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Credit Rating Agencies and Regulatory Reform

Aline Darbellay and Frank Partnoy
1. Introduction

The law and economics of credit ratings has been a topic of increasing importance and interest. A decade ago, few scholars were interested in the study of ratings from either a theoretical or empirical perspective. Yet in recent years, research in the area has become prolific. One reason for this increase in interest was the prominent role credit rating agencies played in the recent financial crisis (Crouhy et al. 2008; Mathis et al. 2009; White 2009; Griffin & Tang 2009; Hill 2010a). In particular, various commentators have raised questions about the role of rating agencies in the proliferation of structured finance products (Alexander et al. 2007; Hunt 2009).

One important area of research has addressed the unusual hybrid gatekeeper role played by the rating agencies as a cross between government and private providers of rating services. Historically, ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs) have been part of a wide range of regulatory and contractual requirements in the United States and abroad. As legal requirements for ratings have proliferated, some have argued that the rating agencies have evolved from information providers to purveyors of “regulatory licenses” (Partnoy 1999). As this argument goes, NRSROs profit from providing ratings that unlock access to the markets, regardless of the accuracy of their ratings.

Moreover, behavioral reliance on ratings reinforces regulatory reliance (Partnoy 2009b; Hill 2010b). The most intriguing example of behavioral reliance is the extensive use of ratings in private contracting. Ratings are widely used as a contractual signal of a borrower’s creditworthiness. Rating triggers can give counterparties the right to require the posting of collateral based upon a rating downgrade (IOSCO 2003). Contractual clauses can accelerate the repayment of an outstanding loan if the rating falls below a certain level. As a consequence, a rating downgrade can cause a company to default under the terms of its debt covenants (Macey 2002).

In this paper, we describe some of the leading research and ideas related to credit ratings, and we assess several related regulatory proposals. Some of these proposals are new; others are not. We include proposals that became law on July 21, 2010, when President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203 (2010)). Policymakers in the United States and abroad continue to consider measures to make rating agencies more accountable and rating processes more transparent. Proposals to overhaul credit rating agency regulation run the gamut, from increased disclosure requirements to removing references to ratings in rules and regulations. Lawmakers in the European Union have developed a new European credit rating agency regulatory authority (Regulation (EC) No. 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies). In the aftermath of the financial crisis, credit rating agency regulation has also been considered as an important topic by financial market regulators in Japan, Hong Kong, Australia, Mexico and Canada.

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1 Ratings dictate the net capital requirements of banks and broker-dealers, the securities money market funds may hold, and the investment options of pension funds. On a global scale, the Basel II and III Accords explicitly recognize rating agencies, and the standardized approach assigns a prominent role to ratings to measure bank capital requirements (Weber & Darbellay 2008; Alexander et al. 2010).

(Rousseau 2009; IOSCO 2010). One theme, reflected in Section 931 of the Dodd-Frank Act, has been that the “gatekeeper” role of rating agencies justifies a similar level of public oversight and accountability as the role played by other gatekeepers such as securities analysts and auditors.

Two leading sets of regulatory ideas cover oversight and accountability. First, with respect to oversight, one proposal, partially advanced by the Dodd-Frank Act, is to create a new regulatory body with the power to regulate rating agency practices, including disclosure, conflicts of interest, and rating methodologies. We describe and assess the advantages and disadvantages of such an approach. Second, with respect to accountability, the regulatory approaches have largely involved deference to the judiciary in a relatively small number of lawsuits involving the rating agencies. The Dodd-Frank Act includes some limited provisions that would make rating agencies more accountable by treating them the same as bankers, accountants, securities analysts and lawyers with respect to Section 11 of the Securities Act of 1933. The legislation also requires the removal of many rating-based regulations, and thus encourages a reduction in reliance on ratings for both regulatory and behavioral purposes. We describe some potential alternatives to ratings that have emerged in scholarly discussion about decreasing regulatory reliance on ratings.

These legislative reforms are the beginning, not the end, of the regulatory debate. Many of them require additional study or regulation. As a result, the future roadmap for rating agency regulation remains uncertain. Ratings regulation also will remain an important area for scholarly debate about policy. It is not clear what role the NRSROs will play, as compared to non-NRSROs, once regulatory references to ratings are withdrawn. Nor is it obvious how new oversight authority will affect the structure of the rating industry or the reliability of ratings. The success of the Dodd-Frank Act will depend on the interpretation and implementation of the new rules, with the Securities and Exchange Commission (SEC) and, potentially, a proposed new Office of Credit Ratings playing a crucial role.

This paper proceeds as follows. Section II provides some background, explaining why ratings and rating agencies are so important even though they are often so unreliable. Section III and section IV address two major areas of reform: oversight and accountability. Section V concludes.

2. Background

Three players have long dominated the rating business: Moody's, Standard & Poor’s and Fitch. According to Egan (2008), the rating industry is a 5 to 6 billion U.S. dollar market. Despite the presence of seven additional NRSROs, the three leading rating agencies are responsible for 98 percent of all outstanding ratings and collect 90 percent of the total rating revenue (Shorter & Seitzinger 2009). This leading trio has wielded immense, quasi-governmental power.

NRSROs have been the subject of intense criticism because of the part they played in the financial crisis. The three leading rating agencies gave high ratings to eleven large financial institutions that later faltered or failed. They rated AIG in the double-A

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3 Fitch’s market share, however, is significantly smaller than the share of its two main rivals.
category. Lehman Brothers retained its investment-grade rating until a few days prior to collapsing.\footnote{Lehman Brothers was downgraded to junk status on September 12, 2008; on September 15, 2008, this investment bank filed for bankruptcy.} Until the subprime mortgage crisis began in 2007, the three leading rating agencies maintained triple-A ratings on thousands of subprime-related instruments that proved nearly worthless (Moloney 2008; McVea 2010). Moody’s, for instance, was practically a triple-A ratings factory; from 2000 through 2007, Moody’s gave its triple-A rating to 42,625 residential mortgage-backed securities (RMBSs) (Angelides 2010). In 2006, 869 billion U.S. dollars worth of mortgage-related securities were rated triple-A by Moody’s and 83 percent went on to be downgraded within six months (Angelides 2010; Morgenson & Story 2010). Standard & Poor’s had ratings coverage of a similar magnitude and similar ratings; Fitch’s share of the ratings market was smaller, but still substantial (Hill 2010b).

In June 2008, the SEC reported that its examination of the three dominant agencies had uncovered serious deficiencies in their ratings and rating processes. Most infamously, one Standard & Poor’s analyst expressed concern that the firm’s model did not capture “half” of a deal’s risk, and that “[w]e rate every deal… it could be structured by cows and we would rate it” (SEC 2008b). Legislators have held hearings criticizing the agencies, and regulators recommended reforms. However, the SEC released only a handful of e-mails and little evidence from its investigation. Most of the evidence uncovered during this investigative process has remained inaccessible to researchers and the public.

2.1. From Information Intermediaries to Regulatory Licensors

Rating agencies began as information intermediaries, entities that step in to assess product quality when sellers cannot credibly make claims about product quality themselves.\footnote{In the early debt markets, rating agencies helped to bridge information gaps between bond buyers and sellers. In 1909, John Moody published his first Manual of Railroad Securities, in which he rated 200 railroads companies and their securities. Moody’s insight was that he could profit by selling to the public a synthesis of complex bond data in the form of single letter ratings: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C, in declining order of credit quality. These letter ratings were a rough compilation of disparate information about bonds that investors found difficult or costly to assess on their own.} Information intermediaries function best when they have reputational capital at stake and will suffer a loss if their assessments are biased, negligent, or false.

