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Thomas J. Pate

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Thomas J. Pate[*]

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* LL.M., Harvard Law School, J.D., University of Miami School of Law, J.D., Universidad Catolica Andres Bello. Mr. Pate's practice focuses on bank, project and asset finance transactions typically involving an international component.

I. INTRODUCTION

Credit rating agencies (CRAs) are in the business of providing credit ratings for a varied number of securities and other debt-related instruments.[1] Theoretically, the purpose of CRAs is to help the investor public with the problematic aspects of principal-agent and asymmetric information by providing an easily understandable reference on a particular financial product's likelihood of default, thus assisting in setting a market price for the product in question.[2]

In the years leading up to the "credit crisis,"[3] CRAs strayed from their original purpose and began to play the role of facilitators, enabling investment banks and other financial institutions to more easily market structured products and to disguise the high level of risk associated with these products. Without a rating from one of the privileged CRAs, any given offering was doomed to failure.[4] Although, traditionally, regulators had seen CRAs as "gatekeepers," in the recent past, they have done more to allow financial products to access the market rather than keeping high-risk, or so-called "toxic products," out of the market.[5]

As the real estate bubble grew over the past years, major U.S. CRAs saw their revenues double, from $3 billion in 2002 to $6 billion in 2007.[6] These revenues are staggering when compared to the losses CRAs have assisted in generating. As of August 2008, over $500 billion in losses relating to mortgage-based assets had been reported, primarily by major international banks. In addition to commercial

1. *See* Credit Rating Agency Reform Act of 2006, S. 3850, 109th Cong. (2006) (enacted), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_bills&docid=f:s3850enr.txt.pdf (A CRA is defined as a person "A) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; B) employing either a quantitative or qualitative model, or both, to determine credit ratings; and C) receiving fees from either issuers, investors, or other market participants, or a combination thereof.").

2. Giles Turner, *CRA's: A. Andersen All over Again*, http://gsl.tv/blog/giles-turner7/cras-andersen-all-over-again.

3. BBC News, *Timeline: Global Credit Crisis*, Mar. 18, 2009, *available at* http://news.bbc.co.uk/2/hi/business/7521250.stm (In August 2008 BNP Paribas S.A. was forced to stop withdrawals from three investment funds because of their exposure to the U.S. subprime market. These funds were subsequently closed due to the bank's inability to properly value the underlying U.S. assets. This caused a sharp rise in the cost of credit and, by most accounts, the start of the "credit crisis.").

4. David Reiss, Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market, 33 FLA. ST. U. L. REV. 985 (2006).

5. *See* Frank Partnoy, How and Why Credit Rating Agencies are Not Like Other Gatekeepers, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59 (Barry Bosworth & Robert Litan eds., Brookings Inst. Press 2006).

6. Fitch Ratings ("Fitch"), Moody's Investor Services, Inc. ("Moody's"), and Standard & Poors' Ratings Services ("S&P").

banks, the largest exposures to the U.S. subprime market are held by insurance companies and hedge funds, and greater losses and write-downs can be expected.[7]

Due to a number of circumstances to be analyzed in this paper, the fundamental role assigned to CRAs by market participants and regulators has been left in the hands of three rating institutions. These CRAs have been able to gain a de facto regulatory oligopoly and have captured a 95% market share of the global ratings business.[8] This factor, together with others, may have contributed to a situation where some investors inappropriately relied on CRA ratings as their sole method of assessing the risk of holding these types of securities. Consequently, when the quality of the CRAs' ratings was questioned due to the inordinate number of downgrades of residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs), some investors were left with no independent means of assessing the risk of these securities,[9] ultimately resulting in market failure.

In the present analysis, the role the CRAs played in developing markets for certain types of asset-backed securities will be reviewed in order to identify how the CRAs promoted the leverage build up that occurred over the past 15 years. In doing so, the fundamental flaws in the ratings process will be highlighted, with a view toward being able to assign responsibility accordingly. Further, the motivations of banks, financial institutions, and corporate issuers in relying on the CRAs will be critiqued.

Additionally, the principal past and current in-court claims against the CRAs will be analyzed and hypotheses will be drawn on the liability that may await the CRAs for their involvement in assisting the credit crisis. Finally, several proposals for legislative reform will be suggested and conclusions will be offered on the future role CRAs may be expected to play.

II. STRUCTURED FINANCE AND THE CREDIT CRISIS

A. Background

On October 9, 2007, the Dow Jones Industrial Average reached an all-time high.[10] However, not all was well. The 15-year period leading up to the credit cri-

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7. Andrew Ross Sorkin, *If Goldman Returns Aid, Will Others?*, N.Y. TIMES, Mar. 24, 2009, *available at* http://finance.yahoo.com/banking-budgeting/article/106793/If-Goldman-Returns-Aid-Will-Others??sec=topStories&pos=7&asset=TBD&ccode=TBD ("We see another $1.5 to $2 trillion of as yet unrecognized losses from U.S. assets still to hit global financial sector balance sheets and challenge its institutions.").

8. *The Role of Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. on Capital Markets, Ins., and Gov't Sponsored Entities of the H. Comm. on Fin. Servs.*, 110th Cong. 137 (2007) (statements of Julia Whitehead and Sean Mathis), *available at* http://www.docstoc.com/docs/19960167/THE-ROLE-OF-CREDIT-RATING-AGENCIES-IN-THE-STRUCTURED-FINANCE-MARKET-House-Congressional-Hearing-110th-Congress-2007-200 [hereinafter Whitehead] (This market share is divided as follows: Moody's 39%, S&P 40%, Fitch 16%.).

9. Technical Committee of the International Organization of Securities Commissions, *The Role of Credit Rating Agencies in Structured Finance Markets*, Final Report (May 2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf.

10. Dow Jones Industrial Average Historical Quote, *available at* http://www.marketwatch.com/investing/index/INDU/historical (On Oct. 9, 2007, the Dow peaked at 14,165).

sis saw substantial changes in the ways commercial mortgage loans were originated and held.

Securitization, which traditionally has been defined as the "aggregation and pooling of assets with similar characteristics in such a way that investors may purchase interests or securities backed by those assets,"[11] grew from a limited specialized structured finance technique into the principal way in which term loans were originated and commercialized. With the objective of maximizing profits, lenders joined together in order to create larger loan offerings than they would have been able to originate on their own. They then targeted specific investors with particularized appetites for certain types of risk.[12]

Loan packages were split into components with varying priorities and differing terms, with certain components destined for securitized pools and other components destined for direct sales.[13] Further, interests in the securitized pools were carved into tranches each with varying degrees of priority. Many of the ultimate purchasers of these tranched interests barely glanced at the underlying real estate and rather sought comfort solely from the ratings assigned by the CRAs to each tranch.[14]

Most of the so-called "asset-backed securities" traded in the market were issued in the form of either residential mortgage-backed securities (RMBS), collateralized debt obligations (CDOs), or asset backed securities (ABS).[15] The principal instruments to be analyzed in this paper are the first two.[16]

B. RMBS

The process for creating a RMBS typically began when an arranger, most frequently an investment bank, packaged mortgage loans into a pool and transferred them to a trust that would in turn issue securities collateralized by the pool. The trust would serve as a special purpose vehicle (SPV) that would be remote from bankruptcy.[17] Also, by detaching the assets from the principal business of the issuer, the instruments became highly fungible.[18] The trust would purchase the loan pool and would finance the purchase by issuing RMBS. The monthly interest and

11. Securitization: Asset-Backed and Mortgage-Backed Securities § 1.01, at 1-3 (Ronald S. Borod ed., 2003).

12. *See generally* Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101 (1997).

13. Warren Bernstein, *Sales of Whole Loans and Fractional Interests Loans*, *in* Commercial Real Estate Financing 2009: How the World Changed, Feb. 12-13, 2009, PLI Order No. 18111, 299, 301 (Feb. 12-13, 2009).

14. *Id.*

15. Dennis Vink & André E. Thibeault, *ABS, MBS and CDO Compared: An Empirical Analysis* (Aug. 2007), *available at* http://www.securitization.net/pdf/Publications/Vink_ABSMBSCDO.pdf [hereinafter Vink & Thibeault, *Empirical Analysis*].

16. RMBS and CDOs are the instruments that have come under particular scrutiny, with respect to the assignment of ratings by the CRAs, by the SEC in past months. *See* U.S. Securities and Exchange Commission (SEC), *Summary Report of the Issues Identified in the Commission Staff's Examination of Select Credit Rating Agencies*, July 2008, *available at* http://sec.gov/news/studies/2008/craexamination070808.pdf [hereinafter SEC Report July 2008].

17. Vink & Thibeault, Empirical Analysis, *supra* note 15.

18. *Id.*

principal payments from the loan pool would then be used to make monthly interest and principal payments to the investors in the RMBS.

The trust would issue different classes of RMBS or tranches offering varying scales of payments to investors based on the level of credit protection. The degree of credit protection, known as forms of "credit enhancement," was provided primarily by the use of subordination (creating a hierarchy among the tranched securities), over-collateralization (creating an equity cushion below the lowest tranched security to absorb losses), excess spread (by accumulating excess spread that is comprised of the total amount by which the total interest received on the underlying loans exceeds the payments to be made to the investors in the trust, less the administrative expenses of running the trust)[19] and, in some cases, bond insurance (insurance provided by a third party).

C. CDOs

The CDO began from a similar base as the RMBS, although the CDOs normally were backed by debt securities rather than mortgage loans, which traditionally underlie the RMBS. Typically, however, the administrators of the CDO actively managed the underlying assets and were able to change the assets over time. Under an RMBS, on the other hand, the mortgage loan pool remained static over time. CDOs currently exist in the market in one of two forms. The first is the so-called "Cash Flow CDO" where the trust issues different tranches of liabilities and uses the net proceeds to purchase the pool of assets. [20] Normally a sponsor began by creating a trust to hold the CDO's assets and to issue its securities. Generally, a CDO was comprised of 200 or more debt securities.[21] The trust was structured to provide differing levels of credit enhancement to the securities it issued. Initially, in the early 1980's and 1990's, CDOs were backed by high-yield corporate bonds,[22] but in recent years CDOs became one of the largest purchasers of "subprime" RMBS and the drivers of demand for those securities.[23] In fact, the rapid

19. SEC Report July 2008, *supra* note 16.

20. Standard & Poor´s, *Structured Finance: Global Cash Flow and Synthetic CDO Criteria*, Mar. 21, 2002, *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/cdo_criteria2002_FINALTOC.pdf [hereinafter Standard & Poor's, *Global Cash Flow*].

