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## If You Rate It, He Will Come: Why Uncle Sam's Recent Intervention with the Credit Rating Agencies Was Inevitable and Suggestions for Future Reform

Nicholas D. Horner  
1@1.com

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# FLORIDA STATE UNIVERSITY LAW REVIEW



IF YOU RATE IT, HE WILL COME:  
WHY UNCLE SAM'S RECENT INTERVENTION WITH THE  
CREDIT RATING AGENCIES WAS INEVITABLE  
AND SUGGESTIONS FOR FUTURE REFORM

*Nicholas D. Horner*

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**IF YOU RATE IT, HE WILL COME:  
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SUGGESTIONS FOR FUTURE REFORM**

NICHOLAS D. HORNER\*

ABSTRACT

*One decides to make an investment based on the knowledge one has at the time of purchase, taking into account, at the most basic level, notions of risk and reward. Assuming risk-neutrality, when investors have accurate information regarding an investment, they will make an informed decision, and therefore markets will, in theory, be efficient. When there is simply a lack of information, investors will discount for the increased uncertainty, and therefore, because investors have accurate information about the lack of information, the market will still, to a certain degree, be efficient. However, when information is not lacking but rather is inaccurate with regard to an investment, a market for “lemons” may develop. Investors, unaware of such misinformation, may attribute a lower degree of uncertainty (i.e., less risk) to such investments than is warranted, thereby jeopardizing the efficiency with which the market operates. Accordingly, it is the prevalence of misinformation and, ironically, not the lack thereof that has the greatest potential to bring down an entire market, or all of the markets, as we nearly observed in 2008. It is misinformation that poses the greatest threat to market efficiency because when investors trade on misinformation, everyone faces potential hardship—everyone, except those responsible for supplying that misinformation (i.e., the credit rating agencies), at least before the passage of Dodd-Frank. However, one must ask a larger, more fundamental question before approaching the issue of rating agency reform: Should those parties who supply that misinformation be held responsible? Or are we to blame for allowing those parties to supply such misinformation?*

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\* J.D./M.B.A. 2013, *cum laude*, Florida State University College of Law. I would like to thank Murat C. Mungan for providing me with the tools necessary to further develop my understanding of law and the economic implications thereof.

*"[W]e rate every deal, it could be structured by cows and we would rate it."*

– S&P Analyst

## I. STATEMENT OF THE PROBLEM

When a creditor issues a loan to a debtor,<sup>1</sup> the creditor typically has an incentive to investigate the creditworthiness of the borrower so as to assess the potential of returning not only its investment but also a profit. Contrast that hypothetical with a situation where a creditor subsequently securitizes its loan by chopping up the original debt into 100 smaller loans, for example, which it then sells to third parties who assume the risk of the original debtor's default. Suddenly, the creditor lacks incentive both to monitor the riskiness of the investment and to transfer information it possesses regarding the investment to potential investors to the extent that such disclosure would reveal adverse or proprietary information.<sup>2</sup> More broadly, once the creditor securitizes its debt, the creditor's incentives become more aligned with those of the debtor's.<sup>3</sup>

Securitizing debt has the potential to create a "market for lemons"<sup>4</sup> when there is an insufficient level of transparency regarding the underlying debts being secured and the models used to select and value them. Because each security has a certain degree of creditworthiness, or quality, and because there exists asymmetry of information between the security issuer and the potential investors, the investors cannot distinguish the "good" investments from the "bad."<sup>5</sup> Consequently, there is an incentive for the issuer to sell bad securi-

1. Assuming the loan is unsecured, or secured and of significant duration.

2. Assuming that all parties are profit-maximizing, the creditor would not reveal adverse information regarding the investment (e.g., the debtor's income is unstable) because doing so would directly and negatively affect the creditor's ability to sell its securities to third parties. Similarly, the creditor would not reveal proprietary information (e.g., the algorithm it uses to determine the creditworthiness of its borrowers) because doing so would facilitate the replication of its processes by competitors, thereby abating any relative advantage it previously enjoyed over such competitors. This is why the notion of "self-induced disclosure" does not hold in the securities context. See John C. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 737-38 (1984) (expressing doubt regarding the theory of voluntary disclosure).

3. Debtors have an incentive to inflate their creditworthiness so as to obtain more funding, whereas creditors have an incentive to be critical of the debtor's creditworthiness so as to protect against loss from their investment. Once the creditor securitizes its loan, however, it now has an incentive to inflate the creditworthiness of the security it is selling (which indirectly represents the creditworthiness of the original debtor) so as to shift its risk to dispersed investors while simultaneously recouping its investment. See Brent J. Horton, *Toward a More Perfect Substitute: How Pressure on the Issuers of Private-Label Mortgage-Backed Securities Can Improve the Accuracy of Ratings*, 93 B.U. L. REV. 1905 (2013) (explaining how the interests of investors and mortgage securitizers were misaligned).

4. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-90 (1970).

5. See *id.*

ties.<sup>6</sup> In order to distinguish their securities from the competition, issuers can demonstrate the superiority of their product over their competitors' product but must be careful not to reveal enough information so as to give a competitive advantage to their competitors. Michael Spence suggests firms do this by sending signals to potential buyers (investors), either by directly making statements about their product's quality to the investors themselves or by indirectly having third parties verify the product's quality.<sup>7</sup> Credit rating agencies ("CRAs") perform the latter function,<sup>8</sup> which is the primary focus of this Note.

Because reputational effects and professional certification can influence market performance, it has been posited that the private market can solve the market-for-lemons problem via third-party verification.<sup>9</sup> CRAs serve the purpose of verifying, if not establishing, the creditworthiness of securities by providing an independent check on what the issuers claim.<sup>10</sup> As such, the rating agencies serve a pivotal role in the functioning of capital markets and have been responsible for severe market contractions in the past.<sup>11</sup>

As will be shown in Part III, two factors have perverted credit ratings over the years, both of which are a consequence of shifting from an investor- or subscriber-pays model to an issuer-pays model. First, issuers can and do hire CRAs to consult and advise the issuer on how to increase the rating of its security prior to actually rating the product itself. Second, because issuers solicit multiple ratings from competing CRAs prior to hiring a particular CRA to rate its product, securities issuers are able to manipulate the signals they send to investors regarding the creditworthiness of their product, thereby rendering the verification anything but "independent."<sup>12</sup> These two

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6. See *id.* at 488.

7. See Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973) (setting forth the concept of economic signaling for the first time).

