

BUYER OWNED AND CONTROLLED
RATING AGENCIES:
A SUMMARY INTRODUCTION

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1. Introduction.

Credit rating agencies are in crisis. The President,¹ members of Congress,² and the new chair of the SEC³ have lost confidence in Moody's and Standard & Poor's. Senior European Union

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¹ Barack Obama's Economic Agenda, www.barackobama.com/pdf/issues/economy/EconomicPolicyFullPlan.pdf ("Barack Obama supports an immediate investigation into the ratings agencies and their relationships to securities' issuers."). See Mark Landler, *A Towering Economic To-Do List for Obama*, N.Y. TIMES, Nov. 6, 2008, at B1 ("Mr. Obama has . . . pledged to impose stronger liquidity, capital and disclosure requirements on financial institutions, and to subject unregulated financial businesses — like . . . credit-rating agencies — to federal oversight."). See also Stephen Labaton, *Obama Plans Fast Action To Tighten Financial Rules*, N.Y. TIMES, Jan. 25, 2009, at A1.

² During a Congressional hearing on the credit rating agencies, members of the House Committee on Oversight and Government Reform voiced blistering criticism of the agencies. Chairman Waxman said in his opening statement, "The story of the credit rating agencies is a story of a colossal failure. The credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent objective assessments. The rating agencies broke that bond of trust." *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight & Government Reform*, 110th Cong. 4 (2008) [hereinafter *CRA Hearing*] (opening statement of Rep. Henry A. Waxman, Chairman, H. Comm. on Oversight and Government Reform).

Speaking for the minority, Rep. Shays also expressed disapproval of the rating agencies. "When the referee is being paid by the players, no one should be surprised when the game spins out of control. That is what happened on Wall Street when credit rating agencies . . . sold their independence to the highest bidder." *Id.* at 12 (statement of Rep. Christopher H. Shays, H. Comm. on Oversight and Government Reform).

officials have complained the raters failed to “sniff the rot” in the mortgage market which led to the world’s current economic collapse.⁴ No one, it seems, rushes to the agencies’ defense unless they are on the agencies’ payroll.

Two factors explain most of the industry’s woes. The first is that issuers pay for credit ratings. While rating agencies rationally seek to maintain reputations for independence and integrity, they have little incentive to antagonize paying customers. This business model appears to generate a pervasive conflict of interest that benefits issuers at the expense of investors as the agencies inflate ratings to curry favor with paying customers.⁵

The agencies’ own employees have offered sordid accounts of this conflict’s corrosive effect. In an instant message exchange between two rating agency officials the first complains

³ “‘Until we deal with the compensation model, we’re not going to deal with the conflict of interest, and people are not going to have confidence that the ratings are worth relying on, worth the paper they’re printed on,’ Mary L. Schapiro said in testimony earlier this month before being confirmed by the Senate to head the Securities and Exchange Commission.” Labaton, *supra* note 1. In response to questions posed by Senator Levin following her nomination hearings, Chairman Schapiro stated that “As early as 1994, I’ve called for stronger regulation of credit rating agencies....Moving forward on credit rating agency reform is a top priority of mine. We need to examine how rating agencies are compensated, how they manage conflicts of interest, and what role they should play in our markets.” Questions from Senator Carl Levin for Mary Schapiro, Nominee to be Chair of the Securities and Exchange Commission, Response to Question 7, Jan. 8, 2009. *See also*, Marcy Gordon, *SEC Chairman Sees Independent Role for Agency*, ASSOCIATED PRESS, Mar. 26, 2009 (“Schapiro has suggested the SEC needs to explore ways to diminish the market’s dependence on ratings by the big rating agencies, Moody’s Investors Service, Standard & Poor’s, and Fitch Ratings. They have been widely blamed for contributing to the subprime mortgage debacle that touched off the financial crisis by failing to give investors adequate warning of the risk of mortgage securities tied to the high-risk home loans.”).

