NOTES & COMMENTS

CREDIT RATING AGENCIES: REGULATION AND LIABILITY

by
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In 2007, the economy crashed because of credit rating agency misconduct. Through the early 2000s, credit raters' reckless pursuit of profits facilitated the enormous real estate and structured finance bubble that eventually burst in 2007. This Article examines the ratings industry and its institutions, their role in the crash, the regulation that led to their dominance in the markets, how that regulation changed in the wake of the economic crisis, and how they can be held liable today for present and future misconduct.

Section I describes what credit rating agencies (CRAs) are and what they do. Understanding the function of these institutions is critical to understanding how they operated before and after the crash, and why they should not be shielded from liability. Section II explains the role of the rating agencies in the financial crash of 2007, and how falsely high ratings for very risky instruments helped grow the immense real estate and credit bubble. Section III explains the history of credit rating regulation before the crisis and establishes how the agencies came to occupy such an enormous and important role in financial markets. Section IV details the reactive legislation that came after the financial crisis and explains its effect—or lack thereof—on ratings regulation. Substantial regulatory reliance persists in spite of the Act's overt goals, which means

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that CRAs still occupy a powerful quasi-governmental position in the economy. This Section also adds a current analysis (as of January 2020) of the Office of Credit Ratings, which is a subdivision of the SEC created by the Dodd-Frank Act. Section V outlines theories of liability for credit raters. If oversight of the rating agencies continues to be ineffective, then litigation on statutory, tort, or criminal grounds must be employed to deter misconduct and market manipulation and to punish bad actors. Increasing CRA liability will more effectively combat the conflicts of interest that persist in the industry by deterring risky and fraudulent conduct, and by encouraging due diligence and substantial investment in accurate economic models.

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I. INTRODUCTION

The economy crashed in 2007 because of credit rating agency misconduct. Through the early 2000s, credit raters' reckless pursuit of profits facilitated the enormous real estate and structured finance bubble that eventually burst in 2007. This Article examines the ratings industry and its institutions, as well as their role in the crash, the regulation that led to their dominance in the markets, how that regulation

changed in the wake of the economic crisis, and how they can be held liable today for present and future misconduct.

Section I describes what credit rating agencies (CRAs) are and what they do. Understanding the function of these institutions is critical to understanding how they operated before and after the crash, and why they should not be shielded from liability. This Section briefly explores whether credit ratings are descriptions of fact or merely opinions.

Section II explains the role of the rating agencies in the financial crash of 2007, and how falsely high ratings for very risky instruments helped grow the immense real estate and credit bubble. This Section details the flawed methodologies underlying the ratings, the conflicts of interest inherent in the industry's business model and the toxic practices they encouraged, and why CRAs' reputations are irrelevant to the quality of their analyses.

Section III explains the history of credit rating regulation before the crisis and establishes how the agencies came to occupy such an enormous and important role in financial markets. The dependence of American financial regulation on CRAs granted them immense power to unlock the markets for institutional participants, and strict regulatory barriers to entry have perpetuated the dominance of just three major companies. The resulting lack of competition has assured each major CRA a significant share of the industry market, irrespective of their performance.

Section IV details the reactive legislation that came after the financial crisis and explains its effect—or lack thereof—on ratings regulation. Substantial regulatory reliance persists in spite of the Act's overt goals, which means that CRAs still occupy a powerful quasi-governmental position in the economy. This Section also adds a current analysis (as of January 2020) of the Office of Credit Ratings, which is a subdivision of the SEC created by the Dodd-Frank Act. In short, the Office of Credit Ratings has been ineffective; an examination of its recent reports shows that it neither deters rating agency misconduct nor enforces SEC regulation. Further, this Section discusses two of the Act's attempts to expand liability under existing securities regulation and how they were almost immediately neutered.

Section V outlines theories of liability for credit raters. If oversight of the rating agencies continues to be ineffective, then litigation on statutory, tort, or criminal grounds must be employed to deter misconduct and market manipulation and to punish bad actors. More specifically, private causes of action must be introduced to securities regulation, and mens rea elements of both criminal and tort law need to be lowered to negligence rather than recklessness. Under existing law, plaintiffs can attempt to hold CRAs strictly liable for injuries caused by defective products. Expanding liability for CRAs recognizes the vast power they wield in our economy and assumes that such institutional dominance will not change soon. Accordingly, increasing CRA liability will more effectively combat the conflicts of interest that persist in the industry by deterring risky and fraudulent conduct, and by encouraging due diligence and substantial investment in accurate economic models.

II. WHAT ARE CREDIT RATING AGENCIES?

A complete understanding of CRAs begins with a comprehensive knowledge of the products they peddle. Though their accuracy is contested,[1] credit ratings are marketed as "information products" that are comprised of analyses of credit issuers' backgrounds, futures, and contexts.[2] Credit raters analyze the current and future strength of a debt issuer's business in the context of the market in which the issuer operates, with the goal of pinpointing how likely a default is to occur.[3] Rating agencies consider past, present, and future problems facing issuers and investors, all within the broader context of the issuer's industry and corporate timeline.[4] Short-term ratings are analyses of creditworthiness for one year; long-term ratings weigh the strength of debt obligations for a timeline of three to five years.[5] One constant is that all ratings purport to accurately grade a debtor's likelihood of fulfilling its promise to pay back creditors.[6] Ultimately, the rating process culminates in a simple indicator of creditworthiness—a letter grade.[7]

The simplicity of credit ratings is precisely what makes them so appealing to investors; an astonishing amount of information is collected, weighed, analyzed, and ultimately transmuted into a symbol that (in theory) gives the consumer an accurate idea of how likely it is they will be paid back.[8] At their inception in the nineteenth century, this was the goal of credit raters. Henry Varnum Poor (of Standard and

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[1] Mark J. Flannery, Joel F. Houston & Frank Partnoy, *Credit Default Swap Spreads as Viable Substitutes for Credit Ratings*, 158 U. PA. L. REV. 2085, 2092–95 (2010) (arguing that as the "resources expended per rating declined" and as raters failed to ensure quality, the assertions of creditworthiness took on a "dubious quality"); OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 14 (2008) (finding that "rating agencies made 'out of model adjustments' and did not document the rationale for the adjustment," a practice that, by obscuring the factors motivating such decisions, raised the inference that some ratings were based on either arbitrary considerations or ones that were unrelated to the objective creditworthiness of the debt obligation).

[2] HERWIG M. LANGOHR & PATRICIA T. LANGOHR, THE RATING AGENCIES AND THEIR CREDIT RATINGS: WHAT THEY ARE, HOW THEY WORK, AND WHY THEY ARE RELEVANT xiii–iv, 2, 7 (2008).

[3] *Id.* at 7.

[4] *Id.* at 7–8.

[5] *Id.* at 44.

[6] *Id.* at 7.

[7] MOODY'S INVESTORS SERVICE, RATING SYMBOLS AND DEFINITIONS 6 (2020), https://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/MoodysRatingSymbolsandDefinitions.pdf; S&P GLOBAL RATINGS, S&P GLOBAL RATINGS DEFINITIONS (2019), https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 (listing "AAA" at the top of its "Long-Term Issue Credit Ratings" scale).

[8] GILBERT HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE: AN APPRAISAL OF THEIR EFFECTIVENESS 49–50 (1938).

Poor's, one of the world's largest rating agencies) believed investors needed to be briefed on the default risks of buying stocks and bonds.[9] Ultimately, he hoped CRAs would facilitate well-informed investment, and "directly or indirectly, pressure obligors to respect their obligations."[10] A company that wants to solicit investment from risk-averse financiers must earn an "investment grade" rating that signified their future ability to pay.[11] Thus, most ratings today indicate an investment-grade level of creditworthiness.[12]

One potential problem with credit raters' use of so much information to inform their ratings is that receipt of any new data has the potential to disrupt their published rating for a given stock, bond, or other financial vehicle. A rating that changes daily based on a constant stream of new knowledge hardly seems helpful; indeed, most investors prefer stable ratings that reflect longer term trends than day-to-day changes and analysis.[13] Thus, to satisfy their customers, rating agencies strive to operate on the "efficient frontier," which is what economists call the intersection of accuracy and stability—that is, the ideal rating reflects current analysis and fully-informed trend prediction, but is not so volatile as to be upgraded and downgraded upon receipt of small, albeit important information.[14] When credit raters function properly and make predictions on the efficient frontier, they can serve as a "credit risk compass" for investors seeking the most palatable trade-off between risk and return.[15] Credit raters' business models, it would seem, turn on the credibility and success of their analyses, and therefore, maintaining a high level of "reputational capital" is imperative to their success.[16]

CRAs have maintained their substantial role in domestic and foreign markets because they provide information that investors would not otherwise possess.[17] CRAs bridge the information gap between debt issuers and investors: most investors simply do not have the time or the resources to obtain and analyze the information

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[9] LANGOHR & LANGOHR, *supra* note 2, at 1.

[10] *Id.* at 1–2.

[11] *Id.* at 45.

[12] *Id.* at 44–45.

[13] *Id.* at 8.

[14] *Id.*

[15] *Id.* at 14.

[16] Frank Partnoy, *What's (Still) Wrong with Credit Ratings?*, 92 WASH. L. REV. 1407, 1409 (2017). *Contra* FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 406 (2009) ("Economists have assumed a gatekeeper would not take advantage of investors, because if it did so, its reputation would suffer and no one would use its services. That view has proven . . . naïve . . . . During the past twenty years, gatekeeper institutions have performed unimaginably disreputable acts, but their reputations have suffered only a little—and their profits have not suffered at all.").

