JASON W. PARSONT, ESQ.

June 20, 2011

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: *Solicitation of Comment to Assist in Study on Assigned Credit Ratings Release No. 34-64456: File No. 4-629*

Dear Ms. Murphy:

As an addendum to the letter I submitted on September 13, 2011, I am now attaching the final version of my article *NRSRO Nullification: Why Ratings Reform May Be In Peril*, 77 BROOK. L. REV. 3, 1015 (Spring 2012). My analysis of the Franken Proposal and the feasibility of relying only on the existing Equal Access Rule appear on pages 1057-1067. My central recommendation that the SEC should adopt a refined version of the rating function suggested by the Franken Proposal, but not the allocating function, appears on pages 1083-1086. Both my analysis and central recommendation take into account, among other things, the public comment letters posted to the SEC website at http://www.sec.gov/comments/4-629/4-629.shtml. I hope this article helps you with your study of this important issue and your resulting report to Congress. If you have any questions, or if I can otherwise be of assistance, please don't hesitate to contact me.

Very Truly Yours,

Jason W. Parsont[1]

[1] Judicial law clerk for the Honorable Judge Paul C. Huck in the United States District Court for the Southern District of Florida; Former associate at Sullivan & Cromwell LLP in New York (2007 to 2011) practicing securities and corporate law; Former Careers-in-Law-Teaching Fellow at Columbia Law School. The views expressed in this letter are solely my own and do not reflect the views of my current or former employers.

NRSRO Nullification

WHY RATINGS REFORM MAY BE IN PERIL

Jason W. Parsont[†]

> *[O]ne strategic move might be made by the Big Three [Moody's, S&P and Fitch] that would destabilize the status quo: they could decide to surrender their NRSRO status, and thereby avoid the more demanding provisions of the Dodd-Frank Act, which only apply to NRSROs. . . . [W]hen the burdens outweigh the benefits, it makes sense for them to abandon NRSRO status—if they can.*[1]

INTRODUCTION

In the words of Senator Christopher Dodd, Congress has "spent an inordinate amount of time on the rating agency question."[2] Scholars too have been deeply engaged in answering this question and so have market participants, the Securities and Exchange Commission (SEC), and others.

The rating-agency question asks whether there is a regulatory mechanism that can be adopted to encourage the credit rating agencies (CRAs)—including those that are nationally recognized statistical rating organizations (NRSROs)[3]—to produce more accurate credit ratings on debt securities, or whether another assessment of credit risk exists

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[†] Careers-in-Law-Teaching Fellow, Columbia Law School, J.D. For helpful comments on earlier drafts, I am grateful to Frank Partnoy, Claire Hill, Paul Mahoney, Victor Goldberg, Dan Dunson, Ari Blaut, Jordan Abramson, Jonathan Schalit, Yuliya Guseva, Irene Ten Cate, Elizabeth Sepper, Aarthi Anand, Jennifer Sheridan and all other participants in the Associates' and Fellows' Workshop at Columbia Law School. I am also grateful to John Coffee and Charles Whitehead for their important advice and for the support of friends and family.

[1] John C. Coffee Jr., *Ratings Reform: The Good, the Bad, and the Ugly*, 1 HARV. BUS. L. REV. 231, 264 (2011).

[2] 156 CONG. REC. S3664, 3677 (daily ed. May 13, 2010) (statement of Sen. Christopher Dodd).

[3] "NRSROs," as used herein, mean those ten CRAs, such as Moody's, S&P, and Fitch (the Big Three), that are registered with and regulated by the SEC. *See Commission Orders Granting NRSRO Registration*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/divisions/marketreg/ratingagency.htm (last visited Jan. 22, 2012). For the legal definitions of CRA and NRSRO, see Sections 3(a)(61) and (62) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78c(a)(61), (62) (West 2011).

that could replace the need for credit ratings. Recently, Congress found that inaccurate credit ratings on a type of debt security—structured-finance products,[4] such as subprime residential mortgage-backed securities and collateralized-debt obligations (CDOs)—significantly contributed to the mismanagement of risk by investors during the financial crisis of 2008.[5] This, in turn, was a root cause of the crisis.[6]

Given the close scrutiny that has been devoted to this question, including Congress's recent legislative solution (collectively, Ratings Reform),[7] this article's purpose is not to propose a new answer, but to help refine the proposed answers. It tackles a fundamental problem that has the potential to cause any regulatory solution to the rating-agency question to crumble: "NRSRO Nullification," which is the exercise of the NRSROs' right to voluntarily withdraw from the regulatory regime.[8] Such action would undermine, if not completely nullify, Ratings Reform and any future regulatory solutions. The concept of NRSRO Nullification also encompasses the exercise of the corollary right of the approximately seventy-six unregulated CRAs (non-NRSROs)[9] to refrain from registering and thereby avoid the regulatory framework governing NRSROs.[10]

Ratings Reform was a compromise between the views of two competing camps—the Free Market Camp and the Reform

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[4] The Dodd-Frank Wall Street Reform and Consumer Protection Act defines "structured finance product" as "an asset-backed security, as defined in section 3(a)(77) of the Securities Exchange Act of 1934, as added by section 941, and any structured product based on an asset-backed security, as determined by the Commission, by rule." Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939F(a), 124 Stat. 1376, 1889 (2010) [hereinafter Dodd-Frank].

[5] *See infra* note 66.

[6] *See infra* note 69.

[7] "Ratings Reform," as used herein, means (1) Dodd-Frank, (2) the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006) [hereinafter CRARA], and (3) the rules and regulations adopted thereunder.

[8] *See* Securities Exchange Act of 1934 § 15E(e)(1), 15 U.S.C.A. § 78o-7(e)(1) (West 2011) ("[An NRSRO] may . . . withdraw from registration by furnishing a written notice of withdrawal to the Commission"); *see also* 17 C.F.R. § 240.17g-1(g) (2011) (the related withdrawal rule).

[9] By one recent estimate, there are approximately seventy-six non-NRSROs in the world, which figure includes some foreign affiliates of NRSROs. *See Credit Rating Agencies: (The Full Global List)*, DEFAULTRISK.COM, http://www.defaultrisk.com/rating_agencies.htm (last modified Oct. 2011). Another estimate, from 1999, puts this number at about 130. *See* U.S. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKET 37 n.98 (2003) [hereinafter SEC REPORT OF 2003] (citations omitted).

[10] *See* 15 U.S.C. § 78o-7(a) (setting forth the right of CRAs to voluntarily register, or refrain from registering, as NRSROs).

Camp.[11] The Free Market Camp generally advocates deregulation and replacing credit ratings with market measures or a professional-judgment analysis as the solution to the rating-agency question.[12] Its goal is to decrease reliance on credit ratings. The Reform Camp, on the other hand, generally advocates closer regulation—including purging destructive conflicts of interest—to improve the accuracy and reliability of credit ratings.[13] While Ratings Reform may have been a compromise, the thrust of the combined legislation favors the Reform Camp's solution due to its emphasis on using regulation and oversight to improve the quality of credit ratings, even as it seeks to deemphasize their importance.

The prospect of NRSRO Nullification is thus most problematic for those in the Reform Camp (including this author), because it would permit the NRSROs to foil Congress's intent. In its most drastic form, all ten NRSROs could exercise their withdrawal right, which would precipitate de facto deregulation. It would be more likely, however, that only the seven smallest NRSROs[14] would exercise this right, which would return the regulated club to only the Big Three—Moody's, S&P and Fitch.[15] Either result would deprive society of a regulatory mechanism to effectively promote accurate and reliable ratings. In the absence of regulation, there would be no way to collect comparative performance data, manage or prohibit conflicts of interest, or realign incentives so that accurate ratings—instead of issuer-friendly ratings—would serve the NRSROs' best business interests. If such regulation only applied to the Big Three, then the comparative data set and controls would be confined to this group, and there would be significantly less incentive to compete over accuracy. While some in the Free Market Camp might welcome NRSRO Nullification,[16] they too should be wary since market

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[11] *See* Coffee, *supra* note 1, at 246 (identifying the two camps of reformers); *see also infra* note 63.

[12] *See infra* Part I.C.

[13] *See infra* Part I.C.

[14] The seven smallest NRSROs are A.M. Best Co. (A.M. Best), Dominion Bond Rating Service Limited (DBRS), Kroll Bond Rating Agency, Inc. (Kroll), Japan Credit Rating Agency (JCR), Rating and Investment Information (R&I), Egan-Jones Ratings Company (Egan-Jones) and Morningstar Credit Ratings (Morningstar). *See infra* notes 64, 102, 142.

[15] The Big Three are Moody's Investors Services, Inc. (Moody's), Standard & Poor's Financial Services LLC, a subsidiary of The McGraw-Hill Companies, Inc. (S&P), and Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries (Fitch). *See infra* Part III.A.3.

[16] *See* Lawrence J. White, *A New Law for the Bond Rating Industry*, SEC. & INV., Spring 2007, at 52, *available at* http://www.cato.org/pubs/regulation/regv30n1/v30n1-3.pdf

participants will continue to rely on NRSRO ratings in the near term irrespective of congressional action seeking to decrease reliance on them.[17]

NRSRO Nullification, moreover, is realistic for at least some subset of the regulated club, because Ratings Reform has substantially increased the burdens of regulation *vis-à-vis* the benefits.[18] Indeed, this is precisely the reason some non-NRSROs have refrained from registering and some NRSROs have stopped rating structured-finance products or curtailed plans to expand.[19] Since the NRSROs are only subjected to Ratings Reform if they consent, there is a fragile equilibrium that must be maintained between the benefits and burdens of NRSRO status.[20] The resolution of the two most critical unresolved aspects of Ratings Reform—the Franken Proposal[21] and the new standards of creditworthiness[22]—will impact this equilibrium. To the extent the final form of these items continues to increase NRSRO-specific burdens without providing NRSRO-specific benefits, such measures could tip the balance toward NRSRO Nullification, especially for the seven smallest NRSROs.[23]

The final form of these items could also prevent NRSRO Nullification if such items provide sufficient benefits to avoid the tipping point. The Franken Proposal's CRA Board,[24] which would act as both a "rater" of the NRSROs and an allocator of

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(characterizing abandonment of the entire NRSRO regulatory regime as "an unrealistic pipedream" that would nonetheless be a preferable solution).

[17] *See* Claire A. Hill, *Limits of Dodd-Frank's Rating Agency Reform*, 15 CHAP. L. REV. 133, 144 (2011) ("[P]eople will continue to be influenced by the agencies . . . no matter what the government does . . . . [So] it behooves government to make them better if at all possible."); *see also* 156 CONG. REC. S3955, 3956 (daily ed. May 19, 2010) (statement of Sen. Al Franken) ("Here is the problem. Eliminating federally mandated reliance on NRSRO credit ratings doesn't change the fact that State laws, pension fund policies, and other private market actors will still explicitly rely on NRSRO ratings.").

[18] For a description of how the benefits and burdens of NRSRO status have changed over three different periods, see *infra* Part II.

[19] *See infra* notes 229-30 and accompanying text.

[20] Professor Coffee recently alluded to this problem by suggesting that the Big Three might strategically abandon their NRSRO status to avoid the more demanding provisions of Ratings Reform if the burdens were to outweigh the benefits. *See supra* note 1 and accompanying text. I distinguish my claim by suggesting the more likely problem is that the other seven NRSROs would surrender their NRSRO status for precisely this reason while the Big Three would remain.

[21] *See infra* Part III.A.1.

[22] *See infra* Part III.A.2.

[23] Based on today's existing distinctions between NRSRO and non-NRSRO status, it appears that the smallest seven would be more likely to opt out of the regulatory regime than the Big Three. *See infra* Part III.A.3.

[24] *See infra* notes 235-40 and accompanying text (describing the mechanics of the CRA Board).

initial (but not secondary) rating assignments, is a potential solution for keeping the NRSROs voluntarily regulated while also maximizing accurate and reliable ratings. Through its rating function, the CRA Board could provide a reliable signal to the market about the best performing NRSROs over time. If the new standards of creditworthiness permit investment fiduciaries[25] to optionally rely on credit ratings, such a signal could significantly influence the preferences that such fiduciaries have regarding CRAs. Through its allocating function, the CRA Board could also reward good performance with increased market share. While both functions have the potential to create competition over accuracy, the allocating function may be premature because there is currently no definition of accuracy that the market accepts. My central recommendation,[26] which would only put into place the Franken Proposal's rating function, seeks to address this problem as part of a broader goal of finding an optimal mechanism to address both the rating-agency question and NRSRO Nullification together.

While this article also considers closing the voluntary registration loophole by having Congress adopt a mandatory registration requirement as an alternate way to prevent or reverse NRSRO Nullification,[27] the article concludes that doing so is not necessary if my central recommendation is adopted.[28]

There is also recent precedent demonstrating that the NRSROs would be willing to foil Congress's intent. As part of Dodd-Frank, Congress sought to impose negligence exposure under Section 11 of the Securities Act of 1933 on the NRSROs for misleading ratings disclosed in a registration statement.[29] The NRSROs had historically not been subject to negligence—only recklessness—because of a safe harbor, known as Rule

[25] "Investment fiduciaries," as used herein, means those persons (such as a fund's board of directors and investment advisor) responsible for determining creditworthiness, whether or not under the new standards of creditworthiness, at their respective institutions (e.g., broker-dealers, funds, banks, insurance companies, etc.).

[26] *See infra* Part IV.

[27] *See infra* Part III.B.

[28] *See infra* Part IV.C.

[29] *See* Dodd-Frank § 939G ("Rule 436(g) . . . shall have no force or effect."); *see House-Senate Conference Committee Holds a Meeting on the Wall Street Reform and Consumer Protection Act*, FIN. MARKETS REG. WIRE, June 15, 2010 (statement of Rep. Mary Jo Kilroy) ("Included in the House offer is a simple commonsense proposal that will help change this dynamic, a proposal that would nullify SEC Rule 436(g) and hold all [CRAs] accountable under Section 11 liability, a standard which already covers many experts in the financial world—accountants, auditors, lawyers, investment bankers and the directors, officers and executives of the issuer.").

436(g), that shielded them from such exposure.[30] Congress did not, however, repeal the NRSROs' existing right to withhold consent to negligence exposure.[31] Thus, the NRSROs collectively withheld consent shortly after Dodd-Frank passed and thereby nullified the intent of Congress.[32] While it is troubling that the NRSROs escaped negligence exposure in this manner, NRSRO Nullification would pose a significantly larger problem because it would allow an escape not just from negligence exposure but from the entire regulatory regime. While it would be headline news if the Big Three left the regulated club, few words would likely be uttered if the other seven surrendered their NRSRO status.

This article proceeds in four parts. Part I provides background to the rating-agency question by discussing what credit ratings are and what it means for them to be inaccurate when made. It then describes the debate over the rating-agency question and the ultimate shape of Ratings Reform. Part II examines the question of why a CRA would want to be an NRSRO. It describes the benefits and burdens of being an NRSRO prior to 2006 and in the aftermath of Congress's two recent attempts at Ratings Reform, the Credit Rating Agency Reform Act of 2006 (CRARA)[33] and Dodd-Frank.[34] It shows that being an NRSRO has become significantly less attractive over time. Part III identifies and discusses the financial and reputational implications that today's most critical unresolved items—the Franken Proposal and the new standards of creditworthiness—will have on the NRSROs' decision to withdraw from Ratings Reform. It then assesses the impact that today's existing distinctions in concert with such unresolved items will have on this decision and the legal implications of NRSRO Nullification. This part also assesses the extent to which such items and their alternatives will promote accurate

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[30] *See* 17 C.F.R. § 230.436(g) (2009).

[31] Securities Act of 1933 § 7(a), 15 U.S.C.A. § 77g(a) (West 2010) ("If . . . any person [e.g., an NRSRO] whose profession gives authority to a statement made by him [e.g. a credit rating], is named as having prepared or certified any part of the registration statement . . . the written consent of such person shall be filed with the registration statement.").

[32] *See* Ford Motor Credit Company LLC, SEC No-Action Letter, Item No. 1120 (Regulation AB) (Nov. 23, 2010) [hereinafter Ford No-Action Letter], *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm ("[T]he rating agencies indicated that they were not willing to provide their consent . . . .").

[33] *See* CRARA, Pub. L. No. 109-291, 120 Stat. 1327, 1329 (2006) (adding Section 15E "Registration of Nationally Recognized Statistical Rating Organizations" to the Securities Exchange Act of 1934, 15 U.S.C. § 78o-7).

[34] Dodd-Frank, Title IX, Subtitle C.

and reliable ratings. It concludes that certain proposals for resolving these items would be more likely to tip the balance toward NRSRO Nullification, while other proposals would be more likely to prevent this result, and that the smaller seven are more likely to opt out of Ratings Reform than the Big Three.

In Part IV, I present my central recommendation for resolving the Franken Proposal and new standards of creditworthiness in consonance with the dual goals of promoting accurate and reliable ratings and preventing NRSRO Nullification—adopt a refined version of the rating function suggested by the Franken Proposal, but not the allocating function. In addition, adopt the SEC's current proposal to permit partial reliance by investment fiduciaries on any credit ratings under the new standards of creditworthiness subject to one additional requirement: investment fiduciaries seeking to rely on NRSROs that the rater deems good performers must certify agreement with the rater's methodology for defining accuracy, while investment fiduciaries seeking to rely on non-NRSROs or NRSROs that the rater deems poor performers must publicly explain their disagreement with the rater's methodology or show why certain non-NRSROs, when compared with NRSROs, produce ratings of equal or better quality. Under this proposal, it will not be necessary to close the voluntary registration loophole through a mandatory registration requirement.

I. THE RATING-AGENCY QUESTION

This part provides background to the rating-agency question by discussing what credit ratings are and what it means for them to be inaccurate when made. Then it describes the debate over the rating-agency question and Congress's Ratings Reform solution.

A. What Are Credit Ratings?

Credit ratings are letter- and number-based assessments of risk that are "designed to measure and predict the probability of default, or the expected loss . . . for an individual debt obligation or for an obligor."[35] The ratings scales

[35] U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 9 (2011) [hereinafter SEC 2011 ANNUAL REPORT], *available at* http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf.

typically range from triple-A (denoted by S&P and Fitch as "AAA" and by Moody's as "Aaa")—which represents the least risk of default—to C or D, which represents default or high vulnerability to default.[36] Ratings that fall within the four highest categories assigned (typically "Baa3," "BBB-" or higher) are known as "investment grade," while lower ratings are known as non-investment grade (sometimes referred to as speculative, high-yield or junk). The chart on the following page provides a comparison of the Big Three's long term credit ratings for individual debt obligations.

The CRAs characterize these symbols as forward-looking opinions[37] and not as guarantees of future performance. Moody's states that the CRAs "do not predict which specific bonds within a category are expected to default. Rather, credit ratings communicate that the higher the rating category, the lower the expected frequency of default."[38]

Since ratings are predictions about future risk and are not hard-and-fast facts, a credit rating should not be considered inaccurate when made simply because the rated security performed worse than expected. Good-faith predictions of future risk frequently prove wrong.

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[36] *See, e.g.*, MOODY'S INVESTORS SERV., RATING SYMBOLS AND DEFINITIONS (2011), *available at* http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004; *Credit Rating Definitions & FAQs*, STANDARD & POOR'S, http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us (last visited Mar. 3, 2012); FITCH RATINGS, DEFINITIONS OF RATINGS AND OTHER FORMS OF OPINION (2011), *available at* http://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf.

[37] *See, e.g.*, Letter from Michel Madelain, Chief Operating Officer, Moody's Investor's Serv., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 5 (Dec. 14, 2009), *available at* http://www.sec.gov/comments/s7-25-09/s72509-5.pdf ("[R]atings are inherently and completely forward-looking, rather than backward-looking, in nature.").

[38] *Id.* at 3. Moody's compares its ratings to actuarial predictions made by life insurance companies:

> [A]n actuary would predict that, in the next five years, a 25 year-old non-smoker will be less likely to die than an 80 year-old smoker; nonetheless, in the next five years, some 25 year-old non-smokers will die, while some 80 year-old smokers will survive. Similarly, a rating analyst is predicting that a Ba1 bond will be more likely to default than a Aaa bond; nonetheless, some Aaa bonds will default, while most Ba1 bonds will not default.

Id. at 4.

Moody's[39]	**S&P**[40]	**Fitch**[41]
	Investment Grade	
Aaa	AAA	AAA
Aa	AA	AA
A	A	A
Baa	BBB	BBB
Baa3	BBB-	BBB-
	Non-Investment Grade	
Ba1	BB+	BB+
Ba	BB	BB
B	B	B
Caa	CCC	CCC
Ca	CC	CC
C	C	C
	D	

[39] *See* MOODY'S INVESTORS SERV., *supra* note 36, at 4 ("Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.").

[40] *See* STANDARD & POOR'S, *supra* note 36 ("Ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.").

[41] *See* FITCH RATINGS, *supra* note 36 ("The modifiers '+' or '-' may be appended to a rating to denote relative status within major rating categories.").

B. How Can a Credit Rating Be Inaccurate When Made?

Since any retrospective analysis comparing actual defaults against before-the-fact predictions will show some level of inaccuracy, one must distinguish between those ratings that were inaccurate when made as a result of neglect or bad faith and those ratings that were made in good faith at the outset but only proved inaccurate as a result of naturally occurring market forces. The available evidence identifies at least five different scenarios when neglect or bad faith in the initial production of ratings appears to have contributed to inaccurate ratings.