⁴ “EU Internal Market Commissioner Charlie McCreevy . . . has said ratings agencies failed to ‘sniff the rot’ at the heart of securitized products which they rated highly but quickly became untradeable as underlying home loans defaulted.” Huw Jones, *EU States in Deal on Supervising Rating Agencies*, REUTERS, Mar. 4, 2009.

⁵ This problem appears to be more profound in the recent rating of complex securitized instruments than in the rating of traditional corporate debt. *See* FINANCIAL SERVICES AUTHORITY, *THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS* 76 (2009). The conflicts of interest inherent in the issuer-pays model, and the dangers arising therefrom, are well recognized. SEC. & EXCH. COMM’N, *SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES* 31 (2008); GROUP OF 30, *FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY* 50 (2009); David Evans, *Peddling Tainted Debt to Florida*, BLOOMBERG MARKETS, Feb. 2008, at 61 (“You have rating firms acting as meat inspectors, and unfortunately the rating firms are being paid by the meat producers. It underscores the severely flawed structure of the industry.”); *SEC Proposes New Rating Agency Rules*, VC EXPERTS BUZZ, Nov. 25, 2008, http://vcexperts.com/vce/news/buzz/archive_view.asp?id=620&referrer=buzz&mail_id=buzz834 (“What if Steven Spielberg had hired and worked closely with Siskel and Ebert to get a ‘Two Thumbs Up’ rating on his Raiders of the Lost Ark movie? What if the Four Seasons Resort in Maui were in cahoots with Frommer’s to ensure a 3-Star Rating for its hotel? What if General Motors selects and compensates the Consumer Report analyst who will critique its upcoming line of new automobiles? What if your child who dreams of attending an Ivy League college could appoint and pay the teachers who will determine his grade point average? Perhaps some strict rules and regulations would need to be in place in order to ensure that no unfairness or impropriety takes place . . . ya think?”).

that “that deal is ridiculous. We should not be rating it.”⁶ The second responds, “We rate every deal. It could be structured by cows and we would rate it.”⁷ The Economist describes this exchange as “more than mortifying” and observes that it “cut[s] to a central conflict bedeviling the industry: although ratings are relied on by investors and regulators as impartial measures, the rating agencies are paid by those they rate for their judgments.”⁸

The second concern is that the industry is concentrated with high barriers to entry.⁹ The two dominant rating agencies account for almost 80 percent of industry revenue.¹⁰ At Moody’s, profits quadrupled between 2000 and 2007 and it had the highest profit margin of any company in the S&P 500 for five consecutive years.¹¹ Standard & Poor’s was reportedly not far behind.¹² New entry is difficult because of SEC regulation and Congressional legislation, and the industry’s inherent economies of scale.¹³

⁶ Instant Message Conversation between Shannon Mooney and Rahul Dilip Shah, Structured Finance – New York, Standard & Poor’s (Apr. 5, 2007).

⁷ *Id.*

⁸ *Negative Outlook*, ECONOMIST, Nov. 13, 2008, at 91. This exchange is hardly the only example. An analyst at Standard & Poor’s wrote in an e-mail, “Rating agencies continue to create an even bigger monster – the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters :o)” E-mail from Chris Meyer, Standard & Poor’s, to Beinda Ghetti and Nicole Billick, Standard & Poor’s (Dec. 15, 2006).

In a confidential presentation to Moody’s Board of Directors, Moody’s CEO Raymond McDaniel admitted, “Analysts and MDs are continually ‘pitched’ by bankers, issuers, investors – all with reasonable arguments – whose views can color credit judgment, sometimes improving it, other times degrading it (we ‘drink the kool-aid’). Coupled with strong internal emphasis on market share & margin focus, this does constitute a ‘risk’ to ratings quality.” Credit Policy Issues at Moody’s Suggested by the Subprime/Liquidity Crisis, Confidential Presentation to Moody’s Board of Directors (Oct. 21, 2007).

In a recently filed lawsuit against Moody’s, a former analyst alleged that his supervisor – the ratings committee chairman and director of Moody’s corporate-finance group – resisted upgrading a company, saying it “doesn’t pay us” and “they don’t visit us and they don’t deserve our upgrade.” Jennifer Levitz, *Moody’s Sued in Ratings Case*, WALL ST. J. (Mar. 26, 2009).