Over time, however, rating agencies have shifted from selling information to selling “regulatory licenses,” keys that unlock the financial markets. This shift began after the 1929 crash, when regulators turned to the rating agencies – primarily Moody’s and Standard & Poor’s – for measures of bond quality in banking and insurance guidelines. Federal Reserve examiners proposed a system for weighting the value of a bank’s portfolio based on ratings. Bank and insurance regulators expressed the “safety” or “desirability” of portfolios in letter ratings, and used such ratings in bank capital requirements and bank and insurance company investment guidelines. States relied on rating agencies to determine which bonds were “legal” for insurance companies to hold. The Comptroller of the Currency made similar determinations for federally chartered banks.
The SEC’s introduction of the NRSRO concept in the mid-1970s further encouraged regulators to increase their reliance on ratings. During that same period, the NRSROs stopped selling ratings to investors and began charging the companies that issue the debt they rate. The issuer-pay model introduced significant new conflicts of interest – chiefly, the challenge for credit raters of impartially rating securities of companies that generate their revenues.

Beginning in the 1970s, regulators dramatically expanded their use of ratings in financial market regulations. As a result, financial markets regulators effectively mandated that institutions of all types pay heed to NRSRO ratings as a necessary step for regulatory compliance. Some rules required that certain investors could only buy bonds with high ratings. Other rules reduced capital requirements for institutions that purchased highly rated bonds. Without high ratings, bond issuers could not access certain markets because they did not have a “license” from the NRSROs to comply with NRSRO-dependent regulations.

Regulatory dependence on ratings created higher demand for ratings and increasingly higher profits for NRSROs, even when their ratings proved spectacularly inaccurate. Too often, rating changes lagged the revelation of public information about rated issuers and instruments. Even before the recent financial crisis, prominent examples included California’s Orange County and Enron Corp., both of which received high ratings until just before they filed for bankruptcy protection (Hill 2004, 2009; Flood 2005). More recently, the obligations of major financial institutions, such as Bear Stearns and Lehman Brothers, received high single-A ratings just before they collapsed, and thousands of subprime mortgage-related structured finance instruments similarly received high investment grade ratings. Beginning in 2007, there were massive and sudden rating downgrades, surprising many investors and market participants who had relied on the expertise of the leading rating agencies.

During recent years, rating agencies had begun rating substantially greater numbers of borrowers and increasingly complex instruments. At the same time, the resources expended per rating declined. Specifically, as the rating agencies expanded ratings to cover large numbers of structured finance products, including tranches of various collateralized debt obligations (CDOs), some NRSROs neglected to divert resources to update rating models and methodologies or recruit additional staff needed to keep pace with financial innovation (Hill 2004). Evidence suggests the agencies were not sufficiently concerned about allocating adequate resources to rate complex deals (Kolchinsky 2010; Froeba 2010). As a senior analytical manager at one of the big three rating agencies put it in a February 2007 e-mail, “[w]e do not have the resources to support what we are doing now” (SEC 2008b).

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6 More precisely, the regulatory dependence on ratings began in 1973, when the SEC proposed amending broker-dealer “haircut” requirements, which set forth the percentage of a financial asset’s market value a broker-dealer was required to deduct for the purpose of calculating its net capital requirement. Rule 15c3-1, promulgated two years later, required a different “haircut” based on the ratings assigned by NRSROs. See 17 C.F.R. 240.15c3-1. Since the mid-1970s, statutes and regulations increasingly have come to depend explicitly on NRSRO ratings.  
Interestingly, even as ratings became less accurate, rating agencies maintained their role as powerful and important financial market participants. Rating agencies protected their franchises, and defended themselves against liability. Historically, their success in avoiding liability has been due to legislative policy and also a handful of judicial decisions characterizing their ratings as free speech. With rare exceptions, rating agencies historically have not suffered damages from litigation even when they were negligent or reckless in issuing overly optimistic ratings. More recently, courts have expressed skepticism about the rating agencies’ free speech claims. Moreover, the Dodd-Frank Act marks a turning point by removing the special treatment for rating agencies, which we address in Section IV.

Overall, the lack of accountability has impeded the ability and willingness of rating agencies to effectively function as information intermediaries because they do not – indeed they cannot – credibly pledge reputational and economic capital in the event they fail to perform their core function. Rating agencies that are insulated from liability have a more profitable, dominant franchise, but do not play an effective gatekeeping role.

2.2 The Paradox of Credit Ratings

The leading NRSROs have become more profitable even as the quality of their ratings has declined. Operating margins for some agencies in recent years topped 50 percent. From 2000 to 2007, Moody’s documents reported operating margins averaging 53 percent; in contrast, Microsoft and Exxon respectively had margins of 36 and 17 percent in 2007 (Levin & Coburn 2010). Moody’s market capitalization was nearly 20 billion U.S. dollars at its peak; Standard & Poor’s was similarly profitable and large. The companies that owned NRSROs drew savvy investors, looking to profit from the reliable returns associated with the sale of “regulatory licenses”.

Some evidence suggests that recent fundamental changes in the leading rating agencies reflect an increasingly short-term focus. For example, some commentators have suggested that Moody’s culture suffered a deleterious change after that company’s initial public offering in 2000 (Jones 2008). Others argue that the primary impetus driving changes in ratings practice was economic, and that rating quality and reputational capital became secondary to market share, particularly with respect to structured finance ratings, where maintaining and increasing market share was particularly important (Kolchinsky 2010).

Whatever the cause, it is apparent that the leading rating agencies compromised their standards in order to capture higher fees from increasingly complex deals (CGFS 2008). The leading rating agencies were overwhelmed by the huge volume of new structured finance deals that they were being asked to rate: one Moody’s analyst even recalls rating a $1 billion U.S. dollars structured deal in 90 minutes (Jones 2008). The leading rating agencies also experienced pressure from clients, issuers, and arrangers of these instruments, and junior employees have said they felt pressured by more senior managers (SEC 2008b; Hill 2010a). Consider as one example the following testimony from Mark Froeba (2010), a former Moody’s employee: “[Moody’s senior management]
used intimidation to create a docile population of analysts afraid to upset investment bankers and ready to cooperate to the maximum extent possible.”

As the structured finance market grew, rating agencies increasingly focused on more complex, higher-margin deals. Complex financial instruments generated a significant source of revenues for rating agencies. Coval et al. (2008) report that, in 2006, 44 percent of Moody’s revenue came from rating structured finance products, surpassing the 32 percent of revenue from corporate bonds. According to Levin and Coburn (2010), from 2002 to 2007, the three leading agencies doubled their revenues, from approximately 3 billion U.S. dollars to 6 billion U.S. dollars per year. Froeba (2010) contends that rating agencies were attracted by significant profits and were not deterred from rating complex financial instruments by reputational constraints.

Moreover, market forces penalized rating agencies for issuing quality ratings by awarding rating mandates based on the lowest credit enhancement needed for the highest rating (Wutkowski & Younglai 2008). In fact, the leading rating agencies faced a dilemma to maintain both market share and rating quality (Wutkowski & Younglai 2008). They opted for market share as competitive pressures incentivized them to loosen their rating standards in order to get more issuers’ fees.

To make matters worse, if a rating agency said no to a transaction, investment bankers could easily take their business to another one and obtain the desired triple-A rating (Kolchinsky 2010). Evidence from former employees suggests that the threat of losing deals was significant (SEC 2008b). As a consequence, ratings could be inflated without an effective reputational constraint: rating agencies did not suffer long-term economic consequences because of the deterioration of their reputations. Again, paradoxically, the value of ratings declined, even as rating agencies’ profits rose.