21. *Id.* at 42.

22. Standard & Poor´s, *Global Cash Flow*, *supra* note 20.

23. *See* Joint Ctr. for Hous. Stud. of Harvard Univ., *The State of the Nation's Housing* 2005, at 1, 5 (2005), *available at* http://www.jchs.harvard.edu/publications/markets/son2005/son2005.pdf ("Subprime" lending also had seen significant growth, reaching nearly 20% of all originations in 2004. Subprime lending is the extension of credit to those with lower incomes, less wealth, and riskier credit profiles than traditional, "prime" borrowers. Although it would appear that the increase in subprime lending may have contributed to the crisis, there are those who would refute this claim. Nevertheless, although not a key element of the present analysis, we merely highlight the growth in the practice of subprime loan origination and refinancing.); *see* Chairman Ben S. Bernanke, Stamp Lecture at the London School of Economics, London, England (Jan. 13, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm ("The proximate cause of the crisis was the turn of the housing cycle in the United States and the associated rise in delinquencies on subprime mortgages, which imposed substantial losses on many financial institutions and shook investor confidence in the credit markets. However, although the subprime debacle triggered the crisis, the developments in the U.S. mortgage market were only one aspect of a much larger and more encompassing credit boom, the impact of which transcended the mortgage market and affected adversely many other forms of credit.").

increase in subprime RMBS held by CDOs from the early 2000s through 2006 has been well documented.[24] The so-called "Synthetic CDOs" are the riskiest form of CDO. These are structured vehicles that use credit derivatives to achieve the same credit-risk transfer as "Cash Flow CDOs," but without the physical transfer of the assets.[25] One of the most common forms of derivatives used, and which has been most lethal to the financial system during the present crisis, was the credit default swap.[26] In those cases, rather than purchasing subprime RMBS or CDOs, the arranger or trust manager entered into credit default swaps referencing subprime RMBS or CDOs. The particular importance of Synthetic CDOs and so-called "Hybrid CDOs"[27] to banks and other institutions with respect to meeting regulatory and risk-based capital considerations will be discussed *infra* in Section IV.d.

D. Structured Finance and the CRAs

Historically, banks have played the role of credit monitors in the market because they had access to the debtor's financial information. But today the agencies face pressures that did not exist when John Moody was rating railroads. In the modern era of structured finance, it appeared that banks or issuers no longer had the desire to monitor and evaluate the risks being issued to potential investors. Professor Schwarcz has hypothesized that the new "originate and distribute" model (which encapsulates the broader "issuer pays" concept) of RMBS and CDOs, facilitated by structured finance techniques, undermined the incentive that the banks, financial institutions, and investors usually had in the past to monitor their investments over time.[28] Furthermore, structured finance models used during the past years may have created formidable complexities in the required disclosures, encouraged herd behavior, and created excessive diversification of risk, all of which would have undermined the traditional incentive to monitor.[29] If the last propositions are correct, then investors and issuers would have had to rely on a third party to evaluate the initial risk and to conduct monitoring.

In this respect CRAs provided a bridge between the issuers and the investors. The CRAs theoretically would provide an unbiased opinion on the basis of information that was made available to them, albeit provided directly to them by the

24. *See* Jian Hu, Assessing the Credit Risk of CDOs Backed by Structured Finance Securities: Rating Analysts' Challenges and Solutions, THE J. OF STRUCTURED FIN., Aug. 31, 2007, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1011184 (It has been reported that the average percentage of subprime RMBS in the collateral pools of CDOs in some cases grew by nearly 30% from 2003 through 2006.).

25. Frank Partnoy & David Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007). *See also* Standard & Poor´s, *Global Cash Flow*, *supra* note 20 (Note that the CDOs can be composed entirely of credit default swaps in which case they will be properly deemed "Synthetic CDOs" or they can be a combination of credit default swaps and cash RMBS, in which case they would more appropriately be called "Hybrid CDOs.").

26. *See* Abigail Moses, *CDO Losses Driving Credit-Default Swaps to Record*, *Analysts Say*, Feb. 11, 2008, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agyv_xzB1tIg.

27. Usually the trust will hold both RMBS and certain types of derivatives.

28. Steven Schwarcz, *Protecting Financial Markets: Lessons From the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 388 (2008).

29. *Id.*

issuers.[30] Indeed, a key step in creating and selling RMBS and CDOs was the issuance of a credit rating containing the agency's view of the likelihood that the issuer would default on its obligations to pay interest for each of the tranches issued by the trust.[31]

E. A Common Procedure

According to internal procedures at three of the largest CRAs, the common practice among credit rating agencies was for the arranger or issuer of the RMBS or the CDOs to initiate the ratings process by sending to the CRA a range of data on each of the subprime loans to be held by the trust, the proposed capital structure, and the proposed levels of credit enhancement.[32] Upon receipt of the information, the CRA assigned a lead analyst who was responsible for analyzing the loan pool and the underlying assets. [33]

Eventually, after a series of quantitative loss models, stress tests and cash flow models were run, the analyst would create a ratings recommendation for a rating committee composed of analysts and senior level analytical personnel.[34] However, if the analyst concluded that the proposed capital structure did not support the desired ratings by the issuer, then a preliminary conclusion was delivered to the arranger. The arranger could then accept that determination or adjust the structure to provide for a higher rating.[35] The CRA would then issue a rating decision (which in some cases could be appealed by the arranger). Typically, the CRA was paid only if the credit rating was issued, although on occasion there was a fee for the analytical work conducted in the event the arranger did not go forward with the issue.[36]

III. WHAT WENT WRONG? IDENTIFYING THE FLAWS

With the help of the CRAs, the issuers were able to design structures that would ensure a triple-A rating and, hence, would meet institutional investor crite-

30. *See* SEC Report July 2008, *supra* note 16 (Since the 1970's the clients of the CRAs have primarily become the issuers and not the investors. Usually the investor pool is too dispersed to make it worthwhile to pay for independent credit rating analysis. This point will be further analyzed later in this paper. The SEC has now proposed that the CRAs take steps to deal with the "issuer pays" conflicts of interest.).

31. *See* VK BHALLA, INVESTMENT MANAGEMENT: SECURITY ANALYSIS AND PORTFOLIO MANAGEMENT 143 (S. Chand & Co. Ltd 1994).

32. *See* SEC Report July 2008, *supra* note 16 (Note that as CDOs are actively managed, the rating does not depend so much on the composition of the pool of debt securities, but rather on the covenants that limit the management of the CDO.).

33. The Technical Committee of the International Organization of Securities Commissions, Code of Conduct Fundamental for Credit Rating Agencies, Dec. 2004, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf [hereinafter Code of Conduct].

34. *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit-Rating Agencies*, 77 WASH. U. L.Q. 619 (1999) (S&Ps procedures are almost identical to the ones described here, but allow for the analyst recommendation that is overruled to be protested before an internal appeals court.).

35. SEC Report July 2008, *supra* note 16.

36. *Id.*

ria.[37] The tranches were constructed to achieve this rating at the least expense. Ironically, today many triple-A tranches now have the greatest exposure to subprime mortgages.[38] Unfortunately, it would appear that the procedures outlined above were wholly unsatisfactory. Many ratings issued on RMBS and CDOs turned out to be self-serving, allowing market participants to earn profits and fees,[39] while offering very little reliable information about risks.[40]

A. Failure to Conduct or Require that Due Diligence be Conducted

There is no requirement that a CRA verify the information contained in loan portfolios presented to them for ratings. In fact, judging from the typical procedure, as mentioned *supra*, the CRAs publicly disclose that they receive the information from the issuer. Furthermore, most of the CRAs' "Code of Conduct" contains information that it is under no obligation to perform due diligence.[41] The CRAs do not verify the integrity or accuracy of the information received from issuers, and in the view of the CRAs the due diligence duties belong to the other parties in the process. Perhaps worst of all is the fact that CRAs do not usually seek representations from the issuers that due diligence was indeed performed.[42]

Evidently CRAs will most likely never be required to conduct extensive due diligence, but it does seem shocking that rating agencies normally charge between $40,000 and $120,000 for every $100 million in so-called "structured-finance securities" they rate,[43] and yet they conduct no due diligence and require that none be conducted. In this respect, the SEC has recently proposed two additional areas that a CRA would be required to address concerning the disclosures it would have to provide about how it treats due diligence.[44] It remains to be seen whether these rules will have the desired effect.

37. As will be seen below in Section V, certain institutions can only invest in products with a particular rating.

38. Aaron Unterman, *Innovative Destruction-Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53 (2009).

39. The explosive growth in certain structured products helped generate the highest profits for the issuers (in the form of commissions) and the CRAs (in the form of fees).

40. Unterman, *supra* note 38, at 53.

41. *See* Moody's Investor Service, *Code of Professional Conduct* (June 2005), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/01/2003400000425277.pdf?search=5&searchQuery=code+of+conduct&click=1 ("Moody's has no obligation to perform, and does not perform, due diligence with respect to the accuracy of information it receives or obtains in connection with the rating process. Moody's does not independently verify any such information. Nor does Moody's audit or otherwise undertake to determine that such information is complete. Thus, in assigning a Credit Rating, Moody's is in no way providing a guarantee or any kind of assurance with regard to the accuracy, timeliness, or completeness of factual information reflected, or contained, in the Credit Rating or any related Moody's publication.").

42. *See* SEC Report July 2008, *supra* note 16.

43. Serena Ng and Liz Rappaport, *Raters See Windfall in Bailout Program*, WALL ST. J., Mar. 20, 2009, *available at* http://online.wsj.com/article/SB123751980140092361.html.

44. *See* Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34,57967 (June 16, 2008), *available at* http:www.sec.gov/rules/proposed/2008/34-57967.pdf (The rules would require that the CRA indicate how much verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool is relied on in determining credit ratings.).