[17] LANGOHR & LANGOHR, *supra* note 2, at 9 (arguing that credit raters add value by "[o]vercoming [i]nformation [a]symmetries."); *id.* at 14.

that raters eventually turn into a simple grade. Arguably, this is where rating agencies "add economic value" to participants of the stock market; the ratings and their explanations give outsiders information about the internal dynamics of companies.[18]

Information asymmetry and reputational capital are not the sole reasons CRAs have enjoyed continued success. The federal government institutionalized rating agencies decades ago.[19] For example, some institutional investors may be required to allocate assets according to CRA grades.[20] One scholar describes the quasi-governmental position that CRAs occupy as "Regulatory License," where governmental intervention into the credit rating industry has led to broad institutional reliance on ratings as a "financial license that unlocks access to the markets."[21]

III. WHAT WAS THE ROLE OF CRAS IN THE 2007 FINANCIAL CRISIS?

The gatekeeping function of credit raters coupled with the United States' regulatory reliance on their ratings means that CRAs play an immense role in financial markets. Before a debt obligation—be it a stock, bond, or other, more complex financial vehicle—is marketed, it is rated on the basis of reliability by one of these institutions.[22] Therefore, credit raters facilitate access to credit markets, and more

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[18] *Id.*

[19] HAROLD, *supra* note 8, at 25–35. As early as 1930, for example, various Federal Reserve banks were evaluating the strength of their portfolios with reference to credit ratings; and around the same time, the Comptroller of the Currency began to treat triple-B ratings and higher more favorably. *Id.* at 25–27; *see infra* Section III.

[20] Jonathan W. Heggen, Note, *Not Always the World's Shortest Editorial: Why Credit-Rating-Agency Speech Is Sometimes Professional Speech*, 96 IOWA L. REV. 1745, 1752 (2011) ("Part of the success of the issuer-pays model is that some investors can only invest in offerings that NRSROs have rated highly, which leaves issuers little choice but to have CRAs rate their offering.").

[21] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1409–11; PARTNOY, *supra* note 16, at 406–07 ("[N]o matter how poor the credit-rating agencies are at predicting defaults, companies will still pay these agencies for ratings, because legal rules effectively require them to do so.").

[22] Heggen, *supra* note 20, at 1748 (explaining that, in the context of more complex financial instruments, issuers of debt market various debt obligations according to each issue's specific risk of default, so investors can purchase according to their appetite for risk); Stephen Harper, Note, *Credit Rating Agencies Deserve Credit for the 2007–2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act*, 68 WASH. & LEE L. REV. 1925, 1941–42 (2011). Harper succinctly summarizes the "process of securitization," where an "originator" solicits capital infusions by transferring profitable assets to a separate entity that is wholly owned by the originator. *Id.* at 1941 (quoting Stéphane Rousseau, *Regulating Credit Rating Agencies After the Financial Crisis: The Long and Winding Road Toward Accountability*, CAP. MKTS. INST., July 23, 2009, at 6). The goal of the transfer is to shield the assets from risks borne by the originator, which presumably makes the new entity more creditworthy, at least facially. *Id.* That separate entity then generates debt obligations for sale on the credit market that are first assessed by CRAs. *Id.* at 1942. The originator then has access to the cash flow generated by the separate entity's sale

importantly, frame participants' perceptions of the goods they buy and sell. When credit ratings became compromised, the crash became inevitable.

The highest rating, the "triple-A" grade, is "supposed to be sacrosanct, inviolable."[23] Moody's (one of the largest CRAs in the world) affirmed that triple-A ratings "should survive the equivalent of the U.S. Great Depression."[24] Given the mass ratings downgrades early in the crisis,[25] the rating agencies were experiencing legendary hubris, which had catalyzed a market-wide unquestioning trust in their products. The Financial Crisis Inquiry Commission, which ultimately concluded that the credit bubble and subsequent crash were avoidable, explicitly recognized that "major firms and investors blindly relied on credit rating agencies as their arbiters of risk."[26] So, what actually happened?

From the mid-1990s until the mid-2000s, homeownership began to spike sharply in the United States, due in large part to the over-inflation of home prices and reduced lending standards that allowed many people to purchase homes who otherwise would not have qualified for mortgages.[27] These mortgages given to financially precarious buyers are called "subprime," which refers to debt with a higher likelihood of default.[28] Banks were incentivized to disburse loans to an entire new class of putative homeowners because, on the front end, they were able to collect origination fees at the moment the mortgage hit the books and, on the back end, they were able to profit *and* dispense the risk of default to other parties when they sold the right to collect on that debt in the credit market.[29] It did not matter whether

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of debt. Without the asset transfer and subsequent favorable ratings by CRAs then, securitization was pointless, because the separate entities would not be able to entice investors any more than the originator could. *Id.*

[23] Matt Taibbi, *The Last Mystery of the Financial Crisis*, ROLLING STONE (June 19, 2013), https://www.rollingstone.com/politics/politics-news/the-last-mystery-of-the-financial-crisis-200751/; MOODY'S, *supra* note 7, at 6 (listing "AAA" at the top of its "Global Long-Term Rating Scale"); S&P GLOBAL RATINGS, *supra* note 7 (listing "AAA" at the top of its "Long-Term Issue Credit Ratings" scale).

[24] Taibbi, *supra* note 23.

[25] *Id.*

[26] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xvii (Jan. 2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[27] Heggen, *supra* note 20, at 1747.

[28] John V. Duca, *Subprime Mortgage Crisis*, FED. RES. HIST. (Nov. 22, 2013), https://www.federalreservehistory.org/essays/subprime_mortgage_crisis.

[29] AARON GLANTZ, HOMEWRECKERS: HOW A GANG OF WALL STREET KINGPINS, HEDGE FUND MAGNATES, CROOKED BANKS, AND VULTURE CAPITALISTS SUCKERED MILLIONS OUT OF THEIR HOMES AND DEMOLISHED THE AMERICAN DREAM 14–15 (2019) (referring to mortgage-originating banks as "salesmen," who had no stake in the reliability of the mortgages because they could sell that risk to other investors).

the new homeowners would be able to make their payments, because the originator no longer had a stake in the outcome.[30]

CRAs' culpability is implicated in the second step, when investment banks, who purchased the debt from the originating bank, bundled those mortgages into complex financial units like collateralized debt-obligations (CDOs) supported by residential mortgage-backed securities (RMBS),[31] and structured investment vehicles (SIVs).[32] CDOs, simply put, are groupings of loans which are all pooled together and divided into tiers of risk; RMBS-backed CDOs were collateralized primarily by those subprime loans.[33] SIVs, on the other hand, are financial entities created by banks to allow them to simultaneously move debt off of their books and get around regulatory capital requirements, which are in place to shore up resources in the event of large-scale losses, thereby facilitating their collection of massive investments in subprime CDOs, for example.[34]

How did all of these risky loans make their way into the portfolios of so many investors? They were highly rated and therefore not considered risky. CRAs were the facilitators of the market-wide engagement with subprime loans, for without their high ratings, the originating banks would not have been able to sell those loans and would have been stuck with them on their books. As typically risk-averse institutions, this presumably would have limited banks' willingness to lend in the first place,[35] and subprime loans would likely not have so completely permeated the credit market.

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[30] *Id.*

[31] *See* Heggen, *supra* note 20, at 1748.

[32] *See* Taibbi, *supra* note 23.

[33] Heggen, *supra* note 20, at 1748.

[34] Taibbi, *supra* note 23.

[35] There were benefits to such widespread lending, however: subprime mortgages were beneficial to the extent they allowed various groups of people who had traditionally been barred access to homeownership to purchase real property. *See* Andrew W. Hartlage, Book Notice, *"Never Again," Again: A Functional Examination of the Financial Crisis Inquiry Commission*, 111 MICH. L. REV. 1183, 1183 (2013) (referring to subprime mortgages as "[t]he financial innovations that were once seen as a path to broader homeownership and greater financial equality"). A counter to this position is that subprime mortgage lending was yet another racialized practice by an industry with a consistent history of race discrimination. It appeared after the crisis that redlining had been replaced by subprime mortgage lending—"for all major lenders African-Americans and Latinos were much more likely to receive a subprime loan than whites . . . . [Lenders] impos[ed] risky financial products on their customers and minorities much more often than whites." Jennifer M. Smith, *Mortgage Foreclosures, Mortgage Morality, and Main Street: What's Really Happening?*, 25 J. CIV. RTS. & ECON. DEV. 525, 536 (2011) (citing Richard Marisco & Jane Yoo, *Racial Disparities in Subprime Home Mortgage Lending in New York City: Meaning and Implications*, 53 N.Y.L. SCH. L. REV. 1011, 1020 (2008)).

What remains unanswered is how and why such high ratings were given to suspect investments. Those questions are largely explainable by examination of CRA methodology and conflicts of interest.