The first scenario involves the failure of rating analysts to comply with or adhere to available procedures and methodologies for producing credit ratings.[42] For example, two financial economists reported that the CRAs were regularly making subjective adjustments in certain cases rather than following consistent policies.[43] They reported that "'only 1.3% of AAA CDOs closed between January 1997 and March 2007 met the rating agency's reported AAA default standard,' with the rest falling short."[44] They concluded that "the AAA tranches should have been rated 'as approximately BBB' and that if the AAA tranches in their sample of 916 CDOs were so downgraded to BBB, the total overvaluation 'cumulates to $86.2 billion in cost to investors.'"[45] This example suggests that there was a systematic failure to comply with objective procedures and methodologies for producing ratings. Many other examples have also been alleged where the CRAs failed to comply with their own models or failed to implement existing models that would have produced more accurate, but less issuer-friendly, ratings.[46] As recently as September 2011,

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[42] *See, e.g.*, John M. Griffin & Dragon Yongjun Tang, *Did Subjectivity Play a Role in CDO Credit Ratings?*, J. FIN. (forthcoming), *available at* http://ssrn.com/abstract=1364933; *see also infra* notes 46-47 and accompanying text.

[43] *See* Coffee, *supra* note 1, at 242 ("[Credit rating agencies] did not follow a consistent policy or valuation model with respect to subordination, but rather regularly made 'adjustments' on subjective grounds." (citing Griffin & Tang, *supra* note 42, at 17)).

[44] *Id.* (quoting Griffin & Tang, *supra* note 42, at 4).

[45] *Id.* (quoting Griffin & Tang, *supra* note 42, at 4-5).

[46] *See, e.g.*, Claire A. Hill, *Why Did the Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. PITT. L. REV. 585, 593 (2010) ("[R]ather than adjusting the ratings, they 'fixed' the model so the instruments could continue to 'be' AAA."); *see also* Paul Lasell Bonewitz, *Implications of Reputation Economics on Regulatory Reform of the Credit Rating Industry*, 1 WM. & MARY BUS. L. REV. 391, 394 (2010) ("[F]or years Standard & Poor's (S&P) intentionally failed to implement a model its executives knew more accurately reflected the risk of structured debt products . . . .").

the SEC found that "[o]ne of the larger NRSROs reported that it had failed to follow its methodology for rating certain asset-backed securities" and "[a]ll of the NRSROs failed to follow their ratings procedures in some instances."[47]

The second scenario involves the use of identical rating symbols to express grossly different risks.[48] In spite of years of statistical evidence showing that different securities such as corporate bonds and CDOs had grossly different default rates across the same risk symbols, the CRAs did not seek to alert investors to these differences in risk by using different symbols. For example, two financial economists reported "that the five year cumulative default rate on corporate bonds receiving a 'Baa' rating from Moody's between 1983 and 2005 was only 2.2%, but the same five year cumulative rate between 1994 and 2005 on CDOs with a Baa rating was 24%—a more than ten to one disparity!"[49] Similarly, during the financial crisis of 2008, "[r]ating agencies gave triple-A ratings to 75% of the $3.2 trillion subprime mortgages that lost sizable value only months after the ratings were made."[50] Such triple-A ratings signaled to investors a degree of safety commensurate with U.S. treasury bonds. It is troubling that the CRAs used the symbol associated with the benchmark of safe securities to represent securities that proved to be, and perhaps should have always been known to have been, significantly more risky.

The third and most often cited scenario involves the existence of two inherent conflicts of interests: the issuer-pays conflict and the ratings-shopping problem.[51] The issuer-pays

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[47] *See* SEC. & EXCH. COMM'N, 2011 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATIONS OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION 11, 13 (2011) [hereinafter SEC SEPT. 2011 SUMMARY REPORT], *available at* http://sec.gov/news/studies/2011/2011_nrsro_section15e_examinations_summary_report.pdf.

[48] *See, e.g.*, Charles Calomiris & Joseph Mason, *Reclaim Power from the Ratings Agencies*, FIN. TIMES (Aug. 24, 2007, 3:00 AM), http://www.ft.com/intl/cms/s/0/fac2a61a-51d9-11dc-8779-0000779fd2ac.html#axzz1kay98gwj; *see also* Jess Cornaggia, Kimberly J. Cornaggia & John E. Hund, Credit Ratings Across Asset Classes: A ≡ A? (Mar. 1, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1909091 (testing whether credit ratings contain the same information across asset classes and finding that, relative to traditional corporate bonds, "municipal and sovereign bonds receive harsher ratings and structured products receive more generous ratings").

[49] *See Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 5 (2008) [hereinafter *Senate Turmoil Hearings*] (statement of John C. Coffee, Jr.) (citing Calomiris & Mason, *supra* note 48), *available at* http://banking.senate.gov/public/_files/OpgStmtCoffeeSenateTestimonyTurmoilintheUSCreditMarkets.pdf.

[50] Lynn Bai, *The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?*, 7 N.Y.U. J.L. & BUS. 47, 48 (2010).

[51] *See, e.g.*, Coffee, *supra* note 1, at 234. *See generally* Deryn Darcy, Note, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict*

conflict describes the business model where the issuer, rather than the investor, pays the rating agency for a rating. The ratings-shopping problem occurs where issuers shop privately for preliminary (as opposed to final) ratings and award business to the rating agency willing to give it the highest, rather than the most accurate, final rating.[52] Ample evidence supports the notion that such inherent conflicts of interest put unmanaged pressure on the CRAs to inflate ratings in order to maintain their market share. For example, e-mails uncovered by a Senate committee reveal that one Moody's managing director admitted that its behavior in terms of handing out triple-A ratings for mortgage-backed securities made it "either incompetent at credit analysis, or like we sold our soul to the devil for revenue."[53] An S&P official said that its mortgage team had "become so beholden to their top issuers for revenue [that] they ha[d] developed a kind of Stockholm syndrome which they mistakenly tag as customer value creation."[54] One UBS banker warned S&P as follows: "Heard your ratings could be 5 notches back of mo[o]dy's equivalent. This is going to kill your [residential business]. It may force us [UBS] to do moodyfitch only cdos [sic]."[55]

The fourth scenario involves the failure of the CRAs or their proxies to do due diligence.[56] Most cogently, Professor

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Contributed and What Regulators Might Do About It, 2009 COLUM. BUS. L. REV. 605; 156 CONG. REC. S3664, 3673 (daily ed. May 13, 2010) (statement of Sen. Al Franken).

[52] There is also a related conflict of interest associated with client concentration. Issuances of asset-backed securities equaled and then subsequently exceeded those of corporate bonds beginning in 2002 and "the top six underwriters [of asset-backed securities] controlled over 50 percent of the mortgage-backed securities underwriting market in 2007, and the top eleven underwriters each had more than 5 percent of the market and in total controlled roughly 80 percent of this very lucrative market"; thus it becomes clear that a rating agency's market share could be significantly diminished if a small concentration of clients became unhappy and sought to take business elsewhere. *See Enhancing Investor Protection and the Regulation of Securities Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 55-56 (2009) [hereinafter *Enhancing Investor Protection*] (written statement of John C. Coffee, Jr.). By contrast, for corporate bonds, whose ratings have proven far more accurate, "no one client accounted for more than 1% of their business." *See* Coffee, *supra* note 1, at 237.

[53] Gillian Tett, *E-mails Throw Light on Murky World of Credit*, FIN. TIMES (Aug. 25, 2010), http://www.ft.com/cms/s/0/a9da1aa4-508b-11df-bc86-00144feab49a.html#axzz1RSKtZTp5.

[54] *Id.*

[55] *See* 156 CONG. REC. S3664, 3681 (daily ed. May 13, 2010) (statement of Sen. Carl Levin).

[56] *See, e.g.*, John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 170-71 ("Fitch explains that it 'does not audit or verify . . . or . . . perform any other kind of investigative diligence into the accuracy . . . or completeness' of the information it receives." (citation omitted)); Darcy, *supra* note 51, at 617 ("CRAs do not perform their own due diligence."); Paul

Coffee pointed out that CRAs were alone among financial gatekeepers in that they did not conduct "factual verification with respect to the information on which their valuation models rely."[57] He explains that the problem is "that no valuation model, however well designed, can outperform its informational inputs; hence, use of unverified data results in the well-known 'GIGO Effect'—Garbage In, Garbage Out."[58] While the CRAs used to rely on due diligence firms to test the creditworthiness of securitized mortgages, this practice mostly ended after the year 2000 with the CRAs' tacit approval.[59]

The fifth scenario involves "less-than-thorough business practices."[60] According to the SEC, "[w]hen the firms didn't have enough staff to do the job right, they often cut corners."[61] A senior analytical manager at one of the Big Three stated in an e-mail that "[w]e do not have the resources to support what we are doing now."[62] As the CRAs began expanding their coverage of issuances and began taking on more complex instruments, resources to produce each rating with integrity declined.[63] At present, there is a large disparity in staffing resources when comparing the Big Three against the smaller seven NRSROs. While the Big Three each employ over one thousand credit analysts and supervisors, the smaller seven each employ considerably fewer.[64]

Justensen, Note, *Ratings Recall: Will New Reform Proposals Make Lasting Impact?*, 35 J. CORP. L. 193, 201 (2009) ("In 2008, critics again blamed CRAs for substandard due diligence, particularly with respect to the failing mortgage-backed securities that prompted the worldwide credit crisis.").

[57] *See* Coffee, *supra* note 1, at 244.

[58] *Id.*

[59] *Id.* at 241 ("[F]actual verification of the creditworthiness of securitized mortgages largely disappeared after 2000, as investment banks and deal arrangers ceased to pay for such activities, and the CRAs did not insist on their continuation.").

[60] *See* Hill, *supra* note 46, at 594 (citing OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATINGS AGENCIES 2 (2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf).

[61] *Id.* at 595 (citation omitted).

[62] *See* FRANK PARTNOY, RETHINKING REGULATION OF CREDIT RATING AGENCIES: AN INSTITUTIONAL INVESTORS PERSPECTIVE 5 (2009), *available at* http://www.cii.org/UserFiles/file/CRAWhitePaper04-14-09.pdf.

[63] *See id*. ("Rating agencies also began rating substantially greater numbers of issuers and increasingly complex instruments. But the resources expended per rating declined. As they expanded ratings to cover large numbers of structured finance products, including tranches of various collateralized debt obligations, some NRSROs neglected to divert resources to update rating models and methodologies or recruit additional staff needed to ensure quality.").

[64] A.M. Best (120), DBRS (95), R&I (78), JCR (57), Morningstar (24), Kroll (13) and Egan-Jones (5). *See* SEC SEPT. 2011 SUMMARY REPORT, *supra* note 47, at 8.

C. The Debate over the Rating-Agency Question

Billions, and sometimes trillions, of dollars have been alleged to have been lost during the financial crisis of 2008.[65] Congress's account holds that inaccurate credit ratings misled investors with respect to the level of risk they were assuming.[66] Other accounts hold that sophisticated investors over-relied on credit ratings and share equal blame for making the same mistakes as the CRAs.[67] Substantially all agree, however, that inaccurate and unreliable credit ratings on structured finance products[68] were a root cause of the financial crisis of 2008.[69]

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[65] *See* 156 CONG. REC. S3664, 3673 (daily ed. May 13, 2010) (statement of Sen. Al Franken) ("This conflict of interest has cost American investors and pensioners billions of dollars because supposedly risk-free investments have failed or been downgraded to junk status."); *see id*. at S3675 (statement of Sen. George Lemieux) ("We have a chance to address the issue of the rating agencies, because, but for their failure to do their job, we may not have had this debacle that destroyed, as some estimate, $600 trillion worth of wealth.").

[66] Congress found that,

> [i]n the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of the credit rating agencies.

See Dodd-Frank, Pub. L. No. 111-203, § 931(5), 124 Stat. 1376, 1872 (2010).

[67] *See* Hill, *supra* note 46, at 598 (explaining that both market participants and rating agencies "drank the Kool-Aid"); *see* Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis* 9 (San Diego Legal Studies Paper No. 09-015, 2009), *available at* http://ssrn.com/abstract=1430653 ("Without overreliance on ratings, investors would more likely have looked through the complexity of CDO and SIV transactions to the underlying mortgage-backed securities, and prices would have more accurately reflected market estimates of default probability, recovery, and correlation.").

[68] This phenomenon was limited to asset-backed securities (i.e., structured finance products) and not on other types of debt securities. *See, e.g.*, Hunt, *supra* note 56, at 170-71 ("Official reports on the crisis did not indicate that agencies did a poor job in the corporate segment. Indeed, regulatory authorities' studies drew a fundamental distinction between agencies' traditional and structured-finance ratings and criticized only the latter."); Coffee, *supra* note 1, at 236 ("The failure of the CRAs was largely limited to structured financial products. Similar problems have not characterized the ratings of corporate bonds.").

[69] *See* PARTNOY, *supra* note 62, at 13 ("[I]naccurate and unreasonable credit ratings from NRSROs were a primary cause of the recent crisis. . . ."); *see also* Coffee, *supra* note 1, at 232 ("Few disinterested observers doubt that inflated credit ratings and conflict-ridden rating processes played a significant role in exacerbating the 2008 financial crisis."); 156 CONG. REC. S3965, 3977 (daily ed. May 19, 2010) (statement of Sen. Christopher Dodd) ("I agree with my colleagues that erroneous credit ratings on asset backed securities played a central role in the financial crisis and that we need to improve the regulation of credit ratings.").

The critics generally divide into two camps: the Free Market Camp and the Reform Camp.[70] A fundamental difference between the two camps concerns their views over the informational value of ratings, which influences how the camps might ask and answer the rating-agency question.

The Free Market Camp believes that ratings have little informational value and that better indicators of risk are generally provided by market measures such as credit spreads and credit default swap spreads.[71] One study found that credit-default-swap spreads incorporate new risk information more quickly than credit ratings.[72] While they acknowledge that investors frequently rely on ratings to assess the riskiness of their investments, they argue that this type of reliance is misplaced. For these reasons, the Free Market Camp would ask, do assessments of credit risk exist that are more accurate and reliable than credit ratings?

The Reform Camp, on the other hand, believes that ratings still provide valuable information about risk and that such market measures do not provide a superior substitute, especially in the case of complicated and obscure structured finance products. They believe that CRAs are in a better position than any other market actors to assess risk and that, while blind reliance on ratings should be discouraged, measured reliance is justified from an efficiency standpoint as long as regulatory measures ensure that the incentives to produce accurate and reliable ratings are properly aligned with the CRAs' interests. For these reasons, the Reform Camp would ask, how can CRAs, including those who are NRSROs,

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[70] *See* Coffee, *supra* note 1, at 231 ("[R]eformers divide into two basic camps: (1) those who see the 'issuer pays' model of the major credit ratings firms as the fundamental cause of inflated ratings, and (2) those who view the licensing power given to credit ratings agencies by regulatory rules requiring an investment grade rating from an NRSRO rating agency as creating a de facto monopoly that precludes competition.").

[71] A credit spread for a bond is the difference between a bond's yield and the yield of a comparable risk-free bond. Higher yields (and therefore wider credit spreads) reflect the market's view of the relative riskiness of such bond. Credit default swaps are effectively insurance policies that investors can buy to protect themselves against an entity's default. Credit default swap spreads are equal to the premium on such protection. For higher credit risks, the premium would be higher (and therefore the spread would be wider) and *vice versa. See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 624 (1999) [hereinafter *Siskel & Ebert*] (credit spreads); *see also* Mark J. Flannery, Joel F. Houston & Frank Partnoy, *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085, 2088 (2009) [hereinafter *Credit Default Swap Spreads*] (credit default swap spreads).

[72] *See generally Credit Default Swap Spreads*, *supra* note 71.

be encouraged through regulation to produce more accurate and reliable credit ratings?

Professor Partnoy, the leading advocate for the Free Market Camp, historically favored replacing references to NRSRO credit ratings in statutes and regulations with market-based measures such as credit spreads[73] or credit-default-swap spreads.[74] To ease concerns about volatility, he suggested using thirty-to-ninety day rolling averages of such spreads.[75] He has recently advocated, in light of SEC proposals, that a professional judgment analysis taking into account multiple factors including such market measures and credit ratings could also be a viable substitute for sole reliance on NRSRO credit ratings.[76] He has long argued that references to NRSRO credit ratings in statutes and regulations transformed the NRSROs from providers of risk information to sellers of "regulatory licenses."[77] Regulatory licenses are "the valuable property rights associated with the ability of a private entity [such as an NRSRO], rather than the regulator, to determine the substantive effect of legal rules."[78] Since NRSROs were given this quasi-governmental power in a wide variety of contexts, they were effectively guaranteed continued business even if they performed poorly.[79] This partially explains the phenomenon of widespread inaccurate credit ratings during the recent financial crisis and previous crises. If statutes and regulations were to require a different proxy for risk than NRSRO credit ratings, this would remove the power of the NRSROs to grant regulatory

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[73] *See Siskel & Ebert*, *supra* note 71, at 704 (recommending credit spreads in place of credit ratings).

[74] *See generally Credit Default Swap Spreads*, *supra* note 71.

[75] *See* PARTNOY, *supra* note 62, at 17 ("Investors concerned about the volatility of market prices could use 30-day or 90-day rolling averages."). In addition, to ease concerns that market-based credit spreads would only be available after a market for the bond has arisen, he has suggested "pre-issuance estimates of credit spreads (i.e., 'price talk'), in much the same way investors now rely on pre-issuance estimates of credit ratings, which are not issued until the bonds are issued (credit spreads are available at the same time)." *See Siskel & Ebert*, *supra* note 71, at 706 n.391.

[76] *See, e.g.*, Partnoy, *supra* note 67, at 16 (advocating professional judgment analysis to replace sole reliance on credit ratings that would include market measures, such as credit spreads and swap spreads, as one factor of the analysis).

[77] *See* PARTNOY, *supra* note 62, at 2. *See generally Siskel & Ebert*, *supra* note 71. For further discussion of the NRSRO's "power to license" over time see *infra* Parts II.A.2, II.B.2 and II.C.2.

[78] *Siskel & Ebert*, *supra* note 71, at 623.

[79] *See* PARTNOY, *supra* note 62, at 2 ("A regulatory license is a key that unlocks the financial markets. Credit rating agencies profit from providing ratings that unlock access to the markets, regardless of the accuracy of their ratings."). Professor Partnoy also criticizes, and makes suggestions to remedy, the lack of accountability of the credit rating agencies and the lack of competition. S*ee id.* at 14-18.

licenses and might cause the NRSROs to once again depend only on their reputations to maintain business.[80]

Professor Coffee, the leading advocate for the Reform Camp, disputes this view. He argues that credit ratings cannot simply be replaced by credit spreads or other market measures, and it is unrealistic to expect even sophisticated institutional investors to do their own credit analysis in the context of complex and opaque debt instruments such as CDOs.[81] He compares such "'do-it-yourself' financial analysis" to "'do-it-yourself' brain surgery."[82] Under this view, NRSRO-dependent regulatory licenses may actually improve the quality of ratings to the extent they prevent investors from relying on un-established ("fly-by-night") CRAs instead of those with an established track record. Regulatory licenses are viewed as much less problematic since they do not alone explain the dominance of the Big Three NRSROs. Such NRSROs were dominant before NRSRO status was introduced in the 1970s and have remained dominant since the expansion of the NRSRO club from three to ten rating agencies.[83] Professor Coffee argues that the issuer-pays conflict of interest, rather than the relaxation of high standards from the exploitation of regulatory licenses, is the main impediment to accurate ratings.[84] He also touches upon the independent ratings shopping problem that some accounts treat as equally problematic.[85] Professor Coffee argues that the solution to the issuer-pays conflict must "either (1) divorce issuer payment of the CRA from issuer selection of the CRA, or (2) encourage (and implicitly subsidize) an alternative 'subscriber pays' market for ratings."[86] Any solution adopted must realign the incentives of the CRAs so that they are rewarded for accuracy instead of issuer-friendly ratings: "if the incentives

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[80] *See Siskel & Ebert*, *supra* note 71, at 682 ("The regulatory license view is quite simple. Absent regulation incorporating ratings, the regulatory license view agrees with the reputational capital view: rating agencies sell information and survive based on their ability to accumulate and retain reputational capital.").

[81] *See* Coffee, *supra* note 1, at 233.

[82] *Id.*

[83] *See id.* at 248. ("If licensing power alone could explain the dominance of the Big Three, then the newer members of the SEC's NRSRO club should be sharing in a collective oligopoly.").

[84] *Id.* at 232-34.

[85] *Id.* at 255; *see also, e.g.*, 156 CONG. REC. S3955, 3956 (daily ed. May 19, 2010) (statement of Sen. Al Franken) ("Right now, credit rating agencies have incentives to hand out top AAA ratings to every product because they need to maintain their business. If they hand out low ratings, issuers of financial products can go shop around for a higher rating from a different rating agency.").

[86] Coffee, *supra* note 1, at 234.

remain poorly aligned, regulatory oversight alone is unlikely to ensure ratings accuracy."[87]

D. Congress's Solution

While the debate over the rating-agency question has been ongoing for over a decade, reform has often "seemed stuck in an ever-repeating cycle of futility."[88] This came to an end in 2006 when Congress adopted the first leg of Ratings Reform, known as CRARA. While CRARA contained certain free market aspects such the NRSROs' voluntary withdrawal right,[89] it did not heed the advice of the Free Market Camp to rollback regulatory licenses. The clear purpose of CRARA was to "improve ratings quality."[90] It sought to do so through a narrowly tailored regulatory regime.