B. Conflicts of Interest Abound

Under the "issuer pays" model generally in place since the 1970s, the securities issuer pays the CRAs to issue ratings which can cause the agencies' interests to eclipse those of investors. [45] Evidently the CRAs have an interest in generating business from the underwriting firms, which creates an inherent conflict. [46] To make matters worse, investment banks and others seeking higher profits saw tremendous potential in the risky mortgage business since the interest rates on mortgage products were higher and more money came into the pool, which would then leave more money for commissions, management fees, and for paying interest to investors. For instance, when a bank proposed a rating structure on a pool of mortgage debt, the CRA many times would ask that a capital enhancement be provided (an extra cushion of capital for certain tranches). The bank inevitably would lobby for a thin cushion (the thinner the capitalization, the larger the bank's profits). [47] To some degree it was up to the agency to make sure that the cushion was big enough to safeguard the investors. The process involved extended consultations between the agency and its client as described *supra*. "In short, obtaining a rating was a collaborative process."[48] Ultimately, if the CRA and the issuer failed to reach an agreement, the issuer could take its business elsewhere.[49]

Currently, Section 15E(d) of the Exchange Act requires that CRAs establish and maintain policies and procedures reasonably designed to address and manage conflicts of interest.[50] Such policies in turn should have the purpose of ensuring that the CRAs' judgment remains unbiased.[51] Furthermore, in December 2004, the International Organization of Securities Commissions (IOSCO) published a Code of Conduct for CRAs that, among other things, is designed to address the types of conflicts of interest that CRAs face. [52] This code was fundamentally revised in 2008. [53]

Nevertheless, a recent SEC investigation found a number of internal flaws within the CRAs themselves. In one instance, a CRA allowed senior analytical managers to participate directly in fee discussions with the issuers and it was found

45. Gretchen Morgenson, *Credit Rating Agency Heads Grilled by Lawmakers*, N.Y. TIMES, Oct. 22, 2008, *available at* http://www.nytimes.com/2008/10/23/business/economy/23rating.html?_r=1&scp=3&sq=credit%20rating%20agencies&st=cse (statement was made to the House Committee on Oversight and Government Reform by Jerome S. Fons, who was the managing director for credit policy at Moody's until 2007).

46. It should be noted that there is a high concentration in the firms conducting the underwriting function for most RMBS and CDO deals. *See* SEC Report July 2008, *supra* note 16.

47. Roger Lowenstein, *Triple-A Failure: The Rating Game*, N.Y. TIMES, Apr. 27, 2008, *available at* http://www.nytimes.com/2008/04/27/magazine/27Credit-t.html?pagewanted=1&_r=1.

48. *Id.*

49. This practice has been termed "forum shopping" and will be discussed infra.

50. 15 U.S.C. § 78o-7(a)(1)(B)(iii).

51. *See* Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34,55857, 17 C.F.R. Parts 240 and 249b (June 5, 2007).

52. *See* Code of Conduct, *supra* note 33.

53. The Technical Committee of the International Organization of Securities Commissions, Code of Conduct Fundamental for Credit Rating Agencies, May 2008, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf.

that only one of the three largest CRAs actively monitors for compliance with its internal policy against analysts participating in fee discussions.[54] Furthermore, the SEC found that multiple communications at CRAs indicated that analysts were aware of their firm′s fee arrangement with issuers and held employee discussions about their CRA's market share of business relative to other CRAs.[55] Examples of suspect communications revealed by the SEC investigation that highlight the problem are the following:

> A senior analytical manager in the Structured Finance group wrote, "I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision of assigning separate ratings to principal and interest, and if so how much."[56]
>
> When a competitor's rating methodology changed, a high-level employee stated, "I had a discussion with the team leaders here and we think that the only way to compete is to have a paradigm shift in thinking especially with the interest rate risk."[57]

One final case that serves to illustrate the problem, although from a slightly different perspective, is that of Berkshire Hathaway's triple-A debt rating.[58] In March 2009, news surfaced that the company's debt would be downgraded by S&P and Moody's following Fitch's earlier move to downgrade.[59] Berkshire's CEO, Warren Buffet, typically described as a vocal critic of "Wall Street excesses," has been particularly silent about the possible downgrade and with respect to voicing any possible criticism against the CRAs.[60] It has been suggested that this may be in part due to the fact that Berkshire owns 20% of Moody's, making Berkshire the largest single shareholder.[61] In fact, a recently departed Berkshire employee confessed to a reporter that "Mr. Buffett ha[d] long found his connection to Moody's a

54. *See* SEC Report July 2008, *supra* note 16.

55. *Id.*

56. *Id.* (quoting e-mail No. 32: Senior Analytical Manager to Senior Business Manager (Nov. 9, 2004, 12:11pm)).

57. SEC Report July 2008, *supra* note 16 (quoting e-mail No. 34: Senior Analytical Manager to Analytical Manager (Sept. 25, 2006, 6:50pm)).

58. *See* Aaron Task, *Warren Buffett: The Good, the Bad and the Moody's*, Mar. 25, 2009, *available at* http://finance.yahoo.com/techticker/article/219148/Warren-Buffett:-The-Good,-the-Bad-and-the-Moody's.

59. An S&P analyst was quoted as having said the following: "If continued substantial deterioration in the equity markets hurts capital further, or if it appears that the insurance group will not be able to restore capital back to the 'AAA' level through earnings or through capital contributions from Berkshire's noninsurance operations or external sources, then we might lower the ratings." *See* Jonathan Stempel, *Buffett's Berkshire May Lose "AAA" S&P Rating*, REUTERS, Mar. 25, 2009, *available at* http://www.reuters.com/article/businessNews/idUSTRE52O2S020090325?feedType=RSS&feedName=businessNews.

60. David Segal, *Buffett Is Unusually Silent on Rating Agencies*, N.Y. TIMES, Mar. 17, 2009, *available at* http://www.nytimes.com/2009/03/18/business/18buffett.html?pagewanted=1&partner=rss&emc=rss.

61. Josh Flunk, *Warren Buffet's Berkshire Hathaway Downgraded By Moody's,* THE ASSOCIATED PRESS, Apr. 8, 2009, *available at* http://abcnews.go.com/Business/Economy/wireStory?id=7294808.

little awkward . . . Mr. Buffett never attended any board meetings . . . and Berkshire has never bought any additional shares."[62]

In any event, the conflicts of interest problem is the area that is most easily and commonly identified by critics. Hence, it will be the area most likely to be addressed first by upcoming regulatory proposals.

C. Concentration and Oligopoly Power

In 1975, the SEC promulgated a series of broker-dealer net capital requirements, with the thought being that banks and other financial institutions should not need to keep in reserve the same amount of capital if the financial institution was heavily invested in highly-liquid securities with low levels of risk.[63] This is when the term "Nationally Recognized Statistical Rating Organization" (NRSRO) first came into use.[64] At first the SEC granted NRSRO status through No-Action Letters, but on September 29, 2006, the Credit Ratings Reform Act of 2006 (CRARA) was approved and the process changed.[65] Now the SEC grants the NRSRO status after a CRA becomes registered in accordance with Section 15E of the Securities Exchange Act of 1934 (Exchange Act).[66] Currently, there are ten NRSROs registered with the SEC.[67] However, of the ten, the largest three CRAs (Moody's Investor Services, Standard & Poor's, Inc. and Fitch, Inc.) collectively comprise approximately 85% of the CRA market.[68]

The credit ratings industry may be a state-sanctioned global oligopoly. In 1998 the U.S. Department of Justice (DOJ), although opposed to the NRSRO certification process then outlined by the SEC, believed that "while the historical dominance of Moody's and S&P had eroded in recent years for certain types of securities, the overall level of market power they retained continued to be a competitive"[69]

62. *Id.*

63. 17 C.F.R. § 240.15c3-1 (1983); s*ee generally*, Steven Molinari & Nelson Kibler, *Broker-Dealers' Financial Responsibility Under the Uniform Net Capital Rule – A Case for Liquidity*, 72 GEO. L. J. 1 (1983-1984).

64. *Assessing the Current Oversight and Operations of Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, S. REP. NO. 109-326 (Mar. 7, 2006), *available at* http://banking.senate.gov/public/_files/partnoy.pdf (testimony of Frank Partnoy).

65. *See* Credit Rating Agency Reform Act of 2006 (CRARA), Pub. L. No. 109-291, 120 Stat. 1327 (2006) the Credit Ratings Reform Act of 2006, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_bills&docid=f:s3850enr.txt.pdf.

66. It should be noted that the CRARA preempts any state and local law requiring the registration, licensing, or qualification of an NRSRO (or any employee or contractor) as a credit rating agency or an NRSRO. It declares, however, that nothing in this preemption prohibits a state securities commission from investigating and bringing an enforcement action with respect to fraud or deceit against any NRSRO or associated person.

67. The ten NRSRO's registered are: A.M. Best Company, Inc.; DBRS Ltd.; Egan-Jones Rating Company; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; LACE Financial Corp.; Moody's Investors Service, Inc.; Rating and Investment Information, Inc.; Realpoint LLC; and Standard & Poor's Ratings Services. *See* SEC, Credit Rating Agencies – NRSROs, *available at* http://www.sec.gov/answers/nrsro.htm (last visited Mar. 14, 2010).

68. *See* Code of Conduct, *supra* note 33.

69. SEC, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*, Jan. 2003, at 37, *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf (citing comments of the United States Department of Justice in the Matter of: File No. S7-33-97, Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934 (Mar. 6, 1998)).

obstacle. This remains true today[70] and it would seem that impediments to entering the market have allowed these leading CRAs to dominate the global ratings industry.[71]

Although oligopoly power creates a whole series of concerns for the CRA industry, the most problematic is the systematic overvaluation of securities and debt instruments. This may occur in two ways. The first is the so-called "grade inflation" hypothesis. This problem is particularly pronounced when dealing with securitized products, since it is with these that demand is especially driven by regulated intermediaries.[72] Indeed, the entire viability of being able to market a RMBS or CDO may be seen to rely solely on obtaining a sufficiently high rating. The second is the underestimation of risk and the overvaluation of underlying assets by all market players.[73] This second phenomenon may well have occurred during the last decade when the CRAs were, apparently, overvaluing the price of real estate and undervaluing the risk of default.

D. Failure to Adequately Monitor

It is a common practice for the CRAs to check their ratings on an ongoing basis in a process called "monitoring." A recent SEC investigation found that the CRAs charge a "monitoring" fee on an annual, upfront basis.[74] The monitoring of structured products was found to be of particular importance because the due diligence information underlying the loan pools was generally not available to independent analysts or third parties.[75] However, there has been considerable criticism levied against the CRAs for their inability to properly monitor ratings and conduct timely downgrades on a number of securities and debt instruments. Commentators have suggested that this "lethargy in downgrading" results in the downgrades not being issued promptly enough to warn the investor public.[76]

Although there are multiple examples,[77] a case where the failure to monitor reached epic proportions occurred immediately before Enron´s collapse in 2001. Prior to its demise, Enron's ability to secure low-cost financing was based on an investment grade credit rating (e.g., BBB+ from S&P), which the major CRAs

70. Before the CRARA took effect, the SEC promised to revise the requirements that NRSROs would have to meet, but the issue remains controversial. *See id.*

71. *See* Unterman, *supra* note 38, at 53.