8. See Mark H. Adelson, *The Role of Ratings in the Financial System*, STANDARD & POOR'S (May 17, 2002, 2:24 PM), <http://www.standardandpoors.com/ratingsarticles/en/us/?articleType=HTML&assetID=1245333790527>.

9. John A. List, *The Behavioralist Meets the Market: Measuring Social Preferences and Reputation Effects in Actual Transactions*, 114 J. POL. ECON. 1, 1 (2006); see also Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 684 (1984).

10. See Adelson, *supra* note 8.

11. PRESIDENT'S WORKING GRP. ON FIN. MKTS., DEP'T OF THE TREASURY, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 2 (2008), available at [http://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil\\_03122008.pdf](http://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf).

12. For a comparable analysis of how and why firms send fraudulent signals in the corporate context, see Manuel A. Utset, *Fraudulent Corporate Signals: Conduct as Securities Fraud*, 54 B.C. L. REV. 645 (2013); see also John M. Griffin, Jordan Nickerson & Dragon Yongjun Tang, *Rating Shopping or Catering? An Examination of the Response to Com-*

facets of the credit rating process produce perverse incentives for rating agencies: namely, pressure initially to inflate the security's credit rating in an attempt to gain market share over a CRA's competitors during the credit rating solicitation stage<sup>13</sup> and a disincentive to continue to monitor a security's creditworthiness after being hired by a particular issuer in the event that a downgrade of creditworthiness is warranted.<sup>14</sup>

There have been numerous attempts over the years to mitigate the inherent conflict of interest that arises from the issuer-pays model,<sup>15</sup> with the most recent and perhaps most influential being the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").<sup>16</sup> Dodd-Frank addressed the problem using a handful of techniques, three of which this Note is primarily concerned with: (1) removal of references to CRA ratings in federal statutes/securities laws as an attempt to decrease systemic reliance on CRAs;<sup>17</sup> (2) mandatory disclosure of rating methodologies, data used to calculate a rating, and underlying assumptions used by CRAs in calculating their ratings;<sup>18</sup> and (3) imposing civil liability on CRAs for false or misleading ratings.<sup>19</sup>

In the next Part, I discuss the economic implications inherent in the securities markets without regard to credit rating agencies. In Part III, I provide a brief history of the emergence of CRAs and explain how their payment model has evolved from an investor-pays model to an issuer-pays model. I then examine select provisions of Dodd-Frank in Part IV, where Congress attempted to address many of the issues created by the issuer-pays model. Finally, in Part V, I bring attention to two important facets of the credit rating process that Dodd-Frank failed to address, namely, the need to segment CRAs' advisory services from their rating services and the need to bifurcate the rating processes of traditional debt securities from complex, structured securities. I then propose a regime designed to promote accurate credit ratings, after which I conclude.

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*petitive Pressure for CDO Credit Ratings*, 26 REV. FIN. STUD. 2270 (2013) (explaining why credit ratings are initially inflated).

13. See Griffin, Nickerson & Tang, *supra* note 12, at 2271-72 (explaining why increased competition, and not rating shopping, is the reason for inflated initial credit ratings).

14. See Patrick Bolton, Xavier Freixas & Joel Shapiro, *The Credit Ratings Game*, 67 J. FIN. 85 (2012).

15. Christopher Keller & Michael Stocker, *Reining in the Credit Ratings Industry*, N.Y. L.J., Jan. 11, 2010, at 1.

16. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank].

17. *Id.* § 939, 124 Stat. at 1885-87.

18. *Id.* § 932(s), 124 Stat. at 1879-80.

19. *Id.* § 1416, 124 Stat. at 2153.

## II. THE ECONOMICS OF SELLING SECURITIES

Federal securities laws, as originally enacted in 1933,<sup>20</sup> serve two basic functions: (1) to prohibit fraud and (2) to require disclosure when securities are issued, and occasionally thereafter.<sup>21</sup> The securities laws have retained their importance, primarily because fraud and deficiency of information reduce allocative efficiency,<sup>22</sup> thereby constraining liquidity in markets.<sup>23</sup>

Securities, both traditional and complex,<sup>24</sup> are claims to future income streams, subject to so many risks that even the issuer cannot know with certainty how creditworthy the investment is.<sup>25</sup> Yet the issuer has better information<sup>26</sup> about the nature of these contingencies, as well as how the security will fare under “stressed”<sup>27</sup> scenarios, than the prospective investor has.<sup>28</sup> Hence, an informational asymmetry exists, and the market for securities can aptly be analogized to a market for lemons.<sup>29</sup> Before explaining how investors decipher which securities are creditworthy and which are not (i.e., which secu-

20. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2012).

21. See Ronald J. Colombo, *Buy, Sell, or Hold? Analyst Fraud from Economic and Natural Law Perspectives*, 73 BROOK. L. REV. 91, 122 (2007).

22. Easterbrook & Fischel, *supra* note 9, at 673; cf. Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the “Nancy Reagan Defense”: May Target Boards “Just Say No”? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377, 415-16 (1990) (coining the term “speculative efficiency,” rather than “allocative efficiency”).

23. See Noah L. Wynkoop, *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 FORDHAM L. REV. 3095, 3105 (2008).

24. “Traditional” and “complex” securities are defined *infra* Part V.

25. See Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2012) (“The term ‘security’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a ‘security’; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”).

26. At least, better access to information than the investor has.

27. *Bathurst Reg’l Council v Local Gov’t Fin. Servs. Party Ltd.* (No. 5) [2012] FCA 1200, ¶ 11 (Austl.), available at <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCA/2012/1200.html>.

28. *Id.*

29. See Srinivasan Balakrishnan & Mitchell P. Koza, *Information Asymmetry, Adverse Selection and Joint-Ventures: Theory and Evidence*, 20 J. ECON. BEHAV. & ORG. 99, 100 (1993).

rities are lemons), however, it is necessary to discuss the related problem of adverse selection.