Unfortunately, much of the damage that CRARA sought to prevent had already been done by the time it became effective on June 26, 2007, and new problems were observed in the financial crisis of 2008.[91] As a result, Congress passed the second leg of Ratings Reform in July 2010 as part of the Dodd-Frank Act. While Dodd-Frank builds on CRARA's Reform Camp architecture, it is a clearer compromise than CRARA between the views of the two camps. It seeks to achieve the Free Market Camp's goal of decreasing reliance on ratings, while at the same time pursuing measures to encourage ratings to be more accurate and reliable.[92] It seeks to do the former by eliminating substantially all NRSRO regulatory licenses on the federal level and replacing them with new standards of creditworthiness by July 2012.[93] It seeks to achieve the latter through a multifaceted approach of heightened regulation, accountability and transparency.[94] The crown jewel of the Reform Camp approach, which has not yet been (and

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[87] *Id.* at 278.

[88] Hill, *supra* note 17, at 133.

[89] *See supra* notes 8, 33.

[90] *See* CRARA, Pub. L. No. 109-291, 120 Stat. 1327 (2006) ("An Act to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.").

[91] *See supra* note 66.

[92] *See* Hill, *supra* note 17, at 143 ("The reform has two important goals. One is to decrease reliance on ratings . . . . The other goal is to improve the quality of ratings.").

[93] *See* Dodd-Frank, Pub. L. No. 111-203, §§ 939-939A, 124 Stat. 1376, 1885-87 (2010).

[94] *See id.* §§ 932-938.

may not be) adopted, is known as the Franken Proposal.[95] It is intended to address the issuer-pays conflict and the ratings-shopping problem by creating a centralized board (the CRA Board) controlled by investors to assign NRSROs to issuers with respect to initial, but not secondary, ratings in order to divorce issuer selection from issuer payment. The CRA Board also would serve as a "rater" of at least some subset of the NRSROs and would increase or decrease rating assignments based on past performance. The SEC must adopt the Franken Proposal or one of its alternatives after delivering its findings and recommendations to Congress no later than July 2012.[96]

II. WHY BE AN NRSRO?

This part examines the question of why a CRA would want to be an NRSRO. It describes the benefits and burdens of being an NRSRO prior to 2006 and in the aftermath of CRARA and Dodd-Frank. It shows that being an NRSRO has become significantly less attractive over time.

A. Pre-2006

Before 2006, the CRAs placed a high value on NRSRO status primarily because it afforded financial and reputational benefits without any significant burdens. It conferred—among other advantages—minimal competition because the club had few members, captive business because of regulatory licenses, and a shield against negligence exposure. These, in turn, brought increased visibility and sent a signal to market that NRSRO ratings had the government's seal of approval as proxies for safety and quality. Investment adviser regulation under the Investment Advisers Act of 1940 (the Advisers Act),[97] which also conferred some reputational benefits, was the only burden of NRSRO status, and it was minimal.

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[95] *See* Solicitation of Comment to Assist in Study on Assigned Credit Ratings, Exchange Act Release No. 64456, at 49 (May 10, 2011) [hereinafter Solicitation of Comment], *available at* http://www.sec.gov/rules/other/2011/34-64456.pdf (includes a copy of the Franken Proposal's proposed provisions in Section 15E(w) of the Securities Exchange Act of 1934 as an appendix [hereinafter the Franken Proposal], as those provisions would have been added by Section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010).

[96] *See* Dodd-Frank § 939F(d).

[97] 15 U.S.C.A. § 80b-6 (West, Westlaw through P.L. 112-71 (excluding P.L. 112-55 and 112-56)).

1. The Exclusive Club

From the early 1900s, when the credit rating business first took shape, through 1975, when NRSRO status was first introduced by the SEC, the Big Three (or their predecessors) were the primary issuers of credit ratings on debt securities.[98] In 1975, the SEC recognized the Big Three as the original NRSROs.[99] While four additional CRAs were later admitted, each of them was subsequently merged with or acquired by the Big Three[100] such that the club only comprised its original three members as of January 2003.[101]

While two additional CRAs joined the club by March 2005,[102] the recognition of new NRSROs was tightly controlled by the SEC.[103] "The single most important factor in the SEC staff's assessment . . . [was] whether the rating agency [was] 'nationally recognized' in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings."[104] As a result, new entrants faced a chicken-and-egg dilemma in becoming NRSROs: "it [was] nearly impossible to obtain clients [without] a track record for reliable ratings, yet such a track record [was] difficult to generate unless one first ha[d] clients."[105]

While the SEC's approach created a high barrier to entry for those outside of the club, it made membership in the club more valuable through exclusivity since fewer members meant less competition. This was especially valuable in light of a market norm by which issuers regularly sought two and sometimes three ratings on an issuance of debt.[106] By one estimate, Moody's and

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[98] *See* SEC REPORT OF 2003, *supra* note 9, at 5. For a history of the NRSROs during the twentieth century, see generally *Siskel & Ebert*, *supra* note 71.

[99] *See* SEC REPORT OF 2003, *supra* note 9, at 8-9.

[100] These firms were (1) Duff and Phelps, Inc.; (2) McCarthy Crisanti & Maffei, Inc.; (3) IBCA Limited and its subsidiary, IBCA, Inc.; and (4) Thomson BankWatch, Inc. *Id.* at 9.

[101] *Id.* at 5.

[102] *See* Dominion Bond Rating Service, Ltd., SEC No-Action Letter, 2003 WL 402819 (Feb. 24, 2003), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/dominionbond022403-out.pdf; A.M. Best Co., SEC No-Action Letter, 2005 WL 711823 (Mar. 3, 2005), *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/am030305.htm.

[103] *See* SEC REPORT OF 2003, *supra* note 9, at 9-10.

[104] *Id.* at 9.

[105] Coffee, *supra* note 1, at 234.

[106] *See* Hill, *supra* note 46, at 590.

S&P held "nearly 80 percent of the market"[107] in 2006. Fitch presumably held most of the balance.[108] Many criticized this lack of competition as lowering the quality of ratings.[109]

2. The Power to License

To distinguish safe securities from risky securities, the SEC needed a measure of safety and quality. The NRSRO concept was developed specifically for this purpose in 1975.[110] In the context of broker-dealer net capital requirements,[111] the SEC sought to encourage broker-dealers to hold "investment grade" securities rather than "non-investment grade" securities by permitting broker-dealers to subtract from their net worth a smaller percentage (known as a haircut) for investment grade securities.[112] This allowed such broker-dealers the benefit of disclosing a higher net capital figure. Since the NRSROs were given the regulatory authority to determine the meaning of the term "investment grade," they were empowered to determine the substantive effect of these rules—in the parlance of Professor Partnoy, they were given the power to grant "regulatory licenses."[113] As a result, market actors, such as broker-dealers, became dependent upon NRSRO ratings in making investment decisions.

After 1975, NRSRO credit ratings became widely incorporated as proxies for safety and quality "in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts."[114] For example, they came to influence the holdings of money market

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[107] 152 CONG. REC. E1957, 1957 (daily ed. Sept. 29, 2006) (statement of Brian Carroll submitted by Rep. Fitzpatrick) ("[O]nly three NRSROs have staff No Action letters: Moody's, S&P and Fitch Inc., with the first two capturing nearly 80 percent of the market.").

[108] *Id.*

[109] *See, e.g.*, 151 CONG. REC. H5255, 5255 (daily ed. June 28, 2005) (statement of Rep. Fitzpatrick) ("Two firms dominate the ratings market with SEC approval and this, Mr. Speaker, creates an uncompetitive marketplace, stifles competition from other rating agencies, lowers the quality of ratings and allows conflicts of interest to go unchecked. It is bad for the market and it is hurtful to individual investors.").

[110] *See* SEC REPORT OF 2003, *supra* note 9, at 5 ("Since 1975, the Commission has relied on ratings by market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the federal securities laws.").

[111] *See* 17 C.F.R. § 240.15c3-1 (2011).

[112] *See* Removal of Certain References to Credit Ratings, Exchange Act Release No. 34-64352, 76 Fed. Reg. 26,550, 26,552-53 (Apr. 27, 2011) [hereinafter SEC April 2011 Release].

[113] *See Siskel & Ebert*, *supra* note 71, at 623.

[114] *See* SEC REPORT OF 2003, *supra* note 9, at 6.

funds,[115] banks[116] and insurance companies.[117] They also allowed issuers of registered securities not widely followed by the market to use short-form registration statements instead of long-forms.[118]

NRSRO-dependent laws and regulations created an artificial demand in the market to obtain NRSRO credit ratings, which meant guaranteed business for the NRSROs. Commentators criticized this "regulatory licensing" power since such guaranteed business did not reward accuracy, but only membership in the NRSRO club: they were "insulated from the standard market penalty for being wrong—the loss of business."[119] As an illustrative example of the financial benefits of such membership, as of December 31, 2006, Moody's reported net income of approximately $754 million[120] and, during that December, its market capitalization nearly peaked at $19.32 billion.[121]

3. The Negligence Shield

In 1981, the SEC reversed a long-standing policy prohibiting the disclosure of credit ratings in registration statements because it believed such ratings would help investors make informed investment decisions about the level of risk they would assume.[122] Such disclosure, however, would have made the NRSROs "experts" under the Securities Act of 1933, which would subject their ratings to negligence exposure under Section 11. Since this would have imposed a higher liability standard on the NRSROs in the context of the sale of

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[115] *See* Investment Company Act Rule 2a-7, 17 C.F.R. § 270.2a-7 (2010).

[116] *See, e.g.*, 12 U.S.C.A. § 1831e(d)(4)(A) (West 2010).

[117] *See, e.g.*, CAL. INS. CODE § 1192.10 (2010).

[118] *See, e.g.*, Form S-3, 17 C.F.R. § 239.13 (2010).

[119] *See* Calomiris & Mason, *supra* 48; *see also* Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 60-61 (Yasuyuki Fuchita & Robert E. Litan eds., 2006), *available at* http://ssrn.com/abstract=900257 (In a minimally competitive environment, such regulatory licenses may therefore be responsible for "generat[ing] economic rents for NRSROs that persist even when they perform poorly and otherwise would lose reputational capital.").

[120] *See* Moody's Corp., Annual Report (Form 10-K) 27 (Feb. 25, 2011) [hereinafter Moody's 2010 Annual Report], *available at* http://www.sec.gov/Archives/edgar/data/1059556/000119312511047974/d10k.htm#tx1118549_23.

[121] *See Moody's Corporation Historical Market Cap Data*, YCHARTS, http://ycharts.com/companies/MCO/historical_data/market_cap?start_month=1&start_day=29&start_year=2005&end_month=1&end_day=29&end_year=2012 (last visited Feb. 14, 2012). Moody's market capitalization reached a peak of $20.81 billion on March 31, 2006. *See id.*

[122] Disclosure of Security Ratings in Registration Statements, Securities Act Release No. 6336, 46 Fed. Reg. 42,024 (Aug. 18, 1981) [hereinafter 1981 Release].

registered debt securities than it would have in any other context,[123] the NRSROs informed the SEC that they would not consent to such disclosure.[124]

Since the SEC was comfortable that the antifraud rules[125] would be sufficient to hold the NRSROs accountable for reckless behavior,[126] it created a shield to protect NRSRO credit ratings disclosed in registration statements from negligence exposure in order to encourage disclosure of such ratings. Non-NRSROs, by contrast, would not benefit from such a shield and would therefore need to consent to negligence exposure for ratings disclosed in a registration statement. This gave the NRSROs a considerable competitive advantage over all other CRAs. Commentators cited this benefit as evidence that the NRSROs were held to a lower standard than other comparable gatekeepers such as lawyers, auditors, and even other CRAs.[127]

4. The Seal of Approval

Because the SEC only allowed a small group of "nationally recognized" CRAs into the club and only gave such CRAs the power to license and a negligence shield, it increased the visibility of these CRAs and sent a signal to the market

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[123] CRAs generally have First Amendment protection from common law negligence claims because credit ratings are thought to constitute a form of speech that is of public concern and therefore entitled to the highest form of protection. *See, e.g.*, *Approaches to Improving Credit Rating Agency Regulation: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Gov't*, 111th Cong. 1-2 (2009) (statement of Eugene Volokh, Gary T. Schwartz Professor of Law, UCLA School of Law), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/volokh.pdf. Under this standard, rating agency speech is protected unless a rating is made with actual malice, meaning "with knowledge that it was false or with reckless disregard of whether it was false or not." *See* N.Y. Times Co. v. Sullivan, 376 U.S. 254, 279-80 (1964). Some have indicated that the actual malice standard equates to the scienter element of a Rule 10b-5 claim, but that a state of mind of negligence is not enough. *See, e.g.*, Letter from Laurence H. Tribe & Thomas C. Goldstein, Legal Consultants to Moody's Investors Serv., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n (Dec. 14, 2009), *available at* www.sec.gov/comments/s7-24-09/s72409-13.pdf.

[124] *See* 1981 Release, *supra* note 122, at 42,027 n.27.

[125] *See id.* at 42,025 & n.1. ("[T]he rating organization would continue to be subject to liability under the antifraud provisions of the Federal securities laws. . . . *See, e.g.*, Section 17(a) of the Securities Act (15 U.S.C. 77q(a)); Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b-5 thereunder (17 CFR 240.10b-5); and Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6).").

[126] *See* PARTNOY, *supra* note 62, at 14 ("Rating agencies have been sued relatively infrequently, and rarely have been held liable.").

[127] *See, e.g.*, Partnoy, *supra* note 119, at 83-84 ("The unique problems associated with [NRSROs] as gatekeepers stem from . . . their lack of exposure to civil and criminal liability. Unlike other gatekeepers, [NRSROs] are explicitly immune to prosecution for certain violations of securities law, including section 11 of the Securities Act of 1933 . . . .").

that their ratings could be relied upon as proxies for safety and quality in consonance with their regulatory functions. Some interpreted this signal as conferring governmental approval on the quality of debt securities, much like a USDA Grade A seal would signify the quality of meat products to consumers.[128] Non-NRSROs, in particular, argued that the "lack of NRSRO status substantially hindered their businesses' rate of growth [since] . . . the marketplace views the NRSRO designation as the equivalent of the 'Good Housekeeping Seal Of Approval.'"[129]

By this account, the government would be responsible for the brand name status of the Big Three. By other accounts, however, NRSRO status itself would not be responsible for such reputational benefits because the Big Three dominated the industry long before NRSRO status came into being. These accounts would attribute the stature of the Big Three to the "reputational capital"[130] they acquired over time after being first movers in the industry.[131]

In the absence of informative disclosure, moreover, the SEC had no meaningful mechanism during this period to actually test the accuracy and reliability of the NRSROs' output. So the reputations of the NRSROs were not based on objective performance measures but merely on industry perceptions. The SEC noted in 2003 that "[w]ithout such an assurance as to the quality of the ratings issued by a rating agency, it would be foolhardy to rely upon ratings as a proxy for credit quality in regulation."[132] Yet, national recognition—and not accurate performance—was the primary qualifying attribute for attaining NRSRO status, and investors relied accordingly on NRSRO ratings as a shorthand for risk. Those outside of the club were excluded from this benefit.

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[128] *See Siskel & Ebert*, *supra* note 71, at 684-86.

[129] SEC REPORT OF 2003, *supra* note 9, at 38.

[130] Reputational capital is a metaphor for the value that a company's reputation has in generating future business. Since a CRA's reputation and ability to maintain future business are on the line each time it issues a rating, the CRA is said to be pledging its reputational capital to generate the confidence of investors. *See generally* JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006) (stating the reputational capital view and recognizing its limits).

[131] *See* Coffee, *supra* note 1, at 263 ("Their supremacy thus seems more based on 'first mover' advantages and the difficulty of entering the field without a proven track record. If, as widely assumed, economies of scale characterize the production of financial information, the first entrant can operate more efficiently and exclude later entrants.").

[132] SEC REPORT OF 2003, *supra* note 9, at 38.

5. Investment Adviser Regulation

Investment adviser regulation under the Advisers Act imposed the sole burden on NRSRO status during the pre-2006 period. Its duties, not narrowly tailored to NRSROs, included filing Form ADV,[133] recordkeeping requirements, and periodic examinations.[134] While the NRSROs were purportedly subject to the same duties as all other investment advisers, they viewed their registrations as voluntary[135] and thought that certain requirements such as the recordkeeping rules did not apply to them.[136] The SEC generally acquiesced to this view.[137] This in turn hampered the SEC's ability to perform meaningful examinations and led the agency to characterize the NRSROs as not subject to much "formal regulation or oversight."[138] Advisers Act regulation, however, did confer one benefit: it sent a message to the market that NRSROs were regulated entities whether or not the SEC was really watching them.[139]

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[133] Form ADV required NRSROs to disclose, among other things, information about its advisory business and other business activities, financial industry affiliations, participations or interests in client transactions, disciplinary history, owners and executive officers and the locations of books and records. It did not require any disclosures specifically tailored to NRSROs such as the disclosure of procedures and methodologies, performance data, rating action histories or a description of the data relied on when forming ratings opinions. *See, e.g.*, Moody's Inv. Servs., Form ADV (Feb. 2005), *available at* http://www.adviserinfo.sec.gov/%28S%282ztk5wovxx43l2wyi11rpdaf%29%29/iapd/content/viewform/adv022005/sections/iapd_AdvIdentifyingInfoSection.aspx?ORG_PK=111146&RGLTR_PK=&STATE_CD=&FLNG_PK=0588E7BC000801480305C5F0024CBAAD056C8CC0.

[134] THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION, 2009 WL 86761, § 21.1 at 1 (2009).

[135] *See* Lowe v. SEC, 472 U.S. 181, 208, 211 (1985). The *Lowe* majority held that a publisher of nonpersonalized investment advice that was circulated broadly to the public fell into an exclusion from the defined term "investment adviser." The reason was that the "publications [did] not fit within the central purpose of the Act because they [did] not offer individualized advice attuned to any specific portfolio or to any client's particular needs." *Id.*

[136] *See* SEC REPORT OF 2003, *supra* note 9, at 20 ("[T]he effectiveness of the Commission's examination being hampered by, among other things, the lack of recordkeeping requirements tailored to NRSRO activities, the NRSROs' assertions that the document retention and production requirements of the Investment Advisers Act of 1940 are inapplicable to the credit rating business, and their claims that the First Amendment shields the NRSROs from producing certain documents to the Commission.").

[137] Memorandum from Ann Nazareth, Dir., Sec. Exch. Comm'n Div. of Mkt. Regulation, to William Donaldson, Chairman, Sec. Exch. Comm'n 5 (June 3, 2003), *available at* http://www.sec.gov/spotlight/ratingagency/baker060403.pdf.

[138] *See* SEC REPORT OF 2003, *supra* note 9, at 4.

[139] *See* HAZEN, *supra* note 134 (describing phenomenon in 1985 that entities such as the NRSROs could have deregistered as investment advisers after the Supreme Court's holding in *Lowe*: "Presumably, these publishers believed it would add to their credibility to be able to state that they were registered with the SEC.").

B. *Post-CRARA (2006–2010)*

After the passage of CRARA in 2006, the ratio of benefits to burdens with respect to the NRSROs began to shift. Between 2006 and 2010, the NRSRO club doubled in size, the NRSROs' power to license began to marginally diminish, and the SEC considered repealing—but ultimately did not repeal—the NRSROs' negligence shield. Congress and the SEC also took measures to negate the perception that such credit ratings had the government's seal of approval. While these measures did little to alter the financial and reputational benefits of NRSRO status (especially for the Big Three), the introduction of NRSRO regulation, which conferred some reputational benefits, added significant new legal burdens to all of the NRSROs.

1. The Expanding Club

In light of critiques regarding the exclusive nature of the NRSRO club, Congress sought to make entry easier through objective standards that relied more on the judgment of investors than on the judgment of the SEC.[140] As a proxy for such investors, Congress required certifications from at least ten non-affiliated qualified institutional buyers that used such ratings for at least three years.[141] Nonetheless, no mechanism was put into place to actually test the accuracy and reliability of the NRSROs' output. By December 2007, the NRSRO club doubled to ten.[142]

In addition, Congress adopted other measures to foster competition. For example, it adopted new performance disclosure requirements to permit the market to compare the performance of different NRSROs[143] and an Equal Access Rule to give lesser established NRSROs an equal opportunity to rate structured finance products by requiring issuers to provide the

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[140] *See* Securities Exchange Act of 1934 § 3(a)(62), 15 U.S.C. § 78c(a)(62) (2006).

[141] *See id.* § 15E(a)(C), 15 U.S.C. § 78o-7(a)(C).

[142] *See Commission Orders Granting NRSRO Registration*, U.S. SEC. EXCHANGE COMMISSION, http://www.sec.gov/divisions/marketreg/ratingagency.htm (last visited June 20, 2011). The new members were R&I, JCR, Kroll (the successor to LACE Financial Corp.), Morningstar (the successor to Realpoint LLC) and Egan-Jones. As of August 10, 2011, no additional credit rating agencies have been admitted to the club. Jeannette Neumann, *Call to Downsize Giants of Ratings*, WALL ST. J. (Aug. 10, 2011), http://online.wsj.com/article/SB10001424053111904480904576498493884494956.html?mod=ITP_moneyandinvesting_0#articleTabs%3Darticle.

[143] *See* Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-59342 (Feb. 2, 2009).

same information to hired and non-hired NRSROs.[144] Since the Equal Access Rule is NRSRO-specific, it represents a new benefit of NRSRO status.[145]

Nonetheless, as of year-end 2010, there had not yet been any tangible impact on competition: the Big Three still issued approximately 97 percent of all outstanding ratings across all categories reported,[146] and in the structured finance product realm, they issued approximately 94 percent of all outstanding ratings.[147] Some studies, moreover, suggested that greater competition was inadvertently producing a race to the bottom,[148] possibly as a result of the issuer-pays conflict and ratings-shopping problem.