A. Methodology

Moody's defines their credit ratings as "forward-looking opinions of the relative credit risks of financial obligations issued by non-financial corporates, financial institutions, structured finance vehicles . . . and public sector entities."[36] Credit risk is defined as the likelihood of failure to meet financial obligations and the estimated loss in the event of such failure.[37] To assess credit risk, Moody's assesses debt issuers' contractual obligations, liquidity, and willingness to pay.[38] S&P's definition page indicates a similar methodology.[39]

Facially, these methods are quite limited; the "opinions" are based largely on issuers' existing financial obligations and assets.[40] Contained within this analysis, though, is assessment of issuers' "business fundamentals."[41] In concluding that credit rating analysis is in large part business analysis, Langohr and Langohr summarize the rationale S&P provided as the basis for its downgrade of General Motors corporate credit to B in 2005.[42] They note that GM's industry position was the primary cause of negative trend; though the company had significant liquid assets and borrowing power, its creditworthiness was suspect because of weak North American operations performance due to market share erosion and continuing reduction of its product array.[43]

The above analysis appears flexible and able to consider a variety of factors in assessing credit risk, resembling a "totality of the circumstances" legal analysis. Ratings of more complex financial instruments, however, are often guided by a different

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36 MOODY'S, *supra* note 7, at 5.

37 *Id.*

38 *Id.*

39 S&P states:

> An S&P Global Ratings issue credit rating is a forward-looking opinion about the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program[.] It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated. The opinion reflects S&P Global Ratings' view of the obligor's capacity and willingness to meet its financial commitments as they come due, and this opinion may assess terms, such as collateral security and subordination, which could affect ultimate payment in the event of default.

S&P GLOBAL RATINGS, *supra* note 7.

40 *See id.*

41 LANGOHR & LANGOHR, *supra* note 2, at 2.

42 *Id.* at 3–6.

43 *Id.* at 3.

analysis, and although the programs were published on CRAs' websites, the specific algorithms used—along with their implicit assumptions and limited factor sets—"remained nevertheless a black box."[44] An overlooked feature of converting reality into mathematical equations is that the final product reifies any flawed analytical bases. That is, the final algorithm presents as natural and objective the presumed (or researched) facts underlying the numbers therein, a process that makes it difficult to critically evaluate the results.

Ultimately, the Financial Crisis Inquiry Commission concluded that the credit rating industry (in relation to structured finance) was wholly dependent on computer models, "which turned out to be divorced from reality."[45] The models were deeply flawed, in part because of conflicts of interest (discussed below), but also because ratings ignore market and liquidity risk,[46] and because of an industrywide decline in underlying fact substantiation and due diligence.[47]

Although CRAs were never the verifying entities of facts underlying loans, they eventually stopped insisting on such background information, which is partly how securities founded on "liar's loans" were rated so highly.[48] Ratings given to RMBSs and similar investment vehicles came to possess little (if any) basis in fact, exemplified by one senior quantitative analyst's lament: "Remember the dream of being able to defend the model with sound empirical research? If we are just going to make it up in order to rate deals, then [quantitative analysts] are of precious little value."[49] Such admissions challenge the notions that CRAs would be deterred from this exact type of behavior because it would affect their reputations and ultimately, their profit margins.

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[44] *Id.* at 369.

[45] FIN. CRISIS INQUIRY COMM'N, *supra* note 26, at 28.

[46] LANGOHR & LANGOHR, *supra* note 2, at 369.

[47] John C. Coffee, Jr., *Ratings Reform: The Good, The Bad, and the Ugly*, 1 HARV. BUS. L. REV. 231, 241 (2011).

[48] *Id.* at 237, 241. As Langohr & Langohr noted:

> A serious charge that has been leveled against the leading CRAs is that due diligence in the rating process in inadequate. CRAs have been blamed for taking the issuers' word at face value, undertaking improper reviews of public filings, paying inadequate attention to detail, and aggressive accounting practices in financial statements.

LANGOHR & LANGOHR, *supra* note 2, at 189 (citing SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS AS REQUIRED BY SECTION 702(b) OF THE SARBANES-OXLEY ACT OF 2002 32, (2003)).

[49] Taibbi, *supra* note 23. The article exposes various CRA employees' overt acknowledgments that ratings were devoid of factual foundations. For example, one S&P analyst, in a message to his boss about an SIV issued by Morgan Stanley, mentioned that he "had difficulties explaining 'HOW' we got to those numbers since there is no science behind it . . . ." *Id.*; *see* FIN. CRISIS INQUIRY COMM'N, *supra* note 26, at xix (observing that mathematical models replaced judgment as the primary risk predictor for CRAs, and that these models allowed "risk management [to become] risk justification").

B. Conflicts of Interest

In the abstract, a CRA has no incentive to mislead, to fail to investigate issuers' claims, or to present biased or inaccurate ratings. To be sure, in the reputational capital paradigm, CRAs are negatively reinforced from offering anything but stellar, consistent, fair ratings, because anything else will cost them future business from issuers and investors.[50] However, CRAs do not exist in the abstract. The reputational capital theory, while apparently logical, is flawed because it does not account for the issuer-pays business model, toxic corporate culture and practices, and regulatory reliance.

1. Issuer-Pays Business Model

The most obvious conflict of interest to which CRAs are exposed is that debt issuers, rather than investors, pay to have their financial instruments rated.[51] A logic that accounts for the profit motive quickly leads to the conclusion that a CRA—whose business model revolves around selling ratings to an issuer, which in turn relies on high ratings to maximize its profits as it sells its debt for the maximum value—would be financially incentivized to dole out unjustly high ratings to maintain and secure additional customers. When CRAs' client base shifted from investors to issuers selling corporate bonds, and then to issuers selling structured financial packages, their entire business model shifted too.[52] Their potential customer base shrunk dramatically from all potential investors subscribed to their service to a much smaller number of investment banks and financial institutions marketing CDOs or SIVs or other forms of structured finance.[53] When the credit rating industry had primarily revolved around rating corporate bonds, no single client ever accounted for more than 1% of a CRA's business.[54] During the housing bubble, by contrast, just the top 12 issuers of mortgage-backed securities captured over 80% of the mortgage-backed security rating market.[55]

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[50] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1409, n.3 (briefly describing the reputational capital theory in the text and providing a more substantial description of relevant literature in the footnotes).

[51] Coffee, *supra* note 47, at 255.

[52] *Id.* at 237; Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 623 (1999) ("rating agencies [have shifted] from the business of providing valuable credit information to the far more lucrative business of selling regulatory licenses," i.e., the grades they assign substantively affect institutional investors' and financial institutions' ability to participate in the credit market).

[53] *See* Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 607–08, 639–40 (noting the concentration of the CRAs' customer base in the structured finance market).

[54] Robert C. Pozen & Brian Conroy, Credit Rating Agency Reform in the US and EU 5 (Apr. 27, 2012) (case) (on file with Harvard Business School); Coffee, *supra* note 47, at 237.

[55] Pozen & Conroy, *supra* note 54, at 5; Coffee, *supra* note 47, at 238.

2. Toxic Industry Practices

CRAs were loath to lose any market share.[56] Rating the investment banks' structured finance instruments (highly) was now a massive source of business.[57] At the same time that the big players in structured finance began to develop significant leverage over the CRAs, the rating agencies grappled with the risk of "ratings shopping," which was the implication that if an issuer did not like its rating from one CRA, it could take the same product to a different rating agency and try for a higher grade.[58] The reputational capital argument erases market pressures like this, in spite of their salience. Brian Clarkson, who would later become president of Moody's, "bluntly" acknowledged this reality in a 2004 e-mail when he warned that issuers could just pay a different company to rate the same product.[59]

However, the unfair pressure was not unilateral. CRAs exerted influence over their customers through a process called "notching," which was the practice of rating of financial products lower if they contained elements not rated by that company.[60] This led the issuers to have their products rated by multiple CRAs, which inflated the profits of the industry and simultaneously reinforced the falsehood that the highly rated instruments were extremely low-risk.[61]

3. Reputational Capital and Regulatory Reliance

The reputational capital theory also completely overlooks the reliance of the American regulatory regime on credit ratings made by nationally recognized statistical ratings organizations (NRSROs), specifically, the three largest NRSROs: Moody's Investors Service, S&P Global Ratings, and Fitch.[62] The theory of regulatory reliance is that CRAs are essential players in the market because United States financial regulation necessitates their existence by functionally rendering their rat-

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[56] Coffee, *supra* note 47, at 238 (citing *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies: Hearing Before the S. Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs,* 111th Cong. 14–15 (2010) (statement of Eric Kolchinsky, former Managing Director, Moody's Investors Service)) ("[A] former Managing Director of Moody's with responsibility for supervising their subprime mortgage ratings testified [in front of the Senate Permanent Subcommittee on Investigations] that it was well understood within Moody's that even a small loss of market share would result in a manager's termination.").

[57] FIN. CRISIS INQUIRY COMM'N, *supra* note 26, at 44 ("Investment banks [] paid handsome fees to the rating agencies to obtain the desired ratings.").

[58] Pozen & Conroy, *supra* note 54, at 5.

[59] Taibbi, *supra* note 23.

[60] *Id.* (For example, "if a SIV contained a basket of mortgage-backed securities rated AA by [S&P], Moody's might "notch" those underlying securities down to A, or even lower.").