⁹ See Lawrence White, *The Credit Rating Industry: An Industrial Organization Analysis*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM (R. Levich et al. eds., 2002). See also Re-proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6485, 6492 (proposed Feb. 2, 2009); Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36212, 36218 (proposed June 16, 2008) (both proposing amendments to Rule 17g-5 intended to increase competition among NRSROs).

¹⁰ Richard Tomlinson & David Evans, *The Ratings Charade*, BLOOMBERG MARKETS, July 2007, at 50-51.

¹¹ *CRA Hearing*, *supra* note 2. See Moody’s Corp, Annual Report (Form 10-K) (Feb. 29, 2008) (From 2005 to 2007, Moody’s Investors Service reported operating margins in excess of 50 percent).

¹² J.P. MORGAN, THE MCGRAW-HILL COMPANIES: NO BID FOR MOTHER MCGRAW (Oct. 7, 2008) (reporting Standard & Poor’s margin at 45.6 percent).

¹³ Alex J. Pollock, *End the Government-Sponsored Cartel in Credit Ratings*, AM. ENTERPRISE INST. FOR PUB POL’Y RES., Dec. 22, 2004, available at http://www.aei.org/publications/pubID.21743/pub_detail.asp (“Doubtless it was never the intent of the SEC to create a cartel or the related cartel profits, but this has been the result of its actions (and inaction) over the last three decades since introducing the NRSRO label in 1975.”); Lawrence J. White, *A New*

The result is a comfortable duopoly in which the dominant firms have little incentive to provide more accurate ratings, or to introduce new, more informative descriptions of a security's risk profile, other than in response to legislative or regulatory pressure. Issuers don't complain about duopoly pricing because it supports a pliable pair of rating agencies that provide ratings more to the issuers' liking.

Abandoning the issuer-pays model, however, isn't easy.¹⁴ The ratings industry was supported by investor subscriptions until the 1970s when the Xerox machine made free-riding so easy that the industry switched to its current issuer-pays model.¹⁵ Free rider problems are more severe in the internet era, as any struggling newspaper will quickly tell you. There is also significant public demand for access to free, high quality ratings. Subscription models simply can't support that demand, or defeat modern free-riding concerns.

Suggestions to impose a transactions or portfolios tax to subsidize new rating agencies generate different problems.¹⁶ Because these new agencies would be tax-subsidized, their ratings would not be subject to any form of market discipline: they would, directly or indirectly, have to serve the interests of the political system in order to maintain access to a tax-based revenue stream. These new agencies could therefore quickly devolve into bureaucracies that promote political agendas, rather than competitive organizations that serve investors' best interests. Even if the government-capture problem could be solved, the tax rates imposed on the market would very likely be too high or too low because the government lacks market-based information indicating the optimal amount that should be spent on additional securities ratings.

Suggestions that the SEC simply abolish its regulatory reliance on ratings also fail to solve the problem.¹⁷ There is a legitimate demand for the efficiencies that result from honest, competent ratings. Repealing the regulatory requirements that incorporate formal ratings won't make this demand disappear. Indeed, myriad important private sector contracts rely on ratings

Law for the Bond Rating Industry, REG., Spring 2007, at 50 ("Economies of scale and the importance of reputation in ratings meant that the number of ratings firms would be relatively small.").

¹⁴ For user-pays proposals, see, e.g. Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, N.C. L. REV. (forthcoming 2009), available at <http://papers.ssrn.com/abstract=1199622>; Zach Carter, *Rating Agencies, Discredited*, AM. PROSPECT, Mar. 20, 2009, http://www.prospect.org/cs/articles?article=rating_agencies_discredited.

¹⁵ See White, *supra* note 9.

¹⁶ See Eric Dinallo, *Buyers Should Pay for Bond Ratings*, WALL ST. J. Mar. 3, 2009.