### A. *Adverse Selection*

“Adverse selection” is the phenomenon whereby asymmetric information causes buyers to select “bad” products over “good” products in a particular market and is a direct corollary of the market for lemons.<sup>30</sup> As Akerlof writes in his article on the market for lemons:

There are many markets in which buyers use some market statistic to judge the quality of prospective purchases. In this case there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group whose statistic is affected rather than to the individual seller. As a result there tends to be a reduction in the average quality of goods . . . .<sup>31</sup>

### B. *Adverse Selection Applied to Securities Markets*

The initial application of this phenomenon can be applied to traditional debt securities, whose quality is relatively easy to estimate, and which provide a relatively safe means of increasing liquidity in capital markets.<sup>32</sup> These “traditional” securities consist primarily of corporate bonds, or interests in a particular company’s income stream, and largely originated with the railroad companies in the early 20th century.<sup>33</sup>

As time progressed, demand increased for these investments and, consequently, for information relating to these investments.<sup>34</sup> More complicated debt instruments ensued, taking advantage of the “investment-worthy” reputation that the more simplified, traditional debt securities had earned. As a result, asset-backed securities (“ABSs”), namely the mortgage-backed security (“MBS”), originated in the late 1960s and became widespread over the next decade as mortgage lenders discovered they could shift the risk associated with their loans to end investors by chopping up individual mortgages into smaller investments and selling those “interests” in a particular mortgage to third parties.<sup>35</sup>

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30. *See id.*

31. Akerlof, *supra* note 4, at 488.

32. *See What You Should Know: The Role of Bonds in America*, SEC. INDUSTRY & FIN. MARKETS ASS’N, <http://www.investinginbonds.com/learnmore.asp?catid=3&id=50> (last visited Mar. 16, 2014).

33. *Moody’s History: A Century of Market Leadership*, MOODY’S CORP., <http://www.moody.com/Pages/atc001.aspx> (last visited Mar. 16, 2014).

34. *See id.*

35. *See generally* J. William Brennan, *Securities Backed by Loan Packaging*, 26 BUS. LAW. 401 (1970) (providing a general overview of the creation of MBSs in the 1960s and their further refinement).

Over the last half-century, even more complex financial instruments have evolved, namely collateralized debt obligations (“CDOs”).<sup>36</sup> These are essentially a derivative of ABSs, in which a mortgage lender, for example, would create a Special Purpose Vehicle (“SPV”) that would receive the income streams from numerous mortgages of different risk tranches (i.e., the SPV’s cash flows derived from both high-risk mortgages and low-risk mortgages, depending on the desired level of risk for that particular portfolio or SPV).<sup>37</sup> The end investor would then purchase a fractional interest in the SPV’s income streams, which were a mixture of the different tranches of mortgages that comprised the portfolio.<sup>38</sup> As demand outpaced supply, there developed an incentive to create even riskier derivatives of ABSs and CDOs that only a rocket scientist could fathom—for example, Jupiter High-Grade CDO V.<sup>39</sup> With all of these financial products riding on the historical reputations of traditional debt securities as worthy investments, investors neglected to investigate the creditworthiness of these new products on their own—an oversight that nearly brought down the global economy in 2008.<sup>40</sup>

### C. Solutions to Adverse Selection

Fortunately, scholars have proposed a myriad of solutions to the adverse selection problem. As Spence proposes, one way to mitigate informational asymmetries, and thus, the market for lemons, is through signaling.<sup>41</sup> One popular signaling mechanism that sellers employ to distinguish their products as superior to others is voluntary disclosure of information.<sup>42</sup> This notion of self-induced disclosure, however, has its limitations, as disclosing any information about a firm’s product inherently confers an advantage to its competitors once that information becomes public.<sup>43</sup> Further, scholars agree that because information is akin to a public good,<sup>44</sup> and therefore exudes

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36. THOMAS P. LEMKE ET AL., MORTGAGE-BACKED SECURITIES § 5.16 (2012).

37. See Darrell Duffie & Nicolae Gârleanu, *Risk and Valuation of Collateralized Debt Obligations*, 57 FIN. ANALYSTS J., Jan.–Feb. 2001, at 41, 41.

38. *Id.*

39. Stephen Gandel, *One Bad Bond*, TIME, Mar. 9, 2009, at 30, 30-31, available at <http://www.time.com/time/magazine/article/0,9171,1881974,00.html>.

40. See John Patrick Hunt, *Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 120-24.

41. See Spence, *supra* note 7.

42. See Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 306-12.

43. *Id.* at 271.

44. Coffee, *supra* note 2, at 725 (recognizing, specifically, that “information about corporate securities from non-issuer sources resembles (albeit imperfectly) a public good”).

positive externalities whose benefit cannot be captured by the discloser due to free rider problems, it will be under-produced.<sup>45</sup> Furthermore, it would be easy for inferior competitors to make falsely similar disclosures that the “good” issuers have made, which is where anti-fraud provisions come into play.

Securities fraud liability makes it costly for the “bad” firms to make false disclosures, thereby enhancing the credibility of information disclosed by the good firms.<sup>46</sup> However, the problem associated with self-induced disclosure still remains: firms will not have an incentive to disclose information that confers a benefit to their competition.<sup>47</sup> Therefore, instead of observing a “voluntary unraveling of information,”<sup>48</sup> no issuer will disclose information given the complex and proprietary nature of securities.<sup>49</sup> However, if all issuers were required to disclose a certain amount of information, the cost associated with revealing that information to competitors would be offset by the benefit of discovering that same information regarding each competitor.<sup>50</sup> In other words, issuers do not self-disclose because it puts them at a relative disadvantage.<sup>51</sup> This not only makes it costly for investors to gather and verify such information, it creates social waste in that each investor’s effort will duplicate another’s (because investors are numerous and disperse).<sup>52</sup> Mandatory disclosure, then, can be seen as a cost reduction mechanism in which society “subsidizes search costs to secure both a greater quantity of information and a better testing of its accuracy.”<sup>53</sup> This increases the allocative efficiency of the capital markets, which denotes a more productive

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45. *Id.* at 722; see also Easterbrook & Fischel, *supra* note 9, at 681.

46. Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1041 (2000).

47. See Anita Indira Anand, *An Analysis of Enabling vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley*, 31 DEL. J. CORP. L. 229, 247 (2006).

48. For an explanation of the “unraveling effect,” see Alan D. Mathios, *The Impact of Mandatory Disclosure Laws on Product Choices: An Analysis of the Salad Dressing Market*, 43 J.L. & ECON. 651, 651 (2000).

49. Anand, *supra* note 47, at 237; see also Easterbrook & Fischel, *supra* note 9, at 674 (stating that firms withhold information when disclosure would reveal “commercially valuable secrets to rivals,” and that this is especially prevalent with new, unreleased products or those involving a secret production process—both of which can be observed with issuing securities).

50. See Easterbrook & Fischel, *supra* note 9, at 687.

51. See Bainbridge, *supra* note 46, at 1031-32.

52. See Coffee, *supra* note 2, at 724 (“Although individual investors could also perform these search and verification functions, the professional securities analyst typically can do so at a lower cost because there appear to be significant economies of scale and specialization associated with these tasks.”).