[61] *Id.*

[62] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1409–10; Taibbi, *supra* note 23.

ings into symbols that facilitate access to the credit market, especially for institutional investors.[63] While potential reputational injury could deter CRAs from acting unethically or blatantly in their own interests, the quasi-governmental status of CRAs—apparent from their inclusion in federal regulation—indicates that they may be able to act with impunity.[64]

Ultimately, rating agencies facilitated the bubble and crash of 2007 because their ratings came to mean nothing. Thousands of "triple-A" rated securities and other financial instruments riddled with them were founded upon subprime mortgage loans that were destined to default.[65] When investors discovered the scope of the compromised highly-rated instruments, the markets were destabilized.[66] The initial wave of downgrades began in the summer of 2007 and continued into 2008. CRAs lowered the ratings of many CDOs that were once rated "triple-A."[67] The credit market, containing $28 trillion, ground to a halt as banks stopped lending.[68] Many financial institutions realized they were deeply exposed to subprime default liability and lost faith in their own stores of mortgage-backed instruments, which led them to hoard capital.[69] Though the government tried to help by infusing the markets with capital, the economy continued to plummet, and "[b]y early 2008, Federal Reserve Chairman Ben Bernanke 'feared a global economic collapse.'"[70]

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[63] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1410 (arguing that regulatory reliance "makes ratings valuable as a kind of financial license that unlocks access to the markets—even if the ratings themselves have little or no informational content"). *Contra* LANGOHR & LANGOHR, *supra* note 2, at 429 (arguing that CRAs' ubiquity is "due to the success of CRAs in becoming a pillar of the informational infrastructure of world capital markets"). *Id.* at 431 (noting the permeation of credit ratings in U.S. legislation and regulation. "In June 2005, US Congress hearings reported that at least 8 Federal statutes, 47 Federal rules, and 100 State laws made reference to [ratings].").

[64] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1410.

[65] *See* LANGOHR & LANGOHR, *supra* note 2, at 365–66 (Exhibit 7.2 contains various examples of CRA recognition that the extent of mortgage securities in structured finance potentially compromised the credit market).

[66] *Id.* at 364.

[67] *Id.* (Tracing the downgrade timeline: in "the second week of July 2007 . . . S&P downgraded $7.3 billion of securities issued in 2005 and 2006[,] and a few weeks later, Moody's downgraded 691 securities . . . originally worth $19.4 billion."); Heggen, *supra* note 20, at 1749.

[68] Heggen, *supra* note 20, at 1749.

[69] *Id.*

[70] *Id.* (quoting Alec Klein & Zachary A. Goldfarb, *The Bubble*, WASH. POST (June 17, 2008), https://www.washingtonpost.com/wp-dyn/content/article/2008/06/16/AR2008061602279_2.html?hpid=topnews&sid=ST2008061602328).

IV. REGULATION BEFORE DODD-FRANK

This Section briefly observes the regulatory scheme relating to CRAs leading up to the major financial legislation passed in the wake of the 2007 crisis.[71] The regulatory license framework is critical to understand how CRAs have become so powerful and why they were able to wreak such havoc on the economy in 2007. Simply put, this theory posits that CRAs possess enormous power in the domestic and global economy because the United States government has established laws that permit private, for-profit CRAs to "determine the substantive effect of legal rules."[72] Such power means that regulatory advantages accrue to issuers and investors when a financial instrument in which they each have a stake receives a high rating.[73]

After the stock market crash of 1929, CRAs grew more important to the country's economy,[74] and in 1930, Federal Reserve Banks started to evaluate member banks' assets with bond ratings.[75] The next year, the Comptroller of the Currency incorporated ratings into banks' asset valuation processes.[76] In 1936, the Federal Reserve expanded the reliance on ratings by precluding bank investment in bonds lacking at least a "triple-b" rating from a minimum of two CRAs.[77] The effects of this rule were widespread, due to the fact that roughly 45% of the bonds on the New York Stock Exchange lacked this criteria.[78] The SEC enacted comparable rules throughout the twentieth and the early twenty-first centuries.[79] For example, one rule grants benefits to offerings that have an "investment grade" rating from an NRSRO,[80] and another grants a helpful exemption to issues that bear an equally

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[71] One scholar estimates that a "thorough review [of credit rating-reliant regulation] would occupy hundreds, perhaps thousands, of pages." Partnoy, *supra* note 52, at 692.

[72] *Id.* at 623; *see* LANGOHR & LANGOHR, *supra* note 2, at 429 (tracing the origin of regulatory use of credit ratings) ("[T]he sheer commercial market success of the [CRAs'] product has created its own public interest externalities. This alone would have eventually resulted in a call for some sort of regulatory oversight . . . [b]ut that same commercial success made regulators decide to use ratings for their own prudential regulatory purposes.").

[73] Partnoy, *supra* note 52, at 681.

[74] *Id.* at 686–87.

[75] *Id.* at 687; HAROLD, *supra* note 8, at 25–26.

[76] Piero Cinquegrana, *The Reform of Credit Rating Agencies: A Comparative Perspective*, 12 ECMI Policy Brief 1, 4 (2009) (citing Partnoy, *supra* note 52, at 686–90); LANGOHR & LANGOHR, *supra* note 2, at 430; HAROLD, *supra* note 8, at 26–27.

[77] LANGOHR & LANGOHR, *supra* note 2, at 430.

[78] *Id.* at 430–31 (citing Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED. RES. BANK N.Y. Q. REV. 1, 6 (1994)).

[79] *Id.* at 436–37.

[80] *Id.* (citing Definition of Nationally Recognized Statistical Rating Organization, 70 Fed. Reg. 21,306, 21,307 (Apr. 25, 2005) (to be codified at 17 C.F.R. pt. 240)) (referring to the rule under the Securities Act of 1933 that allows certain instruments to be registered with the SEC

high rating.[81] This list is far from exhaustive. The Federal Reserve Bank of New York noted in a 1994 report that "[t]he reliance on ratings extends to virtually all financial regulators, including the public authorities that oversee banks, thrifts, insurance companies, securities firms, capital markets, mutual funds, and private pensions."[82]

While early regulation incorporating credit ratings primarily involved the CRAs' separation of investment grade securities ("triple-b" or above) from speculative ones ("double-b" and below),[83] the nature of regulatory reliance changed in 1973.[84] This is the point at which credit ratings truly began to permeate financially-related regulation, and when NRSROs received an official induction into securities law.[85]

At the time of the 2007 crash, there were only three major CRAs who, in the aggregate, held 95% of the rating market share.[86] Some scholars argue that the reason for such a small range of competitors in such a profitable sector can be traced to this legislation in the 1970s.[87] Professor Frank Partnoy notes that regulatory power to approve raters limits competition; that the approved NRSROs' power to sell regulatory licenses bolstered their profits; and that "[a]pproved raters are sheltered from new entrants and from foreign competition."[88] The paucity of competitive credit raters gave each of the three major rating companies immense power in the market; this power can be traced to pre-2007 ratings regulation.[89]

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without disclosure of the percentage of shares available for public trading, originally proposed in 2005).

[81] *Id.* at 437–38 (citing 17 C.F.R. § 270.3a-7(2) (2018)) (referring to Rule 3a-7 under the Investment Company Act of 1940, adopted in 1992).

[82] Cantor & Packer, *supra* note 78, at 5; Partnoy, *supra* note 52, at 690; FIN. CRISIS INQUIRY COMM'N, *supra* note 26, at 126.

[83] Cantor & Packer, *supra* note 78, at 5.

[84] Partnoy, *supra* note 52, at 690.

[85] *Id.*

[86] Pozen & Conroy, *supra* note 54, at 3.

[87] *Id.* (discussing the surprising nature of high concentration of CRA business "despite very high profit margins and tremendous growth from 2000 to 2006, with rating agencies doubling revenues from $3 billion to $6 billion").

[88] FIN. CRISIS INQUIRY COMM'N, *supra* note 26, at 119 ("Beginning in 1975, the SEC had to approve a company's application to become an NRSRO."). Other scholars disagree that regulatory intervention has stifled competition. *See* LANGOHR & LANGOHR, *supra* note 2, at 440–54 ("Industry structure regulations aim at maintaining a level playing field on which the CRAs compete for business without reducing the intensity of competition or access to the field."); Partnoy, *supra* note 52, at 686.

[89] Cinquegrana, *supra* note 76, at 4; Partnoy, *supra* note 52, at 686 n.321; *see* Roberta S. Karmel & Claire R. Kelly, *The Hardening of Soft Law in Securities Regulation*, 34 BROOK. J. INT'L. L. 883, 924–29 (2009).

In 2003, the SEC formally recognized what has been termed a "de facto state-sanctioned oligopoly,"[90] and discussed barriers CRAs may face to become NRSROs.[91] It acknowledged the argument that the "nationally recognized" requirement, which it called the "single most important factor in the Commission staff's assessment of NRSRO status,"[92] is a "substantial" barrier to entry.[93] The crux of this argument is that (both obligatory and voluntary) ratings consumers prefer to use NRSROs' ratings due to the regulatory incentive, and that without the official NRSRO recognition, smaller CRAs cannot become "nationally recognized" enough to gain that status.[94] Though the SEC noted that there are possible rebuttals to this point,[95] it did resolve to explore "possible clarifications of the NRSRO criteria."[96]

In the end, the NRSRO certification process remained opaque until 2006, when Congress passed the Credit Rating Agency Reform Act.[97] Its goal was to introduce transparency and competition into the rating industry to hopefully enhance the informational value of ratings.[98] The Act also granted the SEC authority to propose, adopt, and enforce rules for CRAs going forward.[99] The rules promulgated through this legislation were implemented through amendment of and addition to the Securities and Exchange Act of 1934 (Exchange Act).[100] A key requirement of the rules released in June 2007 was that CRAs had to "implement procedures to manage the handling of material nonpublic information and conflicts of interest."[101] Among the specific obligations of rating agencies regarding CRA conflicts were that they had to provide the SEC with the name and address of their designated compliance officer[102] and furnish written copies of the "policies and procedures [they] establish[], maintain[], and enforce[] to address and manage conflicts of interest."[103]

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[90] Cinquegrana, *supra* note 76, at 4; SEC, *supra* note 48, at 9.