¹⁷ See References to Ratings Of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40088 (proposed July 1, 2008); References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40124 (proposed July 1, 2008); Security Ratings, 73 Fed. Reg. 40106 (proposed July 1, 2008); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999); Jerome Fons & Frank Partnoy, *Rated F for Failure*, N.Y. TIMES, Mar. 16, 2009, at A23.

and they will continue to do so even if the Commission disclaims all regulatory use of ratings.¹⁸ Abolishing regulatory reliance on ratings also won't attract new entrants to the market, address the core conflict of interest that plagues the rating process, or stimulate innovation. International capital standards as reflected in the Basel Accords will also continue to rely on rating agency information. Therefore, even if the SEC scrubbed all of its rules relying on credit ratings, the problem would remain.

The better solution addresses these challenges head on. It would create sophisticated, well capitalized new market entrants with strong incentives to promote an investor's point of view in the rating process. The SEC can achieve this outcome by creating a new category of credit rating agencies, Buyer Owned and Controlled Rating Agencies (BOCRAs), that would be owned and operated by the largest, most sophisticated debt market investors. BOCRAs could be organized as for-profit or not-for-profit entities, and because they would be controlled by the investor community they would have powerful incentives to issue prudent, even skeptical ratings.

To provide a revenue stream for these new entities, the SEC would require that every rating by a Nationally Recognized Statistical Rating Organization (NRSRO)¹⁹ paid for by an issuer be accompanied by a BO CRA rating that is also paid for by the issuer. As explained in detail below, the Credit Rating Agency Reform Act of 2006 (CRARA) provides the Commission with the statutory authority necessary to adopt these reforms.

We suggest that there be no regulatory limit on the number of BOCRAs. The scale economies inherent in the rating process, however, make it unlikely that more than two dominant

¹⁸ See Jane Sassen, *Why Moody's and S&P Still Matter*, BUS. WK., July 14 & 21, 2008. Credit ratings, as issued by NRSROs, not all credit rating agencies, are incorporated in the regulation of banks (Basel II), broker-dealers (Rule 15c3-1), money market mutual funds (Rule 2a-7), pension funds (ERISA), insurance companies (NAIC rules) and many other fiduciaries. John P. Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. (forthcoming 2009) (manuscript at 27-29), available at <http://ssrn.com/abstract=1267625>.

Charters of institutional investors, credit agreements, and bond indentures also reference credit ratings. See Renaud Cormier, *Credit Cliff Dynamics: When Rating Agencies Pull the Trigger*, 21 AM. BANKR. INST. J. 16 (2002). See, e.g. Matthew Karnitschnig & Heidi Moore, *Why Banks Will Lend Billions for Pfizer Deal*, WALL ST. J. Jan. 27, 2009 (In Pfizer's \$68 billion acquisition of Wyeth, the lending syndicate could walk away from its financing commitment if Pfizer's credit rating dropped below certain thresholds).

¹⁹ Under CRARA, a "credit rating agency" is any 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." 15 U.S.C. § 78c(a)(61). An "NRSRO" is a "credit rating agency" that "has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration" as an NRSRO. 15 U.S.C. § 78c(a)(62)(A). Thus, NRSROs are a subset of credit rating agencies and regulatory requirements relate to NRSRO status, and not credit rating agency status.

BOCRAs will emerge. Market forces would set BOCRA prices. We anticipate that those prices would be comparable to fees currently charged by the two dominant rating agencies.

Strong, sophisticated investor control over BOCRAs is designed to prevent the evolution of conflicts of interest that otherwise emerge as a consequence of the issuer-pays model. When considering the incentives of the investor community that would control the BOCRA, it is important to recognize that holders of an instrument would, all other factors equal, prefer that it not be downgraded (assuming that the market has not already anticipated the downgrading effect). Purchasers would prefer to be able to buy at a lower price. Thus, once the market has evolved past the initial offering, where the investment community has a coherent interest in acquiring at a lower price, the investment community's interests would seem to be balanced towards ratings that accurately reflect valuations. In contrast, issuers consistently have an interest in obtaining the highest possible ratings. Thus, the concern that BOCRAs might render overly harsh and conservative ratings should be limited to the initial issuance market.