72. Charles W. Calomiris, *Not (Yet) a Minsky Moment,* AM. ENTER. INST., Oct. 5, 2007, at 18, http://www.aei.org/docLib/20071214_Calomiris1.pdf.

73. *See* Steven Schwarcz, *Protecting Financial Markets: Lessons From the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 388 (2008).

74. *See* SEC Report July 2008, *supra* note 16.

75. *Id.*

76. Francis Bottini, Jr., *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 SAN DIEGO L. REV. 579, 603-08 (1993).

77. A much earlier example that was widely criticized was the fact that in 1975 both S&P and Moody's waited too long to change New York City's bond ratings. S&P changed its rating in April 1975 and Moody's changed its rating the following October. However, critics complained that obvious warning signs that existed the previous fall should have caused the rating agencies to downgrade the state's debt rating sooner. *See* Bottini, Jr., *supra* note 76.

gave to Enron's debt from 1995 until November 2001.[78] The CRAs received information during this period indicating that Enron was engaging in substantial derivatives and off-balance sheet transactions, including both non-public information and information disclosed in Enron's annual reports, but they maintained an investment grade rating.[79] If Enron's credit rating had reflected the company's actual debt levels during this period, it would not have been able to leverage such high levels of debt and maintain a high stock price at the same time.[80] What was most astounding was that despite the fact that the CRAs had been aware of the company's off-balance sheet transactions for months, Enron's rating remained at investment grade up to four days before the company went bankrupt. During the aftermath of Enron´s collapse, the CRAs defended themselves, alleging that Enron´s management had deceived them into maintaining the high-level ratings.[81]

During recent times, similar situations have arisen in which the CRAs have issued significant downgrades of RMBS and CDOs. The amount and speed of downgrades being issued since 2008 is unprecedented.[82] Most of the downgrades have been attributed to the precipitous drop in housing prices and the increase in mortgage delinquencies.[83] The following is a summary of the more important downgrades announced thus far:

> As of February 2008 Moody's had downgraded at least one tranche of 94.2% of the subprime RMBS issues it rated in 2006, including 100% of the 2006 RMBS backed by second-lien loans, and 76.9% of the issues rated in 2007.[84]
>
> As of March 2008, S&P had downgraded 44.3% of the subprime tranches it rated between the first quarter of 2005 and the third quarter of 2007.[85]

78. *Rating the Raters: Enron and the Credit Rating Agencies*, *Hearing Before the S. Comm. on Gov't Affairs*, 107th Cong. 7-10 (Mar. 20, 2002) (statement of Ronald M. Barone, Managing Director, Standard and Poor's), *available at* http://www.senate.gov/~gov_affairs/072302barone.pdf.

79. Frank Partnoy, *Lessons from Enron, How Did Corporate And Securities Law Fail?*, 48 VILL. L. REV. 1245 (2003).

80. *Id.*

81. Richard Oppel Jr., *Enron´s Many Strands: The Hearings; Credit Agencies Say Enron Dishonesty Misled Them*, N.Y. TIMES, Mar. 21, 2002, *available at* http://www.nytimes.com/2002/03/21/business/enron-s-many-strands-hearings-credit-agencies-say-enron-dishonesty-misled-them.html.

82. *See* SEC, *Testimony Concerning Oversight of Nationally Recognized Statistical Rating Organizations*, Apr. 22, 2008, *available at* http://www.sec.gov/news/testimony/2008/ts042208cc.htm.

83. *See Concerning Oversight of Nationally Recognized Statistical Rating Organizations: Hearing Before S. Comm. on Banking, Hous. and Urban Affairs* (Apr. 22, 2008), *available at* http://www.sec.gov/news/testimony/2008/ts042208cc.htm (testimony of Christopher Cox).

84. Overall, Moody's has downgraded 53.7% and 39.2% of its 2006 and 2007 subprime tranches, respectively. SEC, *Testimony Concerning Oversight of Nationally Recognized Statistical Rating Organizations*, Apr. 22, 2008, *available at* http://www.sec.gov/news/testimony/2008/ts042208cc.htm (quoting Moody's Investors Service, *U.S. Subprime RMBS 2005-2007 Vintage Rating Actions Update: January 2008*, Feb. 1, 2008).

85. *Id.* (quoting Standard & Poor's Rating Services, *Transition Study: Structured Finance Rating Transition and Default Update as of March 21, 2008,* Mar. 28, 2008).

> As of December 2007, Fitch had downgraded approximately 34% of the subprime tranches it rated in 2006 and in the first quarter of 2007, and, in February 2008, Fitch placed all of the RMBS it rated in 2006 and the first quarter of 2007 backed by subprime first lien mortgages on "Ratings Watch Negative."[86]

As a consequence of untimely downgrades, investors have brought claims against several of the CRAs alleging that they relied on the ratings and that the CRAs failed to duly monitor underlying assets for significant decreases in the quality of the investments they purchased. These claims will be further analyzed *infra* in Section V.

E. Lack of Transparency and Failure to Adequately Keep Records

When Moody´s and S&P rate the same issue their ratings coincide 97% of the time.[87] Still little information exists about how CRAs conduct their ratings. CRAs have published several volumes explaining how they have reached their results, but many details remain highly secretive as this is claimed to be a private, competitive business.

By adding certain sections to the Exchange Act, CRARA requires that CRAs file certain information with the SEC. In particular Sections15E(b)i through 15E(b)x of the Exchange Act require that the CRAs deliver to the SEC, among others, certain statistics, the methodologies used, information concerning the CRAs internal code of ethics and, on a confidential basis, a list of the twenty largest issuers (or clients).[88] Further, under Section 15E(b), the CRAs have a duty to update and amend their registrations.[89]

Nevertheless, the SEC recently found that several CRAs had not published criteria on rating so-called "Hybrid Deals," kept no specific guidelines on rating RMBS and CDOs, and other CRAs had reduced their model's raw loss numbers on second lien mortgages without disclosing it to the public.[90] In some cases, there were considerable time lags between the moment the CRA implemented a new process and when it announced the change to the public, and some CRAs were found to have made out of model adjustments without documenting their rationale.[91]

Under Rule 17g-2 of the Exchange Act, CRAs are required to make certain records relating to their business and retain other business records. For instance,

86. *Id.* (quoting Fitch Ratings, *Update on U.S. Subprime and Alt-A: Performance and Rating Reviews*, Mar. 20, 2008).

87. Partnoy, *supra* note 34, at 651-52.

88. *See* SEC Report July 2008, *supra* note 16.

89. Rule 15E(b) requires that "each nationally recognized statistical rating organization shall promptly amend its application for registration under this section if any information or document provided therein becomes materially inaccurate, except that a nationally recognized statistical rating organization is not required to amend." 15 U.S.C. § 78o-7 (2006).

90. *See* SEC Report July 2008, *supra* note 16.

91. *See id.*

the rule requires that the identity of any credit analyst who participates in the rating process be kept, as well as the identity of persons approving the rating and whether the rating was solicited or unsolicited.[92] Recently, however, it was found that CRAs do not always fully comply with these requirements, making it difficult for examiners to assess compliance with internal policies and procedures.[93] For instance, a recent SEC examination found that the vote tallies of rating committee participants were rarely documented and there were numerous failures to retain memos and minutes.[94] At one CRA, it was found that approximately a quarter of the RMBS deals reviewed lacked an indication of the chairperson's identity, as well as whether a quorum was present at the committee meetings.[95]

IV. UNDERSTANDING THE MOTIVATIONS TO RELY ON CRAS

A. Banking Regulation and Capital Adequacy Requirements

The ratings that CRAs issue on a large range of securities held by banks play a crucial role in determining the financial soundness of banks and other institutions. Under the National Banking Act, for example, a depository institution is deemed "well-managed" only if it has been examined by the appropriate federal banking agency and has thereafter achieved a certain composite rating.[96] In order to conduct the review of financial institutions in the U.S., federal regulators apply the Uniform Financial Institutions Rating System (UFIRS),[97] which was adopted in 1979 and updated in 1997.[98] Its purpose is to evaluate the soundness of financial institutions on a uniform basis and identify those institutions requiring special attention or concern.[99]

One of the elements analyzed under UFIRS (or commonly referred to as CAMELS) to determine capital adequacy is "the balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities."[100] By using Cash Flow CDOs, discussed *supra*, banks and other financial institutions could offload certain assets from their balance sheets, such as riskier mortgage loan pools.

Additionally, a number of banks have been able to "create value" by packaging the underlying assets together and obtaining higher ratings for the bundled as-

92. *See* 17 C.F.R. § 240.17g-2(a)(2)(i)-(iii) (2009).
93. *See* SEC Report July 2008, *supra* note 16.
94. *Id.*
95. *Id.*
96. *See* 12 U.S.C.A. § 24a(g)(6)(A)(i)-(ii) (2009).
97. Also known as CAMELS, which stands for the five elements rated under the UFIRS: Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk, *available at* http://www.federalreserve.gov/boarddocs/press/general/1996/19961224/default.htm.
98. Uniform Financial Institutions Rating System, 62 Fed. Reg. 752 (Jan. 6, 1997) (effective Jan. 1, 1997), *available at* http://www.fdic.gov/regulations/laws/federal/UFIR.pdf.
99. *See* Federal Deposit Insurance Corporation, *5000 - Statements of Policy – Uniform Financial Institutions Rating System*, *available at* http://www.fdic.gov/regulations/laws/rules/5000-900.html (last visited Mar. 5, 2010).
100. *Id.*

sets.[101] Indeed, it has been suggested that the CRAs may have developed methodologies for rating CDOs that resulted in the combination of tranches being worth more than the cost of the underlying assets.[102] In fact, Professor Partnoy, somewhat sarcastically perhaps, said, "the difference between the price investors in aggregate pay for CDO tranches and the cost of the underlying assets must be substantial because it covers the high fees the various participants charge for structuring and arranging a CDO and for managing the underlying assets."[103] If this is so, banks have been able to shore up their balance sheets by holding highly rated RMBS and CDOs.

