X. Credit Rating Agency Independence

A. Introduction

Credit ratings agencies ("agencies") seek to give honest and fair opinions "through a "rigorous and objective review of the facts, free from bias."[1] This is a noble goal. After all, investors, borrowers and regulatory agencies all rely on credit ratings as being accurate assessments of the companies and securities with which they deal.[2] Yet one aspect of the industry's business model has sparked ongoing controversy: the agencies are paid by the entities whose securities they rate.[3] This facet of the ratings industry has been analogized to a legal system in which a judge's salary is provided for by one of the parties.[4] Thus, an agency may be torn between serving investors, who rely on accurate ratings in making informed decisions, and serving the rated entities, which influence agency profit and market-share with their business.[5]

Agencies registered with the SEC are known as Nationally Recognized Statistical Rating Organizations ("NRSROs").[6] There are currently ten registered NRSROs, but three firms dominate the industry: Moody's Investor Services, Standard and Poor's ("S&P") and Fitch Ratings.[7] Recently, the Financial Crisis Inquiry Commission cited reliance on these agencies as a prime contributor to the recent financial crisis.[8] Evidence reveals pressure to retain market share and increase profits, which may have promoted

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[1] Who We Are, MOODY'S CORP., http://files.shareholder.com/downloads/MOOD/1067585332x0x393522/00ea05d1-970e-4352-9825-31405472cc03/Mission-Values.pdf (last visited Nov. 11, 2010).

[2] *Times Topics: Credit Rating Agencies*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_rating_agencies/ (last updated Jun. 3, 2010).

[3] *Id.*

[4] *Ratings Agencies Face Glare of Meltdown Probe,* CBSNEWS, Apr. 23, 2010, http://cbsnews.com/stories/2010/04/23/business/main6425009.shtml [hereinafter *Meltdown Probe]*.

[5] *Times Topics*, *supra* note 2.

[6] *Credit Rating Agencies—NRSROs*, U.S. SECURITIES AND EXCHANGE COMM'N, http://www.sec.gov/answers/nrsro.htm (last modified Sep. 25, 2008) [hereinafter *NRSROs*].

[7] *Times Topics*, *supra* note 2.

[8] FIN. CRISIS INQUIRY COMM'N, ABOUT THE COMMISSION, http://www.fcic.gov/about/ (last visited Nov. 11, 2010).

inaccurate ratings for issuers and banks that sometimes shopped around for the best rating.[9] Congress now attempts to alleviate the alleged potential conflict of interest and promote agency independence through the Dodd-Frank Act ("the Act").[10] Whether the Act's effort will be a success or failure is not entirely known.

B. Credit Rating Agencies and the Credit Crisis

From 2002 to 2007 Wall Street underwrote an estimated $3.2 trillion of subprime mortgages, which were pooled into collateralized debt obligations ("CDOs") that received high ratings.[11] The ratings on these structured financial products turned out to be inaccurate, resulting in catastrophe for the American and global economy.[12] By late 2008, over three quarters of the AAA-rated CDOs issued in 2006 and 2007 had been downgraded.[13] The flawed ratings fueled the collapse of Bear Stearns, Lehman Brothers and Merrill Lynch, which wrote-down $523.3 billion in assets initially given high ratings.[14] Today, asset-backed securities remain frozen due to dissipated investor confidence; a total of $1.8 trillion in write-downs worldwide is the result.[15]

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[9] Blake Ellis, *How Credit Watchdogs Fueled the Financial Crisis,* CNNMONEY.COM, April 24, 2010, http://www.money.cnn.com/2010/04/23/news/economy/credit_rating_agencies_hearing/.

[10] H.R. REP. NO. 111-517, at Sec. 931(4) (2010).

[11] Kathleen Casey and Frank Partnoy, *Downgrade the Ratings Agencies*, N.Y. TIMES, Jun. 6, 2010, at WK11, *available at* http://www.nytimes.com/2010/06/06/opinion/06partnoy.html.

[12] H.R. REP. NO. 111-517, at Sec. 931(5).

[13] Elliot Blair Smith, *'Race to Bottom' at Moody's, S&P Secured Subprime's Boom, Bust*, BLOOMBERG, Sep. 25, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya_Vtdo (stating that Moody's lowered grades for 90 percent of all asset-backed CDO investments issued in 2006 and 2007, including 85 percent of CDOs previously rated AAA, and S&P followed suit, downgrading 84 percent of the CDOs it rated, including 76 percent of CDOs previously rated AAA).