53. *Id.* at 722.

economy.<sup>54</sup> Therefore, a rule of mandatory disclosure for issuing securities, as was recently augmented by Dodd-Frank, is justified.

### III. THE EMERGENCE OF “ISSUER-PAYS” AND THE IMPLICATIONS THEREOF

Given such ravenous demand for securities, it follows that, if left unregulated, there would develop a market for gathering and disseminating the information needed for investing in such securities.<sup>55</sup>

Indeed, such a market did develop, and it developed to the point that, arguably, CRAs have become essential to the efficient operation of our capital markets.<sup>56</sup> Today, the credit rating market is concentrated in just a handful of firms, nearly all of which are sponsored by the federal government under the guise of a “Nationally Recognized Statistical Rating Organization” (“NRSRO”) designation.<sup>57</sup> However, this was not always the case.

In 1909, John Moody became the first financial analyst to assign letter grades to railroad bonds, giving investors an easier way to evaluate the rail companies’ creditworthiness.<sup>58</sup> In the 1930s, federal regulators began using Moody’s ratings, along with other private ratings from newcomers Poor’s Publishing (later Standard & Poor’s) and Fitch, to evaluate the safety of banks’ holdings, among other things.<sup>59</sup> In 1936, the U.S. Comptroller of the Currency initiated investor reliance on credit ratings by issuing a regulation that prohibited banks from investing in speculative securities as determined by “‘recognized [CRAs], and where there [was] doubt as to the eligibility of a security for purchase, such eligibility [had to] be supported by not less than two [credit ratings].’”<sup>60</sup> This reliance on CRAs was criticized for placing too much authority in the hands of private rating agencies, which ultimately led to its subsequent invalidation.<sup>61</sup>

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54. Bainbridge, *supra* note 46, at 1032-33.

55. Compare Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965), for an analogy of how the market for corporate control would necessarily develop if left unregulated.

56. Joseph Philip Forte, *Wall Street Remains a Key Player in Commercial Real Estate Financing Despite Capital Market Fluctuations*, N.Y. ST. B.A. J., July–Aug. 2001, at 34, 35.

57. *Nationally Recognized Statistical Rating Organizations*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/divisions/marketreg/ratingagency.htm> (last visited Mar. 16, 2014).

58. *Moody’s History: A Century of Market Leadership*, *supra* note 33.

59. Lawrence J. White, *Markets: The Credit Rating Agencies*, J. ECON. PERSP., Spring 2010, at 211.

60. Richard Sylla, *A Historical Primer on the Business of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 19, 37 (Richard M. Levich et al. eds., 2002).

61. *Id.* at 37-38.

Enter the 1970s, when the major CRAs began charging issuers, in addition to charging investors, for rating services.<sup>62</sup> This shift marked the beginning of the end, as the ensuing conflict of interest inherent in the issuer-pays model<sup>63</sup> would prove fatal to the independence and accuracy of CRAs' ratings.

Ironically, credit ratings offer securities issuers a means to signal credibly the creditworthiness of their issuances to potential investors, which in turn should lead to an "unraveling effect."<sup>64</sup> This is because investor reliance on credit ratings has evolved to the point that investors may refrain from purchasing a security that is not rated by a CRA.<sup>65</sup> However, as investors have eventually come to realize, much to their detriment, these "signals" transformed into something far from credible once issuers, rather than investors, began hiring the CRAs.<sup>66</sup> One might ask, then, why did CRAs switch payment models? The answer is simple: collective action problems.

Securities research initially consisted of an analyst's report that was shared with institutional investors in exchange for a subscription fee.<sup>67</sup> This state of the world is Pareto superior<sup>68</sup> to a situation in which myriad institutional investors each employ their own analysts because aggregating research efforts into a single group of professional analysts results in "specialization" and "economies of scale."<sup>69</sup> However, once the analyst's information was disseminated to the investors, free riding became a problem, principally because "institutional investors have an incentive (after they trade) to make the analyst's report a self-fulfilling prophecy by encouraging others to

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62. *Moody's History: A Century of Market Leadership*, *supra* note 33.

63. Marilyn Blumberg Cane, Adam Shamir & Tomas Jodar, *Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies*, 17 *FORDHAM J. CORP. & FIN. L.* 1063, 1091 (2012).

64. *See* Mathios, *supra* note 48, at 652-53.

65. *See* Benjamin H. Brownlow, Note, *Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities*, 15 *N.C. BANKING INST.* 111, 115-16 (2011); Caitlin M. Mulligan, Note, *From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors*, 50 *B.C. L. REV.* 1275, 1278-79 (2009).

66. *See* Keller & Stocker, *supra* note 15.

67. Jon Moody first began selling subscriptions to *Moody's Manual of Industrial and Miscellaneous Securities*, a magazine that originally "provided information and statistics on stocks and bonds of financial institutions, government agencies, manufacturing, mining, utilities, and food companies." *Moody's History: A Century of Market Leadership*, *supra* note 33. However, the manual would eventually evolve to do more than merely provide information regarding companies' "property, capitalization, and management": it soon began "offer[ing] investors an analysis of security values." *Id.*

68. Willa E. Gibson, *Banks Reign Supreme Under Revised Article 9 Deposit Account Rules*, 30 *DEL. J. CORP. L.* 819, 855-56 (2005).

69. *See* Rachel S. Tennis & Alexander Baier Schwab, *Business Model Innovation and Antitrust Law*, 29 *YALE J. ON REG.* 307, 335-36 (2012) (quoting Alan A. Fisher & Robert H. Lande, *Efficiency Considerations in Merger Enforcement*, 71 *CALIF. L. REV.* 1580, 1599 (1983)).

trade.”<sup>70</sup> The relatively recent development of technology and the internet,<sup>71</sup> along with the increasingly complex nature of securities being rated (which in turn required the hiring of more sophisticated, and therefore more highly compensated, personnel), have forced CRAs to overcome the free rider problem inherent in the subscriber-pays model by switching to an issuer-pays model.<sup>72</sup>

The issuer-pays model is problematic for two primary reasons: (1) it incentivizes CRAs to inflate ratings out of fear of losing business, and (2) it provides a disincentive to continue to monitor rated securities in the event that a downgrade is warranted.<sup>73</sup> The conflict of interest is further aggravated by the fact that CRAs typically offer consulting services on how to achieve or improve the credit rating of issuers’ securities prior to actually rating the securities.<sup>74</sup>

In response to increased investor reliance on credit ratings, Congress began regulating CRAs. In 1975, the U.S. Securities and Exchange Commission (“SEC”) created the designation, “Nationally Recognized Statistical Ratings Organizations,” which eventually became the benchmark for CRAs despite the SEC’s failure to define or clarify the term “NRSRO” or to describe how a regular CRA might achieve NRSRO status.<sup>75</sup> One thing that was certain, however, was that the big three CRAs (i.e., Moody’s, Standard & Poor’s, and Fitch), which account for nearly ninety-eight percent of the rating agency market share today, qualified.<sup>76</sup> Only NRSROs were to be referenced in regulations from then on, creating a false sense of confidence among investors who relied on the NRSROs’ assessments of the creditworthiness of potential investments.<sup>77</sup> However, it would take another four decades, just two years after the global financial meltdown of 2008,<sup>78</sup> for the NRSROs finally to be subjected to substantive regulation.