1. Basel Guidelines

CRAs have also been granted institutional and governmental recognition in aiding to create investment restrictions for banks and financial institutions. The Basel Committee on Banking Supervision organized by the Bank for International Settlements, under Pillar I of Basel II,[104] has agreed that CRAs may be deemed "External Credit Assessment Institutions."[105] The consequence of this is that it allows regulated entities to rely on ratings for the purpose of determining capital adequacy requirements, on some occasions replacing the need for the banks to assess the risks themselves.[106] Hence, under Basel II, banks may be authorized by their domestic regulators to use ratings from certain approved CRAs when calculating their net capital reserve requirements.[107] In fact, this approach had, until recently, been supported since it was believed that relying on the CRAs would provide greater accuracy than relying on the bank's internal information that it would then provide to the regulators.[108]

In the European Union (EU) this approach is used today as the Basel recommendations for recognizing external rating agencies and the reliability of external ratings have been implemented in Articles 81 to 83 of the Banking Directive.[109] In the case of CRAs seeking recognition in several EU member states, a joint assessment process is carried out among the EU member states concerned. A central con-

101. *See* Kenneth Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1568-70 (2008). The author indicates that CRAs regularly give securitized debt a higher rating than secured debt because the securitized debt is believed to be bankruptcy-isolated.

102. *Id.*

103. Partnoy & Skeel, *supra* note 25, at 1029.

104. The major objective of Basel II is to revise the rules of the 1988 Basel Capital Accord in such a way as to align banks' regulatory capital more closely with their risks, taking account of progress in the measurement and management of these risks and the opportunities which these provide for strengthened supervision.

105. Under the Standardized Approach to credit risk, Basel II establishes credit risk weights for each supervisory category.

106. Walter Schulte-Herbrüggen et. al., *Basel II Ratings – Are They Really Comparable?*, 121 BANKING L.J. 430 (2004).

107. Bank for International Settlement, *Basel Committee on Banking Supervision, Consultative Document*, The New Basel Capital Accord, Jan. 2001.

108. *See, e.g.,* Nadine Cancell, *The New Basel Capital Accord*, 856 PLI/COMM 895 (2003).

109. *See* Articles 81 to 83 of the Banking Directive (2006/48/EC), *available at* http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm (last visited Mar. 5, 2010).

tact and coordinator is appointed within this informal process.[110] The joint evaluation and coordination in the joint assessment of the application by all of the supervisory authorities involved is "intended to ensure that a shared view is reached across member states while at the same time reducing the bureaucracy involved for the applicant."[111] Three international rating agencies (Moody's, S&P, and Fitch) were already assessed in a trial run of the recognition process in 2006.[112]

2. Securities Laws

Other examples of reliance on the CRAs are found in the securities laws. Rule 2a-7 of the Securities Act allows money market funds[113] to hold securities and to value the assets of the fund by looking at the cost of acquisition, plus the premium or discount due on the security. The rule differentiates between so-called "first-tier securities" and "second-tier securities," and limits the amount of second-tier securities that a money market fund can hold. The first-tier securities are defined as "a Rated Security that has received a short-term rating from the Requisite NRSROs."[114] The framework provided in Rule 2a-7 has been seen by some to constitute a regulatory license "because of Rule 2a-7's dependence on NRSRO ratings, whether a commercial paper issue is classified as first-tier or second-tier depends on the ratings assigned to the paper by one or more NRSROs."[115]

Also, in the context of private placements of securities, Rule 144A of the 1933 Securities Act, the SEC has relied on CRAs to make certain determinations.[116] Rule 144A exempts from the registration requirements certain offers and re-sales of securities of foreign and domestic issuers, provided the sale is to a Qualified Institutional Buyer (QIB).[117] However, there are obstacles to determining who may qualify as a QIB, as certain capital or net worth requirements, among others, have to be satisfied. To facilitate this determination, the SEC has declared that sellers may rely on a list of QIBs published by S&P.[118]

Finally, in another example regulators have expressly authorized banks and other financial institutions to directly rely on the CRAs. For instance, under the

110. On January 20, 2006, CEBS published its Guidelines on the recognition of External Credit Assessment Institutions (ECAIs) in order to achieve a maximum of consistency in the interpretation of the Directive in this regard. *See* Committee of European Banking Supervisors, *Guidelines on the Recognition of External Credit Assessment Institutions (ECAIs)*, *available at* http://www.bundesbank.de/download/bankenaufsicht/pdf/cebs/GL07.pdf.

111. Deutsche Bundesbank, *Basel II: Standardised Approach for Credit Risk: External Rating*, *available at* http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_basel_kreditrisiko.en.php (last visited Feb. 1, 2010).

112. *Id.*

113. A money market fund has been described as a mutual fund that mimics the safety and liquidity of a bank savings deposit, but without FDIC insurance.

114. *See* Rule 2a-7(a)(12) of the Securities Act of 1933.

115. Partnoy, *supra* note 34, at 699.

116. Bottini, Jr., *supra* note 76, at 603-08.

117. 17 C.F.R. § 230.144A (1992).

118. *See* Standard & Poor's Corporation, SEC No-Action Letter, [1991-1992 Transfer Binder] FED. SEC. L. REP. (CCH) P 76,021 (July 8, 1991) (SEC grants Standard & Poor's request that a seller may rely on a list of QIBs published by S&P's in its Corporation Records). *See also Sellers May Rely on S&P List for Rule 144A Purposes, Staff Confirms*, 23 SEC. REG. & L. REP. 1095 (1991).

Investment Company Act of 1940, Rule 3a-7 exempts certain financings from registration and compliance with the Act if, among other requirements, the securities are rated "investment grade" by at least one CRA duly registered with the SEC.[119]

3. Arbitrage Opportunities

Finally, banks and other financial institutions have been able to create magnificent arbitrage opportunities by dealing with highly rated structured finance products. For this purpose, many banks have dealt with Synthetic CDOs, described *supra*. Synthetic CDOs are regarded as "pure" arbitrage opportunities, because their tranches typically are priced at higher yields relative to other similarly rated fixed income investments.[120] Also, Synthetic CDOs are typically easier to execute and administratively less burdensome than cash-funded structures because the reference assets are not actually removed from the sponsoring financial institution's balance sheet.[121]

This advantage is particularly important in the case of bank loans, which may require borrower notification and consent or have other restrictions on loan sales that can interfere with borrower relations. Issues related to interest rate and currency hedging are also possible to achieve by using Synthetic CDOs.[122] Finally, the primary motivation for European banks, in particular, to issue Synthetic CDOs is to take advantage of the fact that the risk weightings used to determine a bank's minimum capital adequacy requirements do not differentiate between various levels of risk. By using Synthetic CDOs, a number of banks are able to receive a one-for-one capital charge for the equity tranche retained by the bank.[123]

4. The Government Bailout Programs

More recently, as the credit crisis unfolded, it was announced that the Treasury Department and the Federal Reserve Bank of New York (FRBNY) will rely on the CRAs to make a determination with respect to where bailout money will be allocated.[124] Under the Term Asset-Backed Securities Loan Facility (TALF), the

119. The exemption will be applicable if "[s]ecurities sold by the issuer or any underwriter thereof are fixed-income securities rated, at the time of initial sale, in one of the four highest categories assigned long-term debt or in an equivalent short-term category (within either of which there may be sub-categories or gradations indicating relative standing) by at least one nationally recognized statistical rating organization that is not an affiliated person of the issuer or of any person involved in the organization or operation of the issuer." 15 U.S.C. § 80a (2000).

120. In other words, the rationale for Synthetic CDOs cannot be for a bank to offload its loans for regulatory purposes because the bank does not actually offload any loans in a Synthetic CDO (the transaction uses credit default swaps instead of loans). *See* Standard & Poor's, *Global Cash Flow*, *supra* note 20, at 5; *see also* Standard & Poor's, *Criteria for Rating Synthetic CDO Transactions, Structured Finance Ratings*, Sept. 2003, *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/syntheticcriteria_092004.pdf [hereinafter Criteria for Rating].

121. Alyssa Irving, *Synthetic CDOs: A Growing Market for Credit Derivatives*, THE FINANCIER, Mar. 22, 2000, *available at* http://www.allbusiness.com/finance-insurance/721735-1.html.

122. Donald A. Bendernagel et. al., *Credit Derivatives: Usage, Practice and Issues*, 1700 PLI/CORP 283 (2008).

123. Irving, *supra* note 121.

124. *See generally*, Term Asset-Backed Securities Loan Facility, Press Release by the Board of Governors of the Federal Reserve System, Dec. 9, 2009, *available at* http://www.federalreserve.gov/monetarypolicy/talf.htm.

FRBNY will make loans, initially for up to $200 billion, to issuers of asset-backed securities (ABS) that have the highest investment-grade rating from at least two NRSROs.[125] Those entities that will be eligible for TALF loans will be those with ABS "with a long-term credit ratings of AAA or its equivalent from two or more of Standard & Poor's, Moody's Investors Service or Fitch Ratings (TALF-NRSROs)."[126] Under questioning from members of Congress, Federal Reserve Chairman Ben Bernanke said the central bank has looked at the models of the major rating companies, and is "comfortable they can rate securities eligible for the new program in an appropriate way."[127]

Under the plan, the FRBNY will take the triple-A rated (or otherwise NRSRO sanctioned) ABS as collateral for loans that the issuers will ostensibly use to go out and make more ABS loans, which will provide the financing to make loans to consumers and small businesses.[128] To manage the TALF loans, FRBNY will create a SPV. The SPV will then buy the assets securing TALF loans. The Treasury's Troubled Assets Relief Program (TARP) will buy debt issued by the SPV to finance the first $20 billion of assets purchased and if more than $20 billion in assets are bought by the SPV through TALF, FRBNY will then lend money to the SPV.[129]

The fundamental criticism of this program is that both the TALF and the TARP will be relying on the CRAs and on a system that appears to have serious flaws emanating from within. Unfortunately, it may be that regulators do not have any other efficient way for making rapid determinations concerning which structured products are marketable. One alternative would be to have government regulators try to rate or to sort the products, but there may be a lack of sufficient talent to conduct such a massive effort in a short period of time. On the other hand, the CRAs presumably are somewhat idle, particularly considering that in 2008 the issuances of asset-backed securities declined by approximately 82%.[130] The Wall Street Journal recently estimated that the CRAs would make another $1 billion in fees rating the paper produced in the latest bailout programs.[131] At least these fees will be paid by the issuers . . . or better said . . . the taxpayers.