[14] Elliot Blair Smith, *Bringing Down Wall Street at Ratings Let Loose Subprime Scourge*, BLOOMBERG, Sep. 24, 2008, http://www.bloomberg.com/apps/news?pid=21070001&sid=ah839IWTLP9s [hereinafter *Bringing Down*].

[15] Gretchen Morgenson, *BB? AAA? Disclosure Tells Us More*, N.Y. TIMES, Sep. 5, 2010, at BU1; Joshua Gallu, *SEC Says Dodd-Frank Law Lets Agency Chase Overseas Ratings Fraud*, BLOOMBERG, Sep. 1, 2010,

The titanic flow of capital into these toxic assets may not have occurred without the agencies' AAA stamp of approval.[16] The critical question then becomes: what was the cause of the inaccurate ratings? Several factors, including unprecedented market events, innovative modeling, formula transparency, increased volume and complexity of instruments and errors, can be causally linked to the unduly high ratings; however, a common denominator precedes most of these factors.[17] A conflict of interest, stemming from pressure to serve banks and issuers, may have induced the agencies to rate securities more favorably than they normally would.[18]

Because investment banks sometimes shopped around for the best grade, offering an unfavorably low rating could lead to lost business for an agency.[19] Furthermore, agencies could earn three times more from rating the new, complex CDOs than traditional corporate bonds.[20] Hence, in August of 2004 Moody's implemented a new rating methodology that allowed firms to sell more top-rated, mortgage backed securities.[21] One week later, with an internal email emphasizing the "threat of losing deals," S&P revised their own rating models.[22] The agencies' revenues increased threefold from 2002 to 2007.[23]

Methodology flaws and a pressure to please issuers accompanied the positive revenue gains. Employees at both S&P and Moody's discovered rating errors that overstated the quality of certain CDO securities.[24] Although the errors were corrected, the co-director of CDO ratings at S&P refused to tighten ratings criteria, saying: "Don't kill the golden goose."[25] Similarly, Moody's did not downgrade approximately $1 billion of erroneous notes issued overseas because it might have damaged its reputation.[26] These responses are not surprising in light of the alleged heightened

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http://www.bloomberg.com/news/2010-08-31/sec-says-it-declined-to-sue-moody-s-for-fraud-over-company-s-cdo-ratings.html.

[16] Smith, *supra* note 13.

[17] *Id.*; *Times Topics*, *supra* note 2.

[18] Ellis, *supra* note 9.

[19] *Times Topics*, *supra* note 2.

[20] Smith, *supra* note 13.

[21] *Id.*

[22] *Id.*

[23] *Meltdown Probe*, *supra* note 4.

[24] Smith, *supra* note 13; Morgenson, *supra* note 15.

[25] Smith, *supra* note 13.

[26] Morgenson, *supra* note 15.

pressure to satisfy issuers. Employee statements and testimony portray a coercive environment and a focus on market share, rather than honest analysis.[27]

But some experts doubt that a potential conflict of interest materially contributed to the flawed ratings. Acknowledging that the issuer-pay business model raises eyebrows, perhaps justifiably so, why would an agency knowingly attach its reputation to faulty ratings?[28] After all, an agency's entire product is its reputation of accuracy and objectivity.[29] Risking the agency's core competency on a single security seems short-minded. Further, the reports of pressured and coercive work settings may be explained by the increased volume and complexity of securities.[30] The analysts were not necessarily pressured to assign ratings that favored issuers, but rather pressured to assign ratings *period* so that they could move on to the next security in line.[31]

C. Dodd-Frank's Impact on Credit Rating Agencies

Recognizing the importance of accurate credit ratings, Congress declared the agencies' activities matters of public interest; hence, they justify a level of public oversight similar to that of securities analysts and auditors.[32] Accordingly, the Act directly addresses multiple aspects of credit rating agencies and their activities.[33] Changes include increased Securities and Exchange Commission ("SEC" or "Commission") oversight, liability exposure,

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[27] *Times Topics, supra* note 2 (asserting that the financial investigation commission's June hearing revealed sentiment among S&P employees that focus was on market share, rather than accurate ratings); Ellis, *supra* note 9 (stating that a former vice president at Moody's said he felt pressured to accept deals, and his "unwillingness to say 'no' grew;" a Moody's employee felt pressure from Goldman Sachs to issue high ratings).

