,” 57 BUS. LAW. 1403, 1405 (2002).
45. See Partnoy, supra note 17, at 628.
46. Id. at 629.
47. Id. at 631.
48. See Morrissey, supra note 5.
49. See Partnoy, supra note 17, at 710 (noting British credit rating agency IBCA, Ltd.’s eleven-year battle with the SEC to obtain full NRSRO recognition).
50. See id. at 661.
51. Credit rating agencies are paid by the issuers they rate. See Part IV(B), infra.
52. Partnoy, supra note 17, at 698.
53. See id. at 691-92.
very issuers whose instruments they are rating. This would be akin to restaurants, hoping to gain the coveted three stars, paying Michel-in to visit and supply a rating. Compounding this conflict of interest is the fact issuers unsatisfied with a proposed rating are free to take their business to a different agency, as agencies are only paid for rated deals accepted by the issuer. According to the testimony of one former Moody's officer, “[t]he threat of losing business to a competitor . . . absolutely tilted the balance away from an independent arbiter of risk towards a captive facilitator of risk transfer.”

The influence exerted by the issuer-pays model is more than subliminal. Issuers have explicitly threatened credit rating agencies with a loss of business when desired analytical models were not applied. In turn, agency management threatened analysts with expulsion for being uncooperative with client-issuers, as well as for being too conservative in their assessments.

Moreover, a second type of conflict of interest exists when supposedly neutral credit rating agencies offer, for an additional fee, “assessment services” to issuers. Moody's, S&P, and Fitch's all maintain the ancillary business of providing such services, in which the agencies consult with and advise the issuers on how to structure instruments to achieve a desired credit rating for a particular instrument or class of instruments. 

C. Underresourcing

Leading up to the financial crisis, the rating agencies' volume and complexity of work substantially increased, yet resources did not keep pace. Despite high margins and increasing revenue prior to the crisis, experienced talent was difficult to acquire due to management’s reluctance to pay accordingly. “Guys who can’t get a job on

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54. See ANATOMY OF A FINANCIAL COLLAPSE, supra note 7, at 272-73.
55. See FIN. CRISIS INQUIRY COMM’N, supra note 22, at 210.
56. Id.
57. See ANATOMY OF A FINANCIAL COLLAPSE, supra note 7, at 278-80.
58. See id. at 274-75.
62. See FIN. CRISIS INQUIRY COMM’N, supra note 22, at 149.
Wall Street get a job at Moody’s.’”63 Retaining talent was also difficult, and a revolving door saw rating analysts leaving to work for client-issuers.64 “[Y]ou have the [credit rating agency] asset-backed people, who are basically like brain-dead.’”65

The employees whom the credit rating agencies managed to hire and retain found themselves working longer hours66 without sufficient resources to analyze the complex instruments which were being rated.67 Throughout the years leading up to the financial crisis, credit rating analysts repeatedly raised the issue that such underresourcing by the agencies was having a negative impact on rating quality.68

Underresourcing by the credit rating agencies extended to their RMBS and CDO surveillance departments, whose job it was to monitor the instruments after the initial ratings were assigned in order to affirm, upgrade, or downgrade the initial ratings.69 As noted in Part III, on July 10, 2007, the rating agencies shook the financial markets70 by abruptly downgrading large numbers of RMBSs and CDOs.71 This massive downgrade may have occurred earlier, and in a more wide-spread fashion, had the surveillance departments been adequately resourced.72

D. Flawed Models and Information Asymmetry

According to Professor Partnoy’s 1999 criticism of the models employed by rating agencies to evaluate structured financial instruments:73

CBO structurers appear to be able to make money from these transactions because either (1) high-yield bonds are systematically underpriced . . . or (2) the methodology the credit rating agencies