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125. Barbara Kiviat, *TARP Goes TALF as FRBNY Lends Against AAA ABS*, Nov. 25, 2008, *available at* http://curiouscapitalist.blogs.time.com/2008/11/25/tarp-goes-talf-as-frbny-lends-against-aaa-abs (last visited Mar. 5, 2010).

126. The Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: Current Terms and Conditions*, *available at* http://www.newyorkfed.org/markets/talf_terms_090403.html (last visited Mar. 5, 2010).

127. Ng & Rappaport, *supra* note 43.

128. The U.S. Treasury Department, *The Consumer and Business Lending Initiative: A Note on Efforts to Address Securitization Markets and Increase Lending*, Mar. 3, 2009, *available at* http://www.ustreas.gov/press/releases/reports/talf_white_paper.pdf.

129. The U.S. Federal Reserve, *Term Asset-Backed Securities Loan Facility (TALF): Frequently Asked Questions*, *available at* http://www.federalreserve.gov/newsevents/press/monetary/monetary20090303a2.pdf.

130. Ralph MacDonald, III et. al., *The Federal Reserve's Term Asset-Backed Securities Loan Facility ("TALF")—Expanding New Credit for Consumers and Businesses*, Jones Day Commentaries, Mar. 2009, *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S6069 (last visited Mar. 5, 2010).

131. Henry Blodget, *Lousy Rating Agencies To Make $1 Billion Rating Bailout Debt*, THE BUS. INSIDER, Mar. 20, 2009, *available at* http://www.businessinsider.com/henry-blodget-lousy-rating-agencies-to-make-1-billion-on-bailout-2009-3 (last visited Mar. 5, 2010).

V. CASES AGAINST THE RATING AGENCIES

Having identified the principal flaws with the CRAs and the typical ratings process conducted for RMBS and CDOs, we will now turn to the judicial liability that CRAs have traditionally faced and the innovative claims that are being brought as a result of the credit crisis.

A. First Amendment Defenses

Most of the past cases brought against CRAs have failed on the basis of the argument that they are members of the press and that their ratings are protected under the heightened actual malice standard.[132] In *New York Times v. Sullivan*, judicial activism with respect to the regulation of the press was severely restricted, as a lawsuit brought against the media would have to pass the actual malice standard.[133] In that landmark case, Justice Brennan articulated his famous phrase concerning debate on public issues, considering that it "should be uninhibited, robust, and wide-open."[134] The traditional First Amendment defense brought by CRAs, however, may be weakening.

1. Solicited vs. Unsolicited Ratings

In one high-profile case dealing directly with CRAs, *Jefferson County School District v. Moody's Investment Services, Inc.*,[135] the court held that the First Amendment barred claims by the plaintiffs for intentional interference with contractual relations, intentional interference with prospective contractual relations, and publication of an injurious falsehood. What made this case particularly interesting was the fact that the claim arose from an "unsolicited rating." An unsolicited rating is made when the issuer does not seek the rating, but rather the CRA makes positive or negative buy recommendations to its subscribers.

In this case, the plaintiff, the Jefferson County School District, had decided to issue bonds and had obtained positive ratings from S&P and Fitch, which caused the bond issue to be priced with a low interest rate. [136] However, in the past, the plaintiff had engaged Moody's for previous bond issues.[137] Two hours after the price had been set, Moody's issued an unsolicited "negative outlook" for the new

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132. One S&P official argued at a 2005 legislative hearing, "The very notion that a *bona fide* publisher—whether it be *BusinessWeek*, *The Wall Street Journal*, or S&P—can be required under the threat of penalty or other retribution to obtain a government license, adhere to government dictates about its policies and procedures, and/or submit to intrusive examinations before being permitted to disseminate its opinions to the public is inconsistent with core First Amendment principles." *Rating the Rating Agencies: The State of Transparency and Competition on April 2, 2003: Hearing on 2990 Before the H. Subcomm. on Capital Markets, Ins., and Gov't-Sponsored Enterprises*, 109th Cong. (June 29, 2005) (testimony of Rita M. Bolger, Managing Director and Associate General Counsel, Standard and Poor's).

133. New York Times Co. v. Sullivan, 376 U.S. 254 (1964).

134. *Id.* at 254, 270.

135. Jefferson County Sch. Dist. v. Moody's Inv. Servs., Inc., 175 F.3d 848 (10th Cir. 1999).

136. *Id.* at 850.

137. *Id.*

bond issue, which caused a number of investors to get cold feet and to back out of their purchases.[138] In its complaint, the plaintiff alleged that Moody's negative outlook caused it an increased cost of $769,000.[139] Moody's defense was that its evaluation of the school district's bonds was a constitutionally protected "opinion." The court agreed and its dismissal of the claim was upheld on appeal.[140]

In this respect, a handful of commentators have suggested that unsolicited ratings, like that issued by Moody's in this case, and which have given CRAs tremendous power and leverage in the past,[141] may also serve a much more sinister purpose, which is to preserve their First Amendment defense.[142] If the CRAs rate issues only when they receive payment from issuers, their ratings appear less like protected speech. On the other hand, "if the agencies are publishing 'opinions' about issuers who are not paying fees, they appear to be acting more like journalists."[143] The conclusion would be that if credit rating agencies never issued unsolicited ratings, they would appear to be even less like financial publishers and therefore even less likely to be protected by free speech principles.

It was precisely this distinction that drove another court to find that First Amendment protection did not apply to CRAs where the issuer requests the rating. In *Commercial Financial Services v. Arthur Andersen,*[144] a case arising from the financial collapse of Orange County, California, the court held that the First Amendment does not protect CRAs from liability for alleged inaccuracies when they were asked to rate investment vehicles based on information furnished by the company and were paid a fee by the company, since the CRA would therefore be in a relationship of privity with that company, and thus owed a duty of care to provide accurate ratings.[145] The court noted a "crucial distinction" between the suit before it and the *Jefferson County* case, because Jefferson County had paid no fee to the CRA as the rating was unsolicited.

The court highlighted the distinction as follows: "If a journalist wrote an article for a newspaper about the bonds, the First Amendment would presumably apply, but if [a company] hired that journalist to write a company report about the bonds,

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138. *Id.*

139. *Id.* at 851.

140. *Id.* at 861. Moody's was separately fined $195,000 in 2001 for obstructing justice by destroying documents in the investigation. *See* Alec Klein, *Credit Raters' Power Leads to Abuses, Some Borrowers Say*, WASH. POST, Nov. 24, 2004, at A01.

141. One of the most famous quotes regarding ratings is the statement made by the New York Times columnist Thomas Friedman who said: "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." Interview with Jim Lehrer (PBS Broad. Feb. 13, 1996).

142. *See generally*, Emily Donahue, *SEC Report and Recent Class Action Spell Trouble for Rating Agencies*, AM. BANKR. INST. J. 12, 68 (2008); *see also*, Theresa Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 MINN. L. REV. 140 (2009).

143. Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, Univ. of San Diego School of Law, Legal Studies Research Paper Series, Research Paper No. 07-46, May 2006, *available at* http://ssrn.com/abstract=900257 [hereinafter Partnoy, *Gatekeepers*].

144. Commercial Fin. Servs., Inc. v. Arthur Andersen LLP, 94 P.3d 106 (Okla. Civ. App. 2004).

145. *Id.* at 109.

a different standard would apply."[146] Hence, at least one chink in the CRAs' armor may have fallen, as in the future it may be possible that CRAs will not be able to rely on the First Amendment defense when issuing unsolicited ratings.

In any case, plaintiffs also have the possibility of imputing liability if they can demonstrate actual malice. Still, no case brought thus far has dealt with the degree to which First Amendment protections will prevent federal or state regulators from enforcing enacted regulations.[147] It is possible that this issue will be litigated in the near future as the likelihood of sterner regulation of CRAs gains popularity.

2. Regulation of Commercial Speech

In the years following the landmark *Sullivan* case mentioned above, First Amendment rights have been further defined and narrowed over time. In particular, the Supreme Court has made it clear that commercial speech can be regulated to the extent that it is false or misleading.[148] In fact, the regulation of false or misleading statements is the essence of the Securities laws and, in particular, is the characteristic that makes Rule 10b-5 claims possible.[149] In previous lawsuits, however, the CRAs have alleged that they are covered by the blanket protection of the First Amendment and that regulation of the content of their ratings would amount to a constitutional violation. But the question is, can CRAs really be compared to journalists,[150] or are they really more analogous to financial advisors or to the issuers themselves when publishing prospectuses to sell securities?

During the fallout from Enron's collapse, a number of lawsuits were brought against the CRAs, most of which were wholly unsuccessful. In the events leading up to *Newby v. Enron Corp.*,[151] a public entity entered into a series of transactions with Enron whereby it lent Enron some $220 million. Shortly thereafter, Enron stopped making payments and filed for bankruptcy. In bringing the suit, the plaintiff claimed that S&P, Moody's, and Fitch had failed to communicate information about Enron's creditworthiness accurately. In particular, the plaintiff claimed that at the time of the transaction between it and Enron, all three of the CRAs had rated Enron's debt as investment grade.

In its analysis, the court first set forth the proposition that the First Amendment defense was "qualified" and not absolute given the nature of the information re-

146. *Id.*

147. *See* Larry P. Ellsworth & Keith V. Porapaiboon, *Credit Rating Agencies in the Spotlight, A New Casualty of the Mortgage Meltdown*,18 No. 4 BUS. L. TODAY, March-April 2009.

148. Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n, 447 U.S. 557 (1980).

149. "Rule 10b-5 -- Employment of Manipulative and Deceptive Devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, a. To employ any device, scheme, or artifice to defraud, b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." Rule 10b-5, Securities Exchange Act of 1934.

150. Frank Partnoy suggests that the evidence indicates "that financial market participants do not believe that credit ratings are merely the opinions of journalists . . . if they did, Moody's shares would be worth $3 billion, not $15 billion." *See* Partnoy, *Gatekeepers*, *supra* note 143.

151. Newby v. Enron Corp., 511 F. Supp. 2d 742, 809 (S.D. Tex. 2005).

ported by the CRAs. In reaching its decision, the bench was split and refused to exercise the blanket First Amendment protection that had been applied by courts in the past. Further, the court noted that it would require that the defendant meet the heightened standard of pleading its First Amendment defense.[152] Ultimately, however, the court dismissed the First Amendment claim.