[91] SEC, *supra* note 48, at 9.

[92] *Id.* The SEC explains that this requirement existed "to ensure that [the CRA's] ratings were credible and reasonably relied upon by the marketplace." *Id.* at 6.

[93] *Id.* at 37.

[94] *Id.*

[95] *Id.* at 38.

[96] *Id.* at 40.

[97] Cinquegrana, *supra* note 76, at 4.

[98] *Id.* at 4–5; LANGOHR & LANGOHR, *supra* note 2, at 448.

[99] Cinquegrana, *supra* note 76, at 5.

[100] Oversight of CRAs Registered as NRSRO, 72 Fed. Reg. 33,564, 33,564 (June 18, 2007) (to be codified at 17 C.F.R. pts. 240 & 249(b)).

[101] *Id.*

[102] *Id.* at 33,571 (implemented under Securities Exchange Act of 1934, 15 U.S.C. § 78o-7(j) (2006)).

[103] *Id.* at 33,578 (implemented under Securities Exchange Act of 1934 § 78o–7(h)).

The Exchange Act also limited the categories of businesses CRAs could rate and the practices they could employ.[104] Again, these were implemented to mitigate the moral hazard CRAs faced. NRSROs were prohibited, under the Act, from rating an entity whose business "was the source of 10% or more of the total net revenue of the NRSRO during" the previous fiscal year,[105] from rating an entity "if the NRSRO or an employee involved in the rating decision own any stake in the company rated,"[106] and from rating a business indirectly or directly controlled by the rating agency.[107] Further, CRAs were prohibited from conditioning or modifying ratings or issuances of ratings on other purchases from the issuer,[108] and from deviating from any established procedures in the rating process.[109]

The rules established in 2007 were a response to the signs of the impending subprime-backed securities crisis and from the obvious failure of the CRAs to predict and protect against some of the collapses of the early 2000s.[110] CRA behavior until then had been facilitated by the regulatory foundation that had reified CRAs as a natural gatekeeper to the credit markets.[111] When the crisis hit in 2007 and 2008, legislation was again introduced to reform the credit rating industry.

V. THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT AND ITS EFFECT

As evidenced by the SEC's conclusion that "[investors] were obligated to use [CRAs], [and that] regulatory capital standards hinged on" their ratings, the government was aware of the vast cross-industry reliance on CRAs facilitated through regulation.[112] Accordingly, financial reform legislation introduced in the wake of the crash sought to escape that toxic dynamic. Post-crash legislation endeavored to rid regulation of CRA reliance, created a new oversight agency for CRAs, and attempted to expand statutory liability for rating agencies.

[104] Cinquegrana, *supra* note 76, at 5.

[105] Oversight of CRAs Registered as NRSRO, *supra* note 100, at 33,598 (implemented under 17 C.F.R. § 240.17g-5(c)(1) (2018)); Cinquegrana, *supra* note 76, at 5.

[106] Cinquegrana, *supra* note 76, at 5; Oversight of CRAs Registered as NRSRO, *supra* note 100, at 33,598 (implemented under 17 C.F.R. § 240.17g-5(c)(2) (2018)).

[107] Oversight of CRAs Registered as NRSRO, *supra* note 100, at 33,599 (implemented under 17 C.F.R. § 240.17g-5(c)(3) (2018)).

[108] *Id.* at 33,599–33,601 (implemented under 17 C.F.R. § 240.17g-6(a)(1)–(3) (2018)).

[109] Cinquegrana, *supra* note 76, at 5.

[110] *Id.* at 4–5.

[111] *See, e.g.*, Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1409–11.

[112] FIN. CRISIS INQUIRY COMM'N, *supra* note 26, at xxv.

A. Ending Regulatory Reliance

A primary goal of Dodd-Frank was to reduce regulatory reliance on CRAs. Section 939 of the Act specifically requires the "removal of statutory references to credit ratings," and does so by explicitly striking phrases like "credit rating entities" and "investment grade."[113] Section 939A of the Act requires every federal agency to review its regulations for references to CRAs and to "modify any such regulations identified . . . to remove any reference or requirement of reliance on credit ratings and to substitute in such regulations" a different standard of creditworthiness.[114] Clearly, Congress embraced the SEC's indictment of CRAs and took steps to reduce reliance on the rating agencies.

Despite its efforts, Congress's attempt to eliminate CRAs from regulation has failed. Some scholars have attributed this failure to "stickiness," a theory popularized by behavioral law and economics scholars.[115] Stickiness is the idea that even though a default rule might not be the most efficient or cost effective means of achieving the goal of the rule, parties governed by or employing that rule may be "stuck" with it due to the perceived costs of changing to something else.[116] In the context of regulatory reliance, the proliferation of ratings in law and agency standards made rating usage stickier: as market participants began and continued to rely on ratings, it became more difficult and costly to stop.[117]

Some agencies, like the Federal Deposit Insurance Corporation (FDIC) and National Credit Union Administration (NCUA), have successfully shifted away from ratings reliance.[118] This is because the regulators have simultaneously implemented transition programs to grapple with the stickiness that these regimes face.[119] The FDIC has provided instructions to help banks move away from ratings in conducting due diligence, advising instead that they analyze creditworthiness based on whether the issuer has "adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure."[120] The NCUA, like the

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[113] Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 939, 124 Stat. 1376, 1885 (2010) [hereinafter Dodd-Frank Act].

[114] Dodd-Frank Act § 939A.

[115] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1415.

[116] Omri Ben-Shahar & John A. E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 651–52 (2006).

[117] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1416.

[118] *Id.* at 1419–20.

[119] *Id.*

[120] *Id.* at 1419 (quoting FDIC, *Investment Securities—New Rules for Assessing Credit Risk*, 2014 FDIC CHI. REGION REG. CONF. CALL SERIES 1, 6 (2014), https://perma.cc/7RV3-WAMJ). Ultimately, the goal is the same: to determine whether the debt issuer will be able to pay its financial obligations. The change is that banks are no longer allowed to merely rely on CRA ratings for due diligence. The banks may still "outsource data and analysis." Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1419–20. But the FDIC requires "[b]ank management [to]

FDIC, still allows analysts to consider NRSRO ratings,[121] but also gives substantive methodological advice. The NCUA memo instructs analysts to consider "[c]redit spreads," "[s]ecurities-related research," "[i]nternal or external credit risk assessments," "[d]efault statistics," "[i]nclusion on an index," "[p]riorities and enhancements," and "[p]rice, yield, and/or volume."[122] Professor Partnoy argues that these agency instructions conclude that CRA ratings have little informational value,[123] but the continued allowance of CRA ratings in the factors belies this point—at the very least, the allowance enables analysts to gauge their analysis against NRSRO conclusions. Arguably, the Congressional indictment of CRAs was presented in a way that both asked agencies to remove references to ratings yet still encouraged their use, just in more holistic, multi-factored analyses.[124]

While the FDIC and NCUA are perhaps emblematic of what Dodd-Frank intended—facial removal of references to NRSRO ratings—other agencies have failed to satisfy even this minimum level of compliance. Even the SEC, for example, has failed to meet § 939A's requirements.[125] While explicit references to ratings were removed entirely from Rule 2a-7 of the Investment Company Act of 1940's list of definitions, the agency requires money market funds to disclose "each rating assigned by any NRSRO that the fund's board . . . considered" during their analysis

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ensure that it understands a security's structure and how the security may perform under adverse economic conditions." FDIC, *supra*, at 7.

Though "the final purchase decision still remains with the bank," these new instructions from the FDIC will arguably be only of modest help in the transition away from ratings reliance because "[c]redit agency ratings can [still] be used." *Id.* at 8. That said, the FDIC did provide a list of 13 "key factors" that bank analysts could look to when conducting due diligence. *Id.* at 12.

[121] Nat'l Credit Union Admin. Office of Examination and Ins., Supervisory Letter No. 13-03 on Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organizations (NRSRO) Ratings (June 11, 2013), at 3.

[122] *Id*. at 5–6.

[123] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1420.

[124] Zachary Mollengarden, Note, *Credit Ratings, Congress, and Mandatory Self Reliance*, 36 YALE L. & POL'Y REV. 473, 476 (2018). Mollengarden contends that § 939A of Dodd-Frank was flawed, that "there is a fundamental mismatch between Congress's diagnosis and its prescription" of the problems CRAs caused and the proper solution. "The diagnosis was, inter alia, investor *over*reliance on credit ratings. Section 939A's prescription, however, was the removal of '*any*' reference to credit ratings. Separating the two is Congress's failure to recognize that *over*reliance necessarily implies that *some* level of dependence on credit ratings remains appropriate." *Id.* For example, Mollengarden argues that the NCUA shift was merely facial; that is, while the "magic words" were removed, NRSRO reliance is still implicated and even encouraged by the agency's recommendation that analysts look to "external assessments of creditworthiness" and "other sources of financial information[.]" *Id.* at 489.