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70. Coffee, *supra* note 2, at 726 (explaining that “the public goods-like character of securities research implies that the analyst cannot obtain the full economic value of his discovery”).

71. Prayan Deb & Gareth Murphy, *Credit Rating Agencies: An Alternative Model* 11-12 (Nov. 2009) (unpublished research paper), available at [http://personal.lse.ac.uk/debp/Papers/Ratings\\_Regulation.pdf](http://personal.lse.ac.uk/debp/Papers/Ratings_Regulation.pdf).

72. *Id.*; see also *Moody’s History: A Century of Market Leadership*, *supra* note 33.

73. See Joshua D. Krebs, *The Rating Agencies: Where We Have Been and Where Do We Go from Here?*, 3 J. BUS. ENTREPRENEURSHIP & L. 133, 140-41 (2009).

74. Dodd-Frank, Pub. L. No. 111-203, § 939C(b)(1), 124 Stat. 1376, 1888 (2010).

75. Cane, Shamir & Jodar, *supra* note 63, at 1076.

76. *Id.* at 1072, 1076.

77. Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1117-18 (2009).

78. Hunt, *supra* note 40, at 120-24.

## IV. A SURVEY OF DODD-FRANK

In 2010, Congress enacted Dodd-Frank in an effort to curtail investor reliance on CRAs and to improve the accuracy of credit ratings in general.<sup>79</sup> Dodd-Frank is particularly important not only for domestic investors but for society at large, as our economy has become increasingly more globalized over the years. Congress explained:

Because of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators, the activities and performances of credit rating agencies . . . are matters of national public interest, as credit rating agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy.<sup>80</sup>

Specifically, Dodd-Frank targeted the problems that contributed to the financial crisis of 2008 by eliminating statutory references to NRSROs and their ratings, requiring increased transparency, and, among other things, repealing Rule 436(g) of the Securities Act of 1933, thereby subjecting CRAs to civil liability as experts for the first time.<sup>81</sup>

A. *Decreased Investor Reliance*

One of the main thrusts of Dodd-Frank was the eradication of investor reliance on NRSROs and their ratings.<sup>82</sup> For years, the SEC issued regulation after regulation referencing either an NRSRO or its ratings, either by disallowing certain organizations from purchasing investments below “investment grade,”<sup>83</sup> or by setting margin requirements for a financial institution based on the rating of its securities.<sup>84</sup> Some argue that “[i]n setting margin requirements based on the ratings of private ratings agencies, the SEC formalized the role of rating agencies in U.S. financial markets.”<sup>85</sup>

Dodd-Frank sought to curtail the significance of NRSRO ratings by encouraging institutional investors to investigate the creditwor-

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79. Dodd-Frank, 124 Stat. 1376 (2010).

80. *Id.* § 931(1), 124 Stat. at 1872.

81. Cane, Shamir & Jodar, *supra* note 63, at 1112; Steven McNamara, *Informational Failures in Structured Finance and Dodd-Frank’s “Improvements to the Regulation of Credit Rating Agencies,”* 17 FORDHAM J. CORP. & FIN. L. 665, 738 (2012) (“[S]ection 939G nullifies Securities Act Rule 436(g)”).

82. *See* Cane, Shamir & Jodar, *supra* note 63, at 1112-13.

83. Describing a bond as “investment grade” denotes a threshold level of creditworthiness, as determined by an NRSRO, whereby banks are restricted to investing only in investments with such a designation. It is typically contrasted with “junk bonds,” which are riskier, higher-yielding bonds. *See* McNamara, *supra* note 81, at 675-76.

84. Mulligan, *supra* note 65, at 1281.

85. *Id.*

thiness of potential investments themselves.<sup>86</sup> However, it did so, for example, by removing statutory references to phrases such as “‘rated in one of the two highest rating categories by at least one NRSRO’” and replacing them with obscure phrases such as “‘meets standards of creditworthiness as established by the Commission.’”<sup>87</sup> Additionally, Dodd-Frank gave federal agencies one year to review their regulations and eliminate any benchmark references to credit ratings by replacing them with a standard of creditworthiness that each agency felt would be appropriate.<sup>88</sup> In other words, Dodd-Frank virtually eliminated any uniformity that previously existed with regard to statutory references to NRSROs. Instead of fixing the problem, Dodd-Frank complicated it further by mandating that federal agencies remove references to relatively uniform ratings—references that served (and still do serve) an important purpose—but left the agencies with no guidance on what to do with the gaps that were created thereby, leaving the door open for capricious regulation of financial institutions independently set by each agency.

### B. Mandatory Disclosure

As stated earlier in Parts I and II, the market for securities can be analogized to a market for lemons in that investors do not know whether they are buying a risky or a safe investment when purchasing a security. The good issuers can mitigate this informational asymmetry by sending credible signals to investors, either by providing information directly or by independently having that information and/or the security’s quality itself certified by a third party.<sup>89</sup> Yet because the nature of securities is inherently complex and requires a certain degree of sophistication to comprehend, the issuers collectively remain reluctant to share information out of fear of being the only issuer to do so. Noting that there already exists a rule against fraud,<sup>90</sup> a rule of mandatory disclosure serves as an effective means of solving this collective action problem by putting all CRAs on the same page, thus offsetting the cost of revealing information to others with the benefit of receiving information from others.<sup>91</sup> In other words, it levels the playing field for those firms that disclose.

Dodd-Frank tackled the collective action problem of nondisclosure among CRAs by increasing transparency, for example, by eliminating

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86. Cane, Shamir & Jodar, *supra* note 63, at 1118.