This paradox is partly explained by over-reliance on ratings. As noted above, over-reliance on ratings has been not merely regulatory but also behavioral. Regulatory reliance on ratings implies that profits from the sale of “regulatory licenses” do not depend greatly on the informational value of ratings. Behavioral reliance describes the fact that market participants – such as institutional investors – base decisions on ratings. If regulators and private actors defer to private standard setters, those private standard setters will earn profits from that deference even if their standards are not useful.

Accordingly, the paradox of credit ratings has persisted during the recent financial crisis. Even though ratings have plummeted in informational value, portions of the U.S. government rescue efforts relied on them. Thus, ratings became even more important. For example, the Federal Reserve’s 1 trillion U.S. dollar Term Auction Lending Facility (TALF) plan, which loaned money to investors to purchase new securities backed by consumer debt, mandated that only securities rated investment grade by two or more major NRSROs were eligible for government support.

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Likewise, when government officials anticipated the potential negative impact of AIG's announcement of quarterly earnings in March 2009, they implemented a fourth rescue package for the insurer. They consulted privately with representatives of the dominant NRSROs to be sure the plan would be attractive enough to avoid a downgrade of AIG, because a downgrade would have killed the company. Both regulators and investors were in a ratings trap.

3. Oversight

3.1. Research

Scholars have advocated overhaul of the credit rating industry and process for more than a decade. There were prominent calls for ratings reform in the aftermath of the Enron debacle (Hill 2004). More recently, since the financial crisis of 2007, lawmakers and regulators around the world have acknowledged that the architecture of rating agency regulatory oversight needs reform (Schapiro 2009; IOSCO 2010). Even the President's Working Group on Financial Markets (2008), long a champion of deregulation and financial innovation, sharply criticized the flaws in the rating agencies' assessments of complex products and called them a “principal underlying cause” of the crisis. Lawmakers in the European Union have continued to push for the development of a new European credit rating agency regulatory authority.

Research has shown that necessary improvements would require both a change in regulatory structure and new regulatory powers. Like other areas of financial regulation, regulating ratings has been piecemeal and is spread throughout numerous state and federal governing bodies, including securities, banking, and insurance. A more uniform regulatory structure would consolidate ratings regulation within one umbrella organization with additional responsibilities and new powers. The Dodd-Frank Act includes several attempts to follow this approach.

Some scholars are skeptical of proposals expanding oversight of rating agencies to a great extent. White (2009) contends that some recent regulatory reform is misguided and would make incumbents even more important (Segal 2009). Hill (2010b) argues that regulators would not be able to detect rating inaccuracies better than market participants such as the self-interested money managers who failed to discipline the rating agencies.

The following discussion appraises several regulatory approaches. The next Section discusses the approach actually taken in the recently-enacted Dodd-Frank Act.

3.1.1 Regulatory Structure

One approach would be to create a single independent Credit Rating Agency Oversight Board (CRAOB), with a structure and mission similar to that of the Public Company Accounting Oversight Board (PCAOB). It could be a free-standing entity created by statute to oversee registration, inspections, standards, and enforcement actions related to NRSROs, just as the PCAOB oversees audit firms (Partnoy 2009a; Smith 2009a). The board could also encourage and facilitate the development of alternatives to NRSRO ratings among market participants.
Two alternatives to that approach would be to establish an office within the SEC strictly dedicated to the regulation of NRSROs, with enhanced powers, or to house oversight of rating agencies within the PCAOB (Partnoy 2009a; Smith 2009a). The Dodd-Frank Act opted for the former approach, creating a new SEC Office of Credit Ratings, although the SEC had delayed implementing this new office as of 2011. In either approach, the functions and duties of a rating agency overseer would be somewhat consistent with the mandate of the PCAOB, which was created to protect investors and the public interest by promoting informative, fair, and independent audit reports. Nevertheless, integrating credit rating agency oversight duties into the PCAOB would present organizational and legislative challenges.

Ideally, a consolidated rating agency overseer would have two overriding characteristics: independence and specialized expertise. A free-standing board would require independent funding so that it would not depend on Congress or other agencies for frequent funding or decision-making. Securing reliable funding would be particularly important in order to offer salaries sufficient to attract high caliber board members. Board members should have specific expertise in assessing credit risk and, more generally, an understanding of financial markets, asset pricing, and alternative information sources and intermediaries. Members of the board should be independent and appointed for limited terms. The appointment process should be designed to limit the potential for influence by the rating agencies, and board members should not be permitted to join NRSROs after their service.

The Dodd-Frank Act follows the approach of giving the SEC increased oversight of the rating business. Some critics argued that this approach would be suboptimal, because the SEC has been reluctant to strengthen accountability and disclosure rules in the past (Partnoy 2009a). In fact, the SEC’s Office of Credit Ratings remains unstaffed and inactive a year after the passage of the Dodd-Frank Act.

Critics of a free-standing rating agency oversight board counter that more fragmentation of financial regulation would add more layers to the already complex web of financial market regulation in the United States. They also believe that the SEC already has the staff, expertise, and contacts to regulate rating agencies; they say it simply needs greater authority and resources from Congress (Manns 2009; Smith 2009b). In any event, the future of the SEC’s new Office of Credit Ratings remains unclear.

3.1.2. Scope of Regulatory Authority

Below we briefly highlight a few areas related to the scope of regulatory authority, some of which have generated scholarly interest. The SEC’s regulatory authority in particular is in flux. Although the SEC adopted new rules for credit ratings pursuant to the Credit Rating Agency Reform Act of 2006, the scope of that legislative authority was limited. The Dodd-Frank Act expanded the SEC’s regulatory authority, and the SEC

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11 Initial funding could be in the form of an endowment; alternatively, funding could be provided through required, periodic NRSRO user fees or transaction fees.

12 While the Credit Rating Agency Reform Act of 2006 standardized the process for NRSRO registration and gave the SEC new oversight powers, it prohibited the SEC from regulating "the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings." The act also stated that it "creates no private right of action." The rating agencies supported this act, in part because its scope was so narrowly circumscribed. In June
continues to promulgate new rules in the area. We anticipate that these areas will be of scholarly interest in the future.

Disclosure of Rating Actions. One open question is whether a rating agency overseer should have the statutory authority to require significantly more extensive NRSRO disclosure, including a complete record of rating history, such as initial rating, upgrades, downgrades, placements on watch for upgrade or downgrade, and withdrawals.

Disclosure proposals were previously more limited, in part due to the scope of regulatory authority granted by the Credit Rating Agency Reform Act of 2006 (Bai 2010). For example, the SEC finalized new rules in February 2009 that require NRSROs to make available to the commission individual records for each of their outstanding ratings showing all rating actions. In addition, the rules require NRSROs to publicly disclose rating action histories in eXtensible Business Reporting Language (XBRL) format. However, they can delay disclosures for six months and must disclose rating action histories only for a randomly selected 10 percent of issuer-paid ratings. Similarly, in February, the SEC proposed requiring disclosure, on a 12-month delay, of all issuer-paid ratings issued on or after June 26, 2007. Under the rules adopted in February and proposals still pending, unsolicited ratings and subscriber-paid ratings are exempt from disclosure.