[125] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1422–23.

of the credit risk presented by a security.[126] Moreover, Rule 2a-7's stress test provision requires that money market funds must provide written procedures for dealing with "hypothetical events that include . . . [a]n event indicating or evidencing credit deterioration, such as a downgrade," which indicates the SEC still expects investors to rely on credit ratings when they test the strength of their portfolios.[127]

Until a 2018 amendment removed the reference, the Federal Reserve also demonstrated the stickiness of credit ratings, requiring that collateral for certain types of loans be "registered with the [SEC]as a[n NRSRO] for issuers of asset-backed securities."[128] In addition, Dodd-Frank limited its mandate to federal agencies, which means that state laws and regulations still continue to rely on credit ratings.[129]

This brief survey shows that while Dodd-Frank was largely successful in eliminating express references to NRSROs and credit ratings, it has been unsuccessful at actually reducing ratings reliance. Though the taboo terms have been erased, agencies continue to allow ratings in investor analysis and portfolio review.[130] Part of the problem stems from the fact that § 939A required the removal of references to credit ratings, but did not provide a standard that agencies could use to fill the gap; how the rules changed was up to the regulators' discretion.[131] If the people tasked with removal and replacement did not have a better idea of what to replace the standard of credit ratings with, then all that ended up changing was the words, rather than the methods.[132] Further, § 939A's approach failed to account for a large reason why so many investors relied on credit ratings: efficiency. Many investors relied on CRAs because it was more cost effective to outsource the credit analysis to the "experts" of the private sector, who could much more easily overcome the information asymmetry.[133] These shortcomings help explain why the FDIC, NCUA, and SEC all continue to allow investors to consider the ratings assigned to securities by NRSROs.

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[126] *Id.* at 1422; SEC, FORM N-MFP: MONTHLY SCHEDULE OF PORTFOLIO HOLDINGS OF MONEY MARKET FUNDS Items C.10, 14–16 (May 2016).

[127] *See* Mollengarden, *supra* note 124, at 504–05; 17 C.F.R. § 270.2a-7(g)(8).

[128] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1422 (quoting 12 C.F.R. § 201.3(e)(1)(i) (2015)); Regulation A: Extensions of Credit by Federal Reserve Banks, 83 Fed. Reg. 21,167, 21,168 (May 9, 2018) (to be codified at 12 C.F.R. 201.3).

[129] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1423 (citing CAL. GOV. CODE § 15819.4(a) (2017) ("requiring that certain financing instruments 'shall not be sold by the Treasurer unless, at the time . . . they are rated in the highest short-term rating category by a nationally recognized rating service'")).

[130] *See id.* at 1422–23.

[131] Mollengarden, *supra* note 124, at 506.

[132] *Id.*

[133] *Id.* at 508.

B. Agency Oversight: The Office of Credit Ratings

In addition to Dodd-Frank's attempt to reduce regulatory reliance by removing references to credit ratings in law, the Act also created a new office in the SEC designed to oversee the credit rating industry. Section 15E of the Securities Exchange Act of 1934 was amended by Dodd-Frank in 2010, establishing the Office of Credit Ratings (OCR). This subdivision of the SEC was created to, among other things, protect investors and "maintain fair, orderly and efficient markets,"[134] by "enhanc[ing the] regulation, accountability, and transparency of nationally recognized statistical rating organizations."[135]

As with § 939A, the OCR has been criticized for multiple deficiencies.[136] The most obvious flaw is that the Annual Examinations Summary Reports published by the office do not specify the rating agency that violated regulations.[137] For instance, in the 2019 Summary Report, the OCR determined that "[a] larger NRSRO reviewed an outstanding rating that the NRSRO had, in prior years, incorrectly affirmed after not considering a key rating factor."[138] Though the agency did lower the rating 18 months later, "[t]he relevant rating report did not disclose the [error] from prior years."[139] Notably, the OCR did not identify the specific agency involved.[140]

Other, more alarming transgressions from NRSROs were revealed as well. The OCR found that analytical staff of various "larger" NRSROs participated in selling products or were influenced by commercial staff during the credit analysis process.[141] Further, the OCR found that one "larger" NRSRO specifically asked its analysts to peddle new products to clients whose debt instruments they were charged with rating.[142] These reports indicate that behavior comparable to that preceding the financial crisis is still occurring, wherein the employees tasked with analyzing creditworthiness are influenced by the commercial implications of the rating they

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[134] *About the Office of Credit Ratings*, SEC (modified June 4, 2018), https://www.sec.gov/ocr/Article/ocr-about.html.

[135] *See* Dodd-Frank Act § 932.

[136] *See, e.g.*, Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1428–33; Jack T. Gannon, Jr., *Let's Help the Credit Rating Agencies Get It Right: A Simple Way to Alleviate a Flawed Industry Model*, 31 REV. BANKING & FIN. L. 1015, 1034 (2012) (questioning the oversight capacity of the Office of Credit Ratings because it is "completely unfunded").

[137] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1429.

[138] SEC. EXCH. COMM'N, 2019 SUMMARY REPORT OF COMMISSION STAFF'S EXAMINATION OF EACH NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION 17 (Jan. 2020).

[139] *Id.*

[140] *See id.*

[141] *Id.* at 18, 21.

[142] *Id.* at 21.

provide.[143] In brief, these findings show that NRSROs have not developed adequate procedures for grappling with the conflicts of interest inherent in the issuer-pays business model.

A frustrating feature of these reports is that while the publication does show regulatory violations by both "larger" and "smaller" NRSROs, it does not actually indicate which company was the offender.[144] Further insight has been sought, but denied by the SEC.[145]

Ultimately, this translates to a complete lack of accountability for the NRSROs, even if they violate the regulations prescribed by Dodd-Frank.[146] Moreover, the OCR's reports have no teeth; aside from revealing nothing beyond whether the offending NRSRO is "larger" or "smaller," the OCR response to a rating agency's mismanagement of conflicts of interest does not go beyond "recommend[ing] that the NRSRO not issue or maintain a credit rating where an analytical or criteria employee also: (i) participates in the sale or marketing of a product or service; or (ii) is influenced by sales or marketing considerations."[147] Not only are the rating agencies not identified, but they receive nothing more than a recommendation that they adhere to regulation.[148]

C. Expanding Regulatory Liability

Although the OCR does not substantially increase CRA accountability, Dodd-Frank did make some other changes in pursuit of increased liability. Most notably, it repealed Rule 436(g) under the Securities Act of 1933,[149] which, until then, had

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143 *See id.* at 18, 21.

144 The OCR defines "larger" NRSROs to include S&P, Moody's, and Fitch, while a "smaller" NRSRO could be any of the six other NRSROs: A.M. Best Rating Services, Inc.; DBRS, Inc.; Egan-Jones Ratings Company; HR Ratings de México, S.A. de C.V.; Japan Credit Rating Agency, Ltd.; or Kroll Bond Rating Agency, Inc. *Id.* at 7.

145 Professor Partnoy indicates in a 2017 article that he attempted to compel the SEC to identify the transgressing CRAs with a Freedom of Information Act request, but his request was denied. Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1429 n.107. According to Professor Partnoy, the OCR is breaching its statutorily mandated duty to present publicly summaries of its analysis in "an easily understandable format," pursuant to § 932(p)(3)(C)(i) of Dodd-Frank. *Id.* at 1431. He argues that the current reporting methods of the OCR contravene Congress's goal of "transparen[cy]" from this legislation, but he does not cite to any legislative history proving that to be true. *Id.* Regardless of whether transparency in this sense was Congress's aim, the OCR's failure to name the offending CRAs is further evidence that Dodd-Frank has failed to enact meaningful deterrents to CRA misconduct.

146 Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1431.

147 2019 SUMMARY REPORT, *supra* note 138, at 21.

148 *Id.*

149 Dodd-Frank Act § 939G.

shielded NRSROs from the expert liability scheme by exempting them from consideration as part of a registration statement or prospectus.[150] The SEC was "mindful of the potential significant impact" that rescission of the rule could have on NRSROs,[151] and decided that "potentially increasing liability [for NRSROs] could significantly improve investor protection."[152]

The rating agencies noted this potential for increased liability too, however, and refused to provide liability consents to the companies that relied on their ratings in registration forms and prospectuses.[153] This meant that the public companies governed by the Securities Act could not meet their regulatory requirements if they relied at all on ratings from CRAs and therefore could not raise capital from debt issues covered by the Act, which effectively "shut down the new offerings markets for both investment grade debt and asset-backed securities."[154] Upon recognizing the imminent credit market stagnation, the SEC leapt into action to restart the market and issued a "no-action" letter to two public companies that allowed them to omit the part of the mandatory disclosure that incorporated ratings.[155] Although that relief was temporary, the SEC eventually formalized its "no-action" position, and, in defiance of the clear will of Congress, effectively allowed NRSROs to avoid § 11 expert liability again.[156] One way to characterize the rating agencies' absolute rejection of liability exposure is as an implicit acknowledgement that they are in the business of selling regulatory licenses and not valuable information products;[157] after all, if they were confident in the performance of their ratings, an expansion of liability should not have worried them so.[158]

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[150] Concept Release on Possible Rescission of Rule 436(g) under the Securities Act of 1933, 74 Fed. Reg. 53,114, 53,114 (proposed Oct. 7, 2009) [hereinafter SEC Concept Release].

[151] *Id.* at 53,114–15.

[152] *Id.* at 53,118.