87. *Id.* (quoting Dodd-Frank, Pub. L. No. 111-203, § 939, 124 Stat. 1376, 1886 (2010)).

88. *Id.*

89. *See supra* Part III.

90. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2012); General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.10b-5 (2013).

91. *See supra* Part II.C.

the exemption for CRAs from Regulation FD.<sup>92</sup> Specifically, it requires CRAs to disclose publicly their rating methodologies, the issuers' data used to calculate a rating, and underlying assumptions the CRA relied on,<sup>93</sup> in addition to requiring issuers and underwriters to disclose any information obtained by third-party due diligence reports regarding asset-backed securities.<sup>94</sup> Yet Dodd-Frank goes one step further in an attempt to increase transparency in the performance of credit ratings. Section 932(a)(8) also requires public disclosure of information relating to initial ratings as well as any subsequent changes to those ratings.<sup>95</sup>

This is perhaps the most beneficial provision in all of Dodd-Frank (as it pertains to CRAs), for it was the unreasonable assumptions and data relied on by CRAs and supplied by the issuers, without question, that distorted credit ratings for complex, structured securities in the decade leading up to the "Great Recession."<sup>96</sup> This is because, under the issuer-pays model, there is an inherent conflict of interest that skews the rating agency's incentives toward achieving certain results (e.g., a "AAA" rating), rather than accurately rating the product.<sup>97</sup> Further, as was revealed in *Bathurst Regional Council v Local Government Financial Services Party Ltd. (No. 5)*, rating agencies are predisposed to rely on issuers' inputs and even issuers' models in rating these structured products, instead of independently coming up with their own models or assumptions.<sup>98</sup>

Regardless of statutory references, investors are in the business of investing, not investigating.<sup>99</sup> So long as CRAs investigate, investors will continue to rely on their ratings. Not only will investors continue to do so, it is efficient for them to do so due to excessive "rent-seeking,"<sup>100</sup> such as redundant investigations, since "each [investor's] effort will [necessarily] duplicate another's."<sup>101</sup> Mandatory disclosure, therefore, in addition to curbing the conflict of interest inherent in the issuer-pays model, should also improve market efficiency by al-

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92. Dodd-Frank, § 932, 124 Stat. at 1872-83; see also Regulation FD, 17 C.F.R. § 243.100(b)(2)(iii) (2013).

93. Dodd-Frank, § 932(a)(8), 124 Stat. at 1877-83.

94. *Id.* § 932(a)(8), 124 Stat. at 1881-82.

95. *Id.* § 932(a)(8), 124 Stat. at 1878.

96. See, e.g., *Bathurst Reg'l Council v Local Gov't Fin. Servs. Party Ltd. (No. 5)* [2012] FCA 1200 (Austl.), available at <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCA/2012/1200.html>.

97. See *supra* Part III.

98. See *Bathurst Reg'l Council*, [2012] FCA 1200.

99. Easterbrook & Fischel, *supra* note 9, at 674-75.

100. Anne Krueger was the first to use the term "rent-seeking." Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291 (1974).

101. This is assuming more than one investor researches. Easterbrook & Fischel, *supra* note 9, at 675.

lowing investors to assess not only the security's creditworthiness itself, which indirectly it does, but also the reasonableness of the CRA's rating of the security. Having said that, only a limited number of investors would be sophisticated enough to comprehend the information disclosed so as to assess the reasonableness of CRAs' ratings.

### C. Imposition of Civil Liability

Perhaps the most significant overhaul of the credit rating industry is the imposition of liability, and therefore accountability, on CRAs. Dodd-Frank does this in a number of ways, most notably, under section 939G, which repeals former Rule 436(g) of the Securities Act of 1933, thereby "expos[ing] CRAs to liability as experts under Section 11 . . . for consenting to the disclosure of their ratings in a registration statement."<sup>102</sup> This reflects the view of Congress that CRAs play too significant a role in the functioning of the capital markets to not be held accountable for deceptive practices.<sup>103</sup> Indeed, Congress stated in section 931 of Dodd-Frank that

[c]redit rating agencies . . . play a critical "gatekeeper" role in the debt market that is functionally similar to that of securities analysts, who evaluate the quality of securities in the equity market, and auditors, who review the financial statements of firms. Such role justifies a similar level of public oversight and accountability.<sup>104</sup>

This view is also reflected in section 933, which allows for civil suits against CRAs by applying the enforcement and penalty provisions of the Securities Exchange Act of 1934 (which deals with secondary transactions between investors) to CRAs.<sup>105</sup> In effect, CRAs are now, from a liability standpoint, no different than "public accountants and securities analysts."<sup>106</sup> But Congress did not stop there. Dodd-Frank further relaxed the pleading requirements implemented by the Private Securities Litigation Reform Act of 1995 with respect to actions for monetary damages against CRAs.<sup>107</sup> Whereas before, "a plaintiff had to allege facts giving rise to a 'strong inference' that the CRA "did not genuinely believe its opinions regarding credit quality," now, a plaintiff need only "allege[] facts with particularity giving rise to a strong inference that the [CRA] *knowingly* or *recklessly* 'failed to conduct a reasonable investigation' of the factual elements

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102. Cane, Shamir & Jodar, *supra* note 63, at 1116.

103. *See id.*

104. Dodd-Frank, Pub. L. No. 111-203, § 931(2), 124 Stat. 1376, 1872 (2010).

105. *See id.* § 933, 124 Stat. at 1883-84.

106. Cane, Shamir & Jodar, *supra* note 63, at 1117.

107. *Id.*

relied upon in evaluating the credit risk of the rated security.”<sup>108</sup> Finally, Dodd-Frank further reworded language in the Securities Exchange Act of 1934 to require that CRAs “file,” rather than “furnish,” their registration applications with the SEC.<sup>109</sup> This seemingly innocuous alteration could have massive implications for CRAs, as they will now be subject to civil liability for misleading statements in certain documents filed with the SEC under section 18 of the Securities Exchange Act of 1934.<sup>110</sup>

Now that Congress has sent a clear message to CRAs that they are no longer immune from suit for misleading or overstated credit ratings, the proverbial floodgates for potential litigation have opened, and in has rushed none other than Uncle Sam himself. In February 2013, the U.S. government, along with a host of other state attorneys general, filed a civil suit against the CRA Standard & Poor’s (a unit of McGraw-Hill), seeking damages in excess of five billion dollars.<sup>111</sup> Now, it is up to the courts to jump on Dodd-Frank’s bandwagon and solidify CRAs’ role in the investing world.