[28] Interview with William Chambers, associate professor of professional practice in administrative sciences, BOSTON UNIVERSITY, and former Managing Director, STANDARD & POOR'S, in Boston, Mass. (Nov. 10, 2010).

[29] *Id.*

[30] *Id.*; *Times Topics*, *supra* note 2.

[31] Interview with William Chambers, *supra* note 28.

[32] H.R. REP. NO. 111-517, at Sec. 931(3) (2010).

[33] *Id.*

removal of statutory references to credit ratings, internal control requirements and rating methodology regulations.[34]

Although skeptics may doubt the legitimacy of issuer influence on ratings, Congress has explicitly acknowledged a problematic conflict of interest and now seeks to alleviate the pressure to serve issuers.[35] Measures that provide direct ammunition for battling the problem include SEC involvement, employment regulations, public disclosure requirements and mandated studies by the Commission and the Government Accountability Office ("GAO").[36] At first glance, stakeholders can expect increased time and information required to complete ratings, larger fees for rating services and a rise in the number of lawsuits against the agencies.[37] Proponents and opponents disagree about whether the Act helps or hurts the industry and, ultimately, investors.[38]

1. Increased SEC Oversight and Liability Exposure

The SEC is given new enforcement tools, including the ability to suspend or revoke NRSRO registration for certain classes of securities.[39] The Commission must establish an Office of Credit Ratings ("OCR"), which is to administer rules for the purpose of protecting investors, increasing accuracy and reducing conflicts of interest.[40] In addition to determining penalties for violations, the

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[34] *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact on Credit Rating Agencies,* PRICEWATERHOUSECOOPERS, LLP, Sep., 2010, http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-credit-rating-agencies.pdf (last visited Nov. 11, 2010) [hereinafter *PWC*].

[35] H.R. REP. NO. 111-517, at Sec. 931(4) (2010).

[36] PWC, *supra* note 34.

[37] *The Dodd-Frank Act: Commentary and Insights,* SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, Jul. 12, 2010, at 77, *available at* http://www.skadden.com/Cimages/siteFile/Skadden_Insights_Special_Edition_Dodd-Frank_Act1.pdf [hereinafter *Skadden*].

[38] Yuval Bar-Or, *Rating Agencies Should Get A Death Sentence*, FORBES.COM, Sep. 24, 2010, http://www.forbes.com/2010/09/24/dodd-frank-moodys-financial-advisor-network-credit-ratings.html.

[39] PWC, *supra* note 34, at 1.

[40] *Dodd-Frank Wall Street Reform and Consumer Protection Act: Credit Rating Agency Provisions*, ORRICK, HERRINGTON & SUTCLIFFE, LLP, July 16, 2010, *available at* http://www.orrick.com/fileupoad/2829.htm [hereinafter *Orrick*].

OCR will conduct annual examinations of ethics policies, internal supervisory controls and management of conflicts of interest, among other inspections.[41]

Along with creating the OCR, the Act calls upon the SEC to mitigate conflicts of interest by establishing informational barriers and stringent filing requirements. The SEC must issue rules that prevent sales and marketing considerations from affecting an NRSRO's ratings.[42] The SEC is given the power to suspend or revoke registration for failed compliance.[43] Furthermore, rather than merely providing documents, credit ratings agencies must now "file" with the SEC, which opens the door for actions against agencies who file false or misleading information.[44]

Other provisions of the Act directly increase liability exposure. Notably, the Act gives the Commission the power to pursue litigation resulting from conduct occurring outside the U.S. that has a substantial effect within the U.S.[45] But the most drastic increase of liability exposure might be the elimination of agency exemption under two federal rules: Rule 436(g) and Regulation FD.[46] Without the Rule 436(g) exception, a rating agency will be forced to prove its ratings were reasonable and accurate.[47] The removal of the Regulation FD exception effectively means that material nonpublic information will no longer be provided to the agencies.[48] This particular removal seems inconsistent with the purpose of the Act. If

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[41] *Id.*

[42] Bene I. Ness, Matthew D. Root, & Timothy A. Stafford, *Dodd-Frank Measures Affecting Credit Rating Agencies,* DECHERT LLP, Aug. 2010, *available at* http://www.dechert.com/library/Finance_and_Real_Estate-08-10-35-Dodd-Frank_Measures_Affecting_Credit.pdf.