Congress could authorize the board to require that NRSROs disclose complete records to the public, not merely to the regulator. In addition, disclosure could extend to unsolicited ratings and subscriber-paid ratings. Current rules do not provide investors with the level of information necessary to assess and compare ratings and rating agencies. Securities included in one NRSRO’s 10 percent disclosure pool are not necessarily included in other NRSROs’ pools, thus making a true comparison between rating agencies impossible. Moreover, excluding unsolicited and subscriber-paid ratings from public analysis eliminates valuable data from market scrutiny. Therefore, effective oversight of the rating business must include market oversight, which requires that investors have access to complete data regarding ratings. Critics, however, argue that requiring full disclosure for subscriber-paid ratings would undermine the business model of agencies that issue them.

Symbology. Regulating the use of rating symbols is a contentious topic. Although an oversight board might assess different categories of ratings and require NRSROs to use alternative symbology (e.g., numbers instead of letters, or letter subscripts) for ratings in different categories, it arguably should be cautious in exercising that power. The regulation of rating symbols might generate substantial benefits, but potentially could intrude into rating agencies’ practices of assessing borrowers and debt instruments.

In June 2008, the SEC proposed amendments to current regulations to require NRSROs to distinguish ratings on structured products by either (i) attaching a report to the rating itself describing the unique rating methodologies used in establishing the rating and how the security’s risk characteristics differ from others (i.e. corporate bonds); or (ii) using

2008, the SEC released a report outlining serious deficiencies in the rating process. It subsequently adopted new rules designed to increase the transparency of NRSRO rating methodologies, strengthen NRSRO disclosures of ratings performance, prohibit certain conflicted NRSRO practices, enhance NRSRO recordkeeping, and eliminate certain regulatory references to ratings.

13 The Dodd-Frank Act has addressed this. See infra 3.2.1.
14 The Dodd-Frank Act has partially addressed this. See infra note 29 and accompanying text.
symbols unique to structured products only (i.e. numbers rather than letters). The SEC’s intent was to spur investors to perform more rigorous internal risk analysis on structured products, thereby reducing undue reliance on ratings in making investment decisions. In November 2009, the European Union adopted Regulation (EC) No. 1060/2009 on Credit Rating Agencies, requiring that rating agencies identify ratings on structured products, as well as unsolicited ratings, by different symbols (preamble (21) and (40), art. 10 para. 3 and 5).

Alternative symbology could benefit investors in a number of ways (SEC 2008b). Particular letter ratings mean different things when applied to structured finance issuers as opposed to corporate issuers or municipal issuers. Different symbols for structured products could help differentiate risk for investors, signaling that the securities’ risk characteristics are more volatile than those of other securities.

On the other hand, if NRSROs were required to use different symbols to rate different categories of securities, the investing public might be more confused than informed. The rating agencies also contend that mandating different nomenclature for different classes of securities would violate their First Amendment protection, although they have not succeeded with this particular free speech argument in any venue. In any case, symbology regulation is a sensitive area in which both proponents and opponents have strong views about the benefits and costs.

Methodologies. Some scholars have argued that flawed methodologies were a core reason NRSROs gave overly high ratings to complex structured finance instruments (Manns 2009; Lewis 2010). Allowing investors the opportunity to analyze rating agencies’ methodologies could serve as a vital market-based quality check (IOSCO 2008). Previous SEC registration rules required minimal disclosure of methodologies. Rating agencies’ registrations were stale, and their descriptions of methodologies and procedures were opaque (SEC 2008b). It has not been helpful for investors for rating agencies to release their general statistical methods and models without also specifying the assumptions in those models.

Arguably, regulation should focus on disclosures that would enable investors to assess key underlying variables, such as expected probability of default (Smith 2009b). Letter ratings alone are not particularly helpful in this assessment. Indeed, the rating agencies admit that letter ratings are ordinal, not cardinal, in that they rank issues in order of relative credit risk, but do not specify any particular expected default (Standard & Poor’s 2007). Yet the rating agencies use default probabilities in their models, and ratings reflect implied default probabilities, which can vary substantially from those implied by market prices.

On the other hand, rating agencies contend that their methodologies are proprietary and that requiring detailed disclosure of their methodologies would promote free-riding, remove incentives for innovation, and leave the market with a smaller number

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At a basic level, different symbols for different classes of securities would notify users that the agencies used different methodologies to generate the ratings.

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The Dodd-Frank Act has addressed disclosure of methodologies. See infra note 31 and accompanying text.
of similarly derived ratings rather than a larger pool of ratings based on different methods of analysis.

Certain rating methodologies might be systemically important enough to the global market to warrant regulation notwithstanding the agencies' concerns (Smith 2009b). For example, an oversight board might sanction rating agencies whose ratings consistently failed to meet or exceed an acceptable level of accuracy. The board could bar NRSROs from issuing ratings on new types of securities for which there is little historical data. It also could require NRSROs to use third-party due diligence services to ensure the accuracy of data used to establish ratings on complex securities. Such powers should be exercised cautiously and only after the regulator has investigated the potential costs and benefits.

Conflicts of Interest. Even before the Dodd-Frank Act, Section 15E(h)(1) of the Securities Exchange Act of 1934 required NRSROs to establish, maintain, and enforce policies and procedures reasonably designed to address and manage conflicts of interest (Bai 2010). Congress directed the SEC in 2006 to issue final rules to prohibit or require the management and disclosure of conflicts of interest. However, the SEC was reluctant to, and did not, take full advantage of its power.

Although Congress and regulators have criticized the conflicts of interest between issuers and rating agencies, scholars have responded that a shift to an investor-pay business model is not viable given the public good nature of ratings and the minimal incentives for investors to pay for credit ratings (Grundfest & Hochenberg 2009). Forcing rating agencies to rely exclusively on investors to generate rating fees would result in a lack of financial resources and therefore a decreasing production of financial information (Bai 2010). Further, subscriber-paid NRSROs are not exempt from conflicts of interest. They are subject to potential pressure from clients to slide ratings one way or another. For example, institutions that can only invest in highly rated instruments might pressure a rater to guarantee that a particular security receives an investment-grade rating. Others might press the rating agencies for lower ratings in hopes of receiving higher returns.

An alternative to a blanket prohibition of the issuer-pay business model would be to require disclosure of business relationships and to prohibit NRSROs from engaging in business activities other than issuing ratings. Auditors face similar restrictions. Both the SEC and the rating agencies recognize that conflicts of interest are endemic in the rating process, and the SEC (2008a) stated that “NRSROs that are compensated by subscribers appear less likely to be susceptible to “rating shopping” or reducing quality for initial ratings to induce revenues.” Increased disclosure rules and prohibitions on ancillary business activities arguably should apply equally to all NRSROs.17

Fees. Not surprisingly, the disclosure of rating agency fees and compensation has been a controversial issue. The rationale for requiring disclosure of rating agency fees and compensation is similar to that requiring disclosure of executive compensation more generally: disclosure reduces agency costs and enables investors to determine whether the incentives of the rating agency are sufficiently well aligned with their own to warrant investing. Many commentators believe the overseer should require rating agencies to

17 The Dodd-Frank Act addresses conflicts of interest at several points, but only weakly. See infra note 33 and accompanying text.
disclose their fees; they also call for a reexamination of the compensation structure of NRSROs (SEC 2008b; Bai 2010).

Requiring public disclosure of fee schedules and individual rating fees for every rated deal could increase incentives for ratings accuracy by creating a new method of competition in the rating business.18 “Rating shopping” based on fee levels would not present the same conflicts and challenges as “rating shopping” based on rating standards. Moreover, such disclosure could also reveal potential conflicts of interest arising from an issuer’s heavy use of one particular agency.