## V. A FEW CONSIDERATIONS FOR FUTURE REFORM

Two aspects of the credit rating process that deserve special attention are the need to separate CRAs’ advisory functions from their credit rating services and the need to recognize and treat differently the rating of traditional debt securities from the rating of complex, structured debt securities. I briefly describe both of these issues in subparts A and B, after which, in subpart C, I propose a solution designed to promote accurate credit ratings, based on the new authority given to the SEC to investigate and implement action to curtail the conflict-of-interest issue inherent in the issuer-pays model.

### A. *Advisory and Consulting Services v. Rating Services*

The only indication that Congress is cognizant of the significance behind CRAs providing both advisory and consulting services in addition to providing rating services can be found in sections 939C and 939H of Dodd-Frank. Section 939C refers to the study that is to be conducted by the SEC on strengthening the independence of CRAs.<sup>112</sup>

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108. *Id.* (quoting SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, THE DODD-FRANK ACT: COMMENTARY AND INSIGHTS 75 (2010), available at [http://www.skadden.com/sites/default/files/publications/Skadden\\_Insights\\_Special\\_Edition\\_Dodd-Frank\\_Act1\\_6.pdf](http://www.skadden.com/sites/default/files/publications/Skadden_Insights_Special_Edition_Dodd-Frank_Act1_6.pdf)).

109. *Id.* (citing Dodd-Frank, § 932(a)(6), 124 Stat. at 1877).

110. *See* Dodd-Frank, § 932(a)(6), 124 Stat. at 1877.

111. Daniel Wagner & Christina Rexrode, *S&P Lawsuit: U.S. Accuses Ratings Agency of Fraud in Lead Up to Financial Crisis*, HUFF POST BUS. (Feb. 5, 2013, 6:12 P.M.), [http://www.huffingtonpost.com/2013/02/05/sp-lawsuit\\_n\\_2621561.html](http://www.huffingtonpost.com/2013/02/05/sp-lawsuit_n_2621561.html).

112. Dodd-Frank, § 939C, 124 Stat. at 1888.

It lists as one of the three subjects for evaluation “the management of conflicts of interest raised by a [NRSRO] providing other services, including risk management advisory services, ancillary assistance, or consulting services.”<sup>113</sup> Section 939H encourages the SEC to use its rulemaking authority under the Securities Exchange Act of 1934 to prevent these improper conflicts of interest arising from employees of CRAs providing services to issuers of securities that are unrelated to the issuance of credit ratings.<sup>114</sup> Although it may be too early to determine the impact Dodd-Frank will have on curbing this issue (in that the SEC has yet to complete its study or issue any such rules), one can assume the impact will be limited absent a recommendation that CRAs be barred from providing such ancillary services, or, at the least, that a single institution cannot provide both consulting (advisory) services and rating services to the same issuer.

### B. Rating Traditional v. Structured Securities

Turning away from the conflict-of-interest issue, it is important that future regulation accounts for the differences between rating traditional debt securities and rating complex, structured securities. Newer, structured finance products are the main concern, as rating agencies have developed reliable techniques to rate standard, or traditional, debt securities.<sup>115</sup> “[T]he term ‘structured finance product’ means an asset-backed security, as defined in section 3(a)(77) of the Securities Exchange Act of 1934, as added by section 941 [of Dodd-Frank], and any structured product based on an asset-backed security, as determined by the Commission, by rule.”<sup>116</sup> In valuing these newer structured finance products, rating agencies utilize convoluted models that require various inputs, or assumptions, in making projections as to a particular security’s creditworthiness.<sup>117</sup> So long as the securities issuers, and not the investors, hire CRAs to rate their products, rating agencies will remain predisposed to rely on the issuers’ inputs and models in rating these structured finance products rather than independently coming up with their own. For these complex securities, I propose a solution that seeks to align the incentives of CRAs with those of the end investors in an attempt to produce more accurate credit ratings.

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113. *Id.*

114. *Id.* § 939H, 124 Stat. at 1890.

115. See Joseph R. Mason & Josh Rosner, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions 13, 17 (May 14, 2007) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1027475](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475).

116. Dodd-Frank, § 939F(a), 124 Stat. at 1889.

117. See Mason & Rosner, *supra* note 115.

C. *A Proposed Method for Incentivizing Accurate Credit Ratings*

My proposal alters the nature of the credit rating process altogether in an attempt to produce more accurate ratings by curtailing ratings shopping and thereby pressure to inflate ratings amongst CRAs. Further, Congress explicitly gave the SEC the requisite authority to do so in section 939F(d) of Dodd-Frank.<sup>118</sup>

First, I shall briefly summarize the credit rating process in an effort to highlight the main hindrances to achieving accurate ratings. Security issuers hire a CRA to advise and/or consult the issuer on the marketing of its prospective issuance in an attempt to receive as high of an initial credit rating as possible, after which the issuer then solicits ratings of its prospective issuance from multiple CRAs, usually including the CRA that was previously hired to advise the issuer.<sup>119</sup> Typically, the issuer then hires the CRA (“Hired CRA”) that submits the highest rating.<sup>120</sup> Note that it is not necessarily the fact that the issuer shops for ratings in itself that is the problem, for if all ratings were accurate, there would be no issue. Rather, the problem stems from each CRA’s inability to resist market forces by stretching its standards in order to produce the highest rating possible, in the hope that it will be hired by the issuer, and thus, will gain market share vis-à-vis the other competing CRAs. In essence, it is increased competition that decreases the accuracy of the ratings by increasing the pressure on CRAs to inflate their ratings.<sup>121</sup>

My proposal would require the creation of an independent committee (“Board”) to be composed either of SEC personnel, of one expert from each NRSRO, or of institutional investors. The latter two options would both require appointment by the SEC, which now has the authority to create such a committee under section 939F(d)(1) of Dodd-Frank.<sup>122</sup> I propose that the credit rating process be altered starting with the issuer’s selection of the Hired CRA. After the issuer selects a rating for—that is, hires a CRA to rate—its security, the issuer would then send the Hired CRA’s analysis<sup>123</sup> to the Board,

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118. Cane, Shamir & Jodar, *supra* note 63, at 1116 (citing Dodd-Frank, § 939F(d), 124 Stat. at 1889-90).

119. COMM. ON THE GLOBAL FIN. SYSTEM, BANK FOR INT’L. SETTLEMENTS, THE ROLE OF RATINGS IN STRUCTURED FINANCE: ISSUES AND IMPLICATIONS 2 (2005), available at <http://www.bis.org/publ/cgfs23.pdf>.