[153] Danielle Carbone, *The Impact of the Dodd-Frank Act's Credit Rating Agency Reform on Public Companies*, 24 INSIGHTS: THE CORP. & SEC. L. ADVISOR 1, 1–2 (2010). This behavior mirrored that of NRSROs in 1977, when a comparable liability expansion was proposed, and the NRSROs in existence at the time threatened to withhold consent to be named in registration statements. SEC Concept Release, *supra* note 150, at 53,115.

[154] Carbone, *supra* note 153, at 2.

[155] *Id.*

[156] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1435. Arguably, the SEC was in a worse position after this capitulation than before: prior to the repeal of Rule 436(g), companies would disclose the ratings they relied on because they did not need the consent of CRAs because they were exempt from § 11 liability anyway. After the no-action letter, companies were allowed to omit the ratings disclosures, even if they relied on them. In effect, the SEC's acquiescence to the credit raters allowed public companies to once more opaquely rely on credit ratings for their issuances of asset-backed securities.

[157] *Id.*

[158] By contrast, defenders of NRSROs argued that § 11 liability was unwarranted because ratings are expressions of opinions and, even if a security with a high rating defaults, that would

Another way Dodd-Frank attempted to expand liability for CRAs was through removing the exemption for rating agencies under Regulation Fair Disclosure (Regulation FD).[159] Regulation FD prohibits issuers from selectively disclosing material nonpublic information to various securities market professionals and shareholders.[160] If disclosure of such information is made to a person covered by the regulation, that disclosure must be made to the public.[161] Prior to Dodd-Frank, a provision of this regulation exempted from coverage companies whose primary business was selling credit ratings.[162] Dodd-Frank deleted this liability shield from the regulation with little resistance from CRAs.[163]

Professor Partnoy contends that the CRAs offered such little resistance to this legislation because they knew they could obtain essentially the same exemption from Regulation FD under paragraph (b)(2)(i), which exempts disclosures made "to a person who owes a duty of trust or confidence to the issuer."[164] To strengthen their case, the CRAs added confidentiality provisions to their engagement letters with issuers.[165] It appears as though the CRAs were correct in their assurances to issuers that the change to Regulation FD would not at all affect their ability to receive selective disclosures.[166] Not one OCR report has mentioned violations of Regulation FD.[167]

The final attempt Dodd-Frank made at expanding CRA liability was amending the Securities Exchange Act of 1934 as it related to private lawsuits.[168] The new

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not necessarily be proof that the opinion was erroneous. SEC Concept Release, *supra* note 150, at 53, 116.

[159] Dodd-Frank Act § 939B.

[160] Carbone, *supra* note 153, at 2.

[161] 17 C.F.R. § 243.100 (2020); *see* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,515, 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. §§ 243.100–243.103; 240.10b5-1; 240.10b5-2; 249.308).

[162] Carbone, *supra* note 153, at 2.

[163] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1438–39 (outlining the entire extent of congressional testimony on the matter—it fits on less than a full page. In response to a congressional representative's question about the effect of the removal of the exemption for CRAs, the CEO of Fitch stated that he believed the rating agencies could continue to provide "educated opinions.") (quoting *Reforming Credit Rating Agencies: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters., of the Comm. on Fin. Servs.*, 111th Cong. 38 (2009) (statements of Jackie Speier, Member, H. Comm. on Capital Mkts., Ins., and Gov't Sponsored Enters. and Stephen W. Joynt, President and CEO of Fitch, Inc.)).

[164] 17 C.F.R. § 243.100(b)(2)(i); Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1440.

[165] Carbone, *supra* note 153, at 5.

[166] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1439.

[167] Author checked each of the Office of Credit Ratings annual Summary Examination Reports for mentions of violations of Regulation FD; none were found.

[168] Dodd-Frank Act § 933.

legislation extended the enforcement jurisdiction of securities law to CRAs as traditionally applied to "public accounting firm[s]" and "securities analyst[s]."[169] The amendments also established the minimum requisite mental state burden that plaintiffs would have to prove to be successful in an action against CRAs—"knowingly or recklessly."[170] The fact that the minimum mental state the plaintiff can prove is recklessness demonstrates that legislators were hesitant to fully expose CRAs to private litigation. A negligence standard would not only make plaintiffs better able to succeed on actions against CRAs whose ratings caused massive losses but would also force rating agencies to abide by a certain industry standard of reasonableness or risk findings of liability. Contrary to the prediction that this lowered pleading standard would "revolutionize the liability regime of CRAs for fraud,"[171] the effect of the still-limited liability for CRAs through litigation is evident through the small number of cases that have been brought against them since the financial crisis.[172]

VI. THEORIES OF LIABILITY

As noted above, the regulatory regime changes of Dodd-Frank were largely facial and leave broad room for regulatory reliance and for the CRAs to continue selling regulatory licenses. If anything, such reliance is less visible now, hidden among the financial disclosures of institutional investors rather than facially apparent from the law.[173] Further, Dodd-Frank's redesign of liability and oversight for the CRAs has been ineffective, and the rating agencies continue to conduct business with the confidence that it is difficult to prosecute them.[174] Nonetheless, three categories of potential liability are available to hold CRAs responsible for their misconduct: securities regulation, tortious liability, and criminal sanctions.

A. Securities Regulation

To maintain a securities fraud action a plaintiff must allege, at minimum, that a CRA has been reckless. At first glance, this makes sense; fraud typically implies a

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[169] *Id.*

[170] *Id.*

[171] Noemi Blumberg, Joanna Wirth & Nikita Litsoukov, *The Liability of Credit Rating Agencies to Investors: A Review of the Current Liability Regime and Recent SEC Proposals*, J. STRUCTURED FIN. 34, 39 (2011).

[172] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1441–43 (noting that "[o]nly a handful of private cases were brought against credit rating agencies in response to losses sustained by investors during the financial crisis"). Professor Partnoy's research also shows that "[a]s of early 2017, neither Moody's nor S&P had publicly disclosed more recent litigation in their securities filings." *Id.* at 1442 n.167.

[173] *See id.* at 1422.

[174] *See supra* Section V.

knowing deceit for the transgressing party's gain. However, § 21D(b)(2) of the Securities Exchange Act of 1934 creates no statutory liability for negligent misrepresentation alongside the liability conferred for reckless fraud.[175]

Blumberg, Wirth, and Litsoukov argue that another potential source of CRA liability could come from statutes conferring secondary liability to aiders and abettors of fraud.[176] In *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court held that an action for aiding and abetting securities fraud failed under Rule 10b-5 of the Exchange Act because the Act did not expressly prohibit that conduct and because such a holding would render the defendant liable "without any showing that the plaintiff relied upon the aider and abettor's statements and actions."[177] This decision prompted the legislature to expressly prohibit the aiding and abetting of securities fraud under the Private Securities Litigation Reform Act of 1995.[178] However, there are substantial limits to the application of this rule to CRAs; in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the Court found the plaintiff's reliance on the secondary violator to be too attenuated and held that this rule did not confer a private action for aiding and abetting liability, only a cause of action for the SEC.[179]

With Dodd-Frank, Congress added similar aiding and abetting provisions to the Securities Act of 1933,[180] the Investment Company Act of 1940,[181] and the Investment Advisers Act of 1940.[182] As with the Exchange Act, mentioned above, liability for aiding and abetting violations of these regulations will only be imposed for recklessness and above[183]—again, CRAs avoid liability for negligent misrepresentation.[184] Moreover, each of those amendments explicitly impose aider and abet-

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[175] 15 U.S.C. § 78u-4(b)(2)(B) (2012) This was also the case before Dodd-Frank: a 2002 report from the Senate Subcommittee on Governmental Affairs noted then that CRAs "are not held even to a negligence standard" in many cases and are instead typically usually only liable for affirmative misconduct, like fraud. Blumberg et al., *supra* note 171, at 38 (citing STAFF OF THE S. COMM. ON GOV'T AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 82 (Comm. Print 2002)).

[176] Blumberg et al., *supra* note 171, at 38–39.

[177] Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 180, 191 (1994).

[178] Blumberg et al., *supra* note 171, at 39.

[179] *Id.* (citing Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158–59, 162 (2008)).

[180] Dodd-Frank Act § 929M.

[181] *Id.*

[182] Dodd-Frank Act § 929N.

[183] Dodd-Frank Act §§ 929M–O.

[184] Blumberg et al., *supra* note 171, at 36–37.

tor liability only "[f]or purposes of any action brought by the [Securities and Exchange] Commission."[185] Given that the SEC has a vast workload,[186] and does not necessarily pursue the largest offenders or the most effective punishments,[187] it is unlikely that the Commission will be able to pursue these types of actions against CRAs and create the deterrent effect the Dodd-Frank amendments were designed to establish.

For these forms of statutory liability to effectively deter CRAs, Congress should consider implementing a negligence theory of liability for rating agencies.[188] In addition, the acts imposing liability for aiding and abetting must be amended to expressly create private causes of action, so actors covered by the statutes cannot escape liability simply because the SEC is pursuing other actions with its limited resources.

B. Tortious Liability

1. First Amendment Defense

Tort claims against CRAs have often faltered in the past because the rating agencies successfully deployed a First Amendment defense.[189] By characterizing their ratings as opinions, CRAs convinced some courts that credit analyses are analogous to other financial publications.[190] Thus, the ratings were protected by the high burden of the "actual malice" standard developed in *New York Times, Co. v. Sullivan*,[191] which requires plaintiffs to show that the rating was made "with knowledge that it was false or with reckless disregard" for whether it was true or not.[192] As with the statutory liability discussed above, a theory of negligence will not

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[185] Dodd-Frank Act §§ 929M–N.