2. The First Licensing Rollbacks

In response to criticism over the NRSROs' power to license, the SEC put out three proposals in July 2008 to amend and replace NRSRO-dependent regulatory licenses.[149] These proposals included dismantling regulatory licenses with respect to broker-dealers, funds, and issuers of registered securities. While six commentators supported the proposals, the majority of commentators opposed them.[150]

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[144] 17 C.F.R. § 240.17g-5(a)(3) (2011); *see also* SEC 2011 ANNUAL REPORT, *supra* note 35, at 18 ("[The Equal Access Rule] allow[s] non-hired NRSROs to access information relating to the issuance of structured products that was previously only readily available to hired NRSROs. An NRSRO may then be able to break into the structured finance sector by providing unsolicited ratings on these securities. This would also allow market participants to see differences between credit ratings issued by a non-hired NRSRO and those issued by hired NRSRO and to observe, over time, the differences in the quality of the ratings.").

[145] At present, the Equal Access Rule is being considered as a potential alternative to the Franken Proposal. *See infra* Part III.A. In fact, the majority of commentators on the Franken Proposal prefer enhancing the Equal Access Rule instead of adopting the Franken Proposal. *See infra* text accompanying notes 184-87.

[146] *See* SEC SEPT. 2011 SUMMARY REPORT, *supra* note 47, at 6-7.

[147] *Id.* at 6.

[148] *See, e.g.*, Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?* 36 (Harvard Bus. Sch. Fin., Working Paper No. 09-051, 2010), *available at* http://ssrn.com/abstract=1278150 (claiming that increased competition from Fitch coincided with lower quality ratings from Moody's and S&P).

[149] *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070, 73 Fed. Reg. 40,088 (July 1, 2008); Security Ratings, Securities Act Release No. 8940, Exchange Act Release No. 58071 (July 1, 2008); References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 58070 (July 1, 2008).

[150] *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 60789, Investment Company Act Release No. 28940 (Oct. 5, 2009) [hereinafter SEC October 2009 Release].

As a result, the SEC left all NRSRO regulatory licenses in place except for one: a rule known as the municipal securities exception to the affiliated underwriter prohibition.[151] This first licensing rollback foreshadowed the SEC's proposed approach to the new standards of creditworthiness in the post-Dodd-Frank period by replacing a fund's reliance on an NRSRO's determination of "investment grade" with the professional judgment of its board.[152] Since the NRSROs' regulatory licensing benefit remained substantially intact during this period, substantive damage to the NRSROs cannot be attributed to this rollback. The financial crisis, however, took its toll. As of December 31, 2010, Moody's reported net income of $508 million (down approximately 33 percent from December 31, 2006),[153] and its market capitalization reached a low of $4.72 billion (down approximately 77 percent from its peak) in June 2010.[154]

3. The Negligence Proposals

In light of criticism that the NRSROs were held to a lower standard than similarly situated gatekeepers such as lawyers, auditors, and other CRAs,[155] the SEC issued two releases that together would have repealed the negligence shield for NRSROs and required the disclosure of their credit ratings.[156] This would have forced the NRSROs to consent to

[151] 17 C.F.R. 270.10f-3 (2008). The old NRSRO-dependent rule prohibited registered funds from knowingly purchasing municipal securities from an affiliated underwriter unless they were determined by an NRSRO to be investment grade. *See* SEC October 2009 Release, *supra* note 150, at 23-24.

[152] *See infra* Part II.C.2.

[153] *See* Moody's 2010 Annual Report, *supra* note 120, at 27; *see also* Moody's 2006 Annual Report, *supra* note 120, at 20.

[154] *See Moody's Corporation Historical Market Cap Data*, *supra* note 121.

[155] *See, e.g.*, Concept Release on the Possible Rescission of Rule 436(g) Under the Securities Act, Securities Act Release No. 9071, Exchange Act Release No. 60798, Investment Company Act Release No. 28943 (Oct. 7, 2009) ("NRSROs describe the credit ratings that they provide as opinions with respect to the registrant or security of the registrant, and the Commission notes that other professionals provide opinions upon which investors rely, such as legal opinions, valuation opinions, fairness opinions and audit reports, and we treat these opinions as subject to the Securities Act's provisions for experts, including our requirements that registrants include the consents of such professionals if their reports are referenced in registration statements. It appears to us that NRSROs and other credit rating agencies are experts similar to other parties subject to liability under Section 11 and that it may no longer be consistent with investor protection to exempt NRSROs from the provisions of the Securities Act applicable to experts.").

[156] *Id.*; *see also* Credit Ratings Disclosure, Securities Act Release No. 9070, Exchange Act Release No. 60797, Investment Company Act Release 28942 (Oct. 7,

negligence exposure with respect to their ratings, much as auditors must do with respect to audited financial statements. To the extent that no NRSRO would be willing to consent, however, issuers would not be able to issue registered bonds.[157] Many commentators warned that this would shut down the registered bond market and would likely have a number of other collateral consequences.[158] Fitch pointed out that forced exposure to a negligence standard would defeat the purpose of being an NRSRO.[159] While the majority of commentators expressed an increased willingness to hold the CRAs accountable for their mistakes, most were divided on the utility of this particular set of proposals. To date, the SEC has not acted on it.

4. Attempts to Negate the Seal of Approval

Other criticism suggested that investors placed too much reliance on NRSRO credit ratings.[160] As a result, Congress and the SEC took measures to change the market perception of NRSRO credit ratings. Congress prohibited any representation or implication that any NRSRO "has been designated, sponsored, recommended, or approved, or that the abilities or qualifications thereof have in any respect been passed upon, by the United States or any agency, officer, or employee thereof."[161] The SEC likewise implemented a number of rules to cosmetically remove nonsubstantive references to NRSRO

2009) (discussing proposal that would have replaced the current permissive disclosure standard for ratings with a required disclosure standard).

[157] If credit ratings were required to be disclosed and the CRAs refused consent, issuers would not have been able to issue registered bonds because their registration statements would have contained an omission of a material fact required to be stated therein. This would have subjected such issuers to Section 11 liability.

[158] Commentators warned of the following collateral consequences, among others: a migration from registered deals to unregistered deals (e.g., 144A deals), a contraction in ratings coverage, and less accurate defensive ratings due to incentives favoring caution rather than candor. *See, e.g.*, Letter from Robert E. Buckholz, Jr., Chair, & Trevor Ogle, Sec'y, Comm. on Sec. Regulation, N.Y.C. Bar to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n (Mar. 1, 2010); Letter from Deven Sharma, President, Standard & Poor's to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n (Dec. 14, 2009); Letter from Michel Madelain, Chief Operating Officer, Moody's Investors Servs. to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n (Dec. 14, 2009), *all available at* http://www.sec.gov/comments/s7-24-09/s72409.shtml.

[159] *See* Letter from Charles D. Brown, General Counsel, Fitch Ratings, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n (Dec. 14, 2009) ("The proposal seems to defeat the entire purpose of becoming an NRSRO if one of the perceived benefits of recognition (use of the credit ratings by registrants) creates a significant new liability.").

[160] *See, e.g.*, SEC October 2009 Release, *supra* note 150, at 1 ("NRSRO ratings in Commission rules may have contributed to an undue reliance on those ratings by market participants."); Partnoy, *supra* note 67, at 1.

[161] *See* Securities Exchange Act of 1934 § 15E(f)(1), 15 U.S.C. § 78o-7(f)(1) (2006).

ratings in statutes and regulations.[162] Its initiative explicitly sought to negate the perception of a seal of approval.[163]

The market, however, did not change any of its previous habits due to these signals to stop over-relying on NRSRO ratings, nor did it punish the Big Three in light of the widespread negative media attention focused on them during the financial crisis of 2008. The *Wall Street Journal* pointed out that "[the Big Three's] dominance of the business didn't change after they lost some credibility for being overly optimistic about the performance of thousands of mortgage-related bonds before and during the financial crisis."[164] It also remarked that the market continued to ignore the judgments of lesser established NRSROs such as Egan-Jones.[165] Some attribute this phenomenon to "sticky" market practices, which refers to the strong incentives that market participants have to honor existing market norms, such as relying on the Big Three's credit ratings, even if they appear to be performing poorly.[166] While some may also attribute the phenomenon to the continued dependence on NRSRO regulatory licenses during this period, this does not explain why the other seven NRSROs had so little success in increasing their market share in relation to the Big Three. The most convincing reason for the phenomenon is that "no other ratings firm[s] can come close to matching the number of analysts, broad coverage and decades of experience."[167] Thus, just as the failure of the Big Three during the financial crisis of 2008 did not impact their market share, attempts to negate the government's seal of approval

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[162] These changes were in addition to the aborted proposals to remove regulatory licenses from SEC regulations and the first licensing rollback discussed above. *See* SEC October 2009 Release, *supra* note 150, at 11-14. An example of such a cosmetic change was the test to determine whether an Alternative Trading System (ATS) must be registered as an exchange. This test previously depended upon the number of investment grade and non-investment grade corporate debt securities trading on the ATS. The SEC consolidated these two categories into "corporate debt securities" to remove the superfluous "investment grade" distinction. *See id.* at 7-9.

[163] *Id.* at 36 (The SEC stated that the "initiative [was] designed to address the concern that the inclusion in the Commission's rules and forms of requirements relating to security ratings could create the appearance that the Commission had, in effect, given its 'official seal of approval' on ratings, which could adversely affect the quality of due diligence and investment analysis . . . .").

[164] Neumann, *supra* note 142.

[165] *Id.*

[166] Hill, *supra* note 17, at 144 ("Market practices are sticky, and market actors have strong incentives to abide by them. Even now, after Moody's, Standard & Poor's, and Fitch have done so badly, and when other rating agencies are NRSROs, the Big Three are still highly influential.").

[167] Neumann, *supra* note 142.

had no substantive impact on the Big Three's market share and no positive effect on the growth of the smaller seven.

5. NRSRO Regulation

In light of the SEC's inability to regulate and oversee the NRSROs under the Advisers Act, Congress adopted a new, narrowly tailored regulatory regime for NRSROs. NRSRO regulation imposes substantial new legal burdens on the NRSROs without providing any substantive NRSRO-specific benefits. The new legal burdens include new disclosure obligations,[168] recordkeeping rules,[169] prohibitions on unfair business practices,[170] management of certain conflicts of interest,[171] prohibition of other conflicts of interest,[172] and new and enhanced SEC penalty and examination powers.[173]

Although the new regulatory regime also provides some new legal benefits, such benefits do not bear on the NRSRO Nullification analysis. Two of these benefits were designed to apply equally to all CRAs: protection from SEC or State regulation of the substance of credit ratings and the procedures and methodologies to determine them,[174] and protection against

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[168] Such disclosure obligations include the disclosure of performance statistics, procedures and methodologies, and permitted conflicts of interest. *See* Securities Exchange Act of 1934 §§ 15E(a)(1)(B), (a)(3), 15 U.S.C.A. §§ 78o-7(a)(1)(B), (a)(3) (West 2011). Rules were also adopted requiring disclosure of rating action histories for all credit ratings initially determined on or after June 26, 2007. *See* 17 C.F.R. § 240.17g-2(d)(3) (2011). On a confidential basis, NRSROs must disclose, among other things, a list of their twenty largest clients and various financial statements. *See* Securities Exchange Act of 1934 §§ 15E(a)(1)(B)(viii), (k), 15 U.S.C.A. § 78o-7(a)(1)(B)(viii), (k). The SEC requires such disclosures to be made using Form NRSRO which must be made publicly available on such NRSRO's website. *See* 17 C.F.R. § 240.17g-1 (2011) [hereinafter Form NRSRO].

[169] *See* 17 C.F.R. § 240.17g-2.

[170] *See* Securities Exchange Act of 1934 § 15E(i), 15 U.S.C.A. § 78o-7(i); *see also* 17 C.F.R. § 240.17g-6.

[171] *See* Securities Exchange Act of 1934 § 15E(h), 15 U.S.C.A. § 78o-7(h); *see also* 17 C.F.R. §§ 240.17g-5(a), (b).

[172] *See* 15 U.S.C.A. § 78o-7(h); *see also* 17 C.F.R. § 240.17g-5(c).

[173] The SEC has the power to penalize the NRSROs in that they could lose their NRSRO status or be censured, limited, or suspended if they commit one or more enumerated bad acts, including securities laws violations, felonies or if they fail to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity. *See* Securities Exchange Act of 1934 § 15E(d), 15 U.S.C.A. § 78o-7(d). These powers are in addition to their general powers under the Exchange Act. *See, e.g.*, Securities Exchange Act of 1934 §§ 21, 21A, 21B, 21C, 32, 15 U.S.C.A. §§ 78u, 78u-1, 78u-2, 78u-3, 78ff. The SEC also has examination authority over all records of NRSROs. *See* Securities Exchange Act of 1934 § 17(b), 15 U.S.C. § 78q.

[174] *See* Securities Exchange Act of 1934 § 15E(c), 15 U.S.C. § 78o-7(c) ("Notwithstanding any other provision of this section, or any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate

private rights of action (now repealed).[175] The other benefits include an exemption for the NRSROs from registration under the Advisers Act[176] and the NRSROs' voluntary withdrawal right together with the CRAs' voluntary registration right.[177] The former does not bear on NRSRO Nullification because the SEC has long treated NRSRO registrations as voluntary under the Advisors Act and continues to treat non-NRSRO registrations in the same manner. While the latter permits NRSRO Nullification, it does not, by itself, affect the decision to opt in or out of the regulatory regime. Since this regime is NRSRO-specific, however, regulation under the new regime continues to confer the same, if not an enhanced, reputational benefit as regulation under the Advisers Act did. The new NRSRO-specific legal burdens, on the other hand, impose new costs that weigh in favor of NRSRO Nullification.

C. Post-Dodd-Frank (2010–Present)

After the passage of Dodd-Frank in July 2010, most of the distinct financial benefits of NRSRO status from the previous eras were called into question or removed: the club was no longer exclusive, measures were proposed to increase competition, the power to license was set to be substantially eliminated on the federal level by July 2012, and the negligence shield was repealed (though, as described herein, negligence exposure was not imposed). In addition, the legal burdens of NRSRO status were again increased substantially through heightened regulation. In spite of reputational damage from the financial crisis of 2008, the Big Three's credibility nonetheless appeared to remain mostly intact while the opinions of the other seven NRSROs continued to be mostly

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the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings.").

[175] *See* Securities Exchange Act of 1934 § 15E(m), 15 U.S.C.A. § 78o-7(m) (West 2008), *amended by* Dodd-Frank, Pub. L. No. 111-203, § 933(a), 124 Stat. 1376, 1883 (2010). Dodd-Frank's amendment to section 15E(m) repealed the NRSROs' protection against private rights of action granted under CRARA, which previously read as follows: "Nothing in this section may be construed as creating any private right of action, and no report furnished by a nationally recognized statistical rating organization in accordance with this section or section 17 shall create a private right of action under section 18 or any other provision of law." *Id.*

[176] *See* Investment Advisers Act of 1940 § 202(11)(F), 15 U.S.C.A. § 80b-2(11)(F) (West 2011) (explicitly exempting NRSROs from the definition of investment adviser but not CRAs).

[177] *See* Securities Exchange Act of 1934 § 15E(e)(1), 15 U.S.C.A. § 78o-7(e)(1); *id.* § 15E(a), 15 U.S.C.A. § 78o-7(a).

ignored. It remains to be seen how the two most critical unresolved items—the Franken Proposal and the new standards of creditworthiness—will impact this calculus once they are finalized.

1. The Prospect of a New Elite Club

Since expanding the NRSRO club and other initial measures to foster competition among the NRSROs did not produce tangible results, Congress instead began focusing on a different strategy to increase competition: encouraging the existing members of the club to compete over accuracy. The leading proposal, which has not yet been (and may not be) adopted, is the Franken Proposal.[178] This proposal seeks to increase competition among the existing members of the club by creating an environment where all NRSROs compete over accuracy on a level playing field without having to inflate their ratings to win business.[179] It purports to do this by creating a series of benefits that only accrue to a new elite club for which only NRSROs would be eligible. The members of the new elite club would be known as qualified NRSROs (QNRSROs).[180] To join this new elite club and get these benefits, NRSROs would have to be selected by the investor-controlled CRA Board.[181] The CRA Board would rate the QNRSROs based on their track records for accuracy and reward the best performers, over time, with the most business.[182] This would purportedly encourage a race to the top to issue accurate ratings instead of today's race to the bottom to assign issuer-friendly ratings.[183]

The SEC is also considering five alternative proposals to the Franken Proposal to create incentives for NRSROs to

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[178] *See supra* note 95.

[179] *See* 156 CONG. REC. S3664, 3676 (daily ed. May 13, 2010) (statement of Sen. Charles Schumer) ("[T]he provision Senator Franken is offering and I am proud to cosponsor goes to the heart of the conflict of interest. . . . [T]he smaller rating agencies and investor-paid agencies will have a level playing field to compete against the big three.").

[180] *See* Franken Proposal, *supra* note 95, § 15E(w)(1)(B).

[181] While this new membership requirement creates a new barrier to entry, it appears that such barrier is meant to be exceedingly low to weed out only those NRSROs that are simply unqualified to rate structured finance products. Senator Franken has been clear that one of the express purposes of his proposal is to give the smaller NRSROs a level playing field to compete with the Big Three. *See* 156 CONG. REC. S3664, 3674 (daily ed. May 13, 2010) (statement of Sen. Al Franken) ("Standard & Poor's and Moody's and Fitch do about, what, 94 percent of the business. The other agencies will get a chance because what will be rewarded is accuracy.").

[182] *See* Franken Proposal, *supra* note 95, § 15E(w)(5).

[183] For an analysis of the Franken Proposal and recommendations for improving it, see *infra* Parts III.A.1(i) and IV.A.

compete over accuracy. These proposals include relying only on the existing Equal Access Rule; creating an investor-owned NRSRO to compete with the existing issuer-paid NRSROs; requiring the price-tag for ratings to be split between issuers, secondary market sellers, and investors; legally mandating a user-pays system; and preserving the issuer-pays model but putting the payment decision into the hands of security holders.[184] These proposals vary with respect to the allocation of new NRSRO-specific benefits and burdens.[185] Of these, the large majority of commentators support relying only on the existing Equal Access Rule with certain enhancements, even though no NRSRO has yet used it,[186] while a smaller segment favors implementing a form of the Franken Proposal.[187] None of the other alternatives appear to have gained much traction.

Congress ordered the SEC to study the Franken Proposal and alternative systems and deliver a report by July 2012 with their recommendations.[188] After delivering the report, to the extent necessary or appropriate in the public interest or for the protection of investors, the SEC must establish an assignment system for selecting NRSROs to determine initial credit ratings for structured finance products that prevents the issuer and other issuer-aligned parties from selecting the NRSRO that will determine and monitor initial credit ratings.[189] It must implement the Franken Proposal unless it determines that an alternative system would be better.[190] The resolution of

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[184] *See* Solicitation of Comment, *supra* note 95, at 38-47.

[185] For an analysis of the alternatives to the Franken Proposal, see *infra* Part III.A.1.b.

[186] *See* Letter from Robert Dobilas, President, Morningstar Credit Ratings LLC, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 6 (Sept. 13, 2011) [hereinafter Morningstar Letter], *available at* http://www.sec.gov/comments/4-629/4629-24.pdf ("Since the [Equal Access Rule] became effective, we know of no NRSRO that has issued an unsolicited initial rating as a result of the information available under this rule.").

[187] *See generally Comments on Solicitation of Comment to Assist in Study on Assigned Credit Ratings*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/comments/4-629/4-629.shtml (last visited Jan. 22, 2012) [hereinafter *Comments on Solicitation*].

[188] *See* Dodd-Frank, Pub. L. No. 111-203, § 939F(c), 124 Stat. 1376, 1889 (2010).

[189] *See id.* § 939F(d). Notably, DBRS points out that "[a]lthough Section 939F is awkwardly constructed . . . the correct reading of the provision requires the Commission to make the threshold public interest/protection of investors determination before engaging in any new rulemaking on assigned credit ratings." Letter from Daniel Curry, President, & Mary Keogh, Managing Dir., Regulatory Affairs, DBRS Ltd., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 2 (Sept. 13, 2011) [hereinafter DBRS Letter], *available at* http://www.sec.gov/comments/4-629/4629-21.pdf. This means that the SEC need not adopt a system separating issuer payment and selection to the extent it finds that it is not necessary or appropriate in the public interest or for the protection of investors.

[190] Dodd-Frank § 939.

this item has the potential to bestow important new benefits upon the NRSROs, but it also has the potential to impose significant new burdens.

2. The Elimination of Most Regulatory Licenses

As part of Dodd-Frank, Congress eliminated substantially all NRSRO-dependent regulatory licenses on the federal level effective July 2012 by striking statutory references to NRSRO credit ratings[191] and causing each federal agency to do the same with respect to their regulations.[192] In each case, the relevant federal agencies, such as the SEC, must then replace such references or any "requirement of reliance on credit ratings and . . . substitute in such regulations such standard of credit-worthiness as each respective agency shall *determine as appropriate* for such regulations (emphasis added)."[193] A question remains, however, whether such NRSRO-dependent regulatory licenses will re-emerge unscathed as part of the new standards meant to replace them. Some market participants contend that the requirement to replace such references or any requirement of reliance on credit ratings plainly forbids the federal agencies from incorporating any new form of reliance on NRSRO credit ratings into their new standards of creditworthiness, much like the SEC did with the first licensing rollback.[194] Other market participants, however, interpret the "determine as appropriate" clause to mean that the federal agencies have discretion to incorporate NRSRO ratings as part of the new standards of creditworthiness so long as such incorporation is consistent with Congress's intent to reduce, as opposed to eliminate, reliance on ratings.[195]

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[191] *See id.*

[192] *See id.* § 939A.

[193] *Id.* § 939A(b).

[194] *See, e.g.*, Letter from Dennis M. Kelleher, President & CEO, & Stephen W. Hall, Sec. Specialist, Better Mkts., Inc., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 7 (July 5, 2011) [hereinafter Better Markets Letter] ("The Dodd-Frank Act requires the Commission and other agencies to remove references to credit ratings from their regulations, and to substitute alternative standards of credit-worthiness as each agency deems appropriate. Allowing broker-dealers to continue using credit ratings when assessing credit risk would violate this statutory mandate." (emphasis omitted)).

[195] *See, e.g.*, Letter from Suzanne Rothwell, Managing Member, Rothwell Consulting LLC, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 7 (July 5, 2011) ("It is unclear whether the 'as appropriate' language reflects the intention of Congress that each agency retains some flexibility to continue to rely on credit rating standards in appropriate situations. As reflected in the statement in the Proposing Release, Congress explained that Section 939A of Dodd-Frank is designed '[t]o reduce the

In its proposed new standards of creditworthiness, the SEC has taken the latter view by including partial reliance on NRSRO credit ratings as part of a broader professional judgment analysis.[196] It appears, however, that such partial reliance on NRSRO credit ratings would be permissive—not mandatory—so investment fiduciaries would ultimately decide whether such partial reliance would be appropriate in satisfying their legal duties.[197]

Moreover, it appears that the SEC would not limit such permissive reliance to NRSRO credit ratings.[198] Thus, fiduciaries could equally rely on non-NRSRO credit ratings to the extent they deem appropriate and consistent with their legal duties. Since reliance on credit ratings for these purposes would no longer be limited to NRSROs, this would succeed in eliminating substantially all NRSRO-dependent regulatory licenses on the federal level. Many of the comment letters received to date, especially with respect to the rules governing money market funds, oppose this result and request that the SEC find a way to preserve the NRSRO-dependent rules or lobby Congress to amend Dodd-Frank to this end.[199]

Although NRSRO-specific regulatory licenses may be substantially eliminated on the federal level in the near future, they will not be defunct. A handful of NRSRO-dependent regulatory licenses will still remain on the federal level[200] in

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reliance on ratings.' This explanation appears to indicate that the SEC is only required to 'reduce' rather than 'eliminate' entirely all references to credit ratings.").

[196] *See, e.g.*, SEC April 2011 Release, *supra* note 112, at 11 ("Under the proposed amendments, a broker-dealer, when assessing credit risk, could consider the following factors, to the extent appropriate, with respect to each security: . . . Internal or external credit risk assessments (i.e., whether credit assessments developed internally by the broker-dealer or externally by a credit rating agency, irrespective of its status as an NRSRO, express a view as to the credit risk associated with a particular security . . . .)"); *see also* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Securities Act Release No. 9193, Investment Company Act Release No. 29592, at 9 (Mar. 3, 2011) ("Fund boards of directors (which typically rely on the fund's adviser) would still be able to consider quality determinations prepared by outside sources, including NRSRO ratings, that fund advisers conclude are credible and reliable, in making credit risk determinations.").

[197] *See* sources cited *supra* note 195.

[198] *See* sources cited *supra* note 195.

[199] *See, e.g.*, Letter from Timothy W. Cameron, Managing Dir., SIFMA's Asset Mgmt. Grp., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 2-3 (Apr. 18, 2011) (arguing that ratings provisions should be retained in Rule 2a-7 and supporting efforts to urge Congress to amend Section 939A of Dodd-Frank to retain the references to ratings); *see also* Letter from C. David Messman, Sec'y & Chief Legal Officer, Wells Fargo Funds Mgmt., LLC, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 1 (Apr. 25, 2011) (same).

[200] *See, e.g.*, 12 U.S.C.A. § 1426(c)(6) (West 2011) (depends upon at least one major credit rating agency); *id.* § 1715z-22a(2)(A) (depends upon Standard and Poors or

addition to state NRSRO-dependent regulatory licenses[201] and those in the contracts and other documents of private entities. NRSROs will also continue to benefit from international regulatory licenses though none would bear on the NRSRO Nullification analysis.[202] Thus, a fraction of the previous power to license will continue to be a financial benefit for the NRSROs. Given that the full scope of the regulatory licensing benefit remains unresolved, it is impossible to speculate how the NRSROs' bottom lines may be affected in the future by this impending change.

3. The Repeal of the Negligence Shield

As part of Dodd-Frank, Congress finally repealed the NRSROs' long-standing negligence shield under Section 11 for ratings disclosed in a registration statement,[203] but perplexingly, Congress did not thereby expose the NRSROs to negligence. This is because Congress did not repeal the NRSROs' existing right to refuse consent to negligence exposure,[204] nor did it require that any ratings had to be disclosed (as the SEC considered at one point).[205] As they had threatened to do for some time, the NRSROs withheld their consent to allow issuers to disclose their ratings in future registration statements in order to avoid such exposure.[206] In

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any other nationally recognized rating agency); 29 U.S.C. § 1341(b)(5)(B) (2006) (depends on NRSROs); *id.* § 1083 (builds term "investment grade" into the definition of "corporate bond yield curve."); *id.* § 1306(E)(iv) (references "investment grade corporate bonds"); 20 U.S.C. § 1087-2(d), (r) (2006) (depends on NRSROs); 23 U.S.C. § 601 (2006) (depends on rating agencies defined as NRSROs).

[201] The most significant regulatory licenses that survive Dodd-Frank on the state level are those in insurance regulation. *See* John Patrick Hunt, *Credit Ratings in Insurance Regulation: The Missing Piece of Financial Reform*, 68 WASH. & LEE L. REV. 1667, 1686 (2011) ("If the insurance regulators maintain rating-dependent regulation, then Dodd-Frank's purpose in eliminating credit ratings from federal financial regulation will be substantially frustrated.").

[202] Since NRSRO status is a U.S. legal concept, foreign regulatory schemes and treaties generally do not rely on NRSROs, but rather their own parallel construct. For example, under the Basel III framework, the parallel to NRSROs are external credit assessment institutions or "ECAIs." *See* BASEL COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 52 (2011), *available at* http://www.bis.org/publ/bcbs189.pdf. *But see* SEC REPORT OF 2003, *supra* note 9, at 8 n.22 ("In El Salvador . . . a rating agency can register as a 'classifier of risk' under the country's securities laws if the rating agency is an NRSRO as recognized by the SEC." (citations omitted)).

[203] *See supra* note 29.

[204] *See supra* note 31.

[205] *See supra* note 156.

[206] *See supra* note 32.

spite of some convincing rhetoric that Congress intended negligence exposure through the repeal of the negligence shield,[207] the SEC issued temporary guidance assuring the market that the NRSROs' interpretation of their consent right was correct and that previously required ratings disclosure could henceforth be omitted.[208]

By removing this NRSRO-specific negligence shield, Congress put the NRSROs and non-NRSROs on a level playing field in this respect. As a result, registration statements have generally not included ratings disclosure since the end of July 2010, although issuers have continued to include ratings disclosure in other types of prospectuses.[209] While the repeal of the negligence shield opens up the possibility that CRAs may seek to distinguish themselves from the pack by voluntarily consenting to negligence exposure in the future, there is currently no indication that any would be willing to do so. Since the negligence shield no longer provides a benefit to the NRSROs, however, it removes a distinction that previously weighed against NRSRO Nullification.[210] In addition, Ratings Reform introduced two other forms of heightened liability—

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[207] *See supra* note 29.

[208] *See* Ford No-Action Letter, *supra* note 32 ("[D]isclosure of a rating in a registration statement requires inclusion of the consent by the rating agency to be named as an expert. . . . Pending further notice, the Division will not recommend enforcement action to the Commission if an asset-backed issuer as defined in Item 1101 of Regulation AB omits the ratings disclosure required by Item 1103(a)(9) and 1120 of Regulation AB from a prospectus that is part of a registration statement relating to an offering of asset-backed securities.").

[209] Issuers can disclose credit ratings in free writing prospectuses because such prospectuses do not become a part of the final registration statement and therefore are not subject to Section 11 liability. Such free writing prospectuses can include information, such as credit ratings, even though they are not included in the registration statement. *See* Securities Act of 1933 § 10(b), 15 U.S.C.A. § 77j(b) (West 2011); *see also* 17 C.F.R. §§ 230.408(b), 433 (2011). Typically, such free writing prospectuses are term-sheets filed with the SEC at the time the issuers begin selling their securities. *See, e.g.*, Ford Credit Auto Lease Trust 2011-A, Free Writing Prospectus (June 27, 2011), *available at* http://www.sec.gov/Archives/edgar/data/1524342/000095012311062759/u50533f2fwp.htm (showing credit ratings by Moody's and Fitch). In addition to free writing prospectuses, permissive disclosure of NRSRO credit ratings was also historically allowed in Rule 134 tombstone advertisements without Section 11 liability. *See* Regulation S-K § 10(c), 17 C.F.R. § 229.10(c). The SEC rescinded this rule in July 2011 effective September 2, 2011. *See* Security Ratings, Securities Act Release No. 9245, at 6 (July 27, 2011) ("[W]e are removing Rule 134(a)(17) under the Securities Act.").

[210] There is currently a pending bill in Congress, however, seeking to restore Rule 436(g) and thus reinstate the NRSRO-specific negligence shield. *See* Asset-Backed Market Stabilization Act of 2011, H.R. 1539, 112th Cong. § 2 (2011), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-112hr1539rh/pdf/BILLS-112hr1539rh.pdf.

enhanced SEC penalty powers[211] and exposure to private rights of action under Section 18 of the Exchange Act[212]—that are also NRSRO-specific.[213]

4. The Demise of the Seal of Approval

Dodd-Frank, unlike previous efforts, substantially eliminated references to NRSRO credit ratings on the federal level and, by repealing the negligence shield, eliminated such references in registration statements. The elimination of federal government reliance on NRSRO ratings, which has not yet become effective, would appear to officially sever any perception that NRSRO credit ratings are government-sponsored (at least at the federal level). The elimination of credit ratings from registration statements, moreover, has signaled to investors that the federal government is no longer making it easy for investors to find and rely on such ratings even though they are still available on NRSRO websites and in non-registration statement prospectuses.[214] Moreover, the fact that the NRSROs refused to accept negligence exposure should raise a red flag for investors since the NRSROs themselves do not have sufficient confidence in their ratings to bear this exposure voluntarily.

While the demise of the government's purported seal of approval will significantly reduce the visibility of NRSRO credit ratings in statutes, regulations and registration statements, there has been no shortage of visibility for the Big Three from the media, especially in the realm of debt sold by sovereign nations.[215] Most significantly, S&P sought to make it

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[211] *See* Securities Exchange Act of 1934 § 15E(p)(4), 15 U.S.C.A. § 78o-7(p)(4). Nonetheless, the SEC has indicated that its existing powers under the Exchange Act to "impose fines, penalties, and other sanctions on an NRSRO for violations of Section 15E of the Exchange Act and the rules thereunder" are already "sufficiently broad" such that it is not imposing new fines at this time. *See* Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 64514, at 53 (May 18, 2011) [hereinafter SEC May 2011 Release].

[212] *See supra* note 175; *see also* Dodd-Frank, Pub. L. No. 111-203, § 932, 124 Stat. 1376 (2010) (replacing various references to "furnishing" with references to "filing."). Filing, as opposed to furnishing, brings reports and other documents filed with the SEC (e.g., Form NRSRO) within the purview of liability under Sections 18 of the Exchange Act for false or misleading statements made in such reports or other documents. *See* Securities Exchange Act of 1934 § 18, 15 U.S.C.A. § 78r (West 2012).

[213] Dodd-Frank also lowered the pleading standard in 10b-5 litigation against all CRAs and added a due diligence defense, which will heighten the settlement value and ability to win judgments against the CRAs in future actions and will promote increased due diligence. *See* Dodd-Frank § 933.

[214] *See supra* note 209 and accompanying text.

[215] *See, e.g.*, Stephen Fidler, *Greek Debt Hits a New Low*, WALL ST. J., June 14, 2011, at C3, *available at* http://online.wsj.com/article/SB10001424052702303848104576

abundantly clear that it is at odds with the U.S. government by taking the unprecedented step of downgrading the United States' triple-A credit rating to double-A in August 2011.[216] Tremendous volatility in the stock markets followed. And while Egan-Jones, one of the seven smaller NRSROs, beat S&P to the punch weeks earlier, "[a]lmost no one paid attention."[217] This shows yet again that, in spite of any perceived seal of approval attributed to NRSRO status, the smaller NRSROs do not share this benefit equally with the Big Three. The seal of approval benefit may have always been illusory.

Congress's message, moreover, was not solely that investors and regulators should reduce reliance on ratings. Through heightened regulation and the reintroduction of due diligence, Congress also signaled that the watchdog is now back on guard. This competing message may prove especially salient if the Franken Proposal is adopted. Since QNRSROs would have a new means of regulatory visibility and a new investor-controlled CRA Board to signal the value of NRSRO ratings to investors, this could provide an unprecedented form of visibility and positive press for lesser established NRSROs. It could thereby reverse the long-time reliance on national recognition as a proxy for safety and quality and replace it with an objective assessment of good performance. This might introduce a new investor-sanctioned seal of approval that could provide significant reputational benefits to the best performers.[218]

5. Heightened NRSRO Regulation

In light of the new problems observed during the financial crisis of 2008, Congress adopted a number of

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383660422679124.html?KEYWORDS=Greece+rating (discussing S&P's downgrade of Greece to below investment grade); Patricia Kowsmann, *Portugal's Debt Agency Slams Moody's*, WALL ST. J. (July 8, 2011), http://online.wsj.com/article/SB1000142405270230 3544604576433401104276740.html?KEYWORDS=Greece+downgrade (discussing Moody's downgrade of Portugal to below investment grade); David Weidner, *Rating the Ratings Firms: An "I" for "Ignore"*, WALL ST. J. (Aug. 3, 2011), http://online.wsj.com/article/ SB10001424053111903885604576486780718385072.html?KEYWORDS=weidner+rating (discussing why the market should downgrade Moody's, S&P and Fitch by ignoring them).

[216] *See* Damian Paletta & Matt Phillips, *S&P Strips U.S. of Top Credit Rating*, WALL ST. J., Aug. 7, 2011, at A1, *available at* http://online.wsj.com/article/SB10001 424053111903366504576491421339802788.html?KEYWORDS=SP+downgrade.

[217] *See* Neumann, *supra* note 142.

[218] To make clear that there would be no government seal of approval, the Franken Proposal proposes the following disclaimer: "This initial rating has not been evaluated, approved, or certified by the Government of the United States or by a Federal agency." *See* Franken Proposal, *supra* note 95, § 15E(w)(6).

heightened regulatory measures. These measures once again increase NRSRO-specific burdens without adding any offsetting benefits. Such heightened regulation includes new and enhanced disclosure obligations,[219] new and enhanced recordkeeping rules,[220] additional measures to combat conflicts of interest,[221] the establishment of an Office of Credit Ratings,[222] corporate governance reforms,[223] new qualification standards for rating analysts,[224] new whistle-blower duties,[225] a duty to consider information from sources other than the issuer when making rating decisions,[226] procedures to assess the probability that an issuer will default, clear definitions of symbols used to denote credit ratings, and consistent use of any such symbols.[227] As a result of the expected high costs of compliance, some CRAs that have been considering registration as NRSROs, such as Rapid Ratings,[228] have so far refrained from doing so.[229] A

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[219] *See generally* Securities Exchange Act of 1934 §§ 15E(q)-(s), 15 U.S.C.A. §§ 78o-7(q)-(s) (West 2011). In addition, the SEC has proposed (1) an enhanced Form NRSRO including a new standard format Transition/Default Matrix that all NRSROs would have to use to show performance data; (2) enhanced rating history disclosures for each rating outstanding on or after June 26, 2007; and (3) a new Information Disclosure Form to accompany each rating action, which will include the disclosure of thirteen items that include the main assumptions used in constructing procedures and methodologies, potential limitations of credit ratings, a description of the data relied on for the purpose of determining such ratings and the use of third party due diligence services. *See* SEC May 2011 Release, *supra* note 211, at 56-88, 99-119, 459-63.

[220] *See* SEC May 2011 Release, *supra* note 211, at 315-19 (discussing proposed paragraphs (a)(9) and (b)(12)-(15) to be amended to Rule 17g-2, 17 CFR 240.17g-2).

[221] *See, e.g.*, Dodd-Frank, Pub. L. No. 111-203, § 932(a)(4), 124 Stat. 1376, 1874-76 (2010); SEC May 2011 Release, *supra* note 211, at 25-26, 37-45 (discussing proposed paragraph (c)(8) to Rule 17g-5, 17 C.F.R. § 240.17g-5 and proposed new Rule 17g-8(c), which would be codified at 17 C.F.R. § 240.17g-8).

[222] *See* Securities Exchange Act of 1934 §§ 15E(p)(1), (3), 15 U.S.C.A. §§ 78o-7(p)(1), (3). The Office of Credit Ratings will monitor ratings determinations, promote ratings accuracy, "ensure that such ratings are not unduly influenced by conflicts" and must conduct an annual examination of each NRSRO. *Id.* As of September 30, 2011, this office was not established due to the failure of the House and Senate Appropriations Subcommittees on Financial Services and General Government to provide the necessary approval. *See* SEC SEPT. 2011 SUMMARY REPORT, *supra* note 47, at 8. The proposed CRA Board under the Franken Proposal, by contrast, would likely not have such funding problems since it would be permitted to levy fees periodically from the QNRSROs and QNRSRO applicants. *See* Franken Proposal, *supra* note 95, § 15E(w)(2)(D).

[223] *See* Securities Exchange Act of 1934 § 15E(t), 15 U.S.C.A. § 78o-7(t).

[224] *See* Dodd-Frank § 936.

[225] *Id.* § 934.

[226] *Id.* § 935.

[227] *Id.* § 938.

[228] *See History*, RAPID RATINGS: FIN. HEALTH RATINGS, http://www.rapidratings.com/page.php?25 (last visited Jan. 22, 2012) ("Rapid Ratings may or may not apply for [NRSRO] designation, depending on how the SEC moves forwards on a variety of rule amendment recommendations put forth in June 2008.").

current NRSRO, DBRS, suggestively points out that two current NRSROs, JCR and R&I, have withdrawn their registrations with respect to structured finance products and have thus stopped rating such securities due to the new costs, while another NRSRO, A.M. Best, has curtailed the expansion of its rating activities as a result.[230] Yet another NRSRO, Kroll, advocates for the expansion of the Equal Access Rule, which provides an NRSRO-specific benefit, to include all CRAs.[231] This suggests that Kroll may want the ability to take advantage of this benefit without subjection to the legal burdens of the regulatory regime. Along the same lines, Kroll has described the new disclosure rules as a "disincentive to any credit rating agency considering becoming an NRSRO."[232] Similarly, A.M. Best and Egan-Jones have described the new disclosure rules as "disproportionately hurt[ing]" and "counter-productive for" the smaller NRSROs.[233]

In summation, NRSRO status has become much less attractive than it used to be. Of the three main financial benefits from earlier eras—lack of competition, regulatory licensing power, and the negligence shield—only a fraction of the regulatory licensing power remains and the Equal Access Rule provides a benefit that no NRSROs have yet used. In addition, a reputational benefit remains by virtue of the message sent to the market that such NRSROs are regulated. Nonetheless, the market continues to listen to the opinions of the Big Three and mostly ignores the seven smallest NRSROs, showing that NRSRO status confers no meaningful seal of approval. Finally, the legal burdens of NRSRO status have substantially increased through heightened regulation. While the tipping point towards NRSRO Nullification has not been

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[229] *See* Neumann, *supra* note 142 (Rapid Ratings "decided not to seek SEC approval because of compliance and administrative costs. . . . DBRS [] said it is worried that the costs of complying with tougher disclosures if the rules go through could discourage upstarts from seeking SEC approval.").

[230] *See* DBRS Letter, *supra* note 189, at 8 nn.33-34.

[231] *See* Letter from James Nadler, President of Kroll Bond Rating Agency, Inc. on Release No. 34-64456, File No. 4-629, to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 8 (Sept. 13, 2011) [hereinafter Kroll Letter], *available at* http://www.sec.gov/comments/4-629/4629-15.pdf.

[232] *See* Letter from Jules B. Kroll, Chairman & Chief Exec. Officer, Kroll Bond Rating Agency, Inc., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 11 (Aug. 8, 2011), *available at* http://www.sec.gov/comments/s7-18-11/s71811-36.pdf.

[233] *See* Letter from Larry G. Mayewski, Exec. Vice President, A.M. Best Co., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 2 (Aug. 8, 2011), *available at* http://www.sec.gov/comments/s7-18-11/s71811-39.pdf; Letter from Sean J. Egan, Egan-Jones Ratings Co., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 1 (Aug. 5, 2011), *available at* http://www.sec.gov/comments/s7-18-11/s71811-27.pdf.

reached for any of the club's current members, the evidence suggests that today's NRSROs are paying careful attention to the benefit/burden calculation. Depending on the resolution of today's unresolved items, withdrawal from the club appears to be a realistic possibility.

III. THE IMPLICATIONS OF TODAY'S UNRESOLVED ITEMS

This part identifies and discusses the financial and reputational implications that today's most critical unresolved items—the Franken Proposal and the new standards of creditworthiness—will have on the NRSROs' decision to withdraw from Ratings Reform. It then assesses the impact that today's existing distinctions in concert with such unresolved items will have on this decision and the legal implications of NRSRO Nullification. This part also assesses the extent to which such items and their alternatives will promote accurate and reliable ratings. It concludes that certain proposals for resolving these items would be more likely to tip the balance toward NRSRO Nullification, while other proposals would be more likely to prevent this result, and that the smaller seven are more likely to opt out of Ratings Reform than the Big Three.

A. *Financial and Reputational Implications*

1. The Franken Proposal and its Alternatives

a. The Franken Proposal

Mechanically, the Franken Proposal would require the SEC to create a self-regulatory organization (which could also be a public or private utility),[234] known as the CRA Board, whose directors would be controlled by—and therefore aligned with—the investor community.[235] The CRA Board would determine the QNRSRO club's membership through an application process whereby they would assess, among other things, the institutional and technical capacity of each NRSRO

[234] *See* Dodd-Frank, Pub. L. No. 111-203, § 939F(a)(2), 124 Stat. 1376, 1889 (2010).

[235] *See* Franken Proposal, *supra* note 95, § 15E(w)(2)(C) ("The [CRA] Board shall initially be composed of an odd number of members selected from the industry . . . . [N]ot less than a majority shall be representatives of the investor industry who do not represent issuers . . . not less than 1 member should be a representative of the issuer industry . . . not less than 1 member should be a representative of the credit rating agency industry; and . . . not less than 1 member should be an independent member.").

to issue the required ratings.[236] Unlike the high barrier to entry that prevented non-NRSROs from becoming NRSROs prior to 2006, the QNRSRO barrier is intended to impose an exceedingly low threshold for entry.[237] Its goal of divorcing issuer selection from issuer payment would mitigate the issuer-pays conflict and the ratings shopping problem. The CRA Board would seek to achieve this goal by matching QNRSROs and issuers with respect to the initial rating for a structured finance product that the issuer would presumably purchase in advance.[238] The match would be made through a random assignment system, such as a lottery or rotation, and the CRA Board would rate the best performers and then increase or decrease a QNRSRO's market share in such matches based on accurate performance over time.[239] At least once each year, the CRA Board would assess the performance of the QNRSROs.[240] Issuers would still be free to shop for and purchase second ratings on the open market,[241] and the Equal Access Rule would continue to permit nonhired NRSROs to compete through unsolicited ratings.

This proposal has been met with substantial criticism from the majority of today's NRSROs.[242] In particular, there is a concern that the CRA Board would be poorly suited to determine which NRSROs should be in the QNRSRO club and how assignments should be allocated among them. The smaller NRSROs, for whom the proposal was purportedly developed, are concerned that they will be shut out of the benefits by new conflicts of interest that may favor the Big Three as well as high costs and bias based on their lesser developed track records.[243] Such a club could simply re-entrench the Big Three.[244]

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[236] *See id.* § 15E(w)(3).

[237] *See supra* note 181.

[238] *See* Franken Proposal, *supra* note 95, § 15E(w)(5).

[239] *See id.* ("The [CRA] Board shall . . . evaluate a number of selection methods, including a lottery or rotating assignment system . . . . In evaluating a selection method . . . the Board shall consider . . . a mechanism which increases or decreases assignments based on past performance.").

[240] *See id.* § 15E(w)(7) ("The [CRA] Board shall . . . evaluate the performance of each [QNRSRO], . . . at a minimum, [once per year].").

[241] *See id.* § 15E(w)(9) ("Nothing in this section shall prohibit an issuer from requesting or receiving additional credit ratings with respect to a debt security, if the initial credit rating is provided in accordance with this section.").

[242] *See supra* note 187.

[243] *See, e.g.*, DBRS Letter, *supra* note 189, at 8, 14 (discussing CRA Board's conflicts and arguing that the cost of participating in the Franken Proposal's system would discourage all but the largest rating agencies from even trying); *see* Kroll Letter, *supra* note 231, at 2 ("[W]e question how the Board will evaluate the performance of a

The Big Three are concerned that their dominance could be eroded in a nonmeritorious way[245] and that the CRA Board may be plagued by investor biases.[246]

None, however, appears to take issue with the CRA Board's rating function—only its ability to use this function to allocate ratings business. In fact, many of the NRSROs would seem to support the rating function, because it would provide investors with a new tool to decide which NRSROs to hold in highest esteem.[247]

While some of these concerns may be overstated and could be addressed in the final rule, the widespread concern over the allocating function, especially from the smaller NRSROs, suggests that this cure may be worse than the disease.

The first benefit of the Franken Proposal is that QNRSROs would get a guaranteed percentage of the structured finance market for initial ratings. This guaranteed market

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new NRSRO, such as [Kroll], in a way that enables it to obtain [rating] assignments based on merit.").

[244] *See* Kroll Letter, *supra* note 231, at 2 ("May further entrench the largest incumbents"); Coffee, *supra* note 1, at 258 ("If the Board were to prefer established raters with a demonstrated history of rating accuracy, this would largely perpetuate the existing oligopoly of the Big Three and might subject the Board to criticism for failing to encourage greater competition.").

[245] *See* Letter from Patrick Milano, Exec. Vice President, Operations, Standard & Poor's Ratings Servs., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 3 (Sept. 13, 2011) [hereinafter S&P Letter], *available at* http://www.sec.gov/comments/4-629/4629-19.pdf ("The [Franken Proposal] would effectively treat ratings as a commodity, presuming that all ratings on structured finance products . . . are of equal quality and utility."); *see also* Bai, *supra* note 50, at 50 n.9 (quoting Sen. Christopher Dodd: "Not all the rating agencies are equal . . . . [T]here are different companies of different sizes and needs, and to be choosing rating agencies based on arbitrary choice without considering whether or not the rating agency can actually do the job is my concern." (citations omitted)). Others have expressed similar concerns. *See* Coffee, *supra* note 1, at 258.

[246] *See* S&P Letter, *supra* note 245 ("[T]hose ultimately responsible for selecting NRSROs to perform work may have their own biases. . . .").

[247] *See, e.g.*, DBRS Letter, *supra* note 189, at 2 ("These goals are better served by measures that . . . give investors the tools they need to make informed choices about which credit ratings to employ in making their investment decisions."); Letter from Michel Madelain, President & Chief Operating Officer, Moody's Investors Serv., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 6 (Sept. 13, 2011) [hereinafter 2011 Moody's Letter], *available at* http://www.sec.gov/comments/4-629/4629-23.pdf ("Because investors demand credible (*i.e.* objective, predictive and relatively stable) ratings, . . . issuers are motivated to seek ratings from CRAs that have the best reputations among investors. . . ."); S&P Letter, *supra* note 245, at 11-12 ("By selecting a capable, well-regarded rating agency with a reputation for independence and objectivity, issuers can increase the marketability of their securities."); Morningstar Letter, *supra* note 186, at 4 ("A Section 15E(w) System that examines ratings accuracy and timeliness in the future assignment of ratings will encourage competition among NRSROs to provide the most accurate and timely ratings in order to ensure that they will continue to secure additional business under the Section 15E(w) System.").

share would prove invaluable to any CRA since structured finance products have the proven potential to outpace every other type of debt security and, due to their complexity, such products command justifiably higher prices.[248] On the other hand, exclusion from the QNRSRO club could impose a substantial burden.

The Franken Proposal does not explain how the CRA Board would initially allocate the guaranteed portion of initial ratings business nor how exclusion would be decided.[249] In the free market, as of year-end 2010, the eight NRSROs registered with respect to structured finance products shared the market as follows: S&P (38.98 percent), Moody's (33.57 percent), Fitch (21.34 percent), DBRS (3.34 percent), Morningstar (2.75 percent), A.M. Best (0.02 percent), Egan-Jones (0.00 percent), Kroll (0.00 percent).[250] While these figures show that the Big Three commanded almost 94 percent of this market, such dominance does not seem manifestly disproportionate when taking into account the disproportionately large staffing that the Big Three have compared with the smaller NRSROs. Were we to treat the total staff members at these eight agencies (3,855)[251] as devoted to structured finance ratings only,[252] a proportionate initial allocation of assignments by the CRA Board (assuming all eight were admitted as QNRSROs) *vis-à-vis* staffing would require dividing each agency's total staff devoted to structured finance products by the total staff of all eight agencies devoted to the same. This would produce the following initial allocations: S&P (34.89 percent), Moody's (31.23 percent),

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[248] *See Enhancing Investor Protection*, *supra* note 52, at 55 ("[R]ating structured finance products generated much higher fees than rating similar amounts of corporate bonds. For example, rating a $350 million mortgage pool could justify a fee of $200,000 to $250,000, while rating a municipal bond of similar size justified only a fee of $50,000." (citations omitted)); *see also* Abu Dhabi Comm. Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 167 (S.D.N.Y 2009) ("[T]he Rating Agencies each received fees in excess of three times their normal fees for rating the Cheyne SIV . . . .").

[249] Eight of today's ten NRSROs are registered with the SEC with respect to structured finance products. *See* Solicitation of Comment, *supra* note 95, at 7. Yet only a subset of this group might benefit from the guaranteed business afforded by the CRA Board's system to the extent such NRSROs are not selected to be QNRSROs. *See supra* note 236 and accompanying text.

[250] *See* SEC SEPT. 2011 SUMMARY REPORT, *supra* note 47, at 6-7.

[251] *Id*. at 8.

[252] The actual number of credit analysts and supervisors devoted only to structured finance is not available. Disclosure on Form NRSRO only requires the total number of credit analysts and supervisors and does not distinguish among the five ratings categories: financial institutions, insurance companies, corporate issuers, asset-backed securities (i.e., structured finance) and government securities. *See id.*; *see also* Form NRSRO, *supra* note 168, Exhibit 8.

Fitch (27.20 percent), DBRS (2.46 percent), Morningstar (0.62 percent), A.M. Best (3.11 percent), Egan-Jones (0.13 percent), Kroll (0.34 percent). Accordingly, the Big Three's market share, which would equal approximately 93 percent, would not be meaningfully diluted. Such an allocation, however, would give more work to firms like A.M. Best, Egan-Jones and Kroll, which would help them establish track records for accuracy.

Since the Franken Proposal does not explain how the CRA Board would initially allocate the guaranteed portion of initial ratings nor how it would exclude NRSROs, today's NRSROs understandably have concerns. One potential solution to this problem would be to equate QNRSROs with those NRSROs that are registered to rate structured finance products and require that initial allocations be made in proportion to staffing resources. Form NRSRO could be amended to require the disclosure of the credit analysts and supervisors devoted to each rating category.[253] The institutional and technical capacity test could also be objectified to confirm that it is only meant to weed out NRSROs that are patently unqualified to rate structured finance products. While the smaller NRSROs would likely favor these solutions, the Big Three might actually prefer allowing CRA Board discretion since it could provide a way for investor representatives to filter out NRSROs that the market would not trust. In spite of the Big Three's poor performance during the financial crisis, the market has continued to trust the Big Three, so there is practically no danger that the Big Three would face exclusion from the QNRSRO club.[254] The exclusion of the smaller NRSROs would impose severe financial and reputational burdens, since they would get no market share in initial ratings, which would translate into fewer jobs in the market for second ratings.

The Big Three may also object to allocations in proportion to staffing. Even though this would not meaningfully dilute their current market share, it would encourage smaller NRSROs to hire more credit analysts and supervisors in order to take a larger slice of the pie. This would potentially erode the Big Three's market share in a nonmeritorious way. Any initial allocation, however, would be nonmeritorious since there is not yet an accepted way to

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[253] *Cf. supra* note 252.

[254] *See supra* notes 146-47 and accompanying text.

measure good performance. Merit-based track records for accuracy will take time to develop.[255]

The second benefit of the Franken Proposal for those in the QNRSRO club is that the best performing QNRSROs would be rewarded with bonus assignments on initial ratings. This mechanism would directly reward accurate performance and would permit any subset of the QNRSROs to dominate the field by virtue of their merit.

While initial allocations based on proportionate staffing would not be merit-based, the CRA Board's ability to adjust ratings business in favor of the best performers based on past performance addresses the fundamental problem of non-merit-based allocations. This also addresses any concerns that guaranteed business would remove the incentives of the NRSROs to work hard and produce rigorous and competitive ratings.[256] Thus, merit-based allocations would become the new norm over time, which would confer a significant benefit on the best performing QNRSROs. While it would also impose a burden for the poorer performing QNRSROs, it would provide the proper incentives for such QNRSROs to improve their performance or be penalized.

There is legitimate concern, however, that such allocations will be unfair due to conflicts of interests or plain incompetence. To the extent the CRA Board has subjective discretion to allocate ratings, commentators have pointed out that at least two new conflicts of interest would be introduced: bias in favor of QNRSROs willing to produce more conservative investor-friendly ratings (whether or not justified) since the CRA Board would be controlled by investors;[257] and bias in favor of the Big Three since the CRA Board will depend on fees from the deepest pockets among the QNRSROs for its continued existence.[258] While the final rules could mitigate such new

[255] *See* Letter from Senator Al Franken & Senator Roger F. Wicker, to Honorable Mary Schapiro, Chairman, Sec. & Exch. Comm'n 4 (Sept. 14, 2011), *available at* http://www.sec.gov/comments/4-629/4629-28.pdf ("Of course, these track records would take time to develop. But, over time, it would be possible to effectively judge NRSROs on track records of accuracy.").

[256] *See* 2011 Moody's Letter, *supra* note 247, at 8 ("[S]uch a system may create incentives to conduct the least amount of work and innovation possible to remain in the lottery or rotation system."); *see also* S&P Letter, *supra* note 245, at 2.

[257] *See* S&P Letter, *supra* note 245.

[258] *See* DBRS Letter, *supra* note 189, at 8 ("[I]t is likely to cost at least $300-400 million to operate the Board. Under the best of circumstances, this expense would have to be divided among only four or five rating agencies, and would be in addition to the costs of complying with whatever extra layer of regulation Qualified NRSRO status might entail. At the end of the day, the cost of participating in the Section 15E(w)

conflicts by requiring the metrics for such allocations to be publicly disclosed and based on objectively verifiable performance data, the determination of such metrics is not obvious. The CRA Board would undermine its legitimacy if it appeared to be plagued by new conflicts of interest.

Many in the market are concerned, most saliently, that the CRA Board would be unqualified to discern what accurate performance means and thus could not develop any system to reward or penalize QNRSROs based on past performance. For example, the Investment Company Institute asked, "[W]hat will be the criteria used for determining the 'best performer' for purposes of assigning a rating agency to a new issue? Is an 'A1' rating more correct than an 'A' rating?"[259] The Financial Services Roundtable points out that there are no accepted performance measures, and if investors' preferences and the CRA Board's preferences deviate, investors would be stuck with bonds rated by NRSROs they do not like.[260] S&P altogether "rejects the notion that credit ratings can be 'accurate' or 'inaccurate.'"[261] To the extent the CRA Board is not able to produce a definition of accuracy that the market accepts, the goal of empowering this board to make merit-based allocations would be completely compromised.

At present, some efforts have been made to develop methodologies for defining accuracy. Professor Lynn Bai has provided one example of standards for discerning accurate performance that may be instructive in measuring the performance of the various NRSROs and Professor Coffee has provided another suggestion.[262] In addition, Moody's has identified two methods of measuring ratings accuracy: one ordinal (meaning relative performance) known as Average

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System would be so high that it would discourage all but the largest rating agencies from even trying." (footnote omitted)).

[259] 156 CONG. REC. S3965, 3979 (daily ed. May 19, 2010) (statement of Sen. Christopher Dodd).

[260] Letter from Richard M. Whiting, Exec. Dir. & Gen. Counsel, Fin. Servs. Roundtable, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 15 (Sept. 13, 2011), *available at* http://www.sec.gov/comments/4-629/4629-16.pdf.

[261] *See* S&P Letter, *supra* note 245, at 11.

[262] *See* Bai, *supra* note 50, at 103 ("The default ratio, 'fallen angels' ratio, rating change ratio, and large rating change ratio are used to measure rating agencies' performance."); *see also Senate Turmoil Hearings*, *supra* note 49 (Professor Coffee has suggested that "[t]he SEC should define what 'default' or 'impaired' means so as to include delayed payments, then calculate these rates over five year cumulative periods, and publish its results on its own website. This would enable consumers to engage in a simple, one stop comparison. For smaller institutions (e.g., small pension funds, or college endowments), the in-house financial staff is often thin and only a simplified comparison will enable them to shop effectively.").

Position, and the other cardinal (meaning absolute performance) such as the "investment-grade default rate and the average rating of defaulters prior to default."[263] Bai indicates that ratios measuring default, migration from investment-grade to non-investment-grade, and stability are universally accepted, but other metrics are used without a consensus over their value.[264] Morningstar has suggested that calibrated qualifications "could eliminate any undue influence or the necessity for the CRA Board to make any individual decisions with regard to particular securitization transactions."[265] While such transparency may minimize concerns over conflicts of interest, any system seeking to define accuracy in a business based on future predictions will necessarily come under careful scrutiny, especially by those found to be poor performers. This would suggest that, before there is a consensus in the market over how to measure relative accuracy, any system including an allocating function based on accuracy ratings would be premature.

The final benefit of the Franken Proposal is reputational and indirectly financial. Unless the market has widespread reason to disagree with the rating abilities of the CRA Board, the best performing QNRSROs would be in a better position over time to compete in the market for second ratings than excluded NRSROs and non-NRSROs by virtue of the reputational capital they would develop from the CRA Board's rankings. By publicly rewarding accuracy and thereby communicating to the market a view regarding the agencies that would be most likely to produce accurate initial ratings, such signals would provide a benchmark for accuracy against which the accuracy of second ratings could be tested. This would influence the preferences of investment fiduciaries in relying on NRSROs, since it would provide insight regarding the best performers that is currently hard to identify in the market. These preferences, in turn, would influence the hiring practices of issuers since interest rates on debt securities would be affected in their negotiations with underwriters.

If investment fiduciaries believed in the accuracy of a rating, then they would accept an interest rate commensurate

[263] 2011 Moody's Letter, *supra* note 247, at annex i. "Our principal measure of ratings accuracy is the *Average Position* (AP) of defaulters. Bounded between 0 and 1, AP measures where in the distribution of ratings defaulters were located relative to non-defaulters." *Id.*

[264] *See* Bai, *supra* note 50, at 79-80.

[265] Morningstar Letter, *supra* note 186, at 3.

with the normal range for such rating. If, on the other hand, they believed that a rating may be inflated, they would justifiably demand a premium on the interest rate above the normal range. For example, if an issuer were to hire the worst-performing QNRSRO (or, alternatively, an excluded NRSRO or non-NRSRO) to give a second rating on its securities when it could have hired one of the best-performing QNRSROs, investment fiduciaries would demand a higher interest rate to compensate them for the risk of inflated ratings. They would communicate these preferences to underwriters prior to pricing and such preferences would get incorporated into the pricing negotiations. To avoid this dilemma, issuers would come to prefer hiring the best-performing QNRSROs to give second ratings since this would undermine any such argument about the propriety of a ratings inflation risk premium.

In this way, the CRA Board's rating function would realign the financial and reputational interests of all QNRSROs to favor accuracy. Since the CRA Board would send a signal of credibility into the market, all QNRSROs would be encouraged to produce the most accurate ratings possible to benefit from this signal. Although the poor performers would experience a reputational burden, this would only further incentivize them to improve their performance. Investment fiduciaries, moreover, would generally trust this message since it would come from an investor-controlled board. Since only QNRSROs would be evaluated, the market would encourage non-NRSROs and excluded NRSROs to join the NRSRO and QNRSRO clubs to get this reputational benefit. Opting out of either status, by contrast, would mean sacrificing such reputational benefit. So the rating function would work to keep NRSROs voluntarily regulated (since only NRSROs can be QNRSROs) while at the same time promoting accurate and reliable ratings.

b. Alternatives to the Franken Proposal

As required by Congress, the SEC is also considering five alternative proposals to the Franken Proposal to create incentives for NRSROs to compete over accuracy.[266]

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[266] *See supra* note 95.

i. Rely Only on the Existing Equal Access Rule

The first alternative is to rely only on the existing Equal Access Rule implemented in November 2009.[267] This rule created a mechanism for non-hired NRSROs in the structured finance context to gain equal access to the information that issuers provide to the NRSROs they hire so that such non-hired NRSROs can provide unsolicited second ratings.[268]

While this rule allows non-hired NRSROs to compete in the market for second ratings, and thereby ostensibly helps the lesser known NRSROs develop track records for accuracy, it does not provide a financial patron for such activities.[269] Thus, there is no guarantee that any NRSRO will find it financially rational to take advantage of the Equal Access Rule. Indeed, it appears that no NRSRO has taken advantage of the rule to date.[270] Moreover, they would not be encouraged to do so, since this regime would not reward accuracy. Issuers would continue to provide the primary source of revenue for ratings under this system and NRSROs would be encouraged to please such issuers even in the unsolicited context so that they could potentially gain business from them in the future. Unless this rule were coupled with a rating mechanism, such as that provided by the Franken Proposal, it would only perpetuate today's race to the bottom, since issuers would still prefer to hire NRSROs willing to inflate their ratings, and most investment fiduciaries would not have the ability to forcefully challenge such preferences.