64. See Fin. Crisis Inquiry Comm’n, supra note 22, at 150.
65. Id. at 98-99 (quoting a Morgan Stanley quantitative analyst).
67. See id. at 289-302, 304.
68. See id. at 305-06.
69. See id. at 307.
70. See id. at 243.
71. See id. at 310.
72. Cf. id. at 308-09 (“I talked to Tommy yesterday and he thinks that the [RMBS] ratings are not going to hold through 2007. He asked me to begin discussing taking rating actions earlier on the poor performing deals. I have been thinking about this for much of the night. We do not have the resources to support what we are doing now. A new process, without the right support, would be overwhelming. . . . My group is under serious pressure to respond to the burgeoning poor performance of sub-prime deals. . . . [W]e are really falling behind. . . . I am seeing evidence that I really need to add staff to keep up with what is going on with sub prime and mortgage performance in general, NOW.” Email from Ernestine Warner, head of S&P’s RMBS Surveillance Group, to Peter D’Erchia, global head of S&P’s Global Structured Finance Ratings Group (Feb. 3, 2007) (first alteration in original) (first emphasis added)).
73. A collateralized bond obligation is structured similarly to a CDO. Cf. Partnoy, supra note 17, at 666.
use to rate bonds issued by the CBO vehicle is misguided and allows the creation of a greater whole from the sum of its parts, despite the absence of any conceivable synergy.74

Indeed, the rating agencies’ models leading up to the crisis “assumed that securitizers could create safer financial products by diversifying among many mortgage-backed securities.”75 During this time, the models employed by the agencies severely discounted the correlative risk76 of the assets which comprised RMBSs prior to the crisis.77 This flaw was then carried forward: when rating CDOs, the rating agencies plugged in the ratings previously assigned to the underlying RMBSs rather than the further underlying characteristics of the loans comprising these RMBSs.78

Moreover, even if the credit rating agencies had looked through to the underlying RMBS assets, their models for evaluating the individual loans were flawed, because they only examined “the general characteristics of loan pools.”79 The rating agencies’ models factored in the average credit scores of borrowers in a given RMBS loan pool, which allowed issuers to exploit this information asymmetry and structure pools of loans filled with high-risk borrowers with low credit scores, as long as loans to borrowers with high credit scores were included as offsets.80

The models for evaluating RMBSs were furthered flawed leading up to the crisis because they relied too much on past mortgage industry data, rather than taking into consideration the proliferation of loosening underwriting standards and nontraditional mortgages.81 Furthermore, the models assumed ever-rising home prices, rather than stagnant or falling prices.82

When flaws in the RMBS and CDO models were remedied towards the end of the housing boom, they were only applied to new instruments, rather than being used for the surveillance of existing instruments.83 The agencies instead waited until events on the ground

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74. Id.
75. FIN. CRISIS INQUIRY COMM’N, supra note 22, at 149.
76. “Correlative risk measures the likelihood of multiple negative events happening simultaneously, such as the likelihood of RMBS assets defaulting together.” ANATOMY OF A FINANCIAL COLLAPSE, supra note 7, at 292.
77. Id. at 292-93. S&P’s model assumed a 40% probability of correlated RMBS asset defaults, when in reality, the probability was a least 80%. See id. at 292.
78. See FIN. CRISIS INQUIRY COMM’N, supra note 22, at 146-47 (internal quotes omitted).
79. LEWIS, supra note 63, at 99.
80. Id. at 99-100. Issuers further exploited rating agency RMBS model flaws by selecting loans made to borrowers whose short credit histories gave them artificially high credit scores (“thin-file FICO score[s]”). See id. at 100.
81. See ANATOMY OF A FINANCIAL COLLAPSE, supra note 7, at 288-89.
82. See id. at 289.
83. Id. at 303.
proved their methodologies critically unsound to issue the massive downgrades beginning in July of 2007. 84

V. DODD-FRANK’S REFORMS OF CREDIT RATING AGENCIES
A. Increased Private Liability
1. Sections 932(a), 939(G), and 933(a)

Implicitly, Dodd-Frank’s credit rating agency reforms begin by discreetly subjecting the credit rating agencies to more potential private liability. Pursuant to the Credit Rating Agency Reform Act of 2006, 85 which amended the Securities Exchange Act of 1934 (Exchange Act) 86 to regulate NRSROs, 87 credit rating agencies were required to furnish certain information, certifications, and financial statements to the SEC when initially registering as NRSROs 88 and thereafter. 89 Dodd-Frank amended these 90 and other related provisions to read file instead of furnish. 91 The import of this change becomes apparent when read in conjunction with section 18 of the Exchange Act, which makes any person who files materially false or misleading information with the SEC potentially liable to damaged investors who bought or sold a security in reliance on such information. 92