120. Nan S. Ellis et al., *Conflicts of Interest in the Credit Rating Industry After Dodd-Frank: Continued Business As Usual?*, 7 VA. L. & BUS. REV. 1, 8 (2012) (“Through ratings shopping, issuers approach multiple CRAs about rating their debt and then choose the CRA that assigns the highest rating.”).

121. See Griffin, Nickerson & Tang, *supra* note 12.

122. Dodd-Frank, § 939F(d)(1), 124 Stat. at 1889-90.

123. Note that although this information must be made public under Dodd-Frank, it would only occur after my proposed process is complete. Therefore, it is likely that the reviewing CRAs would not be able to identify the Hired CRA or issuer with ease.

along with a standardized fee. The Board would then redact identifying information regarding both the issuer and the Hired CRA and submit the analysis to two additional NRSROs (“Review NRSROs”), neither of which could originally have been solicited by the issuer for either consulting (advisory) services or rating services.

Only if both Review NRSROs find that the Hired CRA’s analysis and ultimate rating are reasonable (i.e., the inputs, data, and methodologies used in calculating the Hired CRA’s rating, as well as the rating itself) would the Board approve the Hired CRA’s rating. In the event that at least one Review NRSRO finds the Hired CRA’s analysis to be unreasonable, the Board shall downgrade the Hired CRA’s rating one degree (e.g., from “AAA” to “AA”).

The two Review NRSROs will not be made subject to civil liability for simply reviewing the Hired CRA’s analysis; rather, the liability will remain solely with the Hired CRA. However, the Review NRSROs will face a penalty (presumably a fine), to be imposed by the Board, if they are found to have acted in bad faith in conducting their review. To minimize the costs associated with the imposition of a bad faith review by the Board, a finding of bad faith shall be presumed when a Review NRSRO uses unreasonably pessimistic inputs in finding the Hired CRA’s rating to be unreasonable or unreasonably optimistic inputs in finding the Hired CRA’s rating to be reasonable. After the Board conducts its bad faith assessment of the Review NRSROs’ reviews, the Review NRSROs will be paid the standardized fee for their services.

After the review process is complete, the results shall be made available to the public, presumably via a website, so that in the event a Hired CRA’s rating is found to be unreasonable, investors and issuers alike will know that the initial rating supplied by the Hired CRA (now downgraded) was unreasonable, suggesting that the Hired CRA gave in to market forces by stretching its standards to inflate its initial rating.

Insulating the Review NRSROs from civil liability for the Hired CRA’s rating mitigates any initial disincentive to review the Hired CRA’s rating, while the standardized fee provides the Review NRSROs with an incentive to conduct the review in the first place. In addition to the standardized fee, the concealment of both the Hired CRA’s and the issuer’s identities helps prevent the issuer from influencing the Review NRSROs by paying them directly. My proposal also offsets the incentive for a Review NRSRO to find the Hired CRA’s rating unreasonable (because they are directly competing with the Hired CRA for market share, despite not knowing the Hired CRA’s identity) due to the potential of facing a penalty for acting in bad faith.

Further, and most importantly, by publicly disclosing the results of the review process, investors and issuers alike will know which CRAs are predisposed to giving into market pressure by stretching their standards in order to inflate their credit ratings, a notion put forth by Griffin, Nickerson, and Tang.<sup>124</sup> This should have an impact on the marketability of security issuances, since investors will presumably pay a premium for a security that was rated by a CRA with a reputation for producing accurate ratings. This will in turn incentivize issuers to solicit ratings from those CRAs with the least amount of “red flags” on their record, thereby creating an incentive for CRAs to rate accurately in the first place. Therefore, public disclosure of the review process should, in theory, allow the market to police CRAs, similar to how the market polices auditors,<sup>125</sup> a mechanism that currently does not exist within the credit rating industry.

## VI. CONCLUSION

Given the insatiable demand of investors to find the next great investment and of lenders to securitize their loans, thereby ridding their balance sheets of ominous liabilities, the impact of securitization on our economy, on the efficient operation of capital markets, and on the world at large will only become more significant as time progresses, as technology improves, and as the financial sector becomes more sophisticated. Structured finance products will only become more complex, and as long as governmental response remains reactive, the possibility of experiencing even more severe economic recessions, if not depressions, will persist far into the future. We have a choice. We can remain reactive, forever trailing one step behind the finance gurus who are currently orchestrating the beginnings of the next Great Recession, or we can evolve, adapt, and take a proactive approach by incorporating what we know about the vulnerabilities inherent in the securities markets and tackle the problem *ex ante*. We need to do more than merely *mitigate* the problem through disclosure and increased transparency; we need to *prevent* the problem from reoccurring with a mechanism that allows the market to police itself.

Congress’ response in 2010 to the rampant credit ratings that helped facilitate the greatest recession since the Great Depression

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124. Griffin, Nickerson & Tang, *supra* note 12.

125. This notion is referred to as “Reputational Capital.” For further discussion, see Stephen P. Alicanti, A Pattern of Unaccountability: Rating Agency Liability, the Dodd-Frank Act, and a Financial Crisis that Could Have Been Prevented 9 (2011) (unpublished manuscript), available at [http://works.bepress.com/stephen\\_alicanti/4](http://works.bepress.com/stephen_alicanti/4) (“The underlying idea [of the reputational model] is that if investors determine that a rating agency’s ratings are of low quality, they will stop crediting the ratings, and the agency’s business will lose value.” (quoting Hunt, *supra* note 40, at 113)).

was a very large step in the right direction. It was perhaps two steps in the right direction, with enough ground covered to take one step back and rework some of Dodd-Frank's faults—in particular, the need to bifurcate the different functions that CRAs perform and the need to segment the rating of traditional debt securities from the rating of newer, structured finance products.

As a popular antagonist from a 1980s film once said, “greed is good.”<sup>126</sup> Sadly, Gordon Gekko could not have epitomized investors' attitudes towards securities more aptly. But are they to blame? Or are we to blame for allowing such devious investment practices to transpire? Only time will tell how significant of an impact Uncle Sam's changes to CRAs and to the credit rating process in general will have on the accuracy of credit ratings, but one thing is for certain: so long as the “greed is good” mentality holds true in the investing world, governmental intervention is inevitable.

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126. “The point is, ladies and gentleman, that greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge has marked the upward surge of mankind. And greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the USA. Thank you very much.” WALL STREET (Twentieth Century Fox Film Corp. 1987).