Moreover, the enhancements proposed by the various supporters of this proposal generally do not attempt to solve the problem that non-hired NRSROs cannot afford to give unsolicited ratings for free,[271] nor do they propose how market actors should distinguish the best performing NRSROs from the worst, which is a task "far beyond the means of many

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[267] *See supra* note 144.

[268] *See supra* note 144.

[269] *See* Morningstar Letter, *supra* note 186, at 6 ("We believe that the absence of unsolicited initial ratings primarily results from the costs of providing these unsolicited ratings without adequate compensation and a lack of interest by arrangers and investors in these ratings.").

[270] *Id.*

[271] Morningstar appears to be the only exception: it proposes applying the Franken Proposal's framework to the Equal Access Rule such that "NRSROs could be selected on a rotational basis to provide an unsolicited rating. . . . [and] NRSROs could be compensated on a market-value basis that could represent the average compensation paid by the issuer to the Commission or other organization to the other credit rating agencies rating the same transaction." *See id.* at 7.

insurance companies, pension plans, and other small institutional investors."[272] The proposed enhancements are generally focused on two points: relaxing a rule that non-hired NRSROs must rate one out of every ten deals they review[273] and allowing the disclosed information, which is currently available only to NRSROs, to be made available to all market participants (most pertinently, non-NRSROs).[274]

Reliance only on the Equal Access Rule is effectively a do-nothing approach that does not offer new financial benefits to the NRSROs nor a mechanism to promote accurate and reliable ratings. Moreover, it imposes a financial burden as a condition for competing since lesser established NRSROs would need to find separate funding to provide such ratings. One way to indirectly get separate funding would be to leave the regulatory regime and put such costs savings into unsolicited ratings instead. This might be the thinly veiled motivation behind the suggestion from some NRSROs that equal access should be expanded to non-NRSROs. Thus, adopting this proposal may encourage NRSRO Nullification. This proposal, subject to the suggested enhancements described above, is supported by Moody's, S&P, Fitch and Kroll as well as a number of other non-CRA entities.[275]

ii. Create an Investor-Owned NRSRO

The second alternative is to create an investor-owned NRSRO that would compete with the existing NRSROs. By law, issuers would have to obtain initial credit ratings from the

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[272] James Lardner, *The Ratings Agencies and The Franken Amendment*, DEMOS (Aug. 1, 2010), http://www.demos.org/publication/rating-agencies-and-franken-amendment-key-questions-and-answers-0.

[273] 17 C.F.R. § 240.17g-5(e) (2011). *See* Kroll Letter, *supra* note 231, at 3 (suggesting eliminating requirement that one in ten deals reviewed must be rated); Letter from Karrie McMillan, Gen. Counsel, Investment Co. Inst., to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 6-7 (Sept. 13, 2011), *available at* http://www.sec.gov/comments/4-629/4629-22.pdf (suggesting increasing the number of free peeks from ten to twenty-five since a new entrant might find, for example, that it is not qualified to review the first twelve issuances it reviews); Letter from Richard A. Dorfman, Managing Dir., Head of Securitization, & Christopher B. Killian, Vice President, Securitization Grp., Sec. Indus. & Fin. Mkts. Ass'n (SIFMA), to Elizabeth M. Murphy, Sec'y, Sec. Exch. Comm'n 23 (Sept. 13, 2011), *available at* http://www.sec.gov/comments/4-629/4629-9.pdf (suggesting that only one in twenty deals reviewed be required to be rated).

[274] *See* Kroll Letter, *supra* note 231, at 3 (suggesting equal access should be expanded to all market participants, not just NRSROs); 2011 Moody's Letter, *supra* note 247, at 2 (same).

[275] *See Comments on Solicitation*, *supra* note 187.

investor-owned NRSRO and a second issuer-chosen rating from one of the existing NRSROs. While this solution divorces issuer selection from issuer payment in the initial credit rating context by presumably forcing the issuer to pay for a rating from the investor-owned NRSRO, it does not do so with respect to second ratings. Thus, a monopoly would be created for the investor-owned NRSRO in the market for initial ratings while a fierce competition would be set into motion in the market for second ratings.

Since the market for initial ratings would be monopolized, today's NRSROs would be denied their current market share of initial ratings representing the loss of an important financial benefit. Since this model has no mechanism to reward accuracy, the market for second ratings would be plagued by the same race to the bottom that currently exists for all ratings. Issuers (and perhaps investors), moreover, would likely distrust the ratings from the investor-owned NRSRO for a number of reasons: it may have investor biases since investors own it, it may lack incentives to do high quality work since it would have a monopoly, and it would lack an established track record as a newcomer. As a result, such ratings would not provide a reliable benchmark for accuracy against which the accuracy of second ratings could be tested. So this model would remove an important financial benefit from today's NRSROs (the ability to compete for a share of the initial credit ratings market), and like the first alternative approach, it would not address the conflicts of interest at the heart of the rating-agency question. In the comment letters sent to the SEC, no commentators supported this proposal.[276]

iii. Split the Bill Among Participants

The third alternative does not clarify whether it would permit the issuer to select its preferred NRSRO for initial credit ratings. It only focuses on fees by stating, "an NRSRO would be compensated through transaction fees imposed on original issuance and on secondary market transactions. Part of the fee would be paid by the issuer or secondary-market seller and the other portion of the fee by the investors purchasing the security in either the primary or secondary markets."[277]

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[276] *See id.*
[277] *See* Solicitation of Comment, *supra* note 95, at 44.

It appears that this model intends to split the bill among the issuer, investors and secondary-market sellers, which would presumably mitigate some of the loyalty that the NRSROs feel toward the issuer as their sole client. While this would partially divorce issuer selection from issuer payment, it would not satisfy Congress's requirement that the issuer and issuer-aligned parties may not select the NRSRO that will determine and monitor initial credit ratings.[278]

Moreover, although this proposal partially mitigates the issuer-pays conflict, it does not address the ratings-shopping problem if the issuer would ultimately decide which NRSRO to choose. Thus, there would still be a race to the bottom since this model proposes no mechanism to reward accuracy. As a result, the misaligned incentives and today's *status quo* would persist. This model proposes no other benefits to the NRSROs. In the comment letters sent to the SEC, no commentators supported this proposal.[279]

iv. Institute a User-Pays Model

The fourth alternative involves the institution of a user-pays model. Under this model, the issuer would not pay for any ratings and the full fee would be allocated to users, defined as "any entity that included a rated security, loan, or contract as an element of its assets or liabilities as recorded in an audited financial statement."[280] Such users would be required to enter into a contract with an NRSRO and pay for its rating services.[281]

While forcing investors to buy NRSRO ratings would guarantee business to the NRSROs by effectively reinstituting a new form of NRSRO-dependent regulatory license, the failure of a mechanism to reward accuracy would mean that this model would suffer from today's conflicts of interest in reverse. Although it eliminates the issuer-pays conflict, it introduces in its place a user-pays conflict and merely reverses the ratings shopping problem. Under this model, some users would shop to select the NRSROs most willing to deflate (rather than inflate) ratings at the lowest prices.[282] While this might benefit investors in the short-term by driving up interest rates on

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[278] *See supra* note 189.
[279] *See Comments on Solicitation*, *supra* note 187.
[280] *See* Solicitation of Comment, *supra* note 95, at 46.
[281] *See id.*
[282] *See* PARTNOY, *supra* note 62, at 12 (Some institutions "might press the rating agencies for lower ratings in hopes of receiving higher returns.").

relatively safe securities, this type of artificial ratings deflation could significantly raise the cost of capital for issuers which could have unforeseen macroeconomic consequences in much the same way that artificial ratings inflation did during the financial crisis of 2008. Since this model would only offer new financial benefits to those NRSROs most willing to please investors rather than those most able to produce accurate ratings, it would simply flip today's problems instead of address them. In the comment letters sent to the SEC, no commentators supported this proposal, although one commentator provided a detailed alternative user-fee system.[283]

v. Institute an Investor Designation Model

The fifth alternative would be an investor designation model. Under this model, the security holders would select the NRSRO or NRSROs that would get paid and the amount of payment while the issuer would pay the NRSRO or NRSROs according to such directions. This would successfully divorce issuer selection from issuer payment in the market for initial ratings in keeping with Congress's mandate. Instead of the Franken Proposal's CRA Board making rating assignments in advance to a specific NRSRO, however, the NRSROs would choose to do the work before knowing whether they would be compensated and, if so, how much. After the work is done, the security holders would make the compensation decision "based on their perception of [the] research underlying the ratings."[284] They would vote in proportion to their holdings and the payment would be made according to such instructions from a deposit (presumably equal to the cost of one rating) that the issuer would have placed in advance with a third party administrator as opposed to the CRA Board under the Franken Proposal. There does not appear to be any requirement that the security holders would have to consider long-term performance data in allocating such payment.

This model would not only fail to reward accuracy, but would also perpetuate the same financial burden that plagues the Equal Access Rule: the prospect of uncompensated work. Not only would there be no guaranteed minimal level of business, but the NRSROs would be asked to spend time and

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[283] Letter from Jeffrey Manns, Assoc. Professor, George Washington Univ. Law Sch. (Sept. 13, 2011), *available at* http://www.sec.gov/comments/4-629/4629-25.pdf.

[284] *See* Solicitation of Comment, *supra* note 95, at 45.

resources to produce ratings without any guarantee of payment in whole or in part. Moreover, as with the user-pays model, this model reverses the ratings shopping problem by putting the payment decision into the hands of interested security holders, even though the payment source would be the issuer. Since such security holders would not have to consider the long-term accuracy of each NRSRO's rating performance when deciding which NRSROs to pay, they would be encouraged to pay the NRSROs that have given the most deflated ratings in such offering since that would translate into higher interest rates benefiting the security holders in the short-term. The familiar race to the bottom would persist, financial benefits would only accrue to those NRSROs able to win the affection of the most security holders and one new financial burden (uncompensated work) would be imposed. In the comment letters sent to the SEC, no commentators supported this proposal.[285]

In summary, none of the alternatives to the Franken Proposal that the SEC is currently considering would offer NRSRO-specific benefits that are comparable to those offered by the Franken Proposal: none would guarantee today's NRSROs any particular level of business, reward accurate performance through bonus business or provide an investor-controlled signal of credibility. Nonetheless, most NRSROs are concerned that the allocating function would do more harm than good, though all would appear to support the rating function. While the Equal Access Rule has broader support than the Franken Proposal, such support lacks a strong foundation since this rule, like the other alternatives proposed, would not promote accurate and reliable ratings nor work to prevent NRSRO Nullification without being paired with a rating feature. While it cannot be known if the adoption of any of these alternatives in place of the Franken Proposal would cause a tipping point towards NRSRO Nullification, all would fall short of the Franken Proposal in preventing it.

2. The New Standards of Creditworthiness

Since the SEC's proposals for the new standards of creditworthiness do not require, but only permit, reliance on NRSRO credit ratings as part of a broader professional judgment analysis, the SEC's proposed new standards would

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[285] *See Comments on Solicitation*, *supra* note 187.

succeed in eliminating the NRSROs' power to license under the federal securities laws since the NRSROs would no longer have a mandate to determine creditworthiness. Instead, their ratings would become one factor, if a factor at all, in an investment fiduciary's separate credit determination. This would effectively shift the responsibility for such credit determinations from the NRSROs (to the extent they were previously responsible) to the appropriate investment fiduciary in each case. Although some market participants have argued that the federal agencies would be defying Congress's intent by incorporating any new form of reliance on NRSRO credit ratings, voluntary reliance by fiduciaries is not prohibited. Congress's mandate would only prevent the SEC from incorporating a "requirement of reliance."[286] Since requiring reliance would violate Congress's intent by effectively reinstating regulatory licenses through the back door, I analyze the federal agencies' three other options with respect to the incorporation of NRSRO credit ratings into the new standards of creditworthiness: prohibiting reliance on NRSRO credit ratings, permitting reliance on only NRSRO credit ratings, and permitting reliance on any credit ratings.

The first option, advocated by some, would be to prohibit reliance on NRSRO credit ratings altogether under the new standards of creditworthiness.[287] While the federal agencies could hypothetically prohibit such reliance, they would need to have an adequate substitute to replace credit ratings. While the Free Market Camp has put forward some creative possibilities, such as thirty-to-ninety day rolling averages of credit spreads and credit default swap spreads,[288] a chorus of commentators appears to agree that such market measures would not be a sufficient replacement.[289] This likely explains the shift in the Free Market Camp to a professional judgment analysis that would include permissive partial reliance on both market measures and credit ratings.[290]

[286] Dodd-Frank, Pub. L. No. 111-203, § 939A(b), 124 Stat. 1376, 1887 (2010).

[287] *See* Better Markets Letter, *supra* note 194, at 7.

[288] *See supra* note 75 and accompanying text.

[289] *See, e.g.*, Hill, *supra* note 17, at 143-44 ("Something else is to replace these references. . . . The problem is that there is no ready alternative."); *see also* Coffee, *supra* note 1, at 233 ("Alternatives to credit ratings, such as credit default swap spreads, provide at best only a partial substitute."); SEC REPORT OF 2003, *supra* note 9, at 39 ("[T]he volatility of credit spreads, their backward-looking nature, and the fact that their use would be limited to liquid securities, make them an inferior alternative to credit ratings.").

[290] *See* Partnoy, *supra* note 67, at 16.

The second option would be to permit voluntary reliance on only NRSRO credit ratings as part of a professional judgment analysis. This would raise the question of whether such reliance should be limited to NRSRO credit ratings or should apply equally to all credit ratings. If such reliance were limited to NRSRO credit ratings only, this would provide a significant benefit for the NRSROs, because investment fiduciaries seeking to rely in part on credit ratings would be limited to only the NRSRO pool. On the downside, however, such a policy would discourage upstart CRAs that might have the potential to outperform today's NRSROs. In effect, it would reinstate the chicken-and-egg problem that characterized the NRSRO designation process prior to 2006.[291] In addition, this solution might unduly limit the ability of fiduciaries to fulfill their legal duties in accordance with their own professional judgment. On the one hand, investment fiduciaries would be told to take ultimate responsibility for their investment decisions; on the other hand, to the extent they rely on ratings, they would be told to only rely on NRSRO ratings. This would seem inconsistent with the new law's approach of heightening the investment fiduciary's responsibility. While this solution would work to prevent NRSRO Nullification, it would not be in sync with the alternative answer to the rating-agency question: professional judgment.

The third option would permit voluntary reliance on any credit rating as part of a professional judgment analysis. This would achieve the law's purpose of placing greater responsibility on the professional judgment of investment fiduciaries and less on NRSROs. By not limiting fiduciaries to only NRSRO ratings, such fiduciaries would be free to ignore credit ratings altogether or rely in part on either NRSRO or non-NRSRO ratings as part of their professional judgment analysis. Since no adequate substitute for ratings appears to exist, most would likely opt to rely in part on the ratings that would help produce the highest return and best support for such fiduciary's legal duties.

This comports with the SEC's general proposal, which is to permit fiduciaries to rely in part on any credit ratings, whether or not they are NRSRO credit ratings.[292] This levels the playing field for NRSROs and non-NRSROs by allowing both to compete to

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[291] *See supra* note 105 and accompanying text.
[292] *See supra* note 196.

produce credit ratings that fiduciaries would want to incorporate into their analyses. This would solve the chicken-and-egg problem and would be in sync with the new law's approach of heightening the investment fiduciary's responsibility.

Such an approach, however, has two potential downsides: it might encourage NRSRO Nullification and could lead to certain moral hazards. The former could be a potential problem because this approach would not distinguish between NRSROs and non-NRSROs. To the extent a CRA's ratings would be equally in demand as an NRSRO or non-NRSRO, there would be no reason to stay regulated. So any solution must counter this incentive. The latter could be a problem since it presents the potential moral hazard that investment fiduciaries may choose to "cover themselves" by relying blindly or purposefully on poor performing NRSROs or non-NRSROs to maximize returns. For example, if a fiduciary, such as a money market fund manager, is required to invest in only safe securities (i.e., highly rated securities), such a fiduciary, in breach of his duties, might buy securities with higher yields that it believes or should believe are riskier so long as they have the desired safety rating given by some CRA.[293] In good times, if such securities do not default, a fund manager would appear to be outperforming his competitors. In bad times, however, such a fund manager might experience large losses and seek to deflect blame under the cover of a "diligent analysis" and partial reliance on credit ratings commensurate with safety. While a professional judgment test is supposed to prevent excessive risk taking by requiring reliance on other factors in addition to credit ratings, it is not supposed to end risk taking altogether. Proving a breach of fiduciary duty under these circumstances would be very hard since the principals would have no way of checking the professional judgment analysis of their fiduciaries and courts would not want to second-guess private decision making fraught with inherent risks.[294]

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[293] *See* Coffee, *supra* note 1, at 259 ("[T]here is the even more sinister danger that many institutions (in particular, money market funds) wanted inflated ratings so that they could earn the higher returns from riskier securities.").

[294] Traditionally the business judgment rule has protected the investment decisions of fiduciaries relying on investment grade ratings, though this reliance defense may be weakened now. *See id.* at 266 ("Today, if a money market fund's board suffers a major loss on an investment, it will very likely be protected by the business judgment rule (and not be held liable) if an NRSRO ratings agency gave the flawed security an investment grade rating."). *But see* PARTNOY, *supra* note 62, at 6 ("The accountability of NRSROs has deteriorated so much that institutional investors now are vulnerable if they rely on credit ratings in making investment decisions. To the

Interestingly, the rating function from the Franken Proposal could provide a potential solution to both NRSRO Nullification and the moral hazard problems described above. To the extent that the rater only evaluated the disclosed performance statistics of NRSROs (and not non-NRSROs) to tell fiduciaries and ultimate investors which NRSROs are the best performers, this would work against NRSRO Nullification by causing such fiduciaries to prefer NRSRO over non-NRSRO ratings since the accuracy of the former would be better known to the market. To the extent non-NRSROs would not be rated, they would not benefit from the rater's reputational signal. This would work to negate NRSRO Nullification and encourage NRSRO registration since any perceived incentive to leave the regulatory regime would be undermined by the reputational benefit a CRA could get through a rating.

Such a rater could also mitigate the moral hazard of investment fiduciaries choosing to rely on poor performing NRSROs and non-NRSROs to maximize their returns. Since the rater would be opining about which NRSROs are the best performers, investment fiduciaries choosing to ignore such opinions may strike up suspicion among their ultimate investors. Certifying agreement with the rater's methodology for defining accuracy and acting in accordance with such opinions, by contrast, would send the opposite message to investors. However, an investment fiduciary eager to show it is not blindly relying on either credit ratings or the rater may have good reason to ignore such signal. In the case of disagreement with the rater's methodology, the SEC could require that investment fiduciaries explain their reasons for relying on ratings from non-NRSROs and ratings from those NRSROs that the rater considers to be poor performers. This would create a market-based counter-mechanism to check the methodology of the rater and would work against blind reliance on the opinions of such a rater. A requirement that agreement with such methodology must be certified would similarly work against blind reliance. By combining freedom to rely on any ratings with a requirement that agreement with the rater's methodology for determining accuracy be certified and

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extent rating agencies are not subject to liability, an institutional investor's defense of reliance on ratings is weakened, because constituents can argue that ratings are less reliable when rating agencies are not accountable for fraudulent or reckless ratings."). Nonetheless, so long as they have done some private due diligence in addition to relying on credit ratings and have a rational basis for their decision, proving a breach of the duties of care or loyalty would likely be hard to do.

disagreements with the rater's methodology or reliance on non-NRSROs be explained, the law's purpose of heightening the investment fiduciaries' responsibility would be achieved. It would also mitigate the potential moral hazard because investment fiduciaries would have to justify their reliance on either the rater's pronouncements or their own dissenting conclusions in order to satisfy their legal duties.

In sum, while the SEC's proposals for the content of the new standards of creditworthiness would substantially eliminate an important NRSRO-specific financial benefit on the federal level (NRSRO-dependent regulatory licenses), permissible reliance on such ratings as part of a broader professional judgment analysis preserves the opportunity for NRSROs to still capture much of this benefit, even if investment fiduciaries can equally rely on non-NRSRO ratings. Moreover, there appear to be ways to heighten the responsibility of investment fiduciaries without encouraging NRSRO Nullification or otherwise encouraging fiduciaries to take excessive risks that would be contrary to the interests of their principals.

3. Existing Distinctions

At present, there is a sufficient equilibrium between the benefits and burdens of NRSRO status that has kept today's NRSROs from surrendering their NRSRO status, even though some non-NRSROs have chosen not to join the club as a result of the current balance. In assessing whether the impact of today's most critical unresolved items will cause a tipping point toward NRSRO Nullification, the existing benefits and burdens of NRSRO status must be taken into account. The two primary NRSRO-specific benefits that remain are reputational and financial benefits by virtue of the message an NRSRO sends to the market in being regulated and the persistence of NRSRO-specific regulatory licenses. The Equal Access Rule also provides an informational benefit to NRSROs. In addition, two primary NRSRO-specific burdens also remain in the form of the costs of being regulated and heightened liability exposure as a result of the SEC's enhanced penalty powers and exposure to private rights of action. While these benefits and burdens appear to sufficiently cancel each other out at the present, they could become increasingly important in concert with the resolution of today's most critical unresolved items.

First, all ten NRSROs derive an intangible reputational benefit from the message that regulation sends to the market.