[186] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1432.

[187] Brittany Fritsch, *Broken Windows Is a Broken Policy*, 47 U. TOL. L. REV. 767, 768 (2016). Fritsch argues that the SEC's pattern of leniency towards bigger offenders and routine pursuit of purely monetary penalties are ineffective policing tactics for the securities industry. *Id.* Moreover, Fritsch argues that the SEC simply does not have enough resources to aggressively police every small infraction—in the traditional "broken windows" style—especially in lieu of punishing larger institutions for more severe offenses. *Id.*

[188] The rating agencies will certainly object, and it is likely they would attempt to freeze the markets as they did after the repeal of the Securities Act. *See supra* Section V. This time around, though, the SEC must not acquiesce. Indeed, the CRAs probably have less leverage now than in 2011. With the removal of NRSRO mention from most federal regulations, public companies (should) have begun to use their own credit analysis methods to determine the creditworthiness of stocks and other financial instruments, which means that even if CRAs threatened to not publish ratings, institutions relying on credit analyses could nonetheless operate.

[189] Blumberg et al., *supra* note 171, at 35.

[190] *Id.*

[191] New York Times, Co. v. Sullivan, 376 U.S. 254, 255 (1964).

[192] *Id.* at 279–80.

suffice in these cases; however, if a court rejects the First Amendment defense, plaintiffs can proceed on theories of negligence.[193]

Fortunately for plaintiffs, scholars have observed that more courts are rejecting First Amendment defenses from CRAs.[194] This may be due to Dodd-Frank's affirmation that the role of CRAs "is functionally similar to that of securities analysts,"[195] which implies a Congressional recognition that securities analysts are heavily regulated, that their work product is not protected by the First Amendment, and that CRA products deserve comparable treatment.[196]

The key matter in deciding the availability of the First Amendment defense is whether the ratings were public information or merely exchanged between two private parties.[197] The fact that private offerings have come to dominate the credit markets indicates the First Amendment defense will continue to decline.[198] In cases where the defense is rejected, plaintiffs have a better chance at succeeding on negligent misrepresentation claims.[199]

2. Negligent Misrepresentation

Specifically, the Ohio Supreme Court has established a plaintiff-friendly theory,[200] requiring satisfaction of these elements to incur liability: (1) a special relationship between the party giving the information and the party receiving it; (2) the

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[193] Heggen, *supra* note 20, at 1755. Heggen asserts that "[w]hich standard applies in a case will often be outcome determinative." *Id.*

[194] Blumberg et al., *supra* note 171, at 35.

[195] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1444 (citing Dodd-Frank Act § 931(2)).

[196] *Id.*

[197] Blumberg et al., *supra* note 171, at 35; Heggen, *supra* note 20, at 1756. Heggen traces the "public concern" doctrine—which narrowed the "actual malice" standard considerably—to *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 758–61 (1985). There, the Supreme Court decided that the First Amendment was primarily concerned with protecting salient public information, which meant that potential liability for speech about private concerns was more acceptable because it would not chill free speech as the Framers intended it. Heggen, *supra* note 20, at 1756 (citing *Greenmoss*, 472 U.S. at 759–60).

[198] Blumberg et al., *supra* note 171, at 35.

[199] *Id.*

[200] *Id.* at 36 (citing *In re* Nat'l Century Fin. Enters., Inc., Inv. Litig., 580 F. Supp. 2d 630, 646 (S.D. Ohio 2008)). The authors point out that there are several other theories of negligent misrepresentation possible. For example, the Restatement (Second) of Torts, § 552 is also fairly plaintiff-friendly, but in my estimation would be harder to succeed on than the Ohio rule. Under the Restatement, parties who fail to exercise "reasonable care or competence in obtaining or communicating the information" are financially liable to parties who justifiably relied on the statements and were foreseeably harmed by them. RESTATEMENT (SECOND) OF TORTS, § 552 (AM. LAW INST. 1977). Now that regulatory reliance on CRAs has been reduced, it would be harder for plaintiffs to show that their loss is the proximate result of their reliance on ratings, which are, under federal regulations at least, only supposed to be a small consideration for

party with the information did not exercise reasonable care in obtaining and distributing it; and (3) the receiving party justifiably relied upon that information.[201] The second and third elements would probably be fairly easily satisfied here, though satisfaction of the second would of course depend on the standard of care the court required of the CRAs—whether reasonableness would be determined according to the agencies' own policies, or to an industry standard, or to a statutorily decreed set of requirements.

The first element leaves the largest potential for defense. CRAs would argue there is no special relationship between them and the issuers they rate, though this seems likely to fail, considering that CRAs routinely receive nonpublic material information from issuers.[202] Indeed, this is the basis of their argument for why they should *not* be liable under the changes to Regulation FD.[203]

3. Products Liability

If plaintiffs can overcome the First Amendment defense, there is a reasonable chance that a successful claim against CRAs could sound in products liability. This would provide injured parties with presumably an even greater chance at remedy than under a claim sounding in negligence, because successful products liability claims do not require fault on the part of the distributor.[204]

The Restatement (Third) of Torts lays out a strict liability regime for distributors of products that cause injury to persons or property because of defects in the product.[205] Products liability under this section does not require the injured party to be in privity with the manufacturer,[206] and acknowledges that defendants in these cases are treated as experts with high levels of knowledge in the relevant field at the

institutional investors. The authors also describe the reasonable foreseeability theory of liability for negligent misrepresentation. Blumberg et al., *supra* note 171, at 36. The problem with this theory, however, is that it requires the third party—that is, the party harmed who is *not* the debt issuer—to have gotten the statements directly from the CRA. Therefore, this theory would be unavailable to all third parties who received the statement through the financial institution marketing the financial instrument, not the CRA.

[201] Blumberg et al., *supra* note 172, at 36.

[202] *See* Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1436–41; Carbone, *supra* note 154, at 5.

[203] *See supra* Section V.

[204] Blumberg et al., *supra* note 172, at 37.

[205] RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 1 (AM. LAW INST. 1998).

[206] RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 1 cmt. a.

time the product was distributed.[207] Moreover, the product need not be directly sold; liability extends to other forms of product distribution as well.[208]

A successful claim on this ground would require plaintiffs to prove that: (1) the rating (or the financial vehicle premised on the rating) is an intangible product,[209] (2) the product was defective at the time it was distributed,[210] (3) the product was the cause of the plaintiff's harm,[211] and (4) that the plaintiff was in fact harmed.[212]

Plaintiffs arguing that ratings are intangible products would rely on the Restatement's language that "[o]ther items, such as real property and electricity, are products when the context of their distribution and use is sufficiently analogous to the distribution and use of tangible personal property that it is appropriate" to render their distributors liable for their defects.[213] "Other items" allows defective intangible products to be potential bases for liability as well.[214] Though comment b acknowledges that courts have been reluctant to impose strict liability for the dissemination of information due to free speech concerns, it also points out that courts have imposed such liability for items like maps.[215] The comment reasons that courts have imposed strict products liability in that context because the information contained in maps is "unambiguous."[216] Under this rationale, plaintiffs might struggle

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[207] *Id.* Dodd-Frank expressly extended the liability of financial experts like auditors and investment bankers to rating agencies in § 939G, which yields the conclusion that Congress, at least, views CRAs as experts in the field. Valentin Dimitrov, Darius Palia & Leo Tang, *Impact of the Dodd-Frank Act on Credit Ratings*, J. FIN. ECON. 505, 508 (2015); Dodd-Frank Act § 939G; SEC Concept Release, *supra* note 151, 74 Fed. Reg. at 53,114. CRAs, by contrast, argue that they are not experts and mere purveyors of opinions, though this argument has lost potency in the courts. *See supra* Section V.B.1 (discussing the First Amendment defense).

[208] RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 1 cmt b.

[209] *Id.* § 19 cmt. d. It is likely that the plaintiffs suing the rating agencies for their distribution of ratings would be larger institutional investors and issuers of debt and structured financial products. Smaller plaintiffs would probably sue the issuers with the falsely rated credit because of their defective financial products.

[210] *Id.* § 2 (requiring, as a necessary condition to products containing manufacturing defects, the defect to exist "at the time of sale or distribution").

[211] *Id.* § 15. The rule provides that causation for products liability will be governed "by the prevailing rules and principles" of causation in tort law. I take this to require proof of cause in fact and proximate cause.

[212] *Id.* § 1. In addition, § 21, which covers economic loss, is a critical component of the injury discussion because "some forms of economic loss have traditionally been excluded from the realm of tort law even when the plaintiff has no contractual remedy for the claim." *Id.* § 21 cmt. a.

[213] *Id.* § 19.

[214] *Id.* § 19 cmt. d.

[215] *Id. Contra* Birmingham v. Fodor's Travel Publ'ns, Inc., 833 P.2d 70, 73 (Haw. 1992) (travel guide that failed to warn a swimmer of rocks near a beach held not a product for purposes of products liability law).

[216] RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 19 cmt. d.

to show that credit ratings are intangible products, as courts would question whether the information in ratings is truly something other than protected intangible "ideas and expression."[217] However, as noted above, courts are becoming increasingly hostile to the idea that ratings are mere opinions,[218] probably because ratings are based off material nonpublic information to which only CRAs have access.[219] Using that information, raters promulgate credit analyses, which are trusted precisