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## Credit Rating Agencies Deserve Credit for the 2007–2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act

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# Credit Rating Agencies Deserve Credit for the 2007–2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act

Stephen Harper\*

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### I. Introduction

Credit rating agencies (CRAs) played an important role in the financial crisis that began in the summer of 2007 with problems in the United States subprime mortgage market.<sup>1</sup> CRAs have been criticized for misconstruing the risks associated with complex financial instruments that fueled the United States housing bubble, such as mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs).<sup>2</sup> MBSs are fixed-income securities created from pools of mortgage loans, which are sold to investors who acquire rights in the income from the mortgage pools.<sup>3</sup> Companies will purchase pools of individual mortgages from primary lenders, repackage them as bonds, and then sell interests in the pools to investors.<sup>4</sup>

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1. See Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis* 1 (Legal Studies Research Paper Series, Working Paper No. 09-015, July 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1427167](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1427167) ("A primary cause of the recent credit market turmoil was overdependence on credit ratings and credit rating agencies."). The financial crisis that started in the United States quickly turned into a massive global recession. See Siegfried Utzig, *The Financial Crisis and the Regulation of Credit Rating Agencies: A European Banking Perspective* 1 (ADBI Working Paper Series, Paper No. 188, Jan. 2010), available at <http://www.adbi.org/files/2010.01.26.wp188.credit.rating.agencies.european.banking.pdf> (stating that the recent financial crisis, which began in 2007 in the United States, has since taken on global dimensions).

2. See Stephane Rousseau, *Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road Toward Accountability* 4–5 (Capital Markets Institute of the University of Toronto, Paper, July 23, 2009), available at <http://ssrn.com/abstract=1456708> (stating that CRAs "played a significant role in the market turmoil because of the characteristics of structured finance products which made investors particularly dependent on ratings"). Although CRAs are blameworthy, Rousseau also notes that "the credit market turmoil is the product of a perfect storm resulting from failures on the part of issuers, intermediaries, investors, regulators and governments." *Id.* at 4.

3. See *Pub. Employees' Ret. Sys. v. Goldman Sachs Grp., Inc.*, No. 09-CV-1110(HB), 2011 WL 135821, at \*2 (S.D.N.Y. 2011) (describing how MBSs are created) (citing *N.J. Carpenters Vacation Fund v. Royal Bank of Scotland Grp., Plc.*, 720 F. Supp. 2d 254, 258 (S.D.N.Y. 2010)); SEC, *Mortgage-Backed Securities* (July 23, 2010), <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review). For more information regarding the process of securitization, see *infra* Part III.

4. See *Pub. Employees' Ret. Sys.*, 2011 WL 135821, at \*2 ("To sell the pass-through certificates to investors, the issuing trust must return the certificates to the depositor, who, in turn, passes the certificates to one or more underwriters. The underwriters offer the certificates."). The interests in the pool derive their value from the underlying mortgages. Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 313 (2011).

These companies use the cash flows from the underlying mortgages to pay investors who bought chunks of the MBSs.<sup>5</sup> CDOs are "more complex pools-of-pools" of mortgages; they are pools of different structured products, such as MBS tranches.<sup>6</sup>

Following the financial crisis, a heated debate emerged about CRAs, the rating process, and CRA liability because market participants lost confidence in credit ratings associated with MBSs and CDOs.<sup>7</sup> In addition, many investors sued various CRAs in the wake of the financial crisis for violations of the Securities Act of 1933 (Securities Act)<sup>8</sup> and the Securities Exchange Act of 1934 (Exchange Act),<sup>9</sup> fraud, negligent misrepresentation, breach of fiduciary duty, and abuse of control.<sup>10</sup> For the most part, however, CRAs have been successful in avoiding liability because of

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5. See *Pub. Employees' Ret. Sys.*, 2011 WL 135821, at \*2 (describing how "payments of interest and principal on the underlying loans . . . are collected by the loan servicer and distributed, through the issuing trust, to investors at regular intervals throughout the life of the loans").

6. Bruner, *supra* note 4, at 313; see also REPUBLICAN COMM'RS ON THE FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS PRIMER: QUESTIONS AND ANSWERS ON THE CAUSES OF THE FINANCIAL CRISIS 5 (Dec. 15, 2010), available at <http://keithhennessy.com/wp-content/uploads/2010/12/Financial-Crisis-Primer.pdf> ("A CDO is a pool of different structured products, such as MBS tranches, created in order to provide additional diversification to the investment and thus, in theory, lower risks."). Structured products are complex financial instruments that combine payments from a pool of underlying assets into custom packages with different risk and return profiles. HERWIG M. LANGOHR & PATRICIA T. LANGOHR, THE RATING AGENCIES AND THEIR CREDIT RATINGS: WHAT THEY ARE, HOW THEY WORK AND WHY THEY ARE RELEVANT 141 (2008). The custom packages are referred to as tranches. "[S]tructured' finance instruments are so called precisely due to the active process that goes into defining the properties of each class of security." *Id.* MBSs and CDOs are two specific types of structured finance products. See *Senate Passes Tough Rating-Agency Amendments*, CREDIT RATING AGENCY L. BLOG (May 13, 2010), <http://ratingagencylawblog.wordpress.com/2010/05/13/franken-and-lemieux-amendments/> (last visited Nov. 29, 2011) ("'Structured products' is a broad category that embraces the 'alphabet soup' of novel, complex, and/or opaque securities (asset-backed securities (ABS), mortgage-backed securities (MBS), collateralized debt obligations (CDO), and so forth) that have attracted so much attention during the financial crisis.") (on file with the Washington and Lee Law Review).

7. See Utzig, *supra* note 1, at 1 (stating that CRAs contributed to the recent financial crisis, and as a result, there were calls for greater regulation of CRAs).

8. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006).

9. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2006).

10. Caleb Deats, *Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agencies' Faulty Methodologies From Regulation?*, 110 COLUM. L. REV. 1818, 1818 (2010); see also Larry P. Ellsworth & Keith V. Porapaiboon, *Credit Rating Agencies in the Spotlight: A New Casualty of the Mortgage Meltdown*, 18 BUS. L. TODAY 1–2 (2009), available at <http://www.abanet.org/buslaw/blt/2009-03-04/ellsworth.shtml> (describing various claims brought by investors against CRAs).

various exemptions and defenses.<sup>11</sup> In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to restore confidence in the United States financial system.<sup>12</sup> Eighteen of the Act's 848 pages address CRA accountability and the defenses that have allowed CRAs to escape civil liability.<sup>13</sup>

This Note evaluates whether new CRA procedures and government regulations, created by the Dodd-Frank Act, will increase accountability of CRAs, specifically nationally recognized statistical rating organizations (NRSROs), or whether rating agencies will continue to avoid liability for their inaccurate ratings despite the Dodd-Frank Act.

Part II provides readers with a broad overview of CRAs and the development of CRAs throughout the twentieth century. Part III discusses the process of securitization and explains the role CRAs played in the recent financial crisis that began in 2007. Part IV then explains how CRAs successfully avoided liability before the enactment of the Dodd-Frank Act. Part IV specifically focuses on various regulatory exemptions and constitutional defenses traditionally afforded CRAs. Part V discusses the Dodd-Frank Act with regard to CRAs. Part V also explains how the Dodd-Frank Act will affect CRA liability in the future. Part VI describes and evaluates various alternatives to credit ratings. Part VII analyzes the barriers to CRA liability after the Dodd-Frank Act. Finally, Part VIII offers conclusions.

Ultimately, this Note proposes that CRAs will be unable to avoid liability in the future for inaccurate ratings with regard to complex structured products. The CRAs' First Amendment defense should not be successful in future litigation involving MBSs and CDOs. Although the threat of improper liability will deter CRA misconduct, it could also lead to crushing liability for CRAs. Courts should mitigate the risk of crushing liability by imposing a liability cap on damages.

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11. See Ellsworth & Porapaiboon, *supra* note 10, at 2.

12. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010) [hereinafter Dodd-Frank Act] ("An Act [t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.").

13. John Lippert, *Credit Ratings Can't Claim Free Speech in Law Giving New Risks*, BLOOMBERG (Dec. 8, 2010), <http://www.bloomberg.com/news/2010-12-08/credit-ratings-can-t-claim-free-speech-in-law-bringing-risks-to-companies.html> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review).

## II. Credit Rating Agencies

### A. The Origins of CRAs

Credit rating agencies began in the United States in the beginning of the twentieth century and now have a global presence.<sup>14</sup> The development of CRAs is directly related "to the rise of the bond markets which began in the United States because of the need to raise capital for the railroads."<sup>15</sup> Initially, the specialized press, credit reporting agencies, and investment bankers provided investors with the information that CRAs currently supply.<sup>16</sup> The specialized business press reported on business conditions for companies and industries, and credit-reporting agencies evaluated the ability of merchants to pay their financial obligations.<sup>17</sup> Investment banks stabilized the financial markets by putting their reputations at stake every time they underwrote debt.<sup>18</sup> The consolidation of these functions laid the foundation for the current CRA industry.<sup>19</sup> John Moody founded the first CRA in 1909 by combining the functions of the specialized business press, credit reporting agencies, and investment bankers.<sup>20</sup>

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14. Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COM. L. (Supplemental Issue) 341, 342 (2006).

15. *Id.*

16. *Id.* at 342–43.

17. See LANGOHR & LANGOHR, *supra* note 6, at 376 (describing the functions of the specialized business and financial press and credit reporting agencies).

18. See *id.* (stating that investment banks' reputation capital "was the third proxy for credit rating agencies").

19. See *id.* (stating that the first CRA combined the functions of the specialized business press, credit-reporting agencies, and investment banks "in a single business, laying the foundation of the CRA industry and its reputation capital").

20. See *id.* at 375–76 (explaining the development of the CRA industry during the beginning of the twentieth century); see also Christopher M. Bruner & Rawi Abdelal, *To Judge Leviathan: Sovereign Credit Ratings, National Law, and the World Economy*, 25 J. PUB. POL'Y 191, 194 (2005) ("[C]redit 'ratings' as such were an innovation of the early twentieth century, and specifically a response to modern industry and its massive appetite for private capital."); Theresa Nagy, Note, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 MINN. L. REV. 140, 143 (2009) (describing the emergence of CRAs at the beginning of the twentieth century).

B. *The Function of CRAs and Credit Ratings*

CRAs are supposed to be critical gatekeepers to the securities markets.<sup>21</sup> They assess the creditworthiness of companies and governments that issue debt and assign ratings to various fixed-income securities, including complex structured products.<sup>22</sup> Credit ratings fill the information gap between borrowers and investors.<sup>23</sup> Ratings are evaluations of how likely issuers are to make timely payments on their debt obligations, and they also assess the probability of default with respect to specific fixed-income securities.<sup>24</sup> Credit ratings are relative, not absolute, measures of creditworthiness.<sup>25</sup> Ratings are an assessment of one issuer's credit soundness relative to other issuers.<sup>26</sup> Generally, ratings are considered opinions regarding the creditworthiness of a particular company, security, or obligation.<sup>27</sup> They are not guarantees

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21. See Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 2 (2002) ("[CRAs] are the universally feared gatekeepers for the issuance and trading of debt securities . . ." (citing *The Use and Abuse of Reputation*, *ECONOMIST*, Apr. 6, 1996, at 18)); see also Pinto, *supra* note 14, at 343 (stating that CRAs are considered "one of the outside 'gatekeepers' who act as reputational intermediaries by evaluating issuers in order to protect outside investors").

22. See LANGOHR & LANGOHR, *supra* note 6, at 23 ("According to the European Commission, 'Credit rating agencies issue opinions on the creditworthiness of a particular issuer or financial instrument. . . . [T]hey assess the likelihood that an issuer will default either on its financial obligations generally (issuer rating) or on a particular debt or fixed income security (instrument rating)' . . ."); Rousseau, *supra* note 2, at 13–14 (explaining that some CRAs provide ratings, solicited or unsolicited, on debt issuers in a given marketplace using statistical models).

23. See LANGOHR & LANGOHR, *supra* note 6, at 89 ("Credit ratings are an information good at the intersection between borrowers and investors, respectively the demand and supply for capital.").

24. See Rousseau, *supra* note 2, at 15 (stating that CRAs provide an evaluation of issuer creditworthiness and the safety of specific fixed-income securities).

25. LANGOHR & LANGOHR, *supra* note 6, at 50. "Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk." *Definitions of Ratings and Other Forms of Opinion*, FITCHRATINGS, 4 (Jan. 2011), available at [http://www.fitchratings.com/web\\_content/ratings/fitch\\_ratings\\_definitions\\_and\\_scales.pdf](http://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf).

26. See LANGOHR & LANGOHR, *supra* note 6, at 50 ("Ratings exist for a large and diverse group of entities and debt instruments, which allows investors to assign an individual issuer or debt instrument a credit risk class *vis-à-vis* the overall universe of debt issuers and instruments.").

27. See *id.* at 89 (stating how the Securities and Exchange Commission, the International Organization of Securities Commissions, and the Committee of European Securities Regulators define credit ratings). CRAs prefer to characterize their ratings as "opinions" because "it supports their claim that they are 'publishers,'" and historically, this

against default.<sup>28</sup> By issuing various ratings, CRAs help to increase the efficiency of capital markets.<sup>29</sup>

Credit ratings serve three main functions: to measure credit risk, to provide a means of comparison between different securities issues, and to provide market participants with a common standard to refer to credit risk.<sup>30</sup> The primary objective of credit ratings, however, is to eliminate information asymmetries in credit markets.<sup>31</sup> Many investors are ignorant of what goes on in a company.<sup>32</sup> By issuing credit ratings, CRAs provide fixed income investors with information that is generally only available to company insiders.<sup>33</sup> When evaluating a security or company, CRAs consider capacity to meet financial obligations, exposure to business conditions, and the consequences of actual default.<sup>34</sup> CRAs assign their ratings a letter grade, the highest usually being AAA, with lower grades moving down the alphabet.<sup>35</sup> These ratings help investors and regulators

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characterization was accurate. Lawrence J. White, *Markets: The Credit Rating Agencies*, 24 J. ECON. PERSP. 211, 212 n.2 (Spring 2010). However, today, credit ratings probably cannot be characterized as opinions in all situations. See *infra* Part VII (explaining that CRAs should not be considered members of the press in the CDO and MBS context). "One implication [of characterizing credit ratings as opinions] is that the credit rating agencies thus enjoy the protections of the First Amendment of the U.S. Constitution when they are sued by investors and by issuers who claim that they have been injured by the actions of the agencies." White, *supra*, at 212 n.2. However, CRAs emphasize that their ratings are not buy or sell recommendations regarding particular securities. Rousseau, *supra* note 2, at 15.

28. Standard & Poor's, *Credit Ratings Definitions & FAQs*, <http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review).

29. See Rousseau, *supra* note 2, at 15 ("[T]he activities of CRAs can contribute to the efficiency of capital markets by rectifying some of the information asymmetries that exist between issuers and investors.").

30. See LANGOHR & LANGOHR, *supra* note 6, at 89–91 (describing the three main functions of credit ratings).

31. See Anthony M. Santomero, *Foreword* to HERWIG M. LANGOHR & PATRICIA T. LANGOHR, *THE RATING AGENCIES AND THEIR CREDIT RATINGS: WHAT THEY ARE, HOW THEY WORK AND WHY THEY ARE RELEVANT*, at x (2008) ("Credit rating agencies and their output play a unique . . . role in overcoming the information asymmetries that are endemic to the capital market.").

32. See LANGOHR & LANGOHR, *supra* note 6, at 9 ("One of the most critical impediments to investor rights is their ignorance of what goes on in a company, i.e. the information asymmetry between outside investors and insiders who control company operations.").

33. See *id.* at 9 (explaining that the aim of credit rating agencies is "to remedy the information shortage for fixed income investors" that develops from the information asymmetry between outside investors and company insiders).

34. *Id.* at 75.

35. See Christopher Alessi & Roya Wolverson, *The Credit Rating Controversy*,

distinguish between investment grade securities—securities that are rated at least BBB on the Standard & Poor's (S&P) scale—and speculative securities, or junk bonds.<sup>36</sup> A high credit rating is generally more attractive to conservative investors because it signals low credit risk.<sup>37</sup> However, some investors might find lower-rated securities more attractive because they provide a higher return.<sup>38</sup> Ratings are reduced as the capacity to meet financial obligations decreases and business or economic conditions deteriorate.<sup>39</sup> These ratings are highly valued by investors, who rely on CRAs to analyze and assess the risks associated with various financial transactions.<sup>40</sup> Credit ratings not only reduce the cost of information for investors,<sup>41</sup> but they also improve a borrower's ability to raise capital.<sup>42</sup>

### C. Factors that Shaped the Current CRA Industry

Six main factors shaped the current CRA industry: financial disintermediation, institutionalization of investments, accelerated rate of industry change, complex financial innovations, the globalization of capital markets, and the growth of regulatory uses of ratings.<sup>43</sup> Financial

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COUNCIL ON FOREIGN RELATIONS (Aug. 10, 2011), [http://www.cfr.org/publication/22328/credit\\_rating\\_controversy.html](http://www.cfr.org/publication/22328/credit_rating_controversy.html) (last visited Nov. 29, 2011) (describing briefly the characterization of raters' opinions) (on file with the Washington and Lee Law Review).

36. White, *supra* note 27, at 213.

37. Schwarcz, *supra* note 21, at 8.

38. See Rousseau, *supra* note 2, at 15 (explaining that some individual investors may prefer to purchase lower-rated securities if they receive appropriate compensation for the additional risk).

39. See LANGOHR & LANGOHR, *supra* note 6, at 75 (explaining that a CRA will reduce credit ratings as the level of adversity increases).

40. See Schwarcz, *supra* note 21, at 3 (explaining that investors rely on rating agencies for comfort regarding the risks associated with payment of debt securities); see also Alessi & Wolverson, *supra* note 35 ("Credit rating agencies are meant to provide global investors with an informed analysis of the risk associated with debt securities."). The success of a CRA is directly related to the CRA's reputation. CRAs offer their reputation as a guarantee of the quality of an issuer. See Rousseau, *supra* note 2, at 16 (stating that CRAs act as certifying agents by offering their reputation as a guarantee).

41. See LANGOHR & LANGOHR, *supra* note 6, at 89 (stating that CRAs reduce the cost of information for investors and the cost of market access for borrowers by decreasing the distance between lenders and borrowers).

42. See *id.* at 94 (stating that ratings provide issuers with greater access to the public bond markets). Ratings open up "a wider range of funding alternatives in terms of size, length of maturity, geographic market, diversity of instruments and investor base, range of currencies and covenant packages." *Id.*

43. *Id.* at 378.

disintermediation is the substitution of bank loans with securities.<sup>44</sup> This substitution increased the demand for bond ratings and due diligence.<sup>45</sup> In the past, banks had loaned deposits to borrowers based on their own credit assessments.<sup>46</sup> However, as depositors began to invest their money elsewhere and borrowers found market-based sources of capital, the relationship between banks, as the original provider of funds, and borrowers dwindled.<sup>47</sup> Banks realized that they had no logical business reasons to incur the costs of credit analysis for bonds,<sup>48</sup> and CRAs took advantage of the banks' withdrawal from long-term lending to corporations.<sup>49</sup>

The use of bond ratings in institutional investors' portfolio allocations and the accelerating rate of industry change created new opportunities for CRAs as well.<sup>50</sup> The global financial system relies on CRAs to evaluate the prospects of the ever-increasing number of issuers.<sup>51</sup> In addition, increased financial innovation, particularly with regard to structured products, has facilitated disintermediation and the expansion of capital markets.<sup>52</sup> This expansion creates more uncertainty in the credit markets and widens the information gap between investors and issuers.<sup>53</sup> Consequently, credit rating is "an ever more important source of qualified credit information."<sup>54</sup>

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44. *Id.*

45. *Id.*

46. *See* Bruner & Abdelal, *supra* note 20, at 196 ("Traditionally banks have taken in money from depositors (the banks' creditors), and then lent it to borrowers based on their own credit evaluations, and at their own risk.").

47. *See id.* (explaining that banks have been marginalized from the traditional lending process as "depositors have put their money elsewhere and borrowers have found other sources of capital (mutual funds, for instance)").

48. *Id.*

49. *See* LANGOHR & LANGOHR, *supra* note 6, at 378–79 (stating that CRAs filled the gap created by financial disintermediation after commercial and investment banks stopped performing their own credit analysis for bonds).

50. *Id.* at 379–80.

51. *See id.* (explaining that industry change makes it harder to apprehend an issuer's future and makes it more efficient for investors to diversify, and as a result, CRAs are incentivized to deepen their ratings and broaden their spectrum).

52. *See id.* at 382 (explaining how complex financial innovations have facilitated disintermediation and capital market expansion and, as a result, stimulated the need for CRAs).

53. *See id.* at 380 (stating that the increasing number of issuers makes it more difficult for a good company to convince investors that it is a valuable investment).

54. *Id.* at 383.

*D. The Development of CRAs in the 1970s*

During the 1970s, CRAs benefited from the default of \$82 million in the market for commercial paper of Penn Central and from numerous changes to the credit rating industry.<sup>55</sup> Prior to the default, investors relied on the reputation of the issuer in making investment decisions.<sup>56</sup> However, after the default, issuers of commercial paper asked CRAs to rate their notes.<sup>57</sup> This also allowed CRAs to shift the cost of ratings from subscribers to issuers.<sup>58</sup> Initially, credit ratings were financed through investors.<sup>59</sup> However, demand for CRAs increased following the Penn Central default, and CRAs began to charge issuers for their ratings.<sup>60</sup> There are several reasons why CRAs might have changed their business model from an investor-pays system to an issuer-pays model. First, CRAs were concerned that too many investors would obtain ratings from subscribing friends and avoid paying CRAs.<sup>61</sup> CRAs provide a public good by rating debt, and in an investor-pays model, CRAs cannot avoid the free rider problem once they publish their "opinions."<sup>62</sup> On the other hand, in an

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55. See Pinto, *supra* note 14, at 347 ("The default of \$82 million in the market for commercial paper of Penn Central in 1970 was a significant event for credit rating agencies.").

56. *Id.*

57. See *id.* (stating that issuers turned to CRAs to rate their commercial paper in order to calm the market).

58. See *id.* (stating that the increased use of CRAs by issuers "made it easier for them to shift the costs from subscribers to issuers for the ratings" (citing Richard Cantor & Frank Parker, *The Credit Rating Industry*, 19 FRBNY Q. REV. 1, 2 (Summer/Fall 1994), available at [http://www.ny.frb.org/research/quarterly\\_review/1994v19/v19n2article1.pdf](http://www.ny.frb.org/research/quarterly_review/1994v19/v19n2article1.pdf))).

59. See Bruner & Abdelal, *supra* note 20, at 195 (stating that credit ratings "initially were financed through subscription fees paid by investors").

60. See Pinto, *supra* note 14, at 347 ("Although [CRAs] were unable to anticipate the problem, their increased use by issuers was clearly a boon to the agencies."); see also Bruner & Abdelal, *supra* note 20, at 195 ("[T]he dominant rating agencies today derive their revenues principally from issuer fees, creating an inherent conflict of interest that is only exacerbated, according to the agencies' critics, by the extension of the ratings franchise to the provision of ancillary services."); Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 96 (2010) ("A company pays a CRA to produce an informational public good relating to the corporation—its credit rating.").

61. See White, *supra* note 27, at 214 ("First, the rating firms may have feared that their sales of rating manuals would suffer from the consequences of the high-speed photocopy machine . . . , which would allow too many investors to free ride by obtaining photocopies from their friends.").

62. See Rousseau, *supra* note 2, at 45 ("Research on creditworthiness is similar to a public good in that it is difficult to limit its accessibility by excluding those investors who

issuer-pays model, the issuer can continue to pass costs on to investors even after their debt has been rated.<sup>63</sup> Second, following Penn Central's bankruptcy, issuers were willing to pay CRAs to assure bond investors that their bonds were low risk.<sup>64</sup> Third, regulatory uses of credit ratings increased during the 1970s, and the opinions of certain recognized CRAs became more valuable. As a result, issuers were willing to pay for the blessing of certain CRAs.<sup>65</sup>

However, the issuer-pays model also opened the door to serious conflicts of interest.<sup>66</sup> In their defense, CRAs argue that concerns about their reputations minimized these conflicts.<sup>67</sup> Although CRAs are paid by one or more of the parties to a transaction, their ratings should be neutral because CRAs should be neutral, third-party advisors.<sup>68</sup>

CRAs also experienced significant growth and became more powerful in the 1970s when the Securities and Exchange Commission (SEC) coined the term nationally recognized statistical rating organizations (NRSROs).<sup>69</sup> NRSROs are prominent CRAs that have been nationally recognized in the United States as "issuers of 'credible and reliable ratings by the predominant users of securities ratings,' permitting financial institutions to

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have not paid for it."). In an investor-pays model, the general public would be deprived of valuable information regarding creditworthiness because credit ratings would only be available to subscribers. *Id.* at 46.

63. See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 653 (1999) ("Although investors are not paying directly for rating agencies to rate the securities they buy, issuers who pay for ratings pass on the costs of those ratings to investors by paying a lower return on debt issues.").

64. See *id.* at 652 (explaining that debt issuers were willing to pay CRAs to have the CRAs vouch for their bonds).

65. *Id.*

66. See Rousseau, *supra* note 2, at 25 (explaining that CRAs may issue favorable ratings in order to retain an issuer's business). In addition, the structure of fees based on the size of offerings might result in a conflict of interest. *Id.* For further information regarding CRAs and conflicts of interest, see *id.* at 25–27.

67. See White, *supra* note 27, at 215 ("[T]he rating agencies' concerns about their long-run reputations apparently kept the actual conflicts in check . . .").

68. See Joshua D. Krebs, *The Rating Agencies: Where We Have Been and Where Do We Go From Here?*, 3 J. BUS. ENTREPRENEURSHIP & L. 133, 134 (2009) ("[Rating agencies] claim they are merely reputational intermediaries sought by numerous market participants for neutral opinions on the safety of securities products." (citing John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW 1403, 1405 (2002))).

69. See Bruner & Abdelal, *supra* note 20, at 196 (stating that "the SEC coined the concept of 'nationally recognized statistical rating organizations', [sic] or NRSROs, in 1975").

count such ratings toward compliance with the wide range of regulations incorporating the concept."<sup>70</sup> In 1973, the SEC issued Rule 15c3-1,<sup>71</sup> which "allowed broker dealers to calculate their net capital requirements based on credit ratings from a NRSRO designated by the [SEC]. Over time the NRSRO concept was used in other contexts including both federal and state legislation[] and in some markets."<sup>72</sup> When Rule 15c3-1 was promulgated, there were only three NRSROs—S&P, Moody's Investors Service (Moody's), and Fitch Ratings Ltd. (Fitch).<sup>73</sup> However, ten CRAs are currently registered with the SEC as NRSROs.<sup>74</sup> NRSROs occupy an important place in banking, insurance, and other regulatory schemes.<sup>75</sup> Some rules require certain investors to only buy highly rated bonds, and other rules reduce capital requirements for entities that purchase highly rated bonds.<sup>76</sup>

The increased regulatory uses of ratings have also stimulated the demand for credit ratings.<sup>77</sup> In the United States, regulations restrict or

70. *Id.* (quoting SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 9 (2003)).

71. 17 C.F.R. § 240.15c3-1 (2008).

72. Pinto, *supra* note 14, at 347. See *id.* at 347 nn.37–38 for examples of rules that incorporate NRSRO ratings. CRAs are particularly important in the securitization market because of various regulations requiring a rating. See *id.* at 347 n.39. Credit ratings were first used in regulations in the 1930s. *Id.* at 346. Banking authorities passed a set of regulations that "prohibited banks from investing in 'speculative investment securities' as determined by 'recognized rating manuals.'" White, *supra* note 27, at 213. This is also when the investment grade concept developed. *Id.*

73. Pinto, *supra* note 14, at 347.

74. Krebs, *supra* note 68, at 135; see Ellsworth & Porapaiboon, *supra* note 10, at 1 ("There are 10 credit rating agencies designated as [NRSROs] by the SEC: [Moody's]; [S&P]; [Fitch]; A. M. Best Company; Dominion Bond Rating Service, Ltd.; Japan Credit Rating Agency, Ltd.; R&I, Inc.; Egan-Jones Ratings Company; LACE Financial; and Realpoint, LLC.").

75. Cf. Listokin & Taibleson, *supra* note 60, at 103 ("If ratings are untrustworthy, they should not be placed at the heart of banking or insurance regulatory schemes.").

76. See Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* 4–5 (Council of Institutional Investors: The Voice of Corporate Governance, Apr. 2009), available at [www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf](http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf) (explaining that NRSRO credit ratings are a necessary step for regulatory compliance for all types of institutions). "For example, Rule 2a-7 under the Investment Company Act of 1940 limits money market funds to investing in only high quality short-term instruments, and NRSRO ratings are used as benchmarks for establishing minimum quality investment standards." Pinto, *supra* note 14, at 347 n.37. Rule 3a-7 under the Investment Company Act of 1940 exempted issues of some ABS from registration as a mutual fund. LANGOHR & LANGOHR, *supra* note 6, at 432. For additional examples of regulatory uses of credit ratings in the United States, see *id.*

77. See LANGOHR & LANGOHR, *supra* note 6, at 384 (stating that the growing use of

prohibit the purchase of securities with low credit ratings, impose capital requirements depending on the holdings' ratings, and affect disclosure requirements for securities that possess "satisfactory" ratings.<sup>78</sup> The main purposes of such regulations are prudence, investor protection, and the integrity of security markets.<sup>79</sup> Prudential regulations aim to maintain market confidence and stability by regulating capital and risk management standards.<sup>80</sup> Regulations also control market access by using ratings to differentiate the due diligence and information requirements that an issuer must satisfy before it can access the market.<sup>81</sup> Additionally, regulations protect the investor by establishing minimum rating standards to ensure quality investments.<sup>82</sup> The United States government mandate requiring the use of credit ratings empowers CRAs while providing them with little accountability.<sup>83</sup>

Until the mid-1970s, when the SEC began relying on CRAs for regulatory purposes, CRAs survived "based on their ability to acquire and retain reputational capital."<sup>84</sup> Their success depended on trust and credibility.<sup>85</sup> Originally, CRAs did not have a governmental mandate.

If this view of the [CRAs] is correct, then credit ratings are simply opinions, not unlike a restaurant star rating from Michelin. Credit ratings respond to investors' demand for information about risks associated with fixed income investments. By specializing in the gathering, analysis, examination, and dissemination of such information,

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ratings for regulatory purposes has resulted in increased opportunity and importance for CRAs).

78. See Bruner & Abdelal, *supra* note 20, at 192 ("Ratings are incorporated into financial regulations in the United States, as well as in many other countries around the world."); LANGOHR & LANGOHR, *supra* note 6, at 431 (explaining the regulatory uses of credit ratings).

79. LANGOHR & LANGOHR, *supra* note 6, at 431.

80. See *id.* at 435 (stating that prudential regulations aim "to mitigate the possibility that firms will be unable to meet their liabilities and commitments to consumers and counterparties").

81. See *id.* at 436 ("Regulators also use credit ratings as an eligibility criterion for issuers tapping the capital markets.").

82. See *id.* at 439 (providing examples of how financial regulation can be traced to investor protection).

83. See Krebs, *supra* note 68, at 134 ("[CRAs] uniquely occupy a niche where government regulation mandates that market participants utilize their ratings; they are, in fact, selling compliance with official regulation." (citing Christopher M. Bruner, *States, Markets, and Gatekeepers: Public-Private Regulatory Regimes in an Era of Economic Globalization*, 30 MICH. J. INT'L L. 125, 168 (2008))).

84. Partnoy, *The Siskel and Ebert of Financial Markets?*, *supra* note 63, at 629.

85. *Id.*

[CRAs] eliminate the duplicative and wasteful (i.e., inefficient) efforts of individuals engaging in such activities. According to this view, credit ratings are a competitive, reputation-driven business, and agencies will survive only to the extent they are accurate and reliable in assessing the credit risks of borrowers.<sup>86</sup>

Three criteria are required before the reputational model can be effective. First, CRAs must suffer a loss of future business if their ratings were inaccurate.<sup>87</sup> Second, the loss in reputational capital must exceed any gain from inaccurate ratings.<sup>88</sup> Third, CRAs must provide a costly service related to the information gap between issuing firms and public investors.<sup>89</sup> CRAs satisfy these three criteria.<sup>90</sup> According to the reputational capital view, CRAs "exist in a competitive market of information providers and live or die based on their reputational capital."<sup>91</sup> Consequently, a heightened liability regime was not needed as much as it is today.<sup>92</sup>

After the 1970s, the reputational capital view was replaced by regulatory licenses. The SEC incorporated credit ratings into various regulations and, in a sense, awarded CRAs a government mandate.<sup>93</sup> As a result, the market became more concerned with whether a CRA had a regulatory license and less worried about whether credit ratings were accurate.<sup>94</sup> The erosion of the reputational capital view has led to decreased market accountability, and the federal government, particularly the SEC, has not yet found a workable method through which it can hold CRAs accountable.

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86. *Id.* at 630–31 (citations omitted).

87. *See id.* at 633 ("[T]he certifying agent would suffer a loss of future relationships because of reduced trustworthiness if it suggested a fair market value in excess of the offering price.").

88. *Id.*

89. *See id.* ("Third, the agent's services must be costly and the cost must be related to the asymmetric information associated with the issuing firm." (citing Roger Stover, *Third-Party Certification in New Issues of Corporate Tax-Exempt Bonds: Standby Letter of Credit and Bond Rating Information*, 25 FIN. MGMT. 1, 63 (1996))).

90. *Id.*

91. *Id.* at 635.

92. *Cf. id.* at 646 (explaining that CRAs suffered during the 1940s and 1950s because of their inability to generate accurate ratings after the 1930s).

93. *See id.* at 681 (stating that "a good rating entitles the issuer (and the investors in a particular issue) to certain advantages related to regulation").

94. *See id.* at 681–82 (explaining the increased growth and increased importance of rating agencies from the mid-1970s through today).

*E. Regulatory Licenses*

As stated above, CRAs have benefited from valuable property rights that are reinforced by regulations requiring credit ratings.<sup>95</sup> "As legal requirements for ratings have proliferated, the rating agencies have evolved from information providers to purveyors of 'regulatory licenses.'"<sup>96</sup> Through these regulatory licenses, CRAs provide ratings that grant issuers access to the financial markets.<sup>97</sup> Regulatory licenses provide benefits to NRSROs regardless of whether or not the ratings are credible and accurate.<sup>98</sup> "[O]nce the ratings of a small number of credit rating agencies are enshrined by regulators who incorporate credit ratings into substantive regulation, the markets become less vigilant about the agencies' reputations."<sup>99</sup> Issuers now pay CRAs to acquire licenses from regulators,<sup>100</sup> and consequently, NRSROs have a product to sell regardless of their credibility.<sup>101</sup> Regulatory licenses are costly because they create oligopolistic pressures in a concentrated industry.<sup>102</sup> Many argue that the benefits of regulatory licenses need to be eliminated or reduced.<sup>103</sup>

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95. See Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 60 (Yasuyuki Fuchita & Robert E. Litan eds., 2006) [hereinafter *Other Gatekeepers*] ("[T]he most successful credit rating agencies have benefited from an oligopoly market structure that is reinforced by regulations that depend exclusively on credit ratings issued by [NRSROs].").

96. Partnoy, *Rethinking Regulation*, *supra* note 76, at 2.

97. See *id.* ("A regulatory license is a key that unlocks the financial markets. Credit rating agencies profit from providing ratings that unlock access to the markets, regardless of the accuracy of their ratings."). Good ratings entitle issuers to certain regulatory advantages. Partnoy, *Other Gatekeepers*, *supra* note 95, at 82. Professor Partnoy argues that ratings are not opinions but instead keys to the financial markets for regulated entities. Partnoy, *Overdependence*, *supra* note 1, at 9.

98. See Partnoy, *Other Gatekeepers*, *supra* note 95, at 60 (stating that NRSROs generate economic rents regardless of whether or not CRAs perform poorly and would otherwise lose reputational capital).

99. Frank Partnoy, *The Paradox of Credit Rating*, in RATINGS, RATING AGENCIES, AND THE GLOBAL FINANCIAL SYSTEM 65, 73 (Richard M. Levich et al. eds., 2002).

100. See Partnoy, *Other Gatekeepers*, *supra* note 95, at 60–61 (stating that CRAs have become more like "gate openers" than gatekeepers).

101. See *id.* (stating that regulatory licenses "generate economic rents for NRSROs that persist even when they perform poorly and otherwise would lose reputational capital").

102. *Id.* at 83.

103. See *id.* at 89–90 (explaining proposals to reduce the benefits of regulatory licenses).

*F. The Current Credit Rating Industry*

Today, there are approximately 150 CRAs in 100 countries.<sup>104</sup> CRAs evaluate more than 745,000 securities, representing at least \$30 trillion.<sup>105</sup> Clearly, CRAs have the ability to influence the fixed income markets.

Although there are 150 CRAs globally, the market is dominated by three main players: Moody's, S&P, and Fitch.<sup>106</sup> Together, Moody's and S&P control over 80% of all rated issues outstanding; Fitch, the third largest CRA by market share, has a market share of 14%.<sup>107</sup>

The credit rating industry is vital to the effective operation of the global financial markets.<sup>108</sup> Because CRAs are central to capital formation, investor confidence, and the United States economy, the activities of CRAs, particularly NRSROs, are current matters of national public interest.<sup>109</sup> The transactions of CRAs "occur in such volume as substantially to affect interstate commerce, the securities markets, the national banking system, and the national economy."<sup>110</sup> CRAs proved to be very influential in the recent financial crisis and ensuing economic downturn.

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104. LANGOHR & LANGOHR, *supra* note 6, at 23.

105. *Id.* at 23.

106. *Id.* at 375.

107. *Id.* at 386.

108. *See* Schwarcz, *supra* note 21, at 2 ("Rating agencies profoundly impact the ordering of global financial markets."). "[CRAs] are essential market participants." Rousseau, *supra* note 2, at 27.

109. *See* Dodd-Frank Act, Pub. L. No. 111-203, § 931(1), 124 Stat. 1376, 1872 (2010) ("Because of the systemic importance of credit . . . the activities and performances of credit rating agencies, including [NRSROs], 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."). On February 13, 1996, *New York Times* columnist Thomas L. Friedman remarked: "There are two superpowers in the world today in my opinion. There's the United States, and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful." White, *supra* note 27, at 216 (quoting Interview with Thomas L. Friedman, *New York Times* columnist, in a PBS "News Hour" interview (Feb. 13, 1996)).

110. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, § 2, 120 Stat. 1327, 1327. Since the 1970s, CRAs developed a significant global presence as more and more sovereign governments issued debt. Bruner & Abdelal, *supra* note 20, at 194. "The [CRAs'] sovereign ratings indirectly affect every other bond rating in the world because of the so-called 'sovereign ceiling.'" *Id.* at 192. A sovereign's local currency ratings are typically higher than its foreign currency ratings because a sovereign's capacity to repay local currency debt can be controlled through taxation and monetary policy. Bruner, *supra* note 83, at 135. With regard to foreign currency debts, sovereigns have less flexibility because they must acquire the foreign currency in the marketplace before repaying debt. *Id.* (citations omitted). "The primacy of a sovereign's claim on available foreign currency

### III. The Role of CRAs in the Financial Crisis

CRAs have been criticized for their role in the recent financial crisis.<sup>111</sup> Investors and banks lost hundreds of billions of dollars because of misguided confidence in mortgage-backed securities, particularly subprime securities.<sup>112</sup> Beginning in the late 1990s, issuers packaged residential mortgages into MBSs and CDOs.<sup>113</sup> The sales of these bonds were used to finance the tremendous United States housing bubble that began in the late 1990s and continued through mid-2006.<sup>114</sup> The underlying financing for these loans was possible through a process of securitization.<sup>115</sup>

The technique of securitization can be summarized as follows. A corporation (the "originator") seeks to raise funds using revenue generating assets that it owns. After having identified such assets, the originator transfers them to [a] special purpose vehicle ("SPV") through a sale. Transferring the assets is meant to shield those assets from risks related to the originator. To pay for the assets, the SPV issues debt-like securities in the capital markets. The cash flows generated by the assets are used to make monthly [interest] and principal payments to investors holding the securities. . . . As a result of securitization, the receivables transferred to the SPV are transformed into capital market instruments.<sup>116</sup>

Issuers divided the risk of default for mortgage-related securities into different tranches, which would be assigned different ratings.<sup>117</sup> The junior

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results in the so-called 'sovereign ceiling' . . . effect—the general trend (though not universal rule) that sub-sovereign entities within a given country will have lower foreign currency ratings than the sovereign." *Id.* at 135–36 (citations omitted). Accordingly, sovereigns seek foreign currency ratings, even in the absence of debt issuances, in order to "gain 'stamps of approval' from international capital markets" and to facilitate access for major sub-sovereign entities. Bruner & Abdelal, *supra* note 20, at 195 (citations omitted).

111. Alessi & Wolverson, *supra* note 35.

112. Ellsworth & Porapaiboon, *supra* note 10, at 1.

113. Krebs, *supra* note 68, at 137–38.

114. See White, *supra* note 27, at 212 ("The sales of [securities based on subprime residential mortgages and other debt obligations] . . . were an important underpinning for the financing of the self-reinforcing price-rise bubble in the U.S. housing market.").

115. *Id.* at 220.

116. Rousseau, *supra* note 2, at 6.

117. See White, *supra* note 27, at 220 ("The subprime mortgage loans were combined into mortgage-related securities, which in turn were divided into a number of more-senior and less-senior tranches, such that junior tranches would bear all losses before the senior tranches bore any.").

tranches would bear all losses before the senior tranches incurred any losses.<sup>118</sup>

Issuers increased profitability through this process and facilitated the market meltdown.<sup>119</sup> CRAs evaluated and produced ratings for securitized loan pools and other collateralized debt obligations, which were at the heart of the financial crisis.<sup>120</sup> Favorable ratings from CRAs were crucial to the success of the securitization of subprime mortgages.<sup>121</sup> Credit ratings had the force of law with respect to MBSs and CDOs.<sup>122</sup> CRAs also established favorable reputations in the corporate and government bond markets, which resulted in a misguided level of trust in MBS ratings by bond purchasers.<sup>123</sup>

In the markets for structured products, CRAs did much more than eliminate information asymmetries.<sup>124</sup> Structured products developed because of quality assurances provided by CRAs about complex financial products.<sup>125</sup> CRAs were very involved in the design and structure of MBSs and CDOs.<sup>126</sup> In contrast to the corporate and government bond context, CRAs consulted extensively with issuers and instructed issuers on how to earn higher ratings for various tranches of MBSs and CDOs.<sup>127</sup> In doing so, they trained issuers to be more profitable; many issuers changed their practices over time to please credit analysts so that they could earn higher

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118. *Id.*

119. *See* Krebs, *supra* note 68, at 137–38 (explaining how issuers maximized profit with regard to MBSs and CDOs).

120. *See* Ellsworth & Porapaiboon, *supra* note 10 (explaining that CRAs produced ratings for many of the subprime securities at the heart of the financial crisis); Krebs, *supra* note 68, at 137–38 (stating that MBS and CDOs were two of the many financial instruments that CRAs covered).

121. *See* White, *supra* note 27, at 220 ("The securitization of these subprime mortgages was only able to succeed—that is, the resulting securities were only able to be widely marketed and sold—because of the favorable ratings bestowed on the more-senior tranches.").

122. *See id.* (stating that "credit ratings had the force of law with respect to regulated financial institutions' abilities and incentives (via capital requirements) to invest in these bonds").

123. *See id.* (stating that CRAs had developed favorable reputations through their corporate and government bond ratings).

124. Utzig, *supra* note 1, at 1.

125. *See id.* ("Markets for structured products could not have developed without the quality assurance provided by CRAs to unsophisticated investors about inherently complex financial products.").

126. *See* White, *supra* note 27, at 220 (stating that CRAs were much more involved in the design of mortgage-related securities than the rating of bonds issued by corporations and government agencies).

127. *Id.* at 220–21.

ratings.<sup>128</sup> Additionally, CRAs were more likely to cater to issuers in the structured finance products context than in the corporate and government debt context because there were far fewer issuers of structured finance products and much higher profit margins.<sup>129</sup> CRAs earned as much as three times more revenue for rating complex MBSs and CDOs as they did from rating corporate debt.<sup>130</sup>

Although CRAs were once considered trusted gatekeepers, many of the ratings that they assigned to MBSs and CDOs were inaccurate.<sup>131</sup> Ratings for structured products turned out to be more unreliable than ratings for plain vanilla corporate and government bonds.<sup>132</sup> CRAs did not perform proper due diligence or verify the accuracy of information provided to them regarding mortgages underlying the MBS pools they rated.<sup>133</sup> Furthermore, many question the methodologies and assumptions CRAs relied on to rate MBSs.<sup>134</sup> CRAs relied on models that did not account for all the risk dimensions of these structured products.<sup>135</sup> CRAs used unreasonable and

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128. *See id.* (stating that CRAs would offer extensive advice to issuers of MBSs and CDOs on what kinds of mortgages would earn what ratings).

129. *See id.* at 221 ("Unlike the market for rating corporate and government debt, where there were thousands of issuers, the market for rating mortgage-related securities involved only a relatively small number of investment banks as securitizers with high volumes; and the profit margins on these mortgage-related securities were substantially larger as well."). An investment bank that was unhappy with an agency's ratings "had a more powerful threat—to move all of its securitization business to a different [CRA]—than would any individual corporate or government issuer." *Id.*

130. Elliot Blair Smith, *Bringing Down Wall Street as Ratings Let Loose Subprime Scourge*, BLOOMBERG (Sept. 24, 2008), <http://www.bloomberg.com/apps/news?sid=ah839IWTL9s&pid=newsarchive> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review).

131. Krebs, *supra* note 68, at 137–38.

132. *See* Utzig, *supra* note 1, at 1 ("[T]he ratings for structured credit turned out to be much less robust predictors of future developments than were the ratings for traditional single name securities.").

133. *See* Rousseau, *supra* note 2, at 23 ("CRAs 'did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated.'").

134. *See* Michel G. Crouhy, Robert A. Jarrow & Stuart M. Turnbull, *The Subprime Credit Crisis of 2007*, 16 J. DERIVATIVES 81, 95–97 (2008) (explaining the rating methodology and summarizing factors that contributed to the crisis).

135. *See id.* (describing the models used to rate MBSs); *see also* Alessi & Wolverson, *supra* note 35 (stating that CRAs created "complex models to calculate the probability of default for individual mortgages and also for the securitized products these mortgages made up"). "Raters deemed many of these so-called 'structured' products top-tier triple-A material for several years during the housing boom, only to downgrade them to below investment grade when the housing market collapsed." *Id.*

inaccurate assumptions in order to complete more deals and generate greater revenue.<sup>136</sup> CRAs used outdated historical assumptions concerning the underlying mortgages in MBSs and CDOs.<sup>137</sup> The inputs for these models included expected default rate, recovery rate, and the correlation of expected defaults.<sup>138</sup> Models, which are representations of reality, will not work if market conditions drastically change.<sup>139</sup> Raters failed to judge the probability of the decline in housing prices, and they did not account for the systemic risks associated with downgrading structured products.<sup>140</sup> Downgrading structured products is more significant than downgrading vanilla bonds because structured products are connected to numerous financial securities.<sup>141</sup> In rating securities backed by mortgages, "the credit rating agencies were operating in a situation where they had essentially no prior experience, where they were intimately involved in the design of the securities, and where they were under considerable financial pressure to give the answers that issuers wanted to hear."<sup>142</sup> In addition, CRAs probably were not too concerned about their reputations because the industry is essentially an oligopoly.<sup>143</sup>

As stated earlier, the ratings for MBSs and CDOs proved to be extremely optimistic.<sup>144</sup> In 2006, housing prices began to decline, and default rates on the mortgages underlying many MBSs and CDOs increased drastically.<sup>145</sup> Nevertheless, CRAs failed to immediately downgrade those

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136. Partnoy, *Overdependence*, *supra* note 1, at 6.

137. *Id.* at 7.

138. *Id.*

139. See Hershey H. Friedman & Linda Weiser Friedman, *The Global Financial Crisis of 2008: What Went Wrong?*, in *LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE* 35 (Robert W. Kolb ed., 2010) (stating that models do not work in periods of extreme market turbulence).

140. See Alessi & Wolverson, *supra* note 35 (stating that the CRAs failed to judge the likelihood of a decline in housing prices and the subsequent effect on defaults).

141. See *id.* ("The negative impact of downgrading a structured product is greater than downgrading a sovereign bond, since structured products are intricately connected to many other securities in the financial system, rather than just one loan.").

142. White, *supra* note 27, at 221.

143. See *id.* ("[I]t is not surprising that the members of a tight, protected oligopoly might become complacent and less worried about the problems of protecting their long-run reputations.").

144. See *id.* (explaining that securities issued and rated in 2005–2007 were particularly optimistic).

145. See *id.* at 212 (stating that initial credit ratings proved to be too optimistic in mid-2006). Although the rating agencies began warning investors about the housing market as early as 2005, CRAs did not "appropriately measure[] the sensitivity of losses to economic activity or anticipate[] the severity of the downturn." LANGOHR & LANGOHR, *supra* note 6,

securities as losses materialized, which further escalated the crisis.<sup>146</sup> The instability and inaccuracy of ratings was a major contributor to the recent financial crisis. It became clear that trusting a credit rating was a poor investment strategy and a dangerous way to issue debt.<sup>147</sup> In addition, it "became clear that most of the participants in the financial markets had little idea of what [CRAs] really do, why they do it, and what to expect from them."<sup>148</sup>

#### IV. CRA Liability Before the Dodd-Frank Act

Until recently, CRAs were completely unregulated.<sup>149</sup> In 2006, Congress passed the Credit Rating Agency Reform Act (CRARA), which attempted to increase accountability, transparency, and competition in the CRA industry.<sup>150</sup> However, CRARA was unsuccessful, as it actually shielded CRAs from securities law liability and proscribed SEC regulation

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at 365–67.

146. See White, *supra* note 27, at 221 ("As of June 30, 2009, 90 percent of the collateralized debt obligation tranches that were issued between 2005 and 2007 and that were originally rated AAA by [S&P] had been downgraded, with 80 percent downgraded below investment grade . . .").

147. See Santomero, *supra* note 31, at viii ("It soon became clear that blindly following a credit rating agency grade was an ill-conceived investment strategy, an ill-conceived way to issue debt, and an ill-conceived way to regulate institutions and their capital market investments."). CRAs lost credibility because of their negligence and mistakes. "The most evident trigger of this loss of credibility occurred during the second week of July 2007 when S&P downgraded \$7.3 billion of securities issued in 2005 and 2006 and a few weeks later, Moody's downgraded 691 securities of the 2006 vintage, originally worth \$19.4 billion." LANGOHR & LANGOHR, *supra* note 6, at 364. "This torrent of downgrades precipitated a major government review of the credit-rating agencies. As one Moody's executive said in an internal memo about these downgrades: 'These downgrades make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue.'" ROBERT POZEN, TOO BIG TO SAVE? HOW TO FIX THE U.S. FINANCIAL SYSTEM 60 (2010) (citing *Credit Rating Agencies and the Financial Crisis: Congressional Hearings by Comm. on Oversight and Gov't Reform* (Oct. 22, 2008) (statement of Henry A. Waxman, Chairman)).

148. Santomero, *supra* note 31, at viii.

149. See Scott McCleskey, *The Scott McCleskey Report: The Next Unintended Consequence—An Unregulated U.S. Credit Rating Industry?*, REUTERS (Nov. 11, 2010), <http://www.complinet.com/dodd-frank/news/analysis/article/the-scott-mccleskey-report-the-next-unintended-consequence-an-unregulated-credit-rating-industry.html> (last visited Nov. 29, 2011) ("[U]ntil Congress passed a law regulating [CRAs] in 2006 (only implemented in late 2007), there were virtually no regulatory requirements imposed on NRSROs and their activities.") (on file with the Washington and Lee Law Review).

150. See Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327 (stating the purpose of the Act).

of the substance of ratings.<sup>151</sup> Consequently, lawsuits by private parties against CRAs generally have been unsuccessful,<sup>152</sup> and CRAs have been able to escape liability for their poor ratings.<sup>153</sup>

For decades, CRAs have been successful in arguing for legal immunity. CRAs assert that credit ratings are expressions of free speech, and as a result, their publishers—the CRAs—should be afforded protection under the First Amendment.<sup>154</sup> In addition, CRAs include broad disclaimers in their ratings and advise investors not to rely on their ratings.<sup>155</sup> These arguments have proven successful in the past, and as a result, CRAs were basically exempt from legal liability prior to the enactment of the Dodd-Frank Act.<sup>156</sup>

The [SEC] ha[d] relieved NRSROs from the accountability that would otherwise apply under the federal securities laws: it ha[d] exempted NRSROs from expert liability under Section 11 of the Securities Act if their ratings appear in a prospectus for a public offering of a security registered under that Act. As a result, issuers d[id] not have to obtain consents from NRSROs before publishing their ratings and NRSROs [were] exempt from Section 11 liability if their ratings [were] included in a registration statement. The exemption of NRSROs from the normal liability provisions of Section 11 of the Securities Act mean[t] that NRSROs [were] not held to a negligence standard of care. The rating agencies also maintain that they are members of the "media" that are

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151. Thomas J. Fitzpatrick IV & Chris Sagers, *Credit Rating Organizations, Their Role in the Current Calamity, and Future Prospects for Reform*, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE 379 (Robert W. Kolb ed., 2010).

152. *See id.* (stating that "U.S. courts have held that the [CRAs] are protected by the free speech protections of the First Amendment, so regulation of or litigation against the CROs for their ratings might be unconstitutional.").

153. *See id.* at 381 (stating that CRAs enjoyed substantial legal protections prior to the Dodd-Frank Act).

154. *See* LANGOHR & LANGOHR, *supra* note 6, at 182 (stating that ratings are opinions on matters of public concern, not statements of fact or investment recommendations (quoting J.M. Dering, Executive Vice President for Global Regulatory Affairs and Compliance for Moody's Corp., Remarks to the American Enterprise Institute 5 (Sept. 27, 2005))).

155. POZEN, *supra* note 147, at 64.

156. LANGOHR & LANGOHR, *supra* note 6, at 182; *see also* POZEN, *supra* note 147, at 64 (stating that CRAs have avoided liability in the past because of the First Amendment and broad disclaimers in their ratings). For examples of cases, see *Jefferson Cnty. Sch. Dist. No. R-1 v. Moody's Investor's Serv., Inc.*, 175 F.3d 848 (10th Cir. 1999); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 511 F. Supp. 2d 742 (S.D. Tex. 2005); *Cnty. of Orange v. McGraw Hill Co.*, 245 B.R. 151 (C.D. Cal. 1999); *First Equity Corp. of Fla. v. Standard & Poor's Corp.*, 690 F. Supp. 256 (S.D.N.Y. 1988).

providing their "opinions," and thus claim that they can only be liable if their conduct can be said to have been "reckless."<sup>157</sup>

Former Rule 436(g),<sup>158</sup> which was promulgated under the Securities Act, exempted NRSROs from certain liability under the Securities Act.<sup>159</sup> Rule 436(g) provided that credit ratings assigned to a class of debt securities, convertible debt securities, or preferred stock by a NRSRO would not be considered "part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the [Securities] Act."<sup>160</sup> Section 7 provides that registrants of a registration statement must file written consent of experts, who prepare or certify any part of the registration statement.<sup>161</sup> Section 11 exposes certain people to civil liability if the registration statement misrepresents a material fact or omits to state a material fact.<sup>162</sup> Thus, liability could not be imposed on

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157. LANGOHR & LANGOHR, *supra* note 6, at 182 (quoting *SEC Hearing on Issues Relating to Credit Rating Agencies*, Nov. 21, 2002, § 3, Point 4 (2002) (statement of Amy Lancelotta, Senior Counsel of Investment Company Institute)).

158. 17 C.F.R. § 230.436 (2011).

159. See SEC, *Fact Sheet: Strengthening Oversight of Credit Rating Agencies* (Sept. 17, 2009), <http://www.sec.gov/news/press/2009/2009-200-factsheet.htm> (last visited Nov. 29, 2011) (stating that Rule 436(g) exempted NRSROs from certain liability and was adopted to facilitate voluntary disclosure of ratings in registration statements) (on file with the Washington and Lee Law Review). NRSROs have also avoided certain liability because they are excluded from the definition of "investment adviser." See Gibson, Dunn & Crutcher LLP, *Repeal of Credit Ratings Agency Exemption from Regulation FD* (Oct. 11, 2010), <http://www.gibsondunn.com/publications/pages/RepealOfCreditRatingsAgencyExemptionFromRegFD.aspx> (last visited Nov. 29, 2011) ("The Credit Rating Agency Reform Act also amended Section 2(a)(11)(F) of the Investment Advisers Act of 1940 so that NRSROs are specifically excluded from the definition of 'investment adviser' . . .") (on file with the Washington and Lee Law Review).

160. International Law Office, *Dodd-Frank Act: Elimination of Rating Agency Protections* (Aug. 24, 2010), <http://www.internationallawoffice.com/newsletters/detail.aspx?g=6955b391-ee87-41a4-84d4-f7f356cad724> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review). Former Rule 436(g) provided in pertinent part:

Notwithstanding the provisions of paragraph (a) and (b) of this section, the security rating assigned to a class of debt securities, a class of convertible debt securities or a class of preferred stock by a nationally recognized statistical rating organization, . . . shall not be considered part of a registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Act.

17 C.F.R. § 230.436 (2011).

161. See International Law Office, *supra* note 160 ("Section 7 provides that when certain experts are named as having prepared or certified 'any part' of the registration statement, the registrant must file the written consent of such person with the registration statement.").

162. See *id.* ("Section 11 imposes civil liability on specified classes of person in the

NRSROs for any credit rating information in a registration statement.<sup>163</sup> Issuers could include rating information in their public statements without obtaining the consent of CRAs.<sup>164</sup>

## V. Credit Rating Agencies and the Dodd-Frank Act

### A. Background and Findings

The Dodd-Frank Act was enacted, in part, to prevent another financial crisis<sup>165</sup> and "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system."<sup>166</sup> CRAs facilitated the recent financial crisis and, as a result, reform of the CRA industry is necessary to promote financial stability and prevent future crises. The Dodd-Frank Act addresses the following topics with regard to CRAs: increased accountability, conflicts of interest and ratings accuracy, reliance on ratings by federal agencies, and public disclosure of rating methodologies.<sup>167</sup> The Dodd-Frank Act attempts to

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event that any part of the registration statement contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading."). Section 11(a)(4) permits any person acquiring a security that contains an untrue statement of material fact or omits to state a material fact to sue

every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.

15 U.S.C. § 77k(a)(4) (2006).

163. See International Law Office, *supra* note 160 (explaining the effect of former Rule 436(g)).

164. *Id.*

165. See Dodd-Frank Wall Street Reform: Conference Report Summary of H.R. Rep. No. 111-517, at 1 (2010) [hereinafter Brief Summary], available at [http://banking.senate.gov/public/\\_files/070110\\_Dodd\\_Frank\\_Wall\\_Street\\_Reform\\_comprehensive\\_summary\\_Final.pdf](http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf) (stating the major goals of the Dodd-Frank Act).

166. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010).

167. See Orrick, Herrington & Sutcliffe LLP, *Dodd-Frank Wall Street Reform and Consumer Protection Act: Credit Rating Agency Provisions* (July 15, 2010), <http://www.orrick.com/fileupload/2829.htm> (last visited Nov. 29, 2011) (listing the topics related to CRAs that the Dodd-Frank Act covers) (on file with the Washington and Lee Law Review). "The Act seeks to impose corporate governance guidelines, reduce conflicts of interest, and improve the rating process through enhanced controls and greater

increase SEC oversight of CRAs and make it easier for investors to sue CRAs.<sup>168</sup>

In the Dodd-Frank Act, Congress found that CRAs are "matters of national public interest" because of the systemic importance of credit ratings.<sup>169</sup> CRAs play a gatekeeper role in the debt market and are often compared to securities analysts, who are the gatekeepers of the equity market, and auditors, who review the financial statements of firms.<sup>170</sup> Congress found that "[b]ecause [CRAs] perform evaluative and analytical services on behalf of clients, much as other financial 'gatekeepers' do, the activities of [CRAs] are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers."<sup>171</sup> Furthermore, Congress found that inaccurate ratings of structured financial products in the recent financial crisis require increased accountability on the part of CRAs.<sup>172</sup>

### B. Summary of Provisions Related to CRAs

The goal of Subtitle C of the Dodd-Frank Act is to enhance regulation, accountability, and transparency of NRSROs.<sup>173</sup> The Dodd-Frank Act establishes an Office of Credit Ratings at the SEC that will oversee NRSROs and administer SEC rules with respect to NRSRO credit rating practices.<sup>174</sup> In addition, Subtitle C of the Dodd-Frank Act requires

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transparency." Gregory A. Fericola & Joshua B. Goldstein, *Credit Rating Agencies: Skadden Commentary on the Dodd-Frank Act* (July 9, 2010), <http://www.skadden.com/Index.cfm?contentID=51&itemID=2135> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review).

168. Fericola & Goldstein, *supra* note 167.

169. *See* Dodd-Frank Act § 931(1), 124 Stat. at 1872 ("[T]he activities and performances of credit rating agencies, including [NRSROs], are matters of national public interest, as [CRAs] are central to capital formation, investor confidence, and the efficient performance of the United States economy.").

170. *See id.* (explaining that CRAs are gatekeepers similar to securities analysts and auditors).

171. *Id.*

172. *Id.*

173. *See* Dodd-Frank Act § 1, 124 Stat. at 1381–82 (listing the names of Subtitle C—Improvements to the Regulation of Credit Ratings Agencies—and § 932—Enhanced Regulation, Accountability, and Transparency of Nationally Recognized Statistical Rating Organizations).

174. *See id.* § 932(a)(5) (stating that "[t]he Commission shall establish within the Commission an Office of Credit Ratings . . . to administer the rules of the Commission");

NRSROs to make various disclosures regarding CRA methodologies, due diligence, and ratings track records.<sup>175</sup> NRSROs must disclose the procedures and methodologies that they use in their ratings, including qualitative and quantitative models.<sup>176</sup> NRSROs must provide the SEC with information regarding the reliability, accuracy, and quality of information, including information from third parties, used in the issuance of ratings.<sup>177</sup> The Act also requires CRAs to consider credible information from outside sources in their ratings.<sup>178</sup>

Subtitle C also addresses the serious conflicts of interest problems associated with the CRA industry, specifically with the current issuer-pays system.<sup>179</sup> Section 932 requires each NRSRO to establish internal controls that will implement, enforce, and maintain credit rating policies, procedures, and methodologies.<sup>180</sup> It requires each NRSRO to have a Board of Directors, at least half of whom are independent of the NRSRO.<sup>181</sup> Additionally, Section 932

[p]rohibits compliance officers from working on ratings, methodologies, or sales; installs a new requirement for NRSROs to conduct a one-year look-back review when an NRSRO employee goes to work for an

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Brief Summary, *supra* note 165, at 10 ("[The Dodd-Frank Act] [c]reates an Office of Credit Ratings at the SEC with expertise and its own compliance staff and the authority to fine agencies. The SEC is required to examine [NRSROs] at least once a year and make key findings public."). The Office of Credit Ratings is designed to promote accuracy in NRSRO credit ratings and to ensure that such ratings are not influenced by conflicts of interest. Dodd-Frank Act § 932(a)(5), 124 Stat. at 1877.

175. Brief Summary, *supra* note 165, at 10.

176. *See* Dodd-Frank Act § 932(a)(5), 124 Stat. at 1879 (stating that the SEC shall prescribe rules with respect to credit rating methodologies).

177. *Id.* § 932(a), 124 Stat. at 1879–82. Section 935 of the Act requires NRSROs, in producing credit ratings, to "consider information about an issuer that the [NRSRO] has, or receives from a source other than the issuer or underwriter, that the [NRSRO] finds credible and potentially significant to a rating decision." *Id.* § 935.

178. *See* Brief Summary, *supra* note 165, at 10 (stating that the Dodd-Frank Act requires "agencies to consider information in their ratings that comes to their attention from a source other than the organizations being rated if they find it credible").

179. *See id.* ("[The Dodd-Frank Act] [r]educes over-reliance on ratings and encourages investors to conduct their own analysis.").

180. *See* Dodd-Frank Act § 932(a)(2), 124 Stat. at 1873 ("Each [NRSRO] shall establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the [SEC] may prescribe, by rule."). Although Section 932 requires each NRSRO to establish an internal control structure, it does not eliminate the conflict of interest problem associated with the issuer-pays model.

181. *Id.* § 932(a)(5), 124 Stat. at 1882.

obligor or underwriter of a security or money market instrument subject to a rating by that NRSRO; and mandates that a [NRSRO] report to the SEC when certain employees of the NRSRO go to work for an entity that the NRSRO has rated in the previous twelve months.<sup>182</sup>

In addition, the Dodd-Frank Act prevents ratings shopping<sup>183</sup> and requires that NRSRO employees are trained properly and tested on their knowledge of the credit rating process.<sup>184</sup> Furthermore, the Act reduces over-reliance on credit ratings;<sup>185</sup> however, it does not eliminate regulatory uses of credit ratings.<sup>186</sup> These newly adopted regulations and policies are intended to increase transparency, mitigate conflicts of interest, and protect investors.

In accordance with the Dodd-Frank Act, the SEC recently has proposed amendments that would remove references to credit ratings in rules and forms promulgated under the Securities Act and the Exchange Act.<sup>187</sup> The focus of the proposal is to remove the use of credit ratings as a prerequisite for companies using short-form registration when selling

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182. Brief Summary, *supra* note 165, at 10.

183. *See id.* at 11 ("The SEC shall create a new mechanism to prevent issuers of asset backed-securities from picking the agency they think will give the highest rating, after conducting a study and after submission of the report to Congress.").

184. Dodd-Frank Act § 936(a), 124 Stat. at 1884–85.

185. *See id.* ("[The Act] reduces over-reliance on ratings and encourages investors to conduct their own analysis.").

186. *See id.* §§ 939–939A, 124 Stat. at 1885–87 (stating that references to credit ratings should be removed from various statutory references and all federal agencies should review regulations referencing credit ratings and replace the references to credit ratings with a different standard of creditworthiness). Thus, although the regulatory requirement of reliance on credit ratings is abolished, the agencies must implement a new standard of creditworthiness for such regulations. *Id.* § 939A, 124 Stat. at 1887. "Section 939A of the [Dodd-Frank Act] requires federal agencies to review how existing regulations rely on credit ratings and remove such references from their rules as appropriate." SEC, *SEC Proposes First in Series of Rule Amendments to Remove References to Credit Ratings* (Feb. 9, 2011), <http://www.sec.gov/news/press/2011/2011-41.htm> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review). The reduction of regulatory uses of credit ratings will be a slow and arduous process. John C. Coffee Jr., *Ratings Reform: The Good, the Bad, and the Ugly* 43 (Columbia Law and Economics, Working Paper No. 359, Sept. 2010), available at [http://papers.ssrn.com/ol3/papers.cfm?abstract\\_id=1650802](http://papers.ssrn.com/ol3/papers.cfm?abstract_id=1650802). Credit ratings are embedded in the debt offering process, and as a result, they cannot be eliminated from regulation instantaneously. *See id.* at 45 ("The message here is that reform needs to be incremental, because ratings are too deeply embedded in the debt offering process to be simply eliminated by the stroke of a pen.").

187. SEC, *SEC Proposes First in Series of Rule Amendments to Remove References to Credit Ratings*, *supra* note 186.

securities to the public.<sup>188</sup> According to the proposal, a new test that evaluates the amount of debt and non-convertible securities the registering company has sold in the past three years will be used instead of ratings.<sup>189</sup> If the SEC determines that the proposal is appropriate, it will limit the regulatory uses of credit ratings.

### C. Provisions that Affect CRA Liability

Although Subtitle C addresses many aspects of CRA regulation, this Note focuses on CRA liability after the Dodd-Frank Act. As stated earlier, CRAs have successfully avoided liability for inaccurate ratings because of various defenses and regulatory exemptions.<sup>190</sup> The Dodd-Frank Act attempts to eliminate CRA immunity by providing for additional penalties and potential liabilities for NRSROs. Section 932 also grants the SEC the power to suspend or permanently revoke an NRSRO's registration with respect to certain securities if the SEC determines that the NRSRO has provided unreliable ratings over time.<sup>191</sup>

Several sections of the Dodd-Frank Act also address the potential liability defenses of NRSROs.<sup>192</sup> The Dodd-Frank Act states that the Exchange Act provisions that prohibit the regulation of the substance of a rating can no longer be used as a defense to CRA liability.<sup>193</sup> Furthermore,

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188. *Id.*

189. See Pamela A. Meredith, *SEC Proposes Rule Amendments To Remove Credit Ratings References*, BALLARD SPAHR LLP (Feb. 15, 2011), [http://www.ballardspahr.com/xml/~link.aspx?\\_id=1E68919DC19C4067ACC146D2A5FD89BE&\\_z=z](http://www.ballardspahr.com/xml/~link.aspx?_id=1E68919DC19C4067ACC146D2A5FD89BE&_z=z) (last visited Nov. 29, 2011) ("[The new requirement] would permit use of a short-form registration statement for primary offerings of non-convertible securities if the issuer has issued . . . more than \$1 billion in non-convertible securities, other than common equity, through registered primary offerings over the last three years and otherwise meets the registrant requirements.") (on file with the Washington and Lee Law Review).

190. See *supra* Part VII (explaining why CRAs avoided liability before the enactment of the Dodd-Frank Act).

191. See Dodd-Frank Act § 932(a)(3), 124 Stat. at 1874 ("The [SEC] may temporarily suspend or permanently revoke the registration of a [NRSRO] with respect to a particular class or subclass of securities, if the [SEC] finds . . . that the [NRSRO] does not have adequate financial and managerial resources to consistently produce credit ratings with integrity.").

192. Thomas O. Gorman, *Dodd-Frank Impact on Credit Rating Agencies*, LEXISNEXIS CORPORATE AND SECURITY LAW COMMUNITY (Aug. 24, 2010), <http://www.lexisnexis.com/Community/corpsec/blogs/corporateandsecuritieslawblog/archive/2010/08/24/dodd-frank-impact-on-credit-rating-agencies.aspx> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review).

193. See *id.* ("The Exchange Act provisions which prohibit the regulation of the

the Dodd-Frank Act increases CRA accountability by amending Section 15(m) of the Exchange Act to read as follows:

(1) In General—The enforcement and penalty provisions of this title shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws, and such statements shall not be deemed forward-looking statements for the purposes of section 21E.<sup>194</sup>

Thus, CRAs will be held accountable for their statements to the same extent as other "gatekeepers," namely, accountants and securities analysts.<sup>195</sup>

Section 933 of the Dodd-Frank Act also alters the pleading standards for lawsuits against CRAs.<sup>196</sup> Prior to the enactment of the Dodd-Frank Act, a Rule 10b-5 plaintiff had to plead that the CRA did not believe its credit ratings or that the ratings lacked a factual basis in order to survive a motion to dismiss.<sup>197</sup> This was a heavy pleading burden.<sup>198</sup> Under the Dodd-Frank Act, investors, for purposes of pleading the required state of mind in a private right of action for damages against CRAs, must only set forth facts supporting an inference that the CRA knowingly or recklessly failed: (i) to conduct a reasonable investigation of the facts it relied on in its credit rating; or (ii) to obtain verification from other independent sources.<sup>199</sup> If a CRA does not conduct its own reasonable investigation or rely on the due diligence of an independent firm, a plaintiff who provides factual pleadings of this failure will survive a motion to dismiss.<sup>200</sup>

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substance of a rating are not a defense to antifraud liability.").

194. Dodd-Frank Act § 933(a), 124 Stat. at 1883.

195. See American Bankers Association, *9.10 Improvements to the Regulation of Credit Rating Agencies*, [http://www.aba.com/RegReform/RR9\\_10.htm](http://www.aba.com/RegReform/RR9_10.htm) (last visited Nov. 29, 2011) ("Enforcement and penalty provisions now apply to statements made by a [CRA] in the same manner and extent as statements made by registered public accountants or securities law analysts.") (on file with the Washington and Lee Law Review).

196. See Dodd-Frank Act § 933(b), 124 Stat. at 1883–84 (addressing the scienter requirements for pleading an anti-fraud action against CRAs). This pleading standard is presumably for anti-fraud actions based on Rule 10b-5. Coffee, *Ratings Reform*, *supra* note 186, at 46.

197. See Fernicola & Goldstein, *supra* note 167 ("In the context of credit ratings, courts required plaintiffs to plead that the rating agency did not genuinely believe its opinions regarding credit quality or that the opinions lacked basis in fact." (citing *In re IBM Corp. Sec. Litig.*, 163 F.3d 102 (2d Cir. 1998))).

198. *Id.*

199. See Dodd-Frank Act § 933(b), 124 Stat. at 1883 (explaining the state of mind required in private actions).

200. See Coffee, *Ratings Reform*, *supra* note 186, at 46–47 (explaining the practical

Nevertheless, the plaintiff will still have to show other elements of a Rule 10b-5 cause of action, including loss causation and reliance.<sup>201</sup>

In addition, the Dodd-Frank Act repeals Rule 436(g), which exempted CRAs from being considered as part of a registration statement, and subjects NRSROs to expert liability under Section 11 of the Securities Act.<sup>202</sup> As stated earlier, Rule 436(g) provided that NRSRO credit ratings are not considered part of a registration statement.<sup>203</sup> The Dodd-Frank Act requires registrants to obtain written consent of an NRSRO before it includes a credit rating in a registration statement.<sup>204</sup> Furthermore, NRSROs may be liable under Section 11 of the Exchange Act if they provide a registrant consent to name them as having prepared or certified a registration statement or valuations used in connection with the statement.<sup>205</sup> In defending a Section 11 claim, CRAs will be required to show that they reasonably believed that the credit rating was accurate.<sup>206</sup>

The United States Congress believes that CRAs do provide valuable information that influences the cost of capital, particularly with regard to complex debt securities.<sup>207</sup> Traditionally, the United States has relied on private enforcement and litigation to dissuade wrongdoing in the financial system.<sup>208</sup> The Dodd-Frank Act is necessary to continue this tradition and

effect of the "State of Mind in Private Actions" pleading standard in Section 933).

201. *Id.*

202. *See* Brief Summary, *supra* note 165, at 10 ("NRSROs will now be subject to 'expert liability' with the nullification of Rule 436(g) which provides an exemption for credit ratings provided by NRSROs from being considered a part of the registration statement."). Expert liability is not a different type of liability; however, experts have a tougher time asserting due diligence defenses to liability.

203. *See supra* Part IV (describing former Rule 436(g)).

204. *See* Orrick, *supra* note 167 ("Written consent of an NRSRO must thus be obtained by a registrant in order to include a credit rating in a registration statement, and NRSROs are therefore subject to liability under Section 11 of the [1933] Act for misstatements or omissions of material facts in connection with credit rating disclosure.").

205. *See* Fericola & Goldstein, *supra* note 166 (explaining that CRAs could be exposed to expert liability if they consent to the inclusion of a credit rating in a registration statement).

206. *See id.* ("In order to defend against a Section 11 claim, a rating agency would be required to show that it had reasonable grounds to believe, and did in fact believe, that the included credit rating was accurate.").

207. *See* Coffee, *Ratings Reform*, *supra* note 186, at 5–6 (explaining that Congress believes that "in the case of complex and opaque debt securities (such as [CDOs]), 'do-it-yourself' credit analysis, even by relatively sophisticated institutional investors, is no more feasible than 'do-it-yourself' brain surgery").

208. *See id.* at 6 (explaining the difference between European and U.S. institutional culture and regulatory options).

increase CRA accountability because alternatives to the current CRA model seem impractical.<sup>209</sup>

### VI. Alternatives to the Current CRA Model

Although financial regulators outsourced the duty to judge credit risk to the CRAs, many policymakers and experts are evaluating various alternatives to the current CRA model because of the CRAs' failure to adequately assess risk before the financial crisis.<sup>210</sup> A credit rating is only one method of assessing credit risk.<sup>211</sup> However, finding alternative standards of creditworthiness is more difficult than initially thought.<sup>212</sup>

One alternative is to replace the issuer-pays model with an investor-pays model.<sup>213</sup> Proponents of this proposal believe it will eliminate conflicts of interest and lead to more accurate ratings.<sup>214</sup> However, a change to an investor-pays model is probably infeasible. Credit ratings are a "public good in that it is difficult to limit [their] accessibility by excluding those investors who have not paid for [them]."<sup>215</sup> This free rider problem

209. See Fericola & Goldstein, *supra* note 167 ("[T]he Act will greatly expand the SEC's oversight and enforcement powers and seeks to make it easier for investors to bring civil lawsuits against rating agencies."); see also Colin Barr, *Gross Rips the Rating Agencies*, CNNMONEY (May 5, 2010), <http://finance.fortune.cnn.com/2010/05/05/gross-rips-the-rating-agencies/> (last visited Nov. 29, 2011) (stating that it is difficult to develop a workable alternative to CRAs) (on file with the Washington and Lee Law Review).

210. See Ben Protess, *S.E.C. Seeks to Reduce Reliance on Credit Reliance*, DEALBOOK (Feb. 9, 2011), <http://dealbook.nytimes.com/2011/02/09/s-e-c-aims-to-reduce-reliance-on-ratings/> (last visited Nov. 29, 2011) ("Rather than judge the safety of corporate bonds and other investments, regulators outsource that duty to the rating agencies.") (on file with the Washington and Lee Law Review).

211. See Utzig, *supra* note 1, at 18 (explaining that there are other ways to implement the service provided by CRAs and a credit rating is only one method of analyzing credit risk).

212. See Edward Wyatt, *Fed Chief Says U.S. Bolstered Its Ability to Handle Failure of a Big Bank*, N.Y. TIMES, Feb. 18, 2011, at B3 ("[A]fter significant study and comment, we have found no practical alternative for [credit] ratings that could be used across the banking sector." (quoting John Walsh, Acting Comptroller of the Currency)).

213. See Rousseau, *supra* note 2, at 45 ("Given that [the issuer-pays] model is the source of serious criticism, commentators have advocated doing away with it and proposed 'to restore the principal-agent relationship that once existed by requiring rating agencies to be paid by the users of their information, not the issuer.'" (quoting J.C. COFFEE, GATEKEEPERS—THE PROFESSIONS AND CORPORATE GOVERNANCE 298 (2006))).

214. See Coffee, *Ratings Reform*, *supra* note 186, at 30–31 (stating that the issuer-pays model undercuts the independence and objectivity of CRAs).

215. Rousseau, *supra* note 2, at 45.

will threaten the profitability and sustainability of CRAs because CRAs will be unable to realize the full value of the financial information they provide.<sup>216</sup> Furthermore, an investor-pays model will deprive the general public of valuable information regarding creditworthiness,<sup>217</sup> and it might prevent entry for new issuers.<sup>218</sup> Thus, replacing the issuer-pays model with an investor-pays model seems impractical. However, permitting "the issuer to pay for the rating, but not to select the rater" might eliminate the conflict of interest inherent in the issuer-pays model.<sup>219</sup>

A second alternative is to have other financial companies, such as investment advisers, rate certain structured products. The New York Insurance Department, along with others, is discussing whether other financial companies, such as BlackRock, PIMCO, Promontory, and Risk Metrics, could replace CRAs in evaluating the creditworthiness of MBSs and CDOs.<sup>220</sup> This would increase competition in the credit rating business and reduce over-reliance on CRAs.

A third alternative involves the replacement of credit ratings in regulation with some market-based measure, such as credit spreads.<sup>221</sup> "Credit spreads are more accurate than credit ratings, and by definition

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216. *See id.* at 46 (explaining that, in an investor-pays model, ratings are easy to communicate to non-paying parties and such accessibility will affect the viability of the credit rating industry).

217. *Id.*

218. *See id.* ("There is a risk that this model induces a bias in favor of established entities or sectors as investors remain concerned about their current holdings. If it were to be the case, this result could stifle financial innovation and create barriers to entry for new issuers.").

219. Coffee, *Ratings Reform*, *supra* note 186, at 31.

220. *See* Yael Bizouati, *NY State Wants to Fire Moody's and S&P*, BUSINESS INSIDER (Sept. 18, 2009), <http://www.businessinsider.com/ny-state-insurance-department-asks-top-firms-to-replace-rating-agencies-2009-9> (last visited Nov. 29, 2011) (explaining that some institutions, in an attempt to reduce reliance on CRAs, are seeking credit ratings from BlackRock, PIMCO and other financial institutions) (on file with the Washington and Lee Law Review). "[In 2009,] a group of state insurance regulators hired PIMCO to replace rating agencies in analysing mortgage-backed securities held by firms they oversee." *The Other Vampires: Pressure Mounts on an Oligopoly*, THE ECONOMIST, May 15, 2010, available at <http://www.economist.com/node/16113071>. Nevertheless, PIMCO has asserted that it is not trying to replace CRAs. *See Pimco Advisory Unit Tops \$1 Trillion in Assets*, MONEYNEWS.COM (Dec. 10, 2009), <http://www.moneynews.com/FinanceNews/pimco-bonds-growth/2009/12/11/id/340764> (last visited Nov. 29, 2011) ("We are not strategically looking to replace the rating agencies, but we believe there is a role for people doing rating agency type work.") (on file with the Washington and Lee Law Review).

221. *See* Partnoy, *The Siskel and Ebert of Financial Markets?*, *supra* note 63, at 704 (stating that "a proposal substituting credit spreads for credit ratings in regulation is workable"). Credit spreads are the market risk measure for bonds. *Id.* at 624.

credit spreads reflect the market price of credit, which should reflect at minimum the information contained in credit ratings."<sup>222</sup> The credit spread is the difference between the yield on a particular bond and its risk-free counterpart.<sup>223</sup> The credit spread is "based on both the probability of default and the expected recovery in the event of default."<sup>224</sup> Lenders rarely have enough information to calculate these factors with certainty, however, and as a result, there is fluctuation in credit spreads.<sup>225</sup> Thus, credit spreads are well-reasoned estimates, not certainties. CRAs assert that their ratings account for additional information that is not reflected in credit spreads.<sup>226</sup> However, it is impossible to verify this claim.<sup>227</sup> Although this proposal is persuasive, it might be very difficult to implement, and the initial substitution of credit spreads for ratings might disrupt credit markets.

The main issue with trying to replace CRAs is the lack of a suitable alternative. Although experts have proposed a number of alternatives to CRAs, there does not appear to be a perfect solution to the credit rating problem. As a result, finding a practical alternative will be more difficult than originally anticipated.

### VII. Barriers to Liability After the Dodd-Frank Act

Although Subtitle C of the Dodd-Frank Act expressly increases CRA liability and accountability, it is unclear whether certain defenses will invalidate the relevant Dodd-Frank provisions.<sup>228</sup> As stated earlier, CRAs have avoided liability based on ratings through various exemptions and defenses, particularly their First Amendment defense.<sup>229</sup> Historically,

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222. *Id.* at 624.

223. *See id.* at 655 ("Credit risk typically is described using the credit spread: the difference between the yield on a particular bond and the yield on a risk-free bond with comparable cash-flow characteristics and maturity.").

224. *Id.* at 656.

225. *Id.* at 657.

226. *Id.* at 658.

227. *See id.* (explaining that even though credit ratings are highly correlated with credit spreads, it is unclear whether they provide additional informational value).

228. *See* Coffee, *Ratings Reform*, *supra* note 186, at 27 (stating that there is a Constitutional question mark that could nullify the Dodd-Frank liability provisions with respect to CRAs).

229. *See* Martha Evans et al., *Rating Agency Claims*, in *MORTGAGE AND ASSET BACKED SECURITIES LITIGATION HANDBOOK* § 6.1 (Talcott J. Franklin & Thomas F. Nealon III eds., 2011) (stating that CRAs defend against liability by asserting that their ratings constitute speech protected by the First Amendment).

CRA's have asserted that their business is financial publishing and their core functions are journalistic.<sup>230</sup> CRA's claim that they gather, as well as analyze, information on matters of public concern and disseminate opinions based on that information to the public.<sup>231</sup> Although CRA's have successfully raised First Amendment objections in civil litigation, this Note argues that CRA's are not financial publishers in the context of complex structured products, and consequently, they should not be exempt from liability for inaccurate ratings based on a freedom of speech rationale.<sup>232</sup>

The analysis for deciding whether the First Amendment protects CRA's is very fact intensive.<sup>233</sup> Originally, the First Amendment defense was plausible because CRA's operated as members of the financial press. CRA's provided information regarding creditworthiness to subscribing clients,<sup>234</sup> and publishers are not liable to their subscribers for negligent erroneous statements.<sup>235</sup> The First Amendment defense arguably became less plausible in the 1970s when credit ratings were incorporated into various regulations and CRA's shifted to an issuer-pays model.<sup>236</sup> CRA's cannot plausibly claim that their ratings are opinions when rules and regulations imbue the ratings with the force of law.<sup>237</sup> Nevertheless, courts continued to recognize the CRA's' freedom of speech argument.<sup>238</sup> With the

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230. Partnoy, *Other Gatekeepers*, *supra* note 95, at 84.

231. *See id.* (stating that NRSROs gather information, analyze that information, form opinions about it, and then disseminate those opinions to the public).

232. *See* Partnoy, *Overdependence*, *supra* note 1, at 13 (stating that rating agencies should not be exempt from liability for statutory and common law claims based on journalistic privileges).

233. *See* David J. Grais & Kostas D. Katsiris, *Not "The World's Shortest Editorial": Why the First Amendment Does Not Shield the Rating Agencies from Liability for Over-Rating CDOs*, BLOOMBERG LAW REPORTS 1 (Nov. 2007) ("To tell whether the First Amendment protects [CRA's], one must first determine whether . . . [CRA's] are members of 'the press,' whose freedom the First Amendment guarantees. The answer depends on the facts of each transaction.").

234. *See* Jonathan S. Sack & Stephen M. Juris, *Rating Agencies: Civil Liability Past and Future*, N.Y. L.J., Nov. 5, 2007 ("Originally, the agencies were compensated by subscriptions paid for by interested investors.").

235. *See* Grais & Katsiris, *supra* note 233, at 2.

236. *See* Partnoy, *Overdependence*, *supra* note 1, at 3 ("For the most part, [CRA's] fit this reputational investor-pay model until the mid-1970s, when . . . the [SEC] began relying substantively on [CRA's] for regulatory purposes and the agencies shifted to an issuer-pay model.").

237. *See* Bruner & Abdelal, *supra* note 20, at 207 (explaining that credit ratings have the force of law because of their regulatory uses, which artificially increase demand for the ratings of NRSROs).

238. *See* Coffee, *Ratings Reform*, *supra* note 186, at 27 (stating that judicial decisions

expansion of securitization, the value of the CRAs' First Amendment defense has dissipated.<sup>239</sup> Recently, some courts have distinguished between the traditional functions of CRAs in the context of corporate debt, as well as government bonds, and the role of CRAs with regard to complex structured products.<sup>240</sup> In the latter context, CRAs do not act as members of the press, and "it is 'game over' for [their] First Amendment defense."<sup>241</sup> Because of this distinction, recent case law is divided on whether or not CRAs should be afforded First Amendment protection.<sup>242</sup>

#### A. *When Is a CRA a Member of the Press?*

Although CRAs assert that the First Amendment protects all their activities, courts have continuously stated that the First Amendment defense is not absolute.<sup>243</sup> Instead, courts have emphasized that they will determine

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have viewed credit ratings as expressions of speech that are protected by the First Amendment (citing *Jefferson Cnty. Sch. Dist. No. R-1 v. Moody's Investor's Serv., Inc.*, 175 F.3d 848, 852–56 (10th Cir. 1999); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 511 F. Supp. 2d 742, 752 (S.D. Tex. 2005)).

239. See *Grais & Katsiris*, *supra* note 233, at 1 (stating that CRAs rarely acted as members of the press in CDO and similar transactions).

240. See *Partnoy, Overdependence*, *supra* note 1, at 15–16 ("As new cases based on 'second-level' securitizations arise, judges should distinguish those prior cases, and make it clear that rating agencies are subject to civil liability and are not protected by any First Amendment privilege."); see also *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 651 F. Supp. 2d 155, 178 (S.D.N.Y. 2009) (stating that the ratings for stable corporate bonds differed drastically from the ratings for structured products). See generally *In re Moody's Corp. Sec. Litig.*, 599 F. Supp. 2d 493 (S.D.N.Y. 2009).

241. *Grais & Katsiris*, *supra* note 233, at 1.

242. See *id.* (stating that the case law in the U.S. is divided on the First Amendment defense issue); see also *Evans et al.*, *supra* note 229 ("[A] recent spate of suits against rating agencies has produced seemingly incongruous results in who may recover for inaccurate ratings."). For examples of cases where the court held that credit ratings are expressions of opinion protected by the First Amendment, see *Jefferson*, 175 F.3d at 852–56 (dismissing claims for tortious interference, injurious falsehood, and antitrust violations because Moody's credit ratings are protected expressions of speech); *Enron*, 511 F. Supp. 2d at 752; *Cnty. of Orange v. McGraw Hill Co.*, 245 B.R. 151, 157 (C.D. Cal. 1999) ("The First Amendment protects S&P's preparation and publication of its ratings."). For examples of cases where the court declined to recognize the CRA's First Amendment defense, see *In re Fitch, Inc.*, 330 F.3d 104, 109–10 (2d Cir. 2003); *Abu Dhabi*, 651 F. Supp. at 176.

243. See *Enron*, 511 F. Supp. 2d at 819 (stating that any First Amendment protection is qualified); *Commercial Fin. Serv., Inc. v. Arthur Andersen LLP*, 94 P.3d 106, 109 (Okla. Civ. App. 2004) (stating that some opinions receive constitutional protection and others do not); see also *McGraw-Hill*, 245 B.R. at 154 ("S & P's status as a financial publisher does not necessarily entitle it to heightened protection under the First Amendment.").

whether a CRA acted in a journalistic capacity on a case-by-case basis.<sup>244</sup> "[T]he most important factor in determining whether [a CRA] is qualified to assert the journalist's privilege is the nature of [the CRA's] relationship with the alleged 'source.'"<sup>245</sup> This Part will illustrate the differences between CRAs and traditional members of the press, particularly in the structured products context.

Courts consider a number of factors when they evaluate whether or not a CRA is a member of the press, and therefore deserving of First Amendment protection. One important factor is whether the CRA only rates those securities it was hired to rate, or whether it rates all public debt.<sup>246</sup> In *Commercial Financial Services, Inc. v. Arthur Andersen LLP*,<sup>247</sup> the court determined that the First Amendment did not protect CRAs in a case involving ratings of asset-backed securities partly because Commercial Financial Services had paid Moody's to rate its bonds.<sup>248</sup> The First Amendment defense seems more plausible when a CRA rates securities for the investing public because, in such an instance, the CRA behaves like a member of the press. Members of the press report about newsworthy transactions; they do not limit their commentary to stories for which they are hired.<sup>249</sup> In *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*,<sup>250</sup> the

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244. See Grais & Katsiris, *supra* note 233, at 2 ("Instead, [courts] have decided case-by-case whether a rating agency was acting as a member of the press, and they will doubtless continue to do so in suits against rating agencies for over-rating structured securities.").

245. *Compuware Corp. v. Moody's Investors Serv., Inc.*, 324 F. Supp. 2d 860, 862 (E.D. Mich. 2004).

246. See Grais & Katsiris, *supra* note 233, at 3 ("One important factor is whether the agency rates most or all securities of a particular kind for the benefit of the investing public, or instead rates only those securities it is hired to rate.").

247. See *Commercial Fin. Serv., Inc. v. Arthur Andersen LLP*, 94 P.3d 106, 110 (Okla. Civ. App. 2004) (finding *inter alia* that the First Amendment does not shield the CRAs from potential liability).

248. See *id.* at 109 ("The Rating Agencies' ratings fall somewhere between those opinions which receive constitutional protection and those that do not."). However, in *Arthur Andersen*, the court also noted that it did not agree with the trial court's granting the motions to dismiss because CRAs owed a duty of care to Commercial Financial Services, as Commercial Financial Services paid for the rating. *Id.* at 110. See also Partnoy, *Other Gatekeepers*, *supra* note 95, at 87 ("The court noted that although a [CRA's] speech might be protected, if CFS had hired that [CRA] to write a company report about the bonds, a different standard would apply.").

249. See *In re Fitch, Inc.*, 330 F.3d 104, 109 (2d Cir. 2003) ("Unlike a business newspaper or magazine, which would cover any transactions deemed newsworthy, Fitch only 'covers' its own clients. We believe this practice weighs against treating Fitch like a journalist.").

250. See *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 761 (1985)

Court determined that speech motivated by profit deserves less protection than other forms of speech.<sup>251</sup> Most members of the press do not receive compensation from their subjects.<sup>252</sup> A CRA that rates securities for the investing public is not motivated by monetary gain and is more likely to be protected by the First Amendment.

Similarly, it is important to determine whether the CRA disseminated its ratings to a select group of investors or the public at large. In *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*,<sup>253</sup> the court stated that "where a [CRA] has disseminated [its] ratings to a select group of investors rather than to the public at large, the [CRA] is not afforded the same protection."<sup>254</sup> CRAs are more likely to be awarded First Amendment protection if they make their ratings available to the public at large.<sup>255</sup>

Additionally, courts consider whether the CRA actively participated in the structuring of the security.<sup>256</sup> As the court explained in *In re Fitch, Inc.*,<sup>257</sup> communications between the CRA and the issuer "reveal a level of involvement with the client's transactions that is not typical of the relationship between a journalist and the activities upon which the journalist reports."<sup>258</sup> Courts are more sympathetic to the claim that a CRA is entitled

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(holding that, in light of the reduced constitutional value of speech involving no matters of public concern, "the state interest adequately supports awards of presumed and punitive damages—even absent a showing of 'actual malice'").

251. *See id.* at 762–63 (explaining that speech motivated by the desire for profit is less likely to be deterred than other speech). However, this case dealt with a credit-reporting agency, not a credit rating agency. *See also Arthur Andersen*, 94 P.3d at 110 (stating that the First Amendment does not shield CRAs from potential liability when CRAs are paid by their clients and the relationship between the issuer and the CRA is more analogous to that of a client and the client's accountant).

252. *See Fitch*, 330 F.3d at 110 (explaining that the fact that Fitch's activities appear to be based on client needs, rather than newsworthiness, weighs against Fitch being able to assert a First Amendment defense).

253. *See Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 651 F. Supp. 2d 155, 176 (S.D.N.Y. 2009) (concluding that investors stated a claim for fraud against the rating agencies, and "[a]s a result, the [CRAs'] ratings were not mere opinions but rather actionable misrepresentations").

254. *Id.* at 176.

255. *Id.*

256. *See In re Fitch, Inc.*, 330 F.3d 104, 110–11 (2d Cir. 2003) (explaining that courts also evaluate the role CRAs play in structuring securities).

257. *See id.* at 111 (finding that "the district court did not abuse its discretion by concluding that Fitch had not sufficiently shown that the information it sought to protect was gathered pursuant to the newsgathering activities of a professional journalist").

258. *Id.* at 110–11.

to First Amendment protection if it only gathers information from its client and does not advise the issuer on how to structure the transaction.<sup>259</sup>

A final factor the courts should consider when analyzing CRA liability is whether the ratings are used as a certification or a benchmark:

The fact that the market seems to value the agencies' ratings mostly as a certification (investment grade v. non-investment grade) or as a benchmark (the ratings triggers in agreements) and not as information, and the fact that the law, in hundreds of statutes and regulations, also uses their work that way, seems to indicate that their ratings are not the equivalent of editorials in *The New York Times*. The fact that the rating agencies have received First Amendment protection for their work should not preclude greater accountability.<sup>260</sup>

Thus, credit ratings are used differently than mere opinions, and CRAs should not be considered members of the press when their ratings are used as benchmarks.

In the context of MBSs and CDOs, all of these factors generally weigh against the assertion that CRAs are financial publishers. The CRAs' role has changed significantly in recent history, especially with the development of complex financial instruments.<sup>261</sup> As stated earlier, issuers now pay CRAs for their ratings, which creates various conflicts of interest.<sup>262</sup> In addition, CRAs play an active role in both rating and advising issuers in the structuring of complex structured products.<sup>263</sup> CRAs determine capital

259. See Partnoy, *Other Gatekeepers*, *supra* note 95, at 88 ("[T]he courts have been more skeptical of free speech claims when the rating agency played a significant role in structuring a transaction that it rated." (citing *In re Fitch, Inc.*, 330 F.3d 104, 111 (2d Cir. 2003))).

260. *Id.* at 89 n.104 (quoting STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE SECTOR WATCHDOGS 97 (Comm. Print Oct. 7, 2002)).

261. See Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* 8 (Working Paper, May 14, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1027475](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027475) (explaining how the CRA industry has changed since the 1970s).

262. See Lisbeth Freeman, Note, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 33 VT. L. REV. 585, 605 (2009) (stating that CRAs play a more active role in the issuance of complex financial products). "[T]he existence of a well-function[ing] information intermediary faltered. The [CRAs] faced little or no risk of loss from inaccurate ratings, while the potential gains from inaccurate ratings increased. Ratings substantially lagged the revelation of public information about rated issuers and instruments, and [CRAs] . . . were forced to revise ratings . . . downward[s]." Partnoy, *Overdependence*, *supra* note 1, at 3–4.

263. See Partnoy, *Overdependence*, *supra* note 1, at 16 (stating that rating agencies are doing much more than speaking and have a "high level of initial and ongoing involvement in

cushions required for the tranches of CDOs and MBSs.<sup>264</sup> They also are involved in the issuer's processes on an ongoing basis.<sup>265</sup> Unlike corporate and government bond transactions, the rating of CDOs and MBSs usually involves the use of the CRAs' mathematical models and assumptions.<sup>266</sup> CRAs also derive significant amounts of revenue from the rating of complex financial products, which enhances the conflict of interest problem associated with the issuer-pays model.<sup>267</sup> These changes suggest that credit ratings are not merely opinions, and as a result, the ratings of CRAs should not be afforded First Amendment protection.<sup>268</sup>

In the context of MBSs and CDOs, all of these factors generally weigh against the assertion that CRAs are journalists. "[CRAs] rarely if ever rate securities they are not hired to rate; reliable information suggests that they often commented (or did until recently) on how a security could be structured to achieve a desired rating; and almost all CDOs and similar instruments are placed privately and confidentially."<sup>269</sup> CRAs rate structured products for their own benefit, not to comment on public issues.

Even if courts consider CRAs members of the press in the context of structured products, CRAs should still be held accountable for their inflated ratings when CRAs consciously disregard the accuracy or methodology

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these deals"). These factors raise significant conflict of interest concerns. Bankers, issuers, and investors continuously make pitches to CRA employees, and such views can influence credit judgments. Amit R. Paley, *Credit-Rating Firms Grilled Over Conflicts*, WASHINGTON POST, Oct. 23, 2008, at A01. Many plaintiffs in CRA liability actions argue that CRAs have a "financial stake in assigning high ratings to securities in that high ratings would generate higher-volume trading in structured finance securities, which would positively affect [CRAs'] business." *Connecticut v. Moody's Corp.*, No. 3:10CV546(JBA), 2011 WL 63905, at \*1 (D. Conn. Jan. 5, 2011). Because a lower rating might affect future business, CRAs might be tempted to inflate the ratings of lower-quality securities. Furthermore, issuers sometimes condition payment of fees on the issuance of desired ratings. *Deats*, *supra* note 10, at 1820 (citing *Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.*, 651 F. Supp. 2d 155, 167 (S.D.N.Y. 2009)). Thus, investors might not receive accurate reports on creditworthiness. In the past, CRAs let "corporate greed trump their responsibility to provide unbiased appraisals for investors." Paley, *supra*.

264. Partnoy, *Overdependence*, *supra* note 1, at 16.

265. *Id.*

266. *Id.*

267. *See id.* (stating that CRAs earn significantly higher fees from ratings of secured products).

268. *See id.* (stating that "judges should reject the claim that ratings of second-level securitizations are merely 'opinions'").

269. Grais & Katsiris, *supra* note 233, at 3. CRAs normally rate structured securities like CDOs only for a fee, and they often participate in the structuring of the securities. *Id.* at 4. In addition, these structured securities are usually sold and traded privately. *Id.*

underlying their ratings. Analysts knew that they did not have enough data about the mortgages that made up the CDOs and MBSs that they rated.<sup>270</sup> Internal documents at various CRAs suggest that analysts and directors knew they were overrating various securities.<sup>271</sup> In April 2007, two S&P analysts acknowledged in an instant message conversation that S&P's "model def [sic] does not capture half of the . . . risk [associated with the deal]."<sup>272</sup> One of the analysts later noted that "[a deal] could be structured by cows and [they] would rate it."<sup>273</sup> It appears that more senior employees were aware of these moral issues, and in September 2007, one managing director stated, "[w]e had blinders on and never questioned the information we were given . . . . These errors make us look either incompetent at credit analysis, or like we sold our souls to the devil for revenue, or a little bit of both."<sup>274</sup>

### B. Is CRA Liability Practical?

Although most people agree that CRAs need to be held accountable following the recent financial crisis, the issue of control and regulation of CRAs is very complex. And although increased regulation and the threat of liability would most likely deter misbehavior, enforcement is probably impractical.<sup>275</sup> A liberalized negligence standard could drastically affect the financial markets and the CRA industry.<sup>276</sup> An increased number of civil

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270. Ronald D. Orol, *Competition, Lack of Data Drove Flawed Credit Ratings*, MARKETWATCH (April 23, 2010), <http://www.marketwatch.com/story/competition-lack-of-data-drove-flawed-ratings-2010-04-23> (last visited Nov. 29, 2011) ("Based on emails reviewed by the committee, [Sen. Carl] Levin found that the credit raters not only didn't have enough data about the mortgages that made up mortgage securities, but also they knew they didn't have that information.") (on file with the Washington and Lee Law Review). Furthermore, S&P knew that its CDO model was flawed. *Id.*

271. Paley, *supra* note 263.

272. *Id.*

273. *Id.*

274. *Id.* In December 2006, a high-ranking official at S&P took a more whimsical tone in describing the risks of MBSs and wrote: "Let's hope we are all wealthy and retired by the time this house of cards falters." *Id.*

275. *See* Pinto, *supra* note 14, at 355 ("While liability has the positive effect of deterring bad behavior and creating norms, it may also lead to frivolous litigation and credit rating firms concerned over liability limiting the issuers they cover thus lessening the amount of information for investors.").

276. *See* Coffee, *Ratings Reform*, *supra* note 186, at 27 ("Although the case for enhanced liability may be strong, three distinct policy reasons suggest that a liberalized negligence standard is ill-advised.").

claims could result in crushing liability for CRAs.<sup>277</sup> The goal of the Dodd-Frank Act and CRA legislation should be deterrence, not compensation.<sup>278</sup> Investors throughout the world have invested in trillions of dollars worth of structured products.<sup>279</sup> It is unrealistic to think that CRAs could compensate most of their victims for losses associated with inaccurate CDO and MBS ratings.<sup>280</sup> "[A] single case could produce a billion dollar (or greater) judgment."<sup>281</sup> Typically, the mistakes of CRAs involve multiple securities issuances. As a result, an error by a CRA may affect the ratings of dozens (or even hundreds) of issuers, causing billions of dollars in damages.<sup>282</sup> Catherine Odelbo, Morningstar's President of Equity Research, stated that "[t]his is Arthur Andersen-type liability; it can bring your company down."<sup>283</sup>

The threat of such liability could lead CRAs to stop rating complex structured securities, which in turn, could further paralyze housing finance in the United States.<sup>284</sup> This will reduce the amount of information available to the investing public.<sup>285</sup> Many CRAs have scaled back their rating operations because some clients are unable to supply the information required under the Dodd-Frank Act.<sup>286</sup> CRAs are concerned that including ratings in registration statements pursuant to the Dodd-Frank Act could expose them to expert liability.<sup>287</sup> Following the enactment of the Dodd-

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277. *See id.* at 27–28 (explaining that a negligence standard could bankrupt the CRAs).

278. *Id.* at 28.

279. *See id.* ("[T]rillions of dollars in structured finance products have been marketed globally.").

280. *See id.* (explaining that CRAs could not realistically compensate even a small percentage of the losses associated with structured securities).

281. *See id.*

282. *Id.* "[B]ecause a misjudgment by a CRA may enable a far greater dollar volume of securities to be sold, the need for deterrence is strong, but the case for a ceiling on its liability may even be stronger." *Id.*

283. Lippert, *supra* note 13.

284. *See* Coffee, *supra* note 186, at 28 (stating that the threat of increased liability could force the CRAs to stop rating certain structured products and explaining that "if the CRAs were to cease to rate structured finance products . . . housing finance in the U.S. might remain paralyzed").

285. Sack & Juris, *supra* note 234.

286. *See* Lippert, *supra* note 13 (stating that Fitch stopped grading development bonds from six port authorities in Ohio in August). The small firms that operate around the ports "don't have the audited financial statements Fitch demanded." *Id.*

287. *See* Sarah Mulholland & Jody Shenn, *SEC Grants Six-Month Delay for Ratings Disclosure on Asset-Backed Bonds*, BLOOMBERG (Jul. 23, 2010), <http://www.bloomberg.com/news/2010-07-23/sec-grants-six-month-delay-for-ratings-disclosure-on-asset-backed-bonds.html> (last visited Nov. 29, 2011) ("Fitch Ratings remains concerned that

Frank Act, CRAs advised clients not to use their ratings in prospectuses and registration statements.<sup>288</sup> Furthermore, the asset-backed securities (ABS) market froze up after CRAs refused to take expert liability as required by the Dodd-Frank Act.<sup>289</sup> CRAs were unwilling to grant issuers their consent to include the CRA's ratings in the issuer's registration statement, and sales were delayed.<sup>290</sup> As a result, the SEC took a no-action position against the CRAs in order to prevent a primary market issuance shutdown.<sup>291</sup> The no-action policy provided members of the securitization industry and regulators the opportunity to craft a compromise that would preserve the securitization markets.<sup>292</sup> Initially, the reprieve was expected to last six months. However, on November 23, 2010, the SEC extended the no-action policy indefinitely.<sup>293</sup> This policy allowed ABS issuers to omit ratings from their offering documents.<sup>294</sup>

In the extreme, CRAs concerned about liability exposure may relinquish their NRSRO status in order to avoid liability. Current and

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including its ranking in prospectuses and registration statements under the new law may expose the firm to expert liability, though the SEC action should offer market participants a window to modify practices as appropriate . . .") (on file with the Washington and Lee Law Review).