With respect to the negligent representation claims, the court painstakingly analyzed past case law, law journal articles, and current regulation. The court was forced to find no liability on the misrepresentation claim, but it did go on to quote a senate committee report stating the following: "It is difficult not to wonder whether lack of accountability-the agencies' practical immunity to lawsuits and nonexistent regulatory oversight—is a major problem."[153]

Nevertheless, what is most important from *Newby v. Enron* seems to be the fact that it clearly opens the door for the imposition of future regulation of CRAs. Now there is at least some precedent to indicate that CRAs can, and very well may, be regulated in the future in the same manner as other vendors of corporate speech (that is not entitled to absolute First Amendment protection).[154]

B. Litigation Arising from the "Financial Crisis"

In May 2008, the New Jersey Carpenters Vacation Fund brought suit against a number of participants associated with the "HarborView Mortgage Loan Trusts."[155] The suit was brought against issuers, investment banks, and the CRAs related to the purchase of Mortgage Loan Pass-Through Certificates, described as "the quintessential mortgage-backed securities."[156]

The complaint alleged that the rating agencies "failed to do the due diligence required under the Securities Act"[157] and that the "Rating Agencies assigned inaccurate, inappropriate and inflated values and ratings to the Certificates."[158] The complaint also alleged a conflict of interest that exists between the investment banks and the rating agencies and describes a process known as "ratings shopping." Similarly, as described earlier in this analysis, the plaintiffs in this case, allege that investment banks work together with the rating agencies to obtain the desired rat-

152. "This Court will not assume blanket protection for the Credit Agency ratings, but will consider any First Amendment protection for credit rating reports as qualified and will scrutinize the facts alleged according to standards and heightened plead." *Newby*, 511 F. Supp. 2d at 819.

153. *Id.* at 817 (quoting The Staff to the Senate Committee on Governmental Affairs, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs,* Oct. 8, 2002).

154. Partnoy, *Gatekeepers*, *supra* note 143.

155. The case was originally filed in the New York Supreme Court and was removed to federal court in Manhattan. The district court denied a motion to remand the case back to state court, but ruled that the issue of whether Section 22 of the 1933 Securities Act, which embodies the statute's anti-removal provision and conflicts with the Class Action Fairness Act of 2005, was a first impression case and would allow immediate appeal. The plaintiff has since then filed an appeal.

156. Verified Complaint, N.J. Carpenters Vacation Fund, v. Harborview Mortg. Loan Trust, 2008 WL 2517997 (S.D.N.Y. June 3, 2008).

157. *Id.* Particularly as required by Sections 11, 12 and 15 of the Securities Act of 1933, and by including material misstatements and omissions in the Registration Statement and Prospectuses in violation of Sections 11, 12 and 15 of the Securities Act.

158. *Id.*

ing.[159] That is, "the process involves extended consultations between the agency and its client . . . obtaining a rating is a collaborative process."[160] An issuer unhappy with the proposed rating offered by one CRA, and with the potential to move to another rating agency, will simply move on to another agency to see if it could get a better rating. The claim is that such practices led to inflated ratings, which in turn led to a substantial decline in the value of the certificates.[161]

Similarly, on July 11, 2008, an asset manager filed an action in the New York State Supreme Court against a number of defendants, including several CRAs. The plaintiff in *Oddo Asset Management v. Barclays Bank PLC*, claimed that its purchase of two structured investment vehicles, or "SIV-Lites," suffered "losses as a result of violations of law by those who created, managed, arranged, and issued credit ratings for those investments."[162] The plaintiff alleges various common law causes of action against the defendants. [163] The central allegation against the CRAs is that they aided and abetted breaches of fiduciary duty by the collateral managers of the two structured vehicles by falsely confirming the credit ratings it had previously given those investments.[164]

1. Securities Class Actions

Shareholders of the CRAs themselves have also begun to file class action lawsuits. This may imply that shareholders, too, are becoming more wary of the CRAs and are looking for innovative ways of getting around the traditional CRA defenses. In *Teamsters Local 292 Pension Trust Fund v. Moody's,*[165] filed on September 26, 2007, the plaintiff alleged that as housing prices began to decline causing a higher than expected delinquency ratio in subprime mortgages, Moody's failed to disclose that it assigned "excessively high" ratings to securities backed by subprime mortgages.[166] The plaintiff class also made a series of other claims against Moody's, including that it failed to properly handle conflicts of interest, duly disclose its ratings methodology, and to inform its shareholders of Moody's dependence on structured finance-related revenues.[167] Although the court found that the plaintiff class had properly alleged the loss causation requirement, on February 19, 2009, the claim was partially dismissed for failure to properly plead the scienter requirement.[168] Nevertheless, the court allowed the plaintiff class leave to

159. *Id.*
160. *See* Lowenstein, *supra* note 47.
161. In essence this is a Section 11 violation of the 1933 Securities Act.
162. The case was referenced in McGraw Hill's 10-Q SEC Filing, filed on 7/30/2008. A summary is available at http://sec.edgar-online.com/mcgraw-hill-companies-inc/10-q-quarterly-report/2008/07/30/Section11.aspx.
163. *Id.*
164. *Id.*
165. Complaint, *In re Moody's Corp*. Sec. Litig. No. 1:07-cv-8375-SWK (S.D.N.Y. Sept. 26, 2007).
166. *See* Ellsworth & Porapaiboon, *supra* note 147 (describing *In re Moody's Corp.*).
167. *Id.*
168. *Id.*

amend its securities fraud complaint.[169] Leave to amend was granted until April 29, 2009.[170]

On July 1, 2008, the Indiana Laborers Pension Fund filed a class action lawsuit against Fitch.[171] The lawsuit alleged that Fitch had applied lax standards and in some cases "no standards" in its ratings of mortgage-backed securities.[172] The complaint claims that the high ratings led to more business from banks that in turn boosted earnings at Fitch, which caused the company's stock to be artificially inflated.[173] On October 3, 2008, however, the plaintiff filed a voluntary dismissal, which allows the plaintiff to refile a new claim at a later date.

2. Derivative Claims – Breach of Fiduciary Duty

Finally, during the present crisis and in an attempt to pierce the CRAs apparent protective veil, a plaintiff has attempted a derivative suit against the officers and directors of Moody's.[174] The complaint alleges that Moody's awarded falsely high ratings to mortgage-backed securities in order to win new, and to keep ongoing, business.[175] The allegation is that this activity constituted a "breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment, and a violation of Section 10(b) of the Exchange Act."[176]

VI. CURRENT AND FUTURE REGULATION

A. Regulatory and Enforcement Limitations Imposed by the Credit Rating Reform Act of 2006 (CRARA)

The CRARA may impose two primary limitations on current and future plaintiffs, regulators, and lawmakers. The first is that the act provides that the SEC will have exclusive enforcement authority over any NRSRO that issues credit ratings in material contravention of the procedures included in its registration application.[177] This may become an impediment to state authorities from taking direct action against the CRAs in the future. In July 2008, for instance, the attorney general of

169. Copy of the order is available at http://securities.stanford.edu/1038/MCO_01/2009218_r01o_078375.pdf.
170. *Id.*
171. Complaint, Ind. Laborers Pension Fund v. Fimalac, S.A., No. 1:08-cv-05994-SAS (S.D.N.Y. July 1, 2008).
172. *Id.*
173. *Id.*
174. Complaint, La. Mun. Police Employees Ret. Sys. v. McDaniel, No. 1:08-cv-09323 (S.D.N.Y. Oct. 30, 2008).
175. *Id.*
176. *See* Ellsworth & Porapaiboon, *supra* note 147 (summarizing the allegations in *In re Moody's Corp.*).
177. Section 15E(c)(1) of the Securities Exchange Act reads as follows: "Authority. The Commission shall have exclusive authority to enforce the provisions of this section in accordance with this title with respect to any nationally recognized statistical rating organization, if such nationally recognized statistical rating organization issues credit ratings in material contravention of those procedures relating to such nationally recognized statistical rating organization, including procedures relating to the prevention of misuse of nonpublic information and conflicts of interest. . . ."

Connecticut filed a lawsuit accusing the CRAs of unfair trade practices by systematically giving the bonds issued by public entities lower ratings as compared to corporate debt.[178] Although the lawsuit is still pending, commentators have already suggested that this action may be preempted by the fact that under CRARA the SEC has sole authority to enforce provisions of the act.[179]

The second limitation imposed by the CRARA is that the act prohibits the SEC or any state or local government from regulating the substance of credit ratings or the procedures and methodologies by which a NRSRO determines credit ratings.[180] This provision may severely limit state and federal lawmakers in trying to implement regulations with respect to CRA activities.

Nevertheless, there have been suggestions that this second provision is to be viewed narrowly as limiting a state's authority to regulate only the day-to-day activities of CRAs. "The preemption provision should not be construed to apply to typical state governmental functions in which states are users of credit ratings."[181] If this is so, "states will continue to have the ability to continue to oversee their departments, programs, and political subdivisions with regard to debt issuance conditions, contract specifications, and investment standards for governmental funds, such as pension portfolios and financial reserves."[182]

B. SEC Rules

On February 2, 2009, the SEC implemented a series of changes. In summary, the rule amendments require: (1) NRSROs to provide enhanced disclosure of performance measurements, statistics and the procedures and methodologies used by the NRSROs in determining credit ratings for structured finance products and other debt securities; (2) NRSROs to make, keep and preserve additional records under Rule 17g-2; (3) NRSROs to make publicly available on their Web sites a random sample of 10% of the ratings histories of credit ratings paid for by the obligor being rated or by the issuer, underwriter, or sponsor of the security being rated ("issuer-paid credit ratings") in each class of credit ratings for which it is registered and has

178. Connecticut v. McGraw Hill Co., No. 3:08-cv-01316-AWT (D. Conn. Aug. 29, 2008).
179. *See* Ellsworth & Porapaiboon, *supra* note 147.
180. Section 15E(c)(2) of the Securities Exchange Act reads as follows: "Limitation. The rules and regulations that the Commission may prescribe pursuant to this title, as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this title applicable to nationally recognized statistical rating organizations. Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."
181. 152 CONG. REC. H7569 (2006). According to Rep. Paul Kanjorski, a leading member of the House Financial Services Committee, the provision should be viewed narrowly as limiting a state's authority to regulate the day-to-day activities of credit rating agencies. The preemption provision should not be construed to apply to typical state governmental functions in which states are users of credit ratings. Thus, states will continue to have the ability to continue to oversee their departments, programs, and political subdivisions with regard to debt issuance conditions, contract specifications, and investment standards for governmental funds, such as pension portfolios and financial reserves. Similarly, the preemption should not be taken to apply to the regulation of insurers and bank solvency standards and generic business licensing requirements normally applied to entities performing business within a state. *Id.*
182. *Id.*

issued 500 or more issuer-paid credit ratings, with each new ratings action to be reflected in such histories no later than six months after they are taken; and (4) NRSROs to furnish the SEC with an additional annual report.[183]

Although some of the new burdens imposed on CRAs appear to be rather innovative (in particular the requirement that a sample of 10% of the ratings histories paid by the issuer be published on their Web sites), it remains to be seen whether these rules will in fact give regulators, or the public at large,[184] the oversight needed to ensure a more transparent and honest process.