[43] PWC, *supra* note 34, at 2.

[44] *Id*. at 1.

[45] Joshua Gallu, *SEC Says Dodd-Frank Law Lets Agency Chase Overseas Ratings Fraud*, BLOOMBERG, Sep. 1, 2010, http://www.bloomberg.com/news/2010-08-31/sec-says-it-declined-to-sue-moody-s-for-fraud-over-company-s-cdo-ratings.html.

[46] Stephen Joyce, *Dodd-Frank Impact on Rating Agencies Includes Expanded Liability, SEC Authority*, BUREAU OF NAT'L AFFAIRS, Aug. 30, 2010.

[47] Orrick, *supra* note 40.

[48] *Id.*

Congress desires more accurate ratings, why would it limit the information available to the agencies?[49]

The increased vulnerability has already resulted in agency action. Immediately after the Act was passed, Moody's, S&P and Fitch stated that they would not give permission for their ratings to be used in registration statements.[50] For a case in point, a Ford bond offering was recently delayed because, as a result of the repeal of the Rule 436(g) exemption, the NRSROs refused to give their consent.[51] Thus, the increased exposure may result in a slowed registration process and additional lawsuits and costs.[52] However, despite increased costs and time requirements, proponents expect the Act to reduce fraudulent activity through the expanded regulatory tools it authorizes. The SEC has already warned NRSROs that it will utilize its expanded oversight power to mitigate fraudulent conduct overseas, an issue it had difficulty with prior to the Act.[53]

2. Internal Control Requirements and Disclosure Obligations

In addition to increased liability exposure and SEC involvement, the Act imposes several internal control and rating methodology changes.[54] At least half of an NRSRO's board of directors must be independent.[55] Each NRSRO must establish an internal control structure regulating adherence to methods for determining credit ratings.[56] A chief compliance officer ("CCO") within each NRSRO, who is effectively disconnected from ratings

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[49] Interview with William Chambers, *supra* note 28 (indicating that in the past, such confidential information was shared with the agencies, who factored it into their models to provide more accurate ratings for investors).
[50] PWC, *supra* note 34, at 1.
[51] Joyce, *supra* note 46.
[52] Skadden, *supra* note 37, at 77.
[53] Yin Wilczek, *In Report, SEC Warns NRSROs to Have Adequate Controls Over Rating Procedures*, BUREAU OF NAT'L AFFAIRS, Sep. 1, 2010; Gallu, *supra* note 41, (indicating that the Commission will be able to deter conduct similar to the Moody's error in 2007, which resulted in $1 billion of European securities bearing an inflated grade).
[54] PWC, *supra* note 34, at 2-3.
[55] *Id*. at 2.
[56] Ness, Root & Stafford, *supra* note 42.

activity, is required to annually report compliance status.[57] Additionally, the agencies must consider any issuer-related information they receive from a third party.[58] Ratings analysts must meet specific qualitative standards, and agencies must report employees who leave to work for a rated entity.[59]

These mandated internal controls are complimented by new disclosure rules, which increase transparency.[60] An NRSRO is required to clearly disclose on its website the initial rating, and any subsequent changes, of each type of security issued.[61] The agencies must provide information about the assumptions and principles used, the risks and limitations of the rating and a detailed account of any third-party influence on the rating.[62] Furthermore, the agencies must provide any information relating to conflicts of interest, along with an attestation that each rating is an objective and independent evaluation, based in no part on other business activities.[63]

In the near term, at least, the changes will likely increase the time and information needed to rate a security, prolonging a security's market deployment.[64] Third party source considerations and complex disclosure obligations, coupled with expanded liability exposure, will heighten due diligence requirements and increase operating costs.[65] Even so, the NRSROs will not bear the costs alone; the expenses will likely be passed on to issuers in the form of higher fees.[66]

3. Statutory Reference Removal and Mandated Studies

The Act requires several studies to be conducted by the SEC and the GAO, including two that are relevant to agency

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[57] PWC, *supra* note 34, at 2 (asserting that the CCO cannot work on credit ratings or receive compensation based on the financial success of the NRSRO.)
[58] *Id*. at 3.
[59] Ness, Root & Stafford, *supra* note 42.
[60] PWC, *supra* note 34, at 4.
[61] *Id.*
[62] *Id*. at 4-5.
[63] *Id*. at 2.
[64] Skadden, *supra* note 37, at 77.
[65] *Id.*; PWC, *supra* note 34.
[66] Skadden, *supra* note 37, at 77.