288. See Anusha Shrivastava, *Bond Sale? Don't Quote Us, Request Credit Firms*, WALL ST. J., July 21, 2010, at C1 (explaining that CRAs have requested that clients don't use their ratings until the CRAs get a better understanding of their legal exposure under the Dodd-Frank Act); Jesse Eisinger, *Postcrisis, A Struggle over Mortgage Bond Ratings*, DEALBOOK (Jan. 5, 2011), <http://dealbook.nytimes.com/2011/01/05/after-financial-crisis-a-struggle-over-rating-mortgage-bonds/> (last visited Nov. 29, 2011) (stating that the CRAs refused to allow their ratings to be used in offerings following the enactment of the Dodd-Frank Act) (on file with the Washington and Lee Law Review).

289. Jacob Gaffney, *Credit Rating Agency Reform: The Best Action Is No Action*, HOUSINGWIRE (Nov. 24, 2010), <http://www.housingwire.com/2010/11/24/credit-rating-agency-reform-the-best-action-is-no-action> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review).

290. Mulholland & Shenn, *supra* note 287.

291. Gaffney, *supra* note 289. "No action policies" are policies by SEC staff members indicating that they will not recommend that the SEC undertake enforcement action against a party for a particular activity. SEC, *No Action Letters* (Mar. 5, 2005), <http://www.sec.gov/answers/noaction.htm> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review).

292. *Id.*

293. Bingham McCutchen LLP, *Dodd-Frank Act's Impact on Rating Agencies as the ABS Market Continues to Evolve* (Dec. 15, 2010), <http://www.bingham.com/Media.aspx?MediaID=11652> (last visited Nov. 29, 2011) (on file with the Washington and Lee Law Review).

294. Mulholland & Shenn, *supra* note 287.

pending legislation seeks to regulate only NRSROs.<sup>295</sup> It is hard to believe that unrecognized CRAs would build up their reputations to become NRSROs if such a status would subject them to increased liability, particularly with decreased reliance on ratings in regulation.<sup>296</sup> If the Dodd-Frank Act reduces reliance on credit ratings in regulations and increases potential liability, NRSROs will be subjected to increased costs with decreasing benefits. In addition, if the NRSROs choose to give up their NRSRO status, issuers, investment advisers, and other market players will not be able to satisfy various regulations requiring ratings from NRSROs.<sup>297</sup> Thus, the threat of increased liability for CRAs might be impractical.

Indeed, increased liability will lead to increased costs for issuers and investors.<sup>298</sup> CRAs might charge higher fees to pay for the increased costs associated with due diligence and to cover the costs of future damages from lawsuits and the costs associated with new regulations. Harold McGraw, Chief Executive Officer of McGraw-Hill Companies, told investors that S&P is "raising prices to help pay for increased regulatory requirements."<sup>299</sup> Shortly after the Dodd-Frank Act was passed, Moody's increased its fee for a \$325 million bond issue 61% from a similar deal in 2009.<sup>300</sup> If CRAs

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295. Coffee, *Ratings Reform*, *supra* note 186, at 43.

296. See Richard Beales, *Cleaning Up the Ratings Agencies*, CNNMONEY (Sept. 30, 2009), [http://money.cnn.com/2009/09/30/news/economy/ratings\\_agencies\\_regulation.breakingviews/index.htm?postversion=2009093014](http://money.cnn.com/2009/09/30/news/economy/ratings_agencies_regulation.breakingviews/index.htm?postversion=2009093014) (last visited Nov. 29, 2011) ("[I]f Congress were to insist that raters shoulder significant liability for ratings that turned out badly, or tried to legislate the criteria that rating firms use . . . that might just drive them to forgo privileged NRSRO status in order to avoid the weight of the associated shackles.") (on file with the Washington and Lee Law Review); see also E-mail from Charles D. Brown, General Counsel, Fitch Ratings, to Elizabeth M. Murphy, Secretary, SEC, (Dec. 14, 2009), available at [http://www.fitchratingsasia.com/web\\_content/nrsro/fitch\\_comment\\_on\\_proposed\\_sec\\_rule\\_and\\_concept\\_release\\_2009Dec14.pdf](http://www.fitchratingsasia.com/web_content/nrsro/fitch_comment_on_proposed_sec_rule_and_concept_release_2009Dec14.pdf) ("The [nullification of Rule 436(g)] seems to defeat the entire purpose of becoming an NRSRO if one of the perceived benefits of recognition (use of the credit ratings by registrants) creates a significant, new liability.").

297. Cf. Beales, *supra* note 296 (explaining that sanctioned ratings would have to be ripped out of laws and regulations if CRAs gave up their NRSRO status).

298. See Partnoy, *The Siskel and Ebert of Financial Markets?*, *supra* note 63, at 646 (stating that "[CRAs] reduced both investors' cost of information and issuers' cost of capital" (citing Amy K. Rhodes, *The Role of the SEC in the Regulation of Rating Agencies: Well-Placed Reliance or Free-Market Interference?*, 20 SETON HALL LEGIS. J. 293, 294–95 (1996))).

299. Lippert, *supra* note 13.

300. See *id.* ("On July 19, four days after Congress passed the law, Moody's asked Montgomery County, Maryland, to pay \$98,400 to rate a \$325 million bond—boosting the fee [61%] from a similar deal in 2009.").

continue to increase fees to account for increased costs and liability, it is safe to assume that issuers will pass those costs on to investors.<sup>301</sup>

### C. Liability Cap Proposal

The Dodd-Frank Act attempts to hold CRAs to a higher standard of accountability for their ratings by providing incentives for CRAs to be objective.<sup>302</sup> However, the policy reasons discussed above suggest that imposing liability on CRAs might be more difficult than originally anticipated.<sup>303</sup> This Note asserts that the government can increase CRA accountability while also limiting the social and political side effects of increased liability by implementing a liability-based system with a cap on liability.<sup>304</sup>

Although CRAs have come under intense pressure from investors, legislators, regulators, and courts following the recent financial crisis, they are a vital and necessary component of the global financial system. CRAs provide a public good by eliminating information asymmetries and providing comprehensive coverage of debt offerings.<sup>305</sup> At the present time, there are no practical alternatives that could replace CRAs.<sup>306</sup> Consequently, regulators and courts must use the threat of liability to deter improper behavior and ensure accurate ratings. However, as explained earlier, increased liability related to inaccurate ratings could result in

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301. See Partnoy, *The Siskel and Ebert of Financial Markets?*, *supra* note 63, at 652 (explaining that issuers pass on the costs of ratings by paying a lower interest rate on debt issues); see also Jessica Holzer & Luca Di Leo, *US Bank Regulators Concerned About Credit-Ratings Ban*, AUTOMATED TRADER (Feb. 17, 2011), [http://www.automatedtrader.net/real-time-dow-jones/47542/-us-bank-regulators-concerned-about-credit\\_ratings-ban](http://www.automatedtrader.net/real-time-dow-jones/47542/-us-bank-regulators-concerned-about-credit_ratings-ban) (last visited Nov. 29, 2011) ("Dodd-Frank is a 'goldmine' for government workers, lobbyists and lawyers but, for most Americans, it will mean 'more red-tape, more government, fewer choices and higher fees.'") (on file with the Washington and Lee Law Review).

302. See Eisinger, *supra* note 288 ("For ratings reform to be successful it needs to provide incentives for rating agencies to be objective," said Gene Phillips, a former Moody's analyst who runs a ratings consulting firm. "The Dodd-Frank act achieves some of that, but absent legal liability, or accountability, it's much weaker.").

303. See *supra* Part VII.B (explaining why increased liability for CRAs might be impractical).

304. See Coffee, *Ratings Reform*, *supra* note 186, at 28 ("[A]ny cause of action against the CRAs should logically be coupled with a ceiling on liability to ensure that the deterrent threat does not lead to the financial destruction of an arguably necessary financial intermediary.").

305. See *supra* note 62 and accompanying text.

306. See *supra* note 212 and accompanying text.

crushing liability and bankrupt the entire CRA industry.<sup>307</sup> Such unlimited liability is not a viable option until legislators and regulators can find a practical alternative to CRAs. One way to mitigate the risk of crushing liability is to cap the liability exposure of CRAs. By implementing a liability cap on damages, courts will provide CRAs with incentives for compliance with rules and regulations without jeopardizing their financial viability.<sup>308</sup>

Although increased liability will impose greater costs on CRAs, CRAs will not be exposed to unreasonable financial burdens under a cap system.<sup>309</sup> The threat of liability, albeit limited, will still "heighten the already substantial leverage that [CRAs] have to demand additional information before agreeing to certify ratings, and provide both [CRAs] and issuers with incentives to spend more time examining disclosures more thoroughly."<sup>310</sup> A liability cap system will result in more reliable credit ratings.

The difficulty with implementing a liability cap system is determining the cap. Some scholars have already proposed imposing limited liability regimes with regard to CRAs. Professor Manns of George Washington University Law School has proposed implementing an earnings-based cap on liability and limiting CRAs' financial liability to cases of gross negligence.<sup>311</sup> Professor Coffee has proposed a modified form of strict liability for CRAs (and other gatekeepers) that would cap obligations at a multiple of annual revenues.<sup>312</sup> Professor Partnoy, of the University of San Diego, has proposed a system based on a percentage of damages.<sup>313</sup>

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307. See *supra* Part VII.B (explaining the effect of a liberalized negligence standard on CRA liability).

308. See Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1076 (2009) ("Limiting rating agencies' financial liability to cases of gross negligence, coupled with an earnings-based cap on liability and other safeguards, would provide rating agencies with incentives for compliance without jeopardizing their financial viability.").

309. *Id.* at 1076–77.

310. *Id.*

311. *Id.* at 1076.

312. See Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 365 (2004) ("Professor John C. Coffee, Jr. proposes a modified form of strict liability for gatekeepers (other than attorneys), which would convert gatekeepers into insurers but cap their insurance obligations based on a multiple of the highest annual revenues the gatekeepers recently had received from their wrongdoing clients."). Because potential damages are astronomical, Professor Coffee concludes that it would be too costly for gatekeepers to internalize liability costs through higher fees. *Id.* at 370.

313. *Id.* at 365–66.

This Note asserts that damages for CRA liability in the context of structured products should be limited to a percentage or small multiple of fees earned from the individual debt issue, which the CRA improperly rated. It is unrealistic to hold CRAs liable for the full value of the issues they rate because it could subject them to crushing liability.<sup>314</sup> CRAs have rated trillions of dollars' worth of debt, yet they have earned only a fraction of that amount in fees.<sup>315</sup> Thus, liability must be limited to a fraction, or at most a small multiple of the fees CRAs earn. Furthermore, the liability cap should differ depending on the level of negligence. In assessing damages, courts should use different caps depending on whether the CRA's actions constitute simple negligence or something more, such as gross negligence or recklessness.

If the CRA is simply negligent, liability should be limited to some percentage of the fee earned, not to exceed the total fee. Although society wants to discourage negligence, courts must realize that, in the context of structured products, the credit rating process is extremely complex and more susceptible to negligent activity. Consequently, when a CRA is simply negligent, it should not be liable for more than the fee earned. Some might argue that such a cap will encourage under-deterrence because it is too low. However, CRAs will be more diligent and cautious throughout the rating process if they realize that they might lose entire fees for simple negligence. This is especially true in the context of CDOs and MBSs because CRAs earn significant revenue from rating structured products.<sup>316</sup> Furthermore, calculating damages based on the fee earned is relatively straightforward and simple. In comparison, a liability cap based on multiples of revenues is much more difficult to determine.<sup>317</sup>

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314. See *supra* Part VII.B (explaining that increased liability could bankrupt the CRA industry).

315. See Coffee, *Ratings Reform*, *supra* note 186, at 28 ("Given that trillions of dollars in structured finance products have been marketed globally, there is no realistic possibility that the [CRAs] could fund meaningful compensation to most [of] their victims. Their pockets are simply not deep enough to cover even a small percentage of the losses . . ."); Jonathan Katz, Emanuel Salinas & Constantinos Stephanou, *Credit Rating Agencies*, THE WORLD BANK GROUP 7 n.5 (Oct. 2009), available at <http://rru.worldbank.org/documents/CrisisResponse/Note8.pdf> (stating that S&P earns 3–4 basis points of the issue size for rating corporate debt issues and up to ten basis points for rating complex transactions (citing Partnoy, *Other Gatekeepers*, *supra* note 95)).

316. See Smith, *supra* note 130 (stating that CRAs earn as much as three times more revenue for rating complex MBSs and CDOs than they do rating corporate debt).

317. See Partnoy, *Strict Liability for Gatekeepers*, *supra* note 312, at 371 (stating that "calculating a revenues multiple is fraught with technical difficulties").

If a CRA is grossly negligent or reckless, the liability cap should be up to three times the total fee earned from that debt issue.<sup>318</sup> Although gross negligence is a vague term, some describe gross negligence as acts or omissions that exhibit a reckless indifference to the rights of others.<sup>319</sup> According to some, gross negligence is willful and constitutes reckless behavior.<sup>320</sup> Under the proposed scheme, CRAs risk losing entire fees and incurring punitive damages if they are grossly negligent or reckless. The increased cap is logical in the context of reckless or grossly negligent behavior because such behavior is willful or intentional. Thus, more is needed to deter similar behavior in the future. However, the courts should be sure not to bankrupt the CRAs. In this situation, treble damages seem appropriate because many statutes in the law impose double or treble damages where some element of recklessness or willfulness entered into the act.<sup>321</sup>

In determining the appropriate damages, courts should balance deterrence factors against the financial burden imposed on CRAs and the risk of market failure in the market for CRA services. This tier-based system with liability caps should be adopted because it offers an appropriate model for deterring CRA misconduct without bankrupting CRAs.

### VIII. Conclusion

CRAs are currently under fire for their failure to adequately assess risks associated with complex structured finance products. Many experts have suggested eliminating CRAs altogether and finding some other alternative to assess credit risk. Although complete elimination of CRAs seems impractical, CRAs must be held accountable for their ratings. This Note asserts that the Dodd-Frank Act will increase CRA accountability and

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318. Cf. Manns, *Rating Risk After the Subprime Mortgage Crisis*, *supra* 308, at 1076 (stating that CRAs' liability should be limited to cases of gross negligence). "A gross negligence approach would impose liability for [CRAs'] failures to identify or engage in diligence of risks of such a nature and degree that the failure constitutes a gross deviation from a reasonable person's standard of care". *Id.* However, "[CRAs] would only have to show slight care or diligence in identifying and assessing risks to avoid liability for gross negligence, which is a modest standard to satisfy." *Id.* at 1079.

319. See 65 C.J.S. *Negligence* § 91 (2010) ("It has been considered that gross negligence consists in such lack of care as evidences recklessness.").

320. *Id.*

321. 22 AM. JUR. 2D *Damages* § 619 (2010).

liability. Furthermore, it argues that CRAs should not be afforded First Amendment protection in the context of MBSs and CDOs; CRAs are much more than financial publishers in this context. Legislators and courts, however, must be careful not to impose crushing liability on CRAs. This Note asserts that the United States can deter the type of behavior that facilitated the recent financial crisis while simultaneously protecting CRAs from crushing liability by implementing a tier-based liability system with different caps depending on the type of misconduct.