C. New York's Attorney General

In June 2008 Andrew Cuomo, New York's Attorney General, struck agreements with the three largest CRAs. The idea of entering into these agreements rather than pursuing some other alternative was most likely to get around the CRARA preemption issue discussed above.[185] The agreements covered some of the following aspects: (1) CRAs will establish a fee-for-service structure for their work under which they will charge a fee even if they don't rate a product because the issuer withdraws; (2) CRAs will disclose information about all securitizations submitted for their initial review; (3) CRAs will develop criteria for the due diligence information that is collected by investment banks on the mortgages comprising an RMBS; (4) CRAs will perform an annual review of their RMBS businesses to identify practices that could compromise their independent ratings; and (5) CRAs will require a series of representations and warranties from investment banks and other financially responsible parties about the loans underlying the RMBS.[186]

Although the New York Attorney General's efforts have been widely applauded, questions remain concerning the enforcement ability the Attorney General will have in the future if the CRAs did not comply with the agreements they have entered into. Again, as mentioned above, the CRARA gives the SEC sole authority to enforce possible violations by CRAs registered as NRSROs.

D. IOSCO and Global Initiatives

IOSCO has also become more vocal about possible reform and enforcement. In 2008, IOSCO recommended measures to combat ratings shopping, including: encouraging structured finance issuers to publicly disclose all relevant information, so investors and other CRAs can conduct their own independent analysis; requiring CRAs to publicly disclose whether an issuer has made public all relevant informa-

183. SECURITIES AND EXCHANGE COMMISSION, AMENDMENTS TO RULES FOR NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS, *available at* http://www.sec.gov/rules/final/2009/34-59342.pdf.

184. Some have indicated that the market would self-regulate the CRAs because these institutions depend highly on the public's perception of their integrity.

185. Aline van Duyn & Joanna Chung, *Rating Agencies Agree to Change Charges*, FIN. TIMES, June 3, 2008, *available at* http://us.ft.com/ftgateway/superpage.ft?news_id=fto060320081915103107.

186. A summary of the key elements of the agreement with the CRAs can be found at the web site of the Office of the Attorney General for the State of New York is available at http://www.oag.state.ny.us/media_center/2008/jun/june5a_08.html.

tion about the product being issued and as a minimum; and that the CRAs provide clear disclosure as to how the CRA that provided a given rating is compensated should be mandatory.[187] Interestingly, IOSCO is promoting standardized regulation of CRAs worldwide.

During the April 2009 G20 Summit in London, world leaders called for the extending of "regulatory oversight and registration" to CRAs to ensure that they complied with IOSCO's code of good practice.[188] Shortly before the G20 summit, it was decided that the IOSCO Task Force on CRAs would be converted into a permanent standing committee of IOSCO's Technical Committee, which will theoretically allow IOSCO to keep abreast of the developments in the CRA industry and facilitate convergence of regulatory approaches of CRAs.[189] But if lessons from past global regulatory initiatives serve as good precedent, the extent to which U.S. regulators may be willing to implement regulatory schemes for the CRAs that have been designed on a global scale remains doubtful.

E. Market Proposal

Finally, since 1999 Professor Partnoy has suggested that perhaps the key is to use market-based measures, such as credit spreads, for ratings rather than determinations by CRAs.[190] The idea comes from studies that have documented that yield spreads of corporate bonds start to expand as credit quality deteriorates but before a rating downgrade, implying that the market often leads a downgrade, thus questioning the informational value of credit ratings.[191] This leads to the suggestion that, rather than rely on CRA ratings in financial regulation, regulators should require banks, broker-dealers and insurance firms to use credit spreads when calculating the risk in their portfolio. However, unless we have misunderstood the theoretical fundamentals that underlie this suggestion, the problem would appear to be that most credit spreads in the corporate bond market are already determined in part by the credit ratings they obtain from a CRA.[192] Hence, under this proposal, CRA ratings would still be relied upon.

VII. CONCLUSIONS

Looking through the rubble of the implosion of the RMBS and CDOs markets, clearly not all the blame can be placed on the CRAs. On the other hand, one would

187. Technical Committee of the International Organization of Securities Commissions, *Consultation Report: The Role of Credit Rating Agencies in Structured Finance Markets*, Mar. 2008, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf.

188. *See* London Summit – Leader's Statement, Apr. 2, 2009, *available at* http://www.londonsummit.gov.uk/resources/en/news/15766232/communique-020409.

189. IOSCO Update on Credit Rating Agencies Oversight, Madrid, Mar. 12, 2009, *available at* http://www.fsa.go.jp/inter/ios/20090318-2/02.pdf.

190. Partnoy, *supra* note 34, at 625.

191. *Id.*

192. *See* Federal Reserve Bank of San Francisco, *What Determines the Credit Spread?* FRBSF Economic Letter, Dec. 10, 2004, *available at* http://www.frbsf.org/publications/economics/letter/2004/el2004-36.html.

be hard pressed to absolve the CRAs from all responsibility. The CRAs primarily seem to have contributed to the present crisis by having helped sustain a false market for RMBS and CDOs where things were not as they appeared.[193] Furthermore, the process used by the CRAs in developing their ratings appears to have been flawed. The CRAs conducted no due diligence and required that none be conducted, they did not properly manage conflicts of interest, they took advantage of their oligopoly power, they failed to put in place adequate monitoring systems for the products they initially rated, and they failed to adequately keep and report information to regulators.

The ratings industry, in its current form, and especially as it relates to structured products, does not merit the semi-official role the CRAs are granted by the SEC and other U.S. regulators, Basel II, governments worldwide, and the investment decisions of asset managers. The overwhelming power that CRAs have been accorded during the past years, together with the failures that led in part to the current financial crisis, indicate that significant reform is warranted. Reform, oversight, and accountability will be required before investor confidence is to return and before large-scale recovery can be expected.

Although the story of the CRAs may well be "the story of a colossal failure,"[194] both U.S. courts and regulators have helped keep in place a protective mantel that has shielded the CRAs from liability. Indeed, most of the litigation brought in the U.S. against the CRAs has been unsuccessful. The protection afforded to CRAs may have diluted the ability to have any private enforcement by the investor public. Perhaps if a plaintiff would have come out of court with a victory against the CRAs some ten years ago, the CRAs would have been encouraged to reform some of their practices.

Some cases decided in the wake of past scandals, such as *County School District v. Moody's* (dealing with the aftermath of the financial collapse of Orange County, California) and *Newby v. Enron Corp*. (involving the fallout of Enron's failure), analyzed above, created cracks in the defenses of the CRAs. Now that the world is dealing with a widespread and massive crisis, it may be possible for plaintiffs to further weaken the traditional CRA defenses. At the moment, CRAs are under considerable pressure coming from multiple directions, including litigants, shareholders, state attorneys general, investors in RMBS and CDOs, the SEC, and politicians, among others. It may only require that one plaintiff be relatively successful against a CRA before a massive wave of claims will be brought seeking CRA accountability and attaching liability.

193. Ohio attorney general Marc Dann has said that the credit-ratings agencies "made the market. Nobody would have been able to sell these bonds without the ratings . . . . That relationship was never disclosed to anybody." Jesse Eisinger, *Overrated*, PORTFOLIO, Sept. 2007, *available at* http://www.portfolio.com/news-markets/national-news/portfolio/2007/08/13/Moody-Ratings-Fiasco.

194. This statement was made in October 2008 by the Chairman of the House Oversight and Government Reform Committee. *See* Amit Paley, *Credit-Rating Firms Grilled Over Conflicts*, WASH. POST, Oct. 23, 2008, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/10/22/AR2008102202311.html.

Looking towards the future, there are suggestions that private litigation could be one possible measure to monitor the CRAs (a form of private enforcement),[195] and if so, it should be facilitated by regulators. The door is now open to regulate ratings as a form of commercial speech. The recent reforms in which the SEC has required the CRAs to make heightened disclosures to the investor public is a good start

Ideally, improved regulatory oversight will be put in place in the near future. After doing so, the next step would seem to be to secure a mechanism under which private oversight can exist. For this, however, private litigants must be able to bring successful claims against the CRAs in court. One suggestion would be to reform the CRARA to create a private right of action under the Exchange Act by which lawsuits could be brought, much in the way Rule 10b-5 does with respect to issuers of securities. By doing so, the obstacles encountered by most plaintiffs would be greatly diminished.

Of course, in order to avoid lawsuits from any investor that has suffered losses regardless of whether it was due to a CRA failure, the jurisdictional requirements could be limited in a similar fashion as Rule 10b-5 claims. The lawsuit would have to arise from a material misrepresentation, the defendant must have known (or have been reckless in not knowing) the true state of affairs of the misrepresentation, the plaintiff must have relied on the misrepresentation, the plaintiff must have suffered actual losses proximately caused by the misrepresentation, and the plaintiff must have suffered damages. Finally, liability would be restricted to misstatements made by the CRAs in the disclosure of their ratings process and the lack of enforcement of their internal procedures. Rules along these lines, upheld by jurisprudence, could be beneficial for both heightening a positive, substantive role for the CRAs and for bringing increased transparency to the capital markets.

195. Alessandro Gullo & Isaac Lustgarten, *Credit Rating Agencies: Opportunities for Legal and Regulatory Reform*, 28 NO. 3 BANKING & FIN. SERVS. POL'Y REP. 1 (2009).