independence.[67] Within three years the SEC must conduct an analysis on strengthening credit rating agency independence, focusing on the management of conflicts of interest and the impact of disallowing NRSROs from providing services other than ratings analysis.[68] The GAO will conduct a similar study on alternatives to the current business model in play, to be completed in two years, assessing the feasibility of alternative methods of compensation in order to improve ratings accuracy.[69] Whether the studies will result in further regulation or inaction is unknown, magnifying uncertainty for the agencies.[70]

In an effort to decrease regulatory reliance on ratings, the Act calls for the removal of many references to credit ratings from federal laws, effective two years after enactment.[71] The removal of references in the Securities Exchange Act of 1934 means the SEC must find another way to determine what qualifies as a mortgage-related or small-business-related security.[72] Similarly, the SEC must find an alternative standard of measuring the creditworthiness of securities held by state-regulated investment companies who seek exemption from the Investment Company Act of 1940.[73] Furthermore, modifications to the National Bank Act will require the 100 largest banks to have at least one debt instrument that meets credit standards issued by the Department of Treasury and Federal Reserve Board, as opposed to an NRSRO.[74]

The removals mean that regulatory agencies may need to develop alternative standards of measuring creditworthiness.[75] This aspect of the act raises questions about whether securities graded with a credit rating will satisfy various regulatory requirements in the future.[76] In the meantime, the call to develop new ratings mechanisms has been met with an international obstacle: the stalling of U.S. implementation of Basel, the international committee designed to set capital and liquidity requirements for banks

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[67] Joyce, *supra* note 46.
[68] PWC, *supra* note 34, at 7.
[69] Joyce, *supra* note 46.
[70] PWC, *supra* note 34, at 7.
[71] Orrick, *supra* note 40.
[72] PWC, *supra* note 34, at 5.
[73] *Id.*
[74] *Id*. at 6.
[75] Ness, Root & Stafford, *supra* note 42.
[76] *Id.*

worldwide.[77] The removal of references to credit ratings has forced U.S. regulators to begin anew in developing capital requirements consistent with both the Act and Basel standards.[78]

D. Conclusion

Supporters of the Act praise strengthened regulatory tools as deterring misconduct and protecting investors. These proponents can point to Congressional findings, which expressly indicate that the agencies play a "gatekeeper" role in the debt market, are burdened with serious conflict of interest problems, and therefore warrant increased accountability and public oversight.[79] Opponents of the Act disagree. By increasing regulatory controls, the argument goes, barriers to entry into the credit ratings industry are increased, and the supposedly flawed business model is perpetuated.[80] In addition to delaying securities offerings and postponing implementation of Basel requirements, the Act may demand too much from the SEC, given current staff levels.[81] But the broader concern, for some, lies in a business model that empowers the large NRSROs. Increased barriers to entry due to heightened regulation requirements will deter innovative business strategies and fair competition.[82] Rather than focusing on more regulation, Congress's attempt to fix the problem should promote increased competition.[83] Maybe then investors would see the demise of the issuer-pay system in favor of a different model.

Notwithstanding differing opinions on the Act, the facts remain. Although credit agencies seek to provide objective and accurate ratings for investors, evidence of pressure to satisfy issuers is ample. The impact, if any, the conflict of interest has had on financial ratings may never be known, but Congress has not hidden its effort to promote agency independence through the Act.

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[77] Yalman Onaran, *Dodd-Frank Ban on Ratings Delays U.S. Implementing Basel Rule,* BLOOMBERG, Sep. 24, 2010, http://www.bloomberg.com/news/2010-09-23/dodd-frank-ban-on-credit-ratings-delays-u-s-adopting-basel-trading-rules.html.

[78] *Id.*

[79] H.R. REP. NO. 111-517, at Sec. 931(3) (2010).

[80] Bar-Or, *supra* note 38.

[81] Onaran; *GAO Report Says SEC Needs to Improve Registration, Exam Process for Credit Raters*, BUREAU OF NAT'L AFFAIRS, Sep. 24, 2010.

[82] Bar-Or, *supra* note 38.

[83] *Id.*

Regardless, entities will continue to pay agencies to rate their products, at least for now.

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