This benefit, however, would be more valuable to the Big Three than the other seven NRSROs because Ratings Reform was put into place on account of the Big Three's past performance. Moreover, the Big Three, unlike the other seven, have been subject to widespread negative media attention as a result of their role as major culprits in the lead-up to the financial crisis of 2008. Ratings Reform therefore signals the return of the watchdog, which has likely restored a good deal of investor confidence in the Big Three. Therefore, were any of the Big Three to leave the regulatory regime, this would produce headline news that might lead to a public outcry. Since such an outcry could severely damage or destroy the Big Three's reputations, it would be unlikely that they would risk NRSRO Nullification even if the costs of remaining regulated were high. Thus, for the Big Three, the reputational benefits of regulation weigh heavily against NRSRO Nullification.

By contrast, Ratings Reform was not put into place for the other seven, nor have they received much criticism or media attention. If any of the other seven opted out of Ratings Reform, the public would be unlikely to react strongly, if at all. The public may not appreciate the important role that the other seven play in mitigating the importance of the Big Three. As a result, the reputational benefits of remaining regulated would weigh considerably less in any calculation favoring NRSRO Nullification by the other seven NRSROs than it would for the Big Three.

Second, all ten NRSROs have the opportunity to derive financial benefits from all pre-Dodd-Frank regulatory licenses through July 2012 and such remaining regulatory licenses (which are mostly on the state and private levels) thereafter. This benefit too, however, is more valuable to the Big Three than the other seven. In spite of the Big Three's poor performance during the recent financial crisis, "sticky"[295] market practices suggest that the Big Three will continue to be the primary beneficiaries of such regulatory licenses unless a rater is put in place to send clear signals that better performers should be hired instead. In the absence of a rater or the Franken Proposal's CRA Board, there would be few new opportunities for the smaller seven to gain market share. To the extent the smaller seven could do comparably good business outside of the regulatory regime, the existence of some

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[295] *See* Hill, *supra* note 17, at 144.

fraction of today's NRSRO-specific regulatory licenses may not stop them from opting out.

Third, all ten NRSROs have the opportunity to benefit from the Equal Access Rule. This rule, however, is meant to favor the smaller seven over the Big Three. Since it provides equal information to non-hired NRSROs, it is supposed to level the playing field for the smaller seven since they are hired less frequently than the Big Three. In reality, it has only provided a marginal benefit, if any benefit, since taking advantage of the rule has not been cost-effective.[296]

Fourth, all ten NRSROs must pay the cost of complying with Dodd-Frank's heightened regulatory regime, whereas non-NRSROs are exempt from these costs. This burden also applies differently to the Big Three and other seven NRSROs since the Big Three, as bigger companies, have larger economies of scale to afford such expenses. For the smaller NRSROs, such costs are therefore relatively higher. As a result, NRSRO Nullification would be more attractive in respect of the compliance cost savings for the smaller seven NRSROs than for the Big Three. So this factor, too, would more readily drive the other seven to NRSRO Nullification than any of the Big Three.

On balance, the current equilibrium suggests that the seven smaller NRSROs are in a more fragile position than the Big Three with respect to NRSRO Nullification. While many of these seven have fought hard for many years to gain NRSRO status, it was more valuable in the past than it is now. Although a sufficient equilibrium currently exists to keep such NRSROs regulated, the resolution of the most critical unresolved items could tip today's balance, especially with respect to the seven smallest NRSROs, if the burdens continue to increase and the benefits continue to decrease.

B. Legal Implications

In addition to the financial and reputational implications discussed above, the NRSROs would not withdraw from the regulatory regime unless it made legal sense. There are two potential legal implications of NRSRO Nullification that may work to deter its exercise: forced registration and regulation under the Advisers Act, and new legislation to force registration and regulation under Ratings Reform.

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[296] *See supra* note 186.

To the extent that any subset of the NRSROs left the Ratings Reform regime, the SEC could force registration and regulation under the Advisers Act without requiring new legislation. This, however, would be undesirable. First, prior to CRARA, the SEC and the case law both took the position that CRAs were not required to be registered as investment advisers.[297] Second, while CRARA only granted an exemption from the Advisers Act to NRSROs, the SEC has not mandated that any non-NRSROs register under the Advisers Act.[298] Third, the Advisers Act was almost completely ineffective in terms of regulating the NRSROs prior to CRARA.[299] Thus, even though withdrawal from NRSRO status might open the door to capturing such newly minted non-NRSROs under the term "investment adviser,"[300] doing so would not replicate the intended benefits to society of Ratings Reform—accurate and reliable ratings—and therefore would not be desirable.

A second possibility is forced registration and regulation under Ratings Reform. While this would require new legislation, it would be a more desirable option than Advisors Act regulation. Congress could supplement the NRSROs' voluntary withdrawal right and the CRAs' voluntary registration right by adopting a mandatory NRSRO registration requirement based on external criteria. Such a requirement could force the CRAs meeting specified criteria to register (or stay registered) and thereby capture such agencies within the web of Ratings Reform. This would mean that NRSROs would not only have to accept the financial, reputational and legal burdens that exist today, but they might also be prevented from avoiding new burdens adopted in the future. This could serve to reverse or prevent NRSRO Nullification.

But how far can the government reach in forcing regulation upon CRAs that are non-NRSROs? Under Congress's commerce power, it can regulate "the use of the channels of interstate commerce . . . the instrumentalities of interstate commerce, or persons or things in interstate

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[297] *See supra* notes 134-36 and accompanying text.

[298] Based on multiple investment adviser searches on the SEC website, it appears that non-NRSROs do not register as investment advisers. For example, neither Rapid Ratings, Pacific Credit Ratings, Global Credit Ratings, nor Dagong are registered as investment advisers. The keyword "rating" produces no results corresponding to any of today's non-NRSROs. *See Investment Adviser Search*, SEC. & EXCHANGE COMMISSION, http://www.adviserinfo.sec.gov/(S(feasnj50jnhzmaljbhw4goio))/IAPD/Content/Search/iapd_Search.aspx (last visited Jan. 18, 2012).

[299] *See supra* notes 135-37 and accompanying text.

[300] *See supra* note 176.

commerce, . . . [and] those activities having a substantial relation to interstate commerce."[301] Thus, Congress could not reach (nor would it want to reach) all of the approximately seventy-six global non-NRSROs, since most are foreign entities that operate primarily outside of the jurisdiction of the United States.[302] For those non-NRSROs that rate debt securities traded within the United States, however, Congress would likely have wide latitude in imposing Ratings Reform if it chose to do so, especially since there would be no First Amendment concerns.[303] Whether or not ratings themselves propose commercial transactions,[304] they become indelibly linked with commercial transactions (the sale of debt securities) that form a part of the core of American capitalism. Especially in light of the role of credit ratings in the financial crisis of 2008, it is likely beyond debate that credit ratings substantially affect interstate commerce. Moreover, Congress has explicitly found that "the activities of credit ratings agencies are fundamentally commercial in character."[305] While the courts do not always afford deference to Congress's findings with respect to commerce,[306] any CRA that rates debt securities traded within the United States would be fighting an uphill battle to challenge prospective legislation on the basis that its ratings are noneconomic activity (i.e., merely speech) that do not substantially affect interstate commerce.

Furthermore, the securities laws already include precedents for such mandatory requirements. For example, every issuer engaged in interstate commerce, in a business affecting

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[301] *See* United States v. Lopez, 514 U.S. 549, 558-59 (1995).

[302] For example, Peru's Pacific Credit Ratings operates primarily in Latin America. *See* PCR: PAC. CREDIT RATING, http://www.ratingspcr.com/acerca.php (last visited Aug. 14, 2011) ("We operate in Latin America . . . ."). South Africa's Global Credit Ratings Co. operates primarily in Africa, though it is seeking to expand to other non-U.S. markets. *See Global Credit Rating Co.*, FIN. MARKETS DIRECTORY, http://www.fmd.co.za/data/M01732/M01732.htm (last visited Jan. 18, 2012) ("Having firmly established a market leadership position in Africa, a major thrust has been to establish a similar position in South America, Eastern Europe, Asia and the Middle East, via a combination of acquisitions, alliances, and organic growth.").

[303] Ratings Reform does not reach the content of CRA speech. *See supra* note 174.

[304] Some have argued in the commercial speech context that credit ratings are merely opinions about commercial transactions that do not themselves propose commercial transactions. *See, e.g.*, Letter from Laurence H. Tribe & Thomas C. Goldstein, Legal Consultants, to Moody's Investors Serv., *supra* note 123, at 2 ("NRSRO ratings . . . are independent evaluations that do not propose any transaction.").

[305] *See* Dodd-Frank, Pub. L. No. 111-203, § 931, 124 Stat. 1376, 1872 (2010).

[306] *See* United States v. Morrison, 529 U.S. 598, 617-18 (2000) (limiting Congress's ability to regulate noneconomic activity based on Congressional findings that it created a substantial effect on interstate commerce).

interstate commerce, or whose securities are traded by any means or instrumentality of interstate commerce can be captured by the public company reporting rules by the mere existence of two external criteria: total assets exceeding $1,000,000 and a class of equity securities held by five hundred or more holders.[307] Similarly, beneficial owners of equity securities of public companies can be forced to make certain disclosures by merely exceeding a 5 percent ownership threshold.[308]

By analogy, Congress could devise similar legislation based on one of these two precedents to similarly capture CRAs in the web of Ratings Reform based on external criteria. For example, Congress could put into place a ratings market share threshold expressed as a percentage of total outstanding ratings in each ratings class (similar to the 5 percent beneficial ownership threshold)[309] or a fixed number based on total ratings outstanding in each ratings class (similar to the public company reporting threshold).[310] This way, the requirement would only force registration and regulation for those CRAs producing more than a de minimis number of ratings in each class.

Currently, the SEC has identified five different rating classes: financial institutions, insurance companies, corporations, asset-backed securities (i.e., structured finance products), and government, sovereign, and municipal securities.[311] As of year-end 2010, each of the Big Three rated more than 1,600 debt securities in each ratings class and held at least 8 percent of the market share of each ratings class.[312] While A.M. Best had approximately 26 percent of the market in insurance company ratings, no other NRSRO had more than 8 percent of the market in any other ratings class and only two other NRSROs (DBRS and Kroll) held more than 7 percent in a different rating class.[313] In each ratings class, however, at least

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[307] *See* Securities Exchange Act of 1934 §§ 12(g), 13(a), 15 U.S.C.A. §§ 78*l*(g), 78m(a) (West 2011). The Jumpstart Our Business Startups Act (JOBS Act), which was signed into law on April 5, 2012, alters the thresholds that trigger registration of an issuer's securities under Section 12(g) of the Securities Exchange Act of 1934, including a different threshold for banks and bank holding companies. *See* Pub. L. No. 112-106, §§ 501, 601, 126 Stat. 306 (2012).

[308] *See* 15 U.S.C. § 78m(d).

[309] *See id.*

[310] *See id.* §§ 78*l*(g), 78m(a).

[311] *See id.* § 78c(a)(62)(B).

[312] *See* SEC SEPT. 2011 SUMMARY REPORT, *supra* note 47, at 6-7.

[313] *Id.*

five NRSROs rated one hundred or more debt securities, and at least four NRSROs rated one thousand or more debt securities.[314]

These statistics, however, do not include non-NRSRO ratings and therefore do not reflect the entire universe of CRA credit ratings. Thus, to the extent Congress seeks to adopt such a mandatory NRSRO registration requirement based on external criteria, it would need to gather information about total outstanding ratings in each class from all CRAs engaged in interstate commerce or affecting interstate commerce. From these figures, it could devise a threshold meant to require at least four or five CRAs in each class to register as NRSROs such that there would be sufficient competition and comparative data available in each ratings class to dampen the impact that the Big Three could have on any segment of the market.

Using the figures from the SEC's most recent summary report on NRSROs[315] and treating them as the entire universe of CRA credit ratings for illustrative purposes, a percentage threshold of outstanding ratings in each class would need to be set at 0.05 percent for each ratings class in order to capture five CRAs in each class and 0.06 percent for each ratings class in order to capture four CRAs in each class. If a fixed number threshold is used instead, one hundred credit ratings in each ratings class would capture five CRAs in each class, while one thousand credit ratings would capture four in each class.

While such a threshold would close the voluntary registration and withdrawal loophole by preventing or reversing NRSRO Nullification, it would not address the underlying goal of Ratings Reform to encourage accurate and reliable ratings. Therefore, to the extent Congress considers adopting a mandatory registration requirement based on external criteria, it must also couple any such measures with a mechanism, such as the rating function of the Franken Proposal's CRA Board, to promote accurate and reliable credit ratings.

In summation, the most critical items that remain unresolved—the Franken Proposal and the new standards of creditworthiness—in concert with existing distinctions based on NRSRO status could lead to a tipping point in favor of NRSRO Nullification for at least some of today's NRSROs to the extent these measures continue to increase NRSRO-specific burdens without providing NRSRO-specific benefits. The resolution of

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[314] *Id.*

[315] *See id.*

these items could also prevent NRSRO Nullification if they provide sufficient benefits to avoid the tipping point. Congress could prevent or reverse NRSRO Nullification by adopting a mandatory NRSRO registration requirement based on external criteria that could force regulation upon a sufficient segment of the CRAs to keep Ratings Reform intact, but this would only be a partial solution since it would not, by itself, promote accurate and reliable ratings.

IV. RECOMMENDATIONS

In this final part, I present my central recommendation for resolving the Franken Proposal and new standards of creditworthiness in consonance with the dual goals of promoting accurate and reliable ratings and preventing NRSRO Nullification: the SEC should adopt a refined version of the rating function suggested by the Franken Proposal—but not the allocating function. In addition, the SEC should adopt its current proposal to permit partial reliance by investment fiduciaries on any credit ratings under the new standards of creditworthiness, subject to one additional requirement: investment fiduciaries seeking to rely on NRSROs that the rater deems good performers must certify agreement with the rater's methodology for defining accuracy, while investment fiduciaries seeking to rely on non-NRSROs or NRSROs that the rater deems poor performers must publicly explain their disagreement with the rater's methodology or show why certain non-NRSROs, when compared with NRSROs, produce ratings of equal or better quality. Under this proposal, it will not be necessary to close the voluntary registration loophole through a mandatory registration requirement.

A. *Create a Rater of the NRSROs, Not a Rater and an Allocator*

My central recommendation is that the SEC should create a rater of the NRSROs, not a rater and an allocator.[316]

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[316] It must be acknowledged that this recommendation has also been advanced by Professor Lynn Bai and Senators Carl Levin and Tom Coburn. *See* Bai, *supra* note 50, at 101 ("[T]he Franken Proposal should be modified in a way such that the primary function of its board would be not to allocate rating jobs for the credit rating industry, but to closely monitor and rank the performances of its players and make this information freely accessible to the investment community."); *see also* CARL LEVIN, CHAIRMAN & TOM COBURN, RANKING MINORITY MEMBER, U.S. PERMANENT SUBCOMM. ON INVESTIGATIONS: COMM. ON HOMELAND SEC. & GOV'T AFFAIRS, WALL

The Franken proposal, by contrast, would put both functions in place. This would avoid the difficult problems created by the allocating function, which function is generally opposed by the precise constituents it is meant to support—the smaller NRSROs. These problems include how to choose the QNRSRO club's membership and how to allocate on a meritorious basis without becoming subject to conflicts of interest or choosing a system that the market thinks is wrong. The rating function, on the other hand, which serves the same underlying goals, would likely find widespread acceptance.

To the extent that the allocating function may eventually be appropriate, there is one primary reason that it is currently premature: there is no consensus on how to measure the relative accuracy of one NRSRO's performance against another's. The Franken Proposal's CRA Board, however, would be well positioned to credibly develop a set of such metrics and to test their acceptance in the market. This is because, as a board controlled by investor representatives, it would be naturally aligned with the interests of investment fiduciaries and ultimate investors.

A distinction nonetheless must be drawn between using such metrics to influence the market and using them to make the market. The rating function would have the effect of doing the former, while the allocating function would have the effect of doing the latter. Since it is predictable that some investment fiduciaries will disagree with whatever metrics are proposed by the CRA Board, such disagreements should also be given room to be tested in the market. Over time, there may be a convergence over the best available methods for ranking NRSROs based on accurate ratings. Since none yet exists, the allocating function should not yet be adopted.

The rating function, on the other hand, should be adopted because, standing alone, it would nonetheless promote accurate and reliable ratings. It would do this by putting investment fiduciaries in a stronger position to influence the hiring decisions of issuers. Although only the allocating

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STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 316 (Apr. 13, 2011) ("The SEC should use its regulatory authority to rank the Nationally Recognized Statistical Rating Organizations in terms of performance, in particular the accuracy of their ratings."), *available at* http://www.ft.com/cms/fc7d55c8-661a-11e0-9d40-00144feab49a.pdf. To this author's knowledge, the ratings inflation risk premium hypothesized in this article that would motivate issuers to prefer hiring the better performing NRSROs on account of the rater's pronouncements is a novel rationale for this recommendation.

function would directly address the issuer-pays conflict by separating issuer payment of the NRSRO from issuer selection,[317] the rating function would put information into the market that does not currently exist about which NRSROs are the best performers.[318] Investment fiduciaries, through underwriters, could use this information during pricing negotiations to penalize issuers for choosing poor performing NRSROs or non-NRSROs. They could demand an interest rate premium to compensate them for ratings inflation risk. To avoid paying such a premium, issuers would come to prefer hiring the most accurate performers since this would undermine any argument that such a ratings inflation risk premium would be appropriate. This would change the game because rating accurately, instead of rating generously, would become good business.

The rating function would also work to prevent NRSRO Nullification so long as the rater only rated NRSROs and not non-NRSROs, took into account all NRSRO ratings (i.e., solicited and unsolicited) and made such accuracy ratings, including the metrics used, publicly available. Such refinements could easily be built into the Franken Proposal's current architecture. This would add significant value to becoming an NRSRO because it would allow agencies to credibly distinguish themselves based upon their superior ability to rate accurately. This would produce more market visibility and more business for the best performers. Opting out of NRSRO status, by contrast, would mean losing this important benefit.

Since the other alternatives that the SEC is considering have no mechanism to promote accurate and reliable ratings nor would they work to prevent NRSRO Nullification, a

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[317] *Cf. supra* note 189.

[318] It must be observed that, independent of whether the SEC creates a rater to interpret performance data, it is requiring the disclosure of such data. *See supra* note 219 and accompanying text. This will allow investors to analyze the same data as any such rater and thereby develop competing accuracy rankings, which is likely a daunting and meticulous task. This author hypothesizes that the interplay between the rater and the market's check and balance on the rater is the best way to create a consensus over the meaning of relative accuracy. In the absence of a rater and a requirement that investors double-check the rater's methodologies, investors may not have sufficient motivation to develop in-house views about which CRAs are the best performers in spite of the new disclosure requirements. Even if sufficient motivation exists for investors to compete among themselves to create accuracy rankings, the various conclusions of innumerable investors may be too scattered to meaningfully influence the hiring decisions of issuers. A rater would help focus the debate about which CRAs are the best performers by providing an objective benchmark on behalf of all investors.

modified form of the Franken Proposal adopting only this refined rating mechanism is justified.

B. Permit Partial Ratings Reliance Under the New Standards

In addition, the SEC should adopt its current proposal to permit partial reliance by investment fiduciaries on any credit ratings under the new standards of creditworthiness subject to one additional requirement: investment fiduciaries seeking to rely on NRSROs that the rater deems good performers must certify agreement with the rater's methodology for defining accuracy, while investment fiduciaries seeking to rely on non-NRSROs or NRSROs that the rater deems poor performers must publicly explain their disagreement with the rater's methodology or show why certain non-NRSROs, when compared with NRSROs, produce ratings of equal or better quality.

Partial reliance on credit ratings is necessary because there is no adequate substitute in the market to replace credit ratings. Investment fiduciaries, moreover, should not be limited to considering only NRSRO ratings because this would undermine the law's purpose in shifting responsibility for determining creditworthiness from the NRSROs to the relevant investment fiduciary in each case. Since the rater I propose would only rate NRSROs, and not non-NRSROs, this limitation should negate any perverse incentives by the NRSROs to opt out of the regulatory regime simply because investment fiduciaries would be permitted to rely on non-NRSRO ratings.

My proposal would also promote accurate and reliable ratings. By requiring investment fiduciaries to certify agreement with the rater's methodology for defining accuracy or to explain disagreements with the rater's methodology or reliance on non-NRSROs, a countermechanism would be introduced into the market to check such rater's pronouncements. This would directly address the Franken Proposal's most serious flaw: the allocation of ratings business based on an accuracy standard that the market does not accept. This "certify or explain" rule would harness the professional judgment of investment fiduciaries in the service of accuracy. While there is currently no accepted definition of accuracy in the market, the collective effort of the rater and the community of investment fiduciaries will help bring one into existence. At the same time, it will work against the moral hazards that investment fiduciaries may be relying blindly on the opinions of the rater or ignoring its signals with impunity.

C. *Consider Closing the Loophole*

Finally, given this article's focus on the threat posed by the NRSROs' voluntary withdrawal right, it is necessary to consider whether this voluntary registration and withdrawal loophole should simply be closed. While I assess this possibility elsewhere,[319] under the central recommendation I advance, closing the voluntary registration and withdrawal loophole by adopting a mandatory registration requirement is not necessary because a rater will produce sufficient financial and reputational benefits for today's NRSROs to prevent NRSRO Nullification. While closing the loophole would be an even more definitive way of preventing NRSRO Nullification, it would not work to promote accurate and reliable ratings by itself and would therefore only be a partial solution. In addition, closing the loophole would require new legislation by Congress, whereas my central recommendation only requires action on the part of the SEC. There is value, in any event, to leaving this particular loophole open: it sends a signal to the NRSROs to stay voluntarily regulated because mandatory regulation is always looming as an option.

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[319] *See supra* Part III.A.3.