But wouldn't the rating market be improved if ratings were provided by intelligent organizations with differing perspectives on the market? Isn't that the sort of difference of opinion that actually makes for a healthy market? Each side of the market would be disciplined by the other, and the odds that traditional sell-side raters could replicate the folly of the last few years should be diminished by the BOCRAs' more gimlet eye. More bluntly, if BOCRAs fail to spot systematic rating inflation by the sell side, then the buy side will have only itself to blame.

There is no absolute truth about how any instrument should be rated. Why then should we try to fool ourselves into believing that, in a world of brutal commerce, subject to profound uncertainty, we can through regulation create rating agencies that are totally pristine, absolutely objective, and Delphic in their pronouncements? An intelligent, principled, potentially adversary process may, as a practical matter, be as good as it gets.

The remainder of this note describes a strategy that allows the Commission to implement this BOCRA proposal without legislative action.

2. Defining a "BOCRA"

BOCRAs have four major defining characteristics. The first defines the extent to which Highly Sophisticated Institutional Purchasers ("HSIP") own and control the BOCRA. The second defines the criteria necessary to qualify as a HSIP. The third describes permissible BOCRA internal governance mechanisms. The fourth addresses whether BOCRAs should be required to operate as not-for-profit entities. Reasonable persons can differ regarding the optimal definition of a BOCRA. We are largely agnostic as to many of the details of the definition, provided that the resulting regulations sustain broad public confidence that BOCRAs have powerful institutional incentives to represent the buy-side of the market.

2.1. Ownership and Control Requirements

At a minimum, HSIPs should hold majority voting and operational control over BOCRA's. This level of control can theoretically be achieved through dual voting structures, super-majority voting rights, board representation rights, and rights to appoint key executive and operating personnel. A simpler structure, however, would establish a one-share-one-vote governance mechanism and require that a majority or a super-majority of voting rights at all times be held by HSIPs. A majority or super-majority of the BOCRA's directors should also be designated by HSIPs, who should further have the right to veto the selection or cause the prompt termination of key executive personnel, including the BOCRA's CEO, CFO, and persons with senior responsibility over the operation of the rating process. The Commission's comment process would provide useful information regarding the detailed structure of these requirements.

2.2. Defining "Highly Sophisticated Institutional Purchasers"

The primary objective of the HSIP definition is to identify a category of institutional investors smart enough to oversee the rating process and sufficiently motivated to monitor BOCRA operations to assure that they reflect a buyer's perspective. This is no easy task, and the comment process will again be useful. As an initial observation, the current QIB definition²⁰ is far too lax: many asset managers control more than \$100 million yet lack the expertise intelligently to monitor the details of a BOCRA's analytic operations. The HSIP definition would therefore likely require a showing that the entity is large and sophisticated, managing billions of dollars in assets, and can be relied upon to represent the buy-side interest in accurately rating debt market instruments. More aggressively, the Commission could require that HSIPs be engaged in active management of a very large debt portfolio with assets well into the billions, and that they have experience managing a sufficiently large and sophisticated staff of debt analysts. Ideally, HSIPs would be perceived as highly credible representatives of the buy-side, and would not themselves issue a material volume of securities that are rated.

2.3. Internal Governance Mechanisms

If BOCRA ownership and control provisions are properly defined, and if the definition of HSIP is appropriately rigorous, then the regulations governing BOCRA status need not also define the BOCRA's internal governance mechanisms. Those can be left to HSIPs to define.

However, given the current interest in governance matters, the Commission could reasonably seek comment as to a range of potential internal governance controls. Separate and apart from traditional and highly predictable requirements relating to board structure, composition, and governance, the Commission might entertain an intriguing compensation-related proposal: that a material portion of a BOCRA's executive compensation be indexed to the accuracy of BOCRA ratings rather than to the BOCRA's economic performance. A

²⁰ 17 C.F.R. § 230.144A (a)(1).

compensation requirement of this form could provide BOCRA's with a powerful additional incentive to "get it right" when rating instruments.

2.4. For-Profit or Not-For-Profit Status?

Sound arguments can be made that BOCRA's should be allowed to operate either as for-profit or not-for-profit entities.²¹ A for-profit form facilitates capital formation and allows non-HSIPs to participate as passive capital providers. It also allows for equity-based incentive compensation which, depending on its structure, can be a desirable incentive mechanism, particularly if coupled with an accuracy-related incentive structure, as discussed above.

A not-for-profit requirement partially addresses concerns that BOCRA's could also barter their integrity for a higher stock price, but does so at a potentially significant cost. Capital would likely be more difficult to raise and non-profits are subject to a broad range of inefficiencies that are well understood in the literature.²²

There is no clear cut answer to this design question. But if HSIPs are sufficiently sophisticated, and if ownership, control, and internal governance measures are adequate to assure buy-side loyalty, then additional not-for-profit status requirements may be unnecessary.

3. The "Buy a BOCRA Rating" Rule

Having defined BOCRA status, the Commission would adopt a rule prohibiting any NRSRO from publicly releasing any rating or opinion on any instrument for which it, directly or indirectly, receives any compensation from an issuer or promoter, unless the NRSRO receives adequate written assurance that the issuer or promoter has made all necessary arrangements to cause the payment of a fee to and issuance of a rating by a BOCRA on or before the date on which the NRSRO is anticipated publicly to release its rating or opinion. The NRSRO's rating or opinion would also have to refer to the identity of the BOCRA scheduled to issue a rating or opinion on the same security.

²¹ See *Hedge Funds and the Financial Markets: Hearing Before the H. Comm. on Oversight & Government Reform*, 110th Cong. (2008) (testimony of James H. Simons, President, Renaissance Technologies, LLC) (suggesting the formation of an investor-sponsored, not-for-profit rating organization, focusing on derivative securities). See *Hedge Funds on the Hill: Statements from John Paulson and James Simons*, WALL. ST. J., Nov. 13, 2008.

²² For a general review of the costs and benefits of the non-profit form, see, e.g. THE GOVERNANCE OF NOT-FOR-PROFIT ORGANIZATIONS (Edward L. Glaeser, ed., University of Chicago Press) (2003); Henry Hansmann, *Economic Theories of the Nonprofit Sector*, in THE NONPROFIT SECTOR (W. Powell, ed., 1987); Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L. REV. 835 (1980).

4. Statutory Authority

Sections 15E(h)(2) and 15E(i)(1) of the Securities and Exchange Act, added to the statute by the Credit Rating Agency Reform Act of 2006 (CRARA),²³ provide the Commission with the requisite statutory authority. Section 15E(h)(2) grants the Commission has authority to “issue final rules ... to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization, including ... (A) the manner in which a nationally recognized statistical rating organization is compensated.”²⁴ Section 15E(i)(1) grants the Commission authority to prohibit “any act or practice relating to the issuance of credit ratings by a nationally recognized statistical rating organization that the Commission determines to be unfair, coercive, or abusive.”²⁵

The critical observation for purposes of statutory analysis is that the proposed BOCRA rating obligation is imposed only on NRSROs subject to Sections 15E(h)(2) and 15E(i)(1), and not on issuers, promoters, or any other person. Therefore, if the Commission finds that the BOCRA requirement is appropriate and in the public interest in order to “prohibit or require the management” of “conflicts of interest relating to the issuance of credit ratings,” then it would have authority to impose the BOCRA requirement pursuant to Section 15E(h)(2).

Further, Section 15E(h)(2)(A) grants authority to regulate the manner in which NRSROs are compensated. This authority allows the Commission to prohibit issuer-pay compensation. The BOCRA rating requirement, however, does not prohibit issuer-pay compensation models. Instead, it takes the less intrusive step of allowing NRSROs to continue to rely on issuer-pay compensation provided that the market is also informed by a credible, contemporaneous BOCRA voice. It follows, *a fortiori*, that if the Commission can prohibit the issuer-pay model, it can impose the less restrictive BOCRA rating requirement as a means of managing the conflicts generated by the issuer-pay model.

Additional statutory authority, which is not necessary to our argument, can be found in Section 15E(i)’s reference to acts or practices that are “unfair, coercive or abusive.” “Unfairness” can arise without deception and does not require fraud.²⁶ Although there is relatively little judicial precedent on point regarding the appropriate interpretation of the terms “unfair, coercive or abusive,” courts commonly refer to dictionary definitions of such terms – definitions that would support an administrative finding that the release of NRSRO ratings pursuant to an issuer-

²³ Credit Rating Agency Reform Act, 15 U.S.C. § 78o-7 (2006).

²⁴ 15 U.S.C.A. § 78o-7(h)(2)(E).

²⁵ 15 U.S.C.A. § 78o-7(e)(1).

²⁶ *Chiarella v. U. S.*, 445 U.S. 222, 232 (1980) (“not every instance of financial unfairness constitutes fraudulent activity under § 10(b)"); *Lycan v. Walters*, 904 F. Supp. 884, 901 (S. D. Ind., 1995) (“As noted by the Supreme Court, ‘not every instance of financial unfairness constitutes fraudulent activity under § 10(b).’ Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”)

pay model constitutes an “unfair” practice.²⁷

4. BOCRA as NRSROs

BOCRAs clearly qualify as CRARA credit rating agencies.²⁸ They cannot, however, immediately qualify as NRSROs because the statute requires that an entity have “been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under Section 15E” as an NRSRO. The market and the Commission therefore could not rely on BO CRA ratings to satisfy the Commission’s own rating-related regulatory requirements until at least three years have passed and the BOCRA has successfully registered as NRSROs.²⁹

This observation is hardly disabling. The fundamental purpose of the BO CRA proposal is to introduce intelligent, credible competition that offers a buy-side perspective on the market. BOCRA can achieve this objective even if they never qualify as NRSROs. After three years of market experience, BOCRA can apply for NRSRO status and, if their applications succeed, can then significantly expand the supply of NRSRO rating sources available to the market.

If the Commission wishes to accelerate the pace at which BOCRA can qualify for NRSRO status, we observe that although CRARA contains no provision granting the Commission exemptive authority, it is codified as an amendment to the Exchange Act. Section 36(a) of the Exchange Act grants the Commission broad ranging exemptive authority that could, upon an appropriate showing, be construed as allowing the Commission to shorten the three year waiting period if that would be “necessary and appropriate in the public interest, and is consistent with the protection of investors.”

²⁷ The American Heritage Dictionary defines unfair as “not just or evenhanded; biased.” American Heritage Dictionary of the English Language (4th ed. 2000). The Merriam-Webster Online Dictionary defines unfair as “marked by injustice, partiality, or deception.” Merriam-Webster Online Dictionary, <http://www.merriam-webster.com/>. Thesaurus.com lists “biased” and “partial” as synonyms of unfair. Thesaurus.com, <http://thesaurus.reference.com/>.

²⁸ BOCRA would be “engaged in the business of issuing credit ratings . . . for a reasonable fee.” They would employ “either a quantitative or qualitative model, or both, to determine credit ratings,” and “receive fees from either issuers, investors, or other market participants, or a combination thereof.” BOCRA would therefore satisfy the statutory definition of “credit rating agency.” 15 U.S.C. § 78c(a)(61).

²⁹ Many observers have complained that this three year requirement, combined with other CRARA provisions, paradoxically constructs even higher barriers to entry into the NRSRO sector and actually strengthens the hand of the largest, most entrenched NRSROs. See, e.g., Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, U. ILL L. REV. (forthcoming 2009) (manuscript at 39-42) (Penn State Legal Studies Research Paper No. 09-2009), available at <http://ssrn.com/abstract=1354062>. While these critiques have substantial merit, the BO CRA approach advocated in this analysis is able to avoid these barriers by not requiring that BOCRA be recognized as NRSROs. It is entirely sufficient that BOCRA simply act as non-NRSRO credit rating agencies.