Alternative pay structures, and the power to reform those structures, might also be considered. Some critics have suggested that issuers could pay a small percentage of any fees upfront, with the remaining fee being “earned out” in the following years, until the maturity of the rated instrument (Partnoy 2009a; Smith 2009b). In order to motivate NRSROs to update their outstanding ratings regularly, fees could depend on certain contingencies or milestones, and might even be related to the accuracy of the rating, as assessed by comparison to other measures of credit risk, including market measures. Over time, such performance-based compensation could discipline NRSROs to strive for greater accuracy (Manns 2009).19 However, these fee structures could create perverse incentives if rating agencies became reluctant to downgrade borrowers or debt instruments for fear of causing further deteriorations that would lead to further downgrades (Hill 2004).

Access to Inside Information. In 2000 the SEC implemented Regulation Full Disclosure – or Regulation FD – in order to eliminate the selective disclosure of material information to a few privileged interested parties (Jorion et al. 2005). For years rating agencies enjoyed an exemption from Regulation FD,20 thereby allowing them to receive inside information from issuers that is not shared with the market. Therefore, rating agencies often had access to information denied to analysts and investors (Flood 2005). The agencies contend that the exemption is needed in order to fully evaluate credit risk.

However, a strong case can be made that this exemption was unjustified (Partnoy 2009b). The Regulation FD exemption gave to rating agencies an unfair privilege as compared with other market participants in need of financial information (Jorion, et al. 2005). Further, it has not been apparent that rating agencies incorporated inside information in their ratings. Most notoriously, even though Enron made non-public rating agency presentations, information about the risks described in those presentations was not reflected in Enron’s ratings. The same has been true of structured finance ratings.21

Regulators also could set governance standards for NRSROs more broadly. It is worth noting that federal overseers have become more involved in governance of other financial institutions as the government’s interest in those institutions has increased during

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18 The rating agencies previously disclosed only summary information regarding fees, and they did not make data available for fees on individual deals.
19 Alternatively, rating agencies might be required to hold stakes in certain instruments that they rate highly.
20 17 C.F.R. 243.100-243.103
21 The Dodd-Frank Act requires the SEC to remove the Regulation FD exemption. See infra note 32 and accompanying text.
the financial crisis. Rating agencies, too, played a key role in the debacle, and their quasi-governmental powers arguably require stronger checks and balances.

3.2. Summary of the Dodd-Frank Act and Open Questions

3.2.1 Summary of the Dodd-Frank Act

The Dodd-Frank Act sets up a new regulatory structure for rating agencies, increasing authority to supervise the rating industry. As noted above, Section 932(a)(8) enhances oversight of the rating industry through the creation of a new authority within the SEC: the Office of Credit Ratings. Ultimately, the Office of Credit Ratings is to have staff and a director who will police the rules of rating agencies and file an annual report to the public. These supervisory rules result from the realization that rating agencies are fundamentally commercial, thereby implying that they have to be subject to stricter regulatory standards similar to other gatekeepers such as auditors and securities analysts. The Dodd-Frank Act expressly acknowledges the systemic importance of ratings.

The Dodd-Frank Act gives regulators increased powers to set standards in the rating industry. The emphasis is on transparency; rating agencies are required to disclose a significant amount of information. The intent is to provide regulators and investors with more information about NRSRO ratings (Dallas 2011). NRSROs have to file reports with the SEC and these reports must be made available to the public as well.

The statute gives the SEC the ability to bar NRSROs in case of serious shortcomings in how they rate. Under Section 932(a)(3)(I), the SEC has the ability to revoke the registration of a NRSRO with respect to a particular class of securities. There are new governance rules. NRSROs have to establish effective internal control structures. Internal controls govern the implementation of the policies, procedures and methodologies for determining ratings.

The law also provides that the SEC must implement rules requiring that NRSROs disclose their rating performance. Disclosure requirements under Section 932(a)(8) aim at allowing users to evaluate the accuracy of ratings and compare the performance of ratings by different NRSROs.

Section 938(a)(2-3) requires NRSROs to (i) define the meaning of any rating symbols and (ii) apply any symbols consistently. NRSROs can use the same symbols across different categories of financial instruments if their symbols are used in a consistent manner. A triple-A rating in structured finance should have the same meaning as a triple-A rating in corporate or sovereign debt. Otherwise, rating agencies have to use

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22 15 U.S.C. 78o-7(p); see supra 3.1.1.
23 With the new Office of Credit Ratings and the many supervisory rules, the Dodd-Frank Act goes further than what most scholars were asking for.
24 Section 931(1).
25 See supra 3.1.2.
29 See supra note 14 and accompanying text.
symbols that differentiate between different rating categories. Rating agencies will likely have to add new symbols in the structured finance segment. Thus, these provisions appear to have recognized the controversial nature of symbology reform, discussed above, and follow a middle ground approach.

The Dodd-Frank Act establishes new regulation of rating procedures and methodologies: NRSROs must create a form to accompany the publication of each credit rating that discloses information on rating methodologies.\textsuperscript{30}\textsuperscript{30} Investors are given access to information regarding the assumptions underlying the ratings such as the correlation of defaults. Rating agencies must determine and publicize which five assumptions would have the greatest impact on their ratings if they were false. This provision also is responsive to prior research on rating agencies: if this information had been available with respect to the subprime mortgage market, investors might have better understood that CDO ratings were heavily dependent on variables such as default correlations and home price appreciation, and they might have been able to assess more completely the risk that CDO ratings would have been rapidly downgraded with increasing default correlations and/or declining house prices.\textsuperscript{31}\textsuperscript{31}

The qualifications of analysts will now fall under regulatory scrutiny. Section 936 includes requirements for standards governing rating agencies’ analysts. A new training process will be supervised by the government. Regulators will have a role to play with respect to whether analysts hired by rating agencies have sufficient skills.

With respect to access to inside information, Section 939B requires the SEC to remove the exemption for rating agencies from Regulation FD. As noted above,\textsuperscript{32}\textsuperscript{32} this exemption allowed issuers to give material non-public information to rating agencies for the purposes of determining or monitoring ratings. The Dodd-Frank Act acknowledged that there is no justified reason to privilege rating agencies in access to financial information.

Finally, legislators were not able to agree on mandatory rules to resolve conflicts of interest in the rating industry.\textsuperscript{33}\textsuperscript{33} Section 931(4) of the Dodd-Frank Act merely acknowledges that rating agencies face conflicts of interest that need to be addressed. Pursuant to Section 932(a)(8), the Office of Credit Ratings is charged to ensure that NRSROs ratings are not unduly influenced by conflicts of interest.\textsuperscript{34}\textsuperscript{34} A few governance rules require rating agencies to monitor conflicts of interest. For instance, the board of directors of the NRSROs has a duty to address conflicts of interests.\textsuperscript{35}\textsuperscript{35}

\textsuperscript{30} 15 U.S.C. 78o-7(s)(1).
\textsuperscript{31} See supra note 16 and accompanying text.
\textsuperscript{32} See supra note 21 and accompanying text.
\textsuperscript{33} See supra note 17 and accompanying text. Senator Al Franken championed a proposal that would end the practice of issuers choosing the rating agencies. The Franken amendment would have created a board, overseen by the SEC, which would have assigned rating agencies to provide ratings in order to eliminate conflicts of interest. However, the House of Representatives did not accept the proposed solution and Congress had to strip the Franken amendment out of the financial reform bill (Sorkin 2010). A similar proposal came from Mathis et al. (2009), suggesting that a central platform could organize the rating process by acting as an independent intermediary between rating agencies and issuers.
These modest governance reforms arguably are directed at symptoms, not causes. For those who believe that conflicts of interest arise primarily out of the issuer-pay business model, the most effective solution would consist of reverting to subscriber-paid ratings. However, that kind of dramatic change was too difficult and controversial for Congress. Instead, the Dodd-Frank Act called for various governmental bodies to undertake studies to analyze how to address the conflict-of-interest issue. Sections 939C-E contemplate three studies: an SEC study on strengthening credit rating agency independence, a Government Accountability Office study on alternative business models, and an SEC study (and rulemaking) on assigned credit ratings.