Next, Dodd-Frank amended the Exchange Act by making clear that statements made by credit rating agencies “shall not be deemed forward-looking statements for the purposes of section 21E.” 93 Section 21E of the Exchange Act contains a safe harbor provision 94 which exempts issuers from liability, in private actions under the Exchange Act, for false or misleading forward-looking statements that are identified as such by the issuer making the statement and that are accompanied by meaningful cautionary statements regarding the pos-

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84. Id. at 243, 303.
87. Id. § 78o-7(n)(2), 7(o)(1).
88. Id. § 78o-7(a)(1)(A).
89. Id. § 78o-7(b), (k).
90. Due to possible drafting error, Dodd-Frank left in place the term furnish when it comes to initial NRSRO registration. See id. § 78o-7(a)(1).
93. Dodd-Frank Act § 933(m) (codified at 15 U.S.C. § 78o-7(m) (Supp. IV 2010)).
sibility of future results turning out differently than those in the statement forecast.95

Skipping ahead, Title IX, Subtitle C of Dodd-Frank closes by explicitly stating that “Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect.”96 Rule 436(g) had exempted the credit rating agencies from the general portion of Rule 436.97 Rule 436 states that if an issuer’s filed registration statement or prospectus quotes or summarizes an expert or states that such an expert has reviewed or passed upon the information contained therein, then the issuer is required to obtain and file the written consent of the expert, which would then become part of the registration statement or prospectus.98 Section 11 of the Securities Act of 1933 (Securities Act)99 renders consenting experts strictly liable to damaged investors for materially false or misleading expert statements included in registration statements or prospectuses.100

2. Section 933(b)

Dodd-Frank’s section 933(b), the focus of this Note, is the coup de grâce in terms of subjecting credit rating agencies to increased (and meaningful) private liability under the securities laws. A bit of background is required to adequately explain the function and import of section 933(b). As explained by the Supreme Court:

Section 10(b) of the Securities Exchange Act of 1934 forbids the “use or employ, in connection with the purchase or sale of any security . . . , [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.” SEC Rule 10b-5 implements § 10(b) by declaring it unlawful:

“(a) To employ any device, scheme, or artifice to defraud,
“(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or
“(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”101

96. Dodd-Frank Act § 939(G).
98. Id. § 230.436(a), (b).
Although the Rule does not say so explicitly, the Supreme Court has held that Rule 10b-5 gives rise to an implied private right of action\(^{102}\) and that to establish liability, the “plaintiff must prove that the defendant acted with . . . a mental state embracing intent to deceive, manipulate, or defraud.”\(^{103}\) While negligence will not suffice, lower courts have ruled that the necessary scienter may be established in certain circumstances by recklessness.\(^{104}\)

Section 21D(b)(2) of the Exchange Act, inserted by the Private Securities Litigation Reform Act of 1995 (PSLRA), requires private class action plaintiffs suing for money damages under the Exchange Act’s anti-fraud provisions to plead “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”\(^{105}\) in order to survive a motion to dismiss.\(^{106}\) Most significantly, PSLRA stays discovery during the pendency of any motion to dismiss.\(^{107}\)

Therefore, prior to Dodd-Frank, a class action plaintiff suing a credit rating agency for money damages under Rule 10b-5 would have had to plead with particularity facts giving rise to a strong inference that the rating agency knowingly or recklessly acted to deceive, manipulate, or defraud, in order to survive a motion to dismiss and get to the crucial step of discovery.

Section 933(b) lowers the bar by creating a specific exception for suits against credit rating agencies. It is now sufficient to plead:

with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed—

“(i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or

“(ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit

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102. See Tellabs, 551 U.S. at 319.
103. Id. at 319 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94, 194 n.12 (1976)).
104. See Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 343-44 (4th Cir. 2003) (surveying the law from other circuits and defining recklessness as “an act so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.” (quoting Phillips v. LCI Int'l Inc., 190 F.3d 609, 621 (4th Cir. 1999)).
107. Id. § 78u-4(b)(3)(B).
rating agency considered to be competent and that were independent of the issuer and underwriter.108

Besides creating a novel carve-out in PSLRA for suits against credit rating agencies, this congressionally-imposed lowered pleading standard is significant in and of itself, as it bucks the recent trend of court-imposed heightened pleading standards in federal lawsuits.109

B. Increased Public Regulation and Oversight

While not the focus of this Note, Dodd-Frank’s new regulation and oversight regime for credit rating agencies is briefly (and broadly) addressed below because, in it, Congress has made an earnest attempt to remedy many of the root causes of rating inaccuracy discussed above.

Early in the text of Title IX, Subtitle C, Dodd-Frank reiterates the fact that neither the SEC nor the states may regulate the substance, procedures, or methodologies of credit ratings.110 NRSROs are required by Dodd-Frank to establish and enforce internal control structures, which the SEC is given authority to monitor.111 In addition to the NRSROs themselves, individuals associated with NRSROs now face the possibility of being suspended or barred from associating with NRSROs for a litany of reasons necessary for investor protection.112 Subtitle C goes on to give the SEC a scalpel with the new authority to suspend or revoke NRSRO status partially for particular instrument classes/subclasses, if the SEC finds that an NRSRO lacks adequate resources to produce accurate ratings for these instruments.113

Dodd-Frank mandates that the SEC promulgate rules to prevent sales and marketing considerations from influencing NRSRO ratings114 and attempts to shrink the revolving door by mandating that NRSROs: (1) establish reviewable internal controls to address this; and (2) report to the SEC when a former senior officer or employee becomes employed by a client-issuer.115

As to compliance officers employed by NRSROs, Dodd-Frank prohibits them from being involved in the ratings process, sales, marketing,

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110. See Dodd-Frank Act § 932(a)(2)(A) (codified at 15 U.S.C. § 78o-7(c)(2)).
111. See id. § 932(a)(2)(B) (codified at 15 U.S.C. § 78o-7(c)(3)).
112. See id. § 932(a)(3) (codified at 15 U.S.C. § 78o-7(d)).
113. See id. § 932(a)(3)(F) (codified at 15 U.S.C. § 78o-7(d)(2)).
114. See id. § 932(a)(4) (codified at 15 U.S.C. § 78o-7(h)(3)(A)).
115. See id. (codified at 15 U.S.C. § 78o-7(h)(4)-(h)(5)).
or in setting compensation. Compliance officers, whose compensation may not be linked to company financial performance, are instead required to establish procedures regarding handling internal and external complaints involving rating methodologies and to file annual reports to the SEC.

Significantly, Dodd-Frank directs the SEC to establish an expert-staffed Office of Credit Ratings (OCR) to administer SEC rules regarding NRSRO: (1) rating practices; (2) ratings accuracy; and (3) conflicts of interest. The OCR is also tasked with NRSRO examination and oversight, and the SEC is required to publicize annual reports which accessibly summarize: (1) the OCR examinations; (2) NRSRO responses to certain identified deficiencies; and (3) the adequacy of NRSRO remediation in response to previous SEC recommendations.

The SEC is directed to establish rules, fines, and penalties applicable to NRSROs for violations of the new provisions relating to credit ratings and is given discretionary authority to promulgate other necessary rules. Dodd-Frank directs the SEC to promulgate rules regarding NRSRO performance transparency, methodologies, and disclosure.

Section 932 addresses NRSRO board independence, mandating “at least [half] of the board of directors, but not fewer than [two] of the members thereof, shall be independent” and that some portion of the independent directors include end-users of the NRSRO’s ratings. Additionally, NRSRO boards are given duties to oversee rating methodologies and internal credit rating controls.

Next, section 934 of Dodd-Frank obligates NRSROs to report, to law enforcement or regulators, credible third-party information regarding material violations of the law by client-issuers. Section 935 mandates that NRSROs consider credible and significant third-party information about issuers when producing ratings. Section 936 directs the SEC to promulgate rules to ensure NRSRO employees

117. See id. (codified at 15 U.S.C. § 78o-7(j)(4)).
118. See id. (codified at 15 U.S.C. § 78o-7(j)(3)).
119. See id. (codified at 15 U.S.C. § 78o-7(j)(5)).
120. See id. § 932(a)(8) (codified at 15 U.S.C. § 78o-7(p)(1)(A), (2)).
121. See id. (codified at 15 U.S.C. § 78o-7(p)(3)).
122. See id. (codified at 15 U.S.C. § 78o-7(p)(3)(C)).
123. See id. (codified at 15 U.S.C. § 78o-7(p)(4)).
124. Regarding internal controls, consistency, public disclosure of the reasoning for changes, and transparency see generally id. (codified at 15 U.S.C. § 78o-7(r)).
125. See generally id. (codified at 15 U.S.C. § 78o-7(q)-(s)).
126. Id. (codified at 15 U.S.C. § 78o-7(q)(1)-2)).
127. Id. (codified at 15 U.S.C. § 78o-7(q)(2)).
128. Id. § 934 (codified at 15 U.S.C. § 78o-7(u)).
129. Id. § 935 (codified at 15 U.S.C. § 78o-7(v)).
engaging in the ratings process are adequately trained, experienced, and competent and that they are “tested for knowledge of the credit rating process.” Section 938 directs the SEC to promulgate rules regarding the clear definition and consistent application of ratings symbols.

Effective in 2012, section 939 of Dodd-Frank begins the process of removing references to NRSROs and credit ratings from myriad federal laws. In a similar vein, Dodd-Frank also directs federal agencies to review their regulations referencing credit ratings and remove such references, substituting appropriate standards of “credit-worthiness.”

Lastly, fitting with the pattern of large pieces of legislation, Dodd-Frank directs a number of studies to be carried out regarding standardized credit ratings, the restriction of NRSRO ancillary services, alternatives to the issuer-pays model, and the creation of an independent self-regulatory body for credit rating analyst professionalism.

VI. SECTION 933(b) IS INDISPENSIBLE TO THE CAUSE OF CREDIT RATING AGENCY REFORM

A. Countercyclical Implementation

1. Background

Financial market discipline is impaired in boom times, as institutions and investors expand their own leverage, lending, and investments. The reverse occurs when booms turn to busts. As the boom-bust cycle is inevitable, policies and regulation should work to “calm the booms and soften the busts.” Countercyclical economic policies are those which “lean against the wind,” tightening regulation, oversight, and fiscal policies during good times, while reverse course during downturns.
The problem with pursuing such an economic policy is that it is extremely difficult to implement. After a crisis which results in a bust, people and policymakers demand more regulation and oversight. 143 This tightening is not needed, because institutions and investors are risk-adverse. 144 And during boom economic times, when optimism and asset prices are rising and tightening is needed, no one wants to be the one to spoil the party. 145

2. Illustrations

Examples can be seen in the passage of Dodd-Frank itself, as well as the Gramm-Leach-Bliley Act (GLBA). GLBA deregulated the financial industry by repealing the decades-long separation of commercial and investment banking mandated by the Glass-Steagall Act. 146 The GLBA was enacted on November 12, 1999, 147 near the height of the Dot-Com technology-asset boom. 148 As for Dodd-Frank, its final passage occurred on July 21, 2010, 149 when the nationwide unemployment rate was 9.5%, a twenty-seven-year high. 150

The fate and effect of section 939(G), discussed in Part IV(A)(I) of this Note, illustrate the danger of cyclical regulation in the midst of a bust. 151 Parts of SEC Regulation AB require that issuers of asset-backed securities disclose whether the issuance of these securities is conditioned on the assignment of a credit rating and, if so, identify the credit rating agency and the minimum rating required for the issuance to proceed. 152 Regulation AB requires issuers to disclose in the prospectus “any arrangements to have such rating monitored while the asset-backed securities are outstanding.” 153

Therefore, after the repeal of Rule 436(g), asset-backed security issuers would be: (1) required by Regulation AB to include infor-
mation on credit ratings and credit rating agencies in instrument prospectuses; and (2) required by Rule 436 to gain the consent of credit rating agencies to be included as experts. The credit rating agencies involved in rating these asset-backed securities would then be subject to Section 11 liability. Once the repeal of Rule 436(g) went into effect, the credit rating agencies refused to provide this needed consent, which in turn threatened to grind the asset-backed securities issuance market to a halt. To avoid this result, the SEC issued no-action letters to asset-backed securities issuers, which exempted them from the problematic Regulation AB requirements.

3. Section 933(b)'s Conduciveness to Countercyclical Implementation

Dodd-Frank took more than a year to come into law—from President Obama's initial proposal for an overhaul of the financial industry in June of 2009, to the act's passage in July of 2010. Moreover, the centerpiece SEC Office of Credit Ratings created by Dodd-Frank has yet to come into existence, due to budgetary issues. Should economic conditions necessitate countercyclical changes to the regulation of credit rating agencies, a lengthy overhaul of the myriad U.S. Code provisions, regulations, and bureaucracies put in place by Title IX, Subtitle C would be necessary. Dodd-Frank's credit rating agency regulatory and oversight regime is ill-suited for countercyclical implementation.

Section 933(b), which minimally amended the U.S. Code to lower the pleading standard in a discreet area of securities law, is conducive to countercyclical implementation and can be further amended to appropriately respond to changing economic circumstances. While Congress and the President would still need to act to alter section 933(b), there are no bureaucracies or regulations which flow from it, and changes made would be self-executing, as the provision is merely a door into the federal courtroom. Simply put, section 933(b) is a litigation valve which can be tightened or loosened, relatively quickly, with a few strokes of the Article I and II pens.

157. See Paredes, supra note 155.
159. See Morrissey, supra note 5.
B. Private Enforcement

"[P]rivate securities fraud actions provide ‘a most effective weapon [for] the enforcement’ of securities laws and are ‘a necessary supplement to [SEC] action.’"\(^{160}\) The latter part of that statement is probably truer today than ever, as the United States faces mounting budget deficits,\(^{161}\) which threaten to divert funding away from the SEC.\(^{162}\) In that regard section 933(b)’s regulation-through-private-litigation approach is generally well-suited to this specific moment in history. Moreover, section 933(b)’s virtues lie beyond the context of recent budgetary constraints, due to the general merits of private enforcement of the securities laws. In this regard, Professor Burch’s work is particularly illustrative.\(^{163}\)

1. SEC Capture and Politicized Prioritization

Regulatory capture in this context means a regulatory body surrenders to the wishes of the industry it is supposed to be regulating, rather than serving the needs of the public.\(^{164}\) When a company has shifted from relying on reputational capital to selling regulatory licenses, regulatory capture is essential to ensuring that public outcry over the company’s deteriorating product quality does not lead to the company’s loss of profits and power; indeed, regulatory capture can sustain a license-seller’s “profit and power indefinitely.”\(^{165}\)

Even if one views claims of regulatory capture of the SEC as exaggerated, the SEC is, at the end of the day, subject to political pressures due to the congressional oversight and appropriations process, as well as the fact that the chairman is appointed by the President,\(^{166}\) and its enforcement priorities are shaped by these pressures.\(^{167}\) This is where private enforcement of the securities laws becomes important. Lawsuits, brought by plaintiffs and attorneys not subject to capture or pressure, act as a “safety valve” to continue to bring important enforcement actions, despite industry predations or po-
Given this, section 933(b) would continue to ensure regulation of the credit rating agencies, even if the SEC's priorities moved elsewhere.

2. **Deterrence**

It is almost axiomatic that the increased threat of large federal lawsuits surviving motions to dismiss to reach the discovery stage and beyond would serve to deter wrongful behavior of profit-maximizing credit rating agencies. But aside from the threat of reduced defendant company profitability, securities class action suits also serve to directly deter CEO misbehavior through the threat of negative personal consequences. Studies show that defendant companies sued in securities class action lawsuits experience higher CEO turnover rates than companies that merely suffer large decreases in stock prices. Thus, section 933(b)'s increased class action liability threat acts as a deterrent to the misbehavior of credit rating agencies and, in particular, their CEOs.

3. **Innovation**

If the SEC ever became ossified and wed to the status quo, at the moment change is needed, section 933(b) would enhance the flow of needed fresh air. “Private rights of action conjoined with claim pooling create self-funded supplemental regulators who can afford to pioneer legal theories, hire cutting-edge experts, design sophisticated damage models, conduct electronic discovery, monitor the market, and engineer fraud detection techniques.”

VII. **THE ELIMINATION OF NRSRO REFERENCES IS A NECESSARY SUPPLEMENT**

Legislative reforms of the credit rating agencies should not stop at section 933(b) of Dodd-Frank. While section 933(b) will go a long way towards curbing the misbehavior of the credit rating agencies, it does not solve the problem of credit rating agencies’ loosened concern for maintaining reputational capital, which has at its root cause the web of state and federal statutory and regulatory references to NRSROs, as discussed in Part IV(A). And while Dodd-Frank begins a move in the right direction via sections 939 and 939A, discussed in Part V(B), these provisions have no effect on nonfederal NRSRO regulatory reliance.

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169. See Burch, supra note 163, at 94-95.


171. See Burch, supra note 163, at 91.
Therefore, to supplement the strides made by Dodd-Frank, the recommendation advanced by Professor Partnoy before\textsuperscript{172} and after\textsuperscript{173} the financial crisis should be implemented. Partnoy recommends that references to credit ratings in regulations should be \textit{universally} excised and substituted with references to credit spreads,\textsuperscript{174} as appropriate.\textsuperscript{175} "[B]ecause credit spreads are determined by the market as a whole, not by any individual entity or entities, a credit spread-based system would not create regulatory licenses for any approved agency."\textsuperscript{176}

With credit rating agencies subject to increased ex post regulation in the form of easier private securities class action lawsuits, and with their ability to sell regulatory licenses eviscerated, credit rating agencies will be incentivized to jealously guard their reputational capital, resulting in the issuance of more accurate ratings.

\textbf{VIII. POTENTIAL PROBLEMS WITH SECTION 933(b)'S APPROACH}

\textit{A. The First Amendment}

The most serious problem with the section 933(b) approach to regulating credit rating agencies through private securities class action lawsuits is the potential First Amendment freedom of speech liability shield for the rating agencies. Several relatively recent lower court rulings have held that agencies’ credit ratings are protected by the First Amendment under the “actual malice standard,”\textsuperscript{177} which protects speakers from liability for false statements unless the statement was made “with knowledge that it was false or with reckless disregard of whether it was false or not.”\textsuperscript{178} Under “actual malice,” communications which cannot be proven false (that is, opinions) are protected by the First Amendment,\textsuperscript{179} and lower courts have held that credit ratings fall into this protected category.\textsuperscript{180}

However, the Supreme Court has not ruled one way or the other on whether credit ratings are entitled to First Amendment protection, and plausible arguments have been advanced that credit ratings

\footnotesize{172. Partnoy, supra note 17, at 704.  
174. A “credit spread is the difference between the yield on the bond and the yield on a risk-free bond [i.e., U.S. Treasury] of comparable structure and maturity.” Partnoy, supra note 17, at 705 n.388.  
175. Id. at 704; Partnoy, supra note 173.  
176. Partnoy, supra note 17, at 705.  
178. Id. at 1832 (quoting N.Y. Times Co. v. Sullivan, 376 U.S. 254, 279-80 (1964)).  
179. Id. at 1833.  
180. Id. at 1833-34.}
fall under the category of commercial speech, which does not receive First Amendment protection if it is misleading.\textsuperscript{181} Indeed, Congress seemed to signal this view when it found that “the activities of credit rating agencies are fundamentally commercial in character.”\textsuperscript{182}

\textbf{B. Political Branch Imperviousness to Countercyclical Implementation}

Section 933(b)’s approach is virtuous because of its conduciveness to countercyclical implementation. However, to alter section 933(b), the political branches of the U.S. government must act. Professor Brunnermeier and others argue that those implementing effective countercyclical measures must “enjoy a degree of [political] independence that allows them to impose potentially unpopular steps.”\textsuperscript{183}

Yet, as argued in Part V(A)(3), section 933(b) is conducive to countercyclical implementation due to the ease and speed to which the political branches (with the will to stand against the wind) can tweak the provision in the face of changing economic facts on the ground. And the question remains: What better alternative to the political branches exists to implement countercyclical changes in the pleading requirements? Courts are certainly politically independent, but they can be slower to make needed changes in the law to conform to new factual situations.

\textbf{IX. Conclusion}

Section 933(b), a brief provision in the midst of the massive and complex Dodd-Frank Wall Street Reform and Consumer Protection Act, opens the door to more meaningful private regulation of credit rating agencies—whose inaccuracy in assessing the risk of mortgage-backed securities and other instruments was a primary cause of the financial crisis of 2007-08. By no means the whole answer to the problem of rating agency inaccuracy, section 933(b) is a dramatic step in the right direction, and if supplemented by regulatory changes away from a reliance on NRSROs, it will incentivize the rating agencies to seek to preserve their reputational capital and strive for rating accuracy above all else.

\begin{itemize}
\item \textsuperscript{181} \textit{Id.} at 1836-37.
\item \textsuperscript{183} \textit{See Brunnermeier et al., supra note 60, at 37.}
\end{itemize}