3.2.2 Open Questions

The Dodd-Frank Act provides for credit rating agency oversight similar to oversight of other gatekeepers. Yet the Act provides regulators with significant room for interpretation and implementation. It is not clear to what extent and in what direction the SEC will use its enhanced regulatory powers. Moreover, the question arises as to whether the Office of Credit Ratings will take full advantage of its new regulatory authority. In comparison to the previous regulatory regime, the rules will be more stringent.

Concern has already been raised that the new bureaucracy might reinforce the rating oligopoly. Altman et al. (2010) suggest that too much oversight would undermine competition in the rating industry by raising regulatory barriers to entry. The oversight framework may make it difficult for competitors of Moody’s, Standard & Poor’s, and Fitch to comply with all the regulatory requirements. It will be easier for leading rating agencies to hire qualified analysts under the new training process. It will be crucial to monitor these issues since the purpose of the Dodd-Frank Act is not only to enhance the regulatory oversight but also to promote competitive incentives in the rating industry. Moreover, behavioral “stickiness” such as described by Hill (2010b) may keep issuers and investors turning on the same rating agencies. The positive effect of the Dodd-Frank Act consists of reducing over-reliance on the credit ratings of the leaders in the rating industry. The agency reform would, however, be counterproductive if it raises additional barriers to entry.

Removing the exemption from Regulation FD is a significant change, but its effects will depend substantially on how issuers react. Will they disclose more information to the public? Or, as some commentators have stated, will they enter into confidentiality agreements under Rule 100(b)(2)(ii) of Regulation FD, or perhaps some new SEC rule, which would enable them to disclose material non-public information to rating agencies (Quinlivan 2010)? Moreover, the effects of removing the Regulation FD exemption will depend on regulatory interpretations and SEC rulemaking. The changes will have little impact if the rating agencies are deemed not to be investment advisers, or do not otherwise fall within the definition of enumerated entities under Rule 100(b)(1) of Regulation FD (Quinlivan 2010).

The Dodd-Frank Act seeks to address concerns about the systemic risks posed by ratings; it mentions this issue in the first sentence of its section on credit rating agency

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36 It is unclear what regulatory treatment applies to ratings based on inside information subject to confidentiality agreements: if the resulting ratings are disclosed to the public, rating agencies may be accused of infringing the confidentiality agreements; if the resulting ratings are selectively disclosed to subscribers, rating agencies may be accused of violating Regulation FD.
reform. However, Congress has not taken any direct measures specifically designed to address systemic problems in the rating industry. Only a few research articles have focused on these problems. One example is a paper discussing the necessity of macroprudential regulation in addressing the systemic risks inherent to ratings (Sy 2009). The systemic risk question should be increasingly taken into account by regulators and researchers.

Last but not least, Dodd-Frank leaves open the question of conflicts of interest in the rating industry. As noted above, the few governance rules address the symptoms of the problem but not the causes. The government studies might offer innovative solutions, or they might leave in place the issuer-pay business model.

4. Accountability

4.1. Research

Research on the accountability of rating agencies has focused on two threats to rating agencies as gatekeepers: liability and competition. A credible threat of civil liability could force rating agencies to be more vigilant in guarding against negligent, reckless, and fraudulent practices. A credible threat that both regulators and market actors will switch to alternatives to ratings could force rating agencies to behave more like information intermediaries than providers of “regulatory licenses”.

4.1.1 Eliminating the Rating Agency Exemption from Liability

Historically, the threat of liability has been an effective tool in encouraging gatekeeper accountability. In general, gatekeepers are less likely to engage in negligent, reckless, or fraudulent behavior if they are subject to a risk of liability. As rational economic actors, gatekeepers factor in the expected costs of litigation, including the cost of defending lawsuits as well as any damage awards or settlements.

Although most financial market gatekeepers have been subject to serious litigation threats, rating agencies have not been constrained by civil liability; they have been sued relatively infrequently, and rarely have been held liable (Partnoy 2006). Given the litigation track record, the fact that the rating agencies have published unreasonably high ratings should not be surprising. Some market observers believe that, with appropriate changes in policy, litigation could become a viable tool for ensuring NRSRO accountability. Hunt (2009) argues that a mechanism to deter rating agencies from issuing low-quality ratings is especially needed for novel product ratings, because reputational constraints fail to work for novel products.

Litigation against the rating agencies was often deterred by statutory provisions and judicial precedents that limited the liability of NRSROs. A handful of judicial decisions accepted the rating agencies’ assertion that ratings are merely “opinions,” which, under the First Amendment, should be afforded the same free speech privileges as opinions of

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37 Even though the Dodd-Frank Act did not explicitly address the systemic risk issue, certain regulatory measures such as the enhanced agency oversight and the removal of regulatory references to ratings may play a role. The removal of regulatory references to ratings may help decrease systemic risks in the rating industry by reducing over-reliance on ratings.
publishers. Moreover, some securities laws explicitly exempted rating agencies from liability. NRSROs were immune from liability for misstatements in a registration statement under Section 11 of the Securities Act of 1933. Rule 436(g) – recently repealed by the Dodd-Frank Act – provided that NRSRO were exempt from expert liability under Section 11. The Credit Rating Agency Reform Act of 2006 also included some limitations on private rights of action.

The threat of NRSRO liability also was limited by judicial precedent in the area (Partnoy 2002). Rating agencies were sued following a number of defaults, including class action litigation related to the Washington Public Power Supply System default in 1983; claims related to the Executive Life bankruptcy in 1991; a suit by the Jefferson County, Colorado, School District against Moody’s in 1995; and claims by Orange County, California, based on professional negligence, against Standard & Poor’s in 1996. However, the only common element in these cases was that the rating agencies won (Partnoy 2002). The suits were dismissed or settled on favorable terms to the rating agencies.38

A recent example was the portion of the consolidated Enron litigation involving claims brought by the Connecticut Resources Recovery Authority.39 The Enron court, like some other courts, extended a qualified First Amendment protection to rating agencies. Ironically, in doing so, the judicial decision cited the Senate Committee on Governmental Affairs report, “Financial Oversight of Enron: The SEC and Private-Sector Watchdogs” (2002) and its statement that “It is difficult not to wonder whether lack of accountability – the agencies’ practical immunity to lawsuits and nonexistent regulatory oversight – is a major problem”.

More recently, a few courts have expressed skepticism about judicial protection of rating agencies from liability. One plaintiff has had success alleging that Moody’s made misrepresentations regarding its independence and rating methodologies.40 Another court indicated skepticism of the rating agency’s First Amendment argument in the context of private placements, where the rating is not published generally to the public.41 With respect to other cases related to the financial crisis, courts have denied motions to dismiss claims against the rating agencies, so these claims likely will be adjudicated in the near future. As one example, the California Public Employees’ Retirement System (Calpers) won an early court decision against the three leading rating agencies (Morse 2010). The pension fund claims that it lost about 1 billion U.S. dollars due to inaccurate ratings.

This judicial pushback against the rating agencies’ free speech assertions is strongly rooted in the economics of ratings, and the fact that rating agencies are compensated for their “opinions” by the same issuers they are opining about. Rating agencies’ profit margins have exceeded 50 percent, whereas more traditional publishing companies’ profit margins have been less than 10 percent. Given the high profile nature of

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38 For instance, Orange County’s 2 billion U.S. dollars lawsuit against Standard & Poor’s nettled a paltry settlement of 140,000 U.S. dollars, roughly 0.007 percent of the claimed damages.
the problems with rating agencies and the continuing profitability of the rating business, rating agencies hardly act like publishers, something courts are finally recognizing.

In order to make NRSROs properly accountable, critics contend, there must be a real threat of liability (Partnoy 2006). Many believe that Congress should amend Section 11 of the Securities Act of 1933 to add NRSROs as potential defendants. Further, they say lawmakers also should adopt legislation indicating that NRSROs are subject to private rights of action under the anti-fraud provisions of the securities laws. That legislation should include a description of the pleading standard for cases against rating agencies, to indicate that it would be sufficient for a plaintiff to plead the required state of mind by stating that the rating agency failed to conduct a reasonable investigation of the rated security or to have obtained reasonable verification from other sources independent of the issuer.42

One final advantage to imposing accountability on rating agencies through liability is that it would obviate the need for regulators to provide parameters upfront governing when NRSROs have satisfied their responsibilities as part of the oversight process. In other words, ex ante oversight does not need to be as specific or draconian if regulators and investors can rely on ex post adjudication of rating agency negligence, recklessness, and fraud. Through an evolutionary approach, judges and private litigants could develop a common law understanding of appropriate rating agency behavior.

As discussed below, the Dodd-Frank Act somewhat encourages litigation against credit rating agencies. It remains unclear whether either future decisions in financial crisis cases or decisions based on future conduct under the new Dodd-Frank standards will lead to substantially increased litigation exposure for credit rating agencies.

4.1.2. Enhancing Accountability through Competition and Reduced Reliance on Ratings

Many critics contend that competition in the rating business has not been effective. White (2009) argues that rating-based regulations created a substantial barrier to entering the rating industry. Opp et al. (2010) argue that regulatory references to ratings distort incentives in the rating industry. Some say the problem is due to insufficient industry competition and that the solution is to designate more NRSROs (SEC 2003; Cinquegrana 2009). Consistent with this view, the Credit Rating Agency Reform Act of 2006 was seeking to enhance competition in the rating industry by opening the NRSRO designation process to make sure that smaller rating agencies could compete with Moody’s, Standard & Poor’s and Fitch. However, merely increasing the number of NRSROs failed to change the fundamental feature of the rating business, which is that ratings are driven by "regulatory licenses".

Moreover, competition among NRSROs may lead to a “race to the bottom” if NRSROs compete on lowering their standards to attract more business instead of competing on quality ratings (Coffee 2009). Rosner (2009) argues that so long as credit ratings are used in regulations, increasing the number of NRSROs may actually result in an ill-conceived competition to inflate ratings. Macey (2008) suggests that issuers may have hired the NRSROs that were the most malleable and the most liberal with the investment-grade rating. According to these arguments, competitive incentives in the

42 The Dodd-Frank Act has introduced a liability regime for rating agencies. See infra 4.2.1.
rating industry can be restored only after eliminating the regulatory use of credit ratings (Darbellay 2011).

Ratings became an important tool for regulators, and sometimes a mandated tool for many categories of market participants. The withdrawal of rating-based regulations is necessary (Partnoy 1999; Weber & Darbellay 2008; Casey & Partnoy 2010). It would remove many of the incentives that led banks and rating agencies to create a huge market for mortgage-related securities (Casey & Partnoy 2010). However, critics contend that if “regulatory licenses” were what was keeping market participants from using other rating agencies, diminution of the leading rating agencies’ market share should have been expected after the designation in the mid 2000s of more NRSROs by the SEC (Hill 2010b). An open question suggested by this criticism is whether behavioral reliance by investors, which remains prevalent and is not directly addressed by regulation, might be the key factor driving the dominant rating agencies’ market share.

In any event, removing the regulatory use of ratings will force regulators and investors to find substitutes. A variety of alternative measures may be used to evaluate credit risk and supplement or even replace ratings. They include:

(a) Using the variables underlying ratings, such as expected probability of default, recovery in the event of default, and default correlation, when relevant. For example, an investor might amend its investment guidelines to state it would only purchase bonds with an expectation probability of default of 1 percent or less during maturity. The decision about expected probability of default then could be made based on a wide range of information.

A “first cut” filter might be based on the market-wide expectation of default, as reflected in a bond’s price. Most bond underwriters can provide this information for a range of issues. Professor Edward Altman also has published extensive data in this area. In addition, credit default swap (CDS) data is available from services, such as Markit, for numerous fixed income issues. Even though CDSs have been criticized in various ways, abundant evidence suggests that CDS spreads reflect underlying credit risks more accurately than ratings (Flannery et al. 2010).

(b) Using the default probability implied by a bond’s price, not only at the time of purchase but over time, as part of their portfolio management process. Many services provide such information. Indeed, NRSROs increasingly incorporate such market measures into their own ratings, though on a lagged basis. Investors concerned about the volatility of market prices could use 30-day or 90-day rolling averages.

43 Today, references to ratings are incorporated in investment guidelines, swap documentation, loan agreements, collateral triggers, and other important documents and provisions. Regulatory and behavioral reliance on ratings has become excessive over the past decades. However, most institutional investors do not rely exclusively on ratings. While ratings are part of the mosaic of information considered as part of the investment process, they are generally not an appropriate sole source for making decisions.

44 The Dodd-Frank Act seeks to remove regulatory references to credit ratings. See infra 4.2.1.

45 Moreover, relatively inexpensive information services, such as Bloomberg and Reuters, also provide such information.
Rolling averages of market prices at least potentially reflect a wider range of available information than ratings, and may be a more timely and accurate measure of credit risk. Rolling averages also more accurately reflect available information than ratings and are not likely to be subject to manipulation or abuse.

(c) Investors might revise their guidelines to reflect a blended standard of information sources used to make investment decisions based in part on professional judgment. For example, investors might rely on: (i) private information obtained through due diligence, (ii) publicly available “soft” information, and (iii) market-based measures and prices. The blended information might include ratings.

(d) Investors and regulators might look to the size and liquidity of an issue. The SEC recently proposed replacing reliance on ratings for Forms S-3 and F-3 and related forms and rules with provisions designed to determine whether issuers are widely followed in the market.46

Liquidity risk is also becoming a more important part of investment decision making. NRSRO ratings do not cover liquidity risk. As a result, the market for information about liquidity risk does not suffer from the same “regulatory license” distortions as the market for credit risk. Many relatively new information intermediaries, such as Markit, Kamakura Corp., and some investor-paid NRSROs, have developed competing analytic systems for assessing both credit and liquidity risk.

4.2. Summary of the Dodd-Frank Act and Open Questions

4.2.1 Summary of the Dodd-Frank Act

The Dodd-Frank Act addresses both legal liability for rating agencies and the regulatory over-reliance on ratings.

The Act is intended to remove the rating agencies’ relative immunity.47 Section 933(a) specifies that rating agencies should be as liable for misconduct as other gatekeepers such as accounting firms or securities analysts.48 Eliminating the exemption from liability threats makes it easier to sue the rating agencies in various ways.

The state of mind standard of the Securities and Exchange Act of 1934 potentially offers an easier path for those who sue rating agencies. Previous cases might have been decided differently under the new standard.49 In private actions, Section 933(b)(2) makes it sufficient to prove that rating agencies knowingly or recklessly failed to conduct a reasonable investigation or to obtain reasonable verification of factual elements relied upon by their methodology.50

47 See supra 4.1.1.
49 For instance, the Enron claims would probably have gone forward.
Further, Section 939G of the Dodd-Frank Act changes the impact of Section 11 of the Securities Act of 1933. The repeal of Rule 436(g) implies that rating agencies will be deemed to be experts under Section 11. The rule had shielded rating agencies from expert liability with respect to the disclosure of ratings in registration statements. Disclosure rules require the filing of written consents by experts. Since rating agencies will be considered experts under Section 11, issuers will have to seek their written consent if they want to use ratings in registration statements. If rating agencies deliver their consent, they are potentially liable as an expert under Section 11.\textsuperscript{51}

The Dodd-Frank Act seeks to remove regulatory references to ratings in many regulations, statutes and other rules.\textsuperscript{52} First and foremost, Section 939(a-f) has expressly removed statutory references to ratings. Even though Congress included the most important references to ratings into the amendment, such as all banking and securities references, Congress did not remove every statutory reference to ratings.\textsuperscript{53} Pursuant to Section 939A, every Federal agency has one year to remove regulatory reliance on ratings. References to ratings thus have to be removed from every type of governmental rule.

Further, although Congress did not require the private sector to eliminate references to ratings, the agency reform should be interpreted as an important message coming from Congress. Every market participant with investment guidelines or other internal rules should understand that such guidelines or rules should not refer to ratings. The culture and practice should change: If institutional investors continue to rely on ratings after one year, their own reputational risks or even litigation risks may arise.

The withdrawal of “regulatory licenses” will fully take effect within two years. In the meantime, interested parties have to work on finding alternatives to ratings. Congress does not propose substitutes but merely requires that regulators have to come up with substitutes. As noted above, there are numerous viable substitutes for ratings.

4.2.2 Open Questions

The Dodd-Frank Act has shown how to enhance accountability in the rating industry. Still, many issues remain unresolved.

One of the main changes regards the prospect of lawsuits. Courts will have to interpret the new legislation. The state of mind rule might be deemed to have limited scope. It remains unclear whether plaintiffs will be able to establish that rating agencies knowingly or recklessly failed to conduct a reasonable investigation, or precisely how courts will apply this standard.

A more difficult issue relates to the repeal of Rule 436(g). The intent was to establish a regime where rating agencies are subject to expert liability. However, major

\textsuperscript{51} See further infra 4.2.2.
\textsuperscript{52} See supra 4.1.2.
\textsuperscript{53} For instance, the Dodd-Frank Act has not removed statutory references to ratings in several provisions: title 20 with respect to student loans, title 23 with respect to highways and infrastructure finance, title 47 with respect to telephone media rules and loan guaranties. It is not clear whether Congress simply forgot some of the statutory references to ratings or whether it is a consequence of the rating agencies lobbying against the amendment.
rating agencies responded to the requirement by refusing to consent to the inclusion of their ratings in certain transaction documents (Ishmael 2010). In response, on July 22, 2010, the SEC has published a no-action letter to avoid enforcement actions so long as the amendment could not be effectively implemented.\(^54\)

It remains unclear how this impasse will be resolved. One possibility is that the rating agencies will give their consent only if they are able to charge a higher fee to cover possible litigation costs. Another is that the rating agencies will persuade the SEC to act in a manner that is contrary to the mandate of the Dodd-Frank Law with respect to Rule 436(g). At this stage, it is unclear whether the rating agencies will be subject to expert liability. Since the purpose of the provision is to hold rating agencies more accountable for their ratings, industry and the SEC will have to work together towards a solution that does not undermine the intent of the financial reform.

Regarding the removal of regulatory reliance on ratings, the challenge consists of finding appropriate substitutes for ratings. The SEC seems receptive to market-based measures. Governmental agencies and market participants will have to work on finding the solutions that are most appropriate for their own needs. In order to reduce private reliance on ratings, credible alternatives and substitutes must be developed, particularly for institutions that lack the resources to assess independently the huge number of available fixed income instruments.

The purpose of any measure of risk is to get the best estimates possible of three variables: probability of default, expected recovery in the event of default, and – for investments with multiple assets – correlation of defaults. There are two potential categories of substitutes for ratings: quantitative and qualitative substitutes. Quantitative substitutes are market measures of risk. The market reflects a great deal of information. Market-based measures have historically been more accurate than ratings. As noted above, they can involve credit spreads (Partnoy 1999) or CDS spreads (Flannery \textit{et al.} 2010).\(^55\) A method that warrants consideration is to take into account lagged market-based measures, for instance 30-day or 90-day rolling averages. The advantage would be to remove the volatility arising out of a day-to-day basis measure. It will in any event be important to go beyond a simple letter rating of risk.

Once regulatory reliance on ratings is eliminated, it is not clear why the NRSRO designation should persist (Altman \textit{et al.} 2010). The Dodd-Frank Act concentrates its regulatory efforts on NRSROs even though it seeks the withdrawal of rating-based regulations. After a transition period, privileges with respect to the NRSRO status are expected to disappear. Eventually, NRSRO status may merely remain as a sort of registration process instead of a certification process.

\(^54\) See supra 4.1.1.
\(^55\) However, regulation based on market-based measures has the potential to distort the market overall in the same way that regulation based on credit ratings distorted ratings. If these distortions became sufficiently large, then market-based measures might no longer provide a superior indication of credit risk. The key question is whether market participants could manipulate a market-based measure in the same way they have manipulated ratings (for example, by buying or selling in order to trigger a regulatory consequence). If the markets that regulators are relying on are sufficiently deep, and the time period of the rolling average is sufficiently long, that degree of manipulation is unlikely.
5. Conclusion

Until recently, rating agencies had thrived from the dysfunctional approach to financial market regulation. They were largely exempt from liability and oversight, yet they benefited from regulations that required the use of ratings. That regime ended when evidence emerged of the rating agencies’ prominent role in the recent financial crisis, and Congress attempted to impose a new liability and oversight regime, while eliminating regulatory reliance on ratings.

However, it remains unclear how the removal of credit rating references from regulation will affect the markets. The central question is how much investors stop relying on ratings, and whether a healthy and competitive market for ratings will emerge. Market over-reliance on ratings will not disappear when references to ratings are removed from regulation. Behavioral reliance on ratings has deeply been anchored in the financial markets. It will take a certain period of time in order to find the appropriate substitutes for ratings. Alternatives are emerging but may be out of reach for some investors for some time. Ultimately, as institutional investors become more comfortable with alternative sources of credit information, competitive pressure could spur rating agencies to improve their performance and accountability. During this transition period, NRSROs, or at least the leading rating agencies, will still enjoy a certain privilege in comparison to other rating agencies. Meanwhile, more vigorous oversight and accountability measures can improve the performance of NRSROs.

In sum, Dodd-Frank introduces at least as many questions as it answers. What will be the effects of increased liability for rating agencies? How will rating agencies deal with issuers without an exemption from Regulation FD? What will regulators and investors use as substitutes for ratings in their own regulations and guidelines? These questions present an interesting and important agenda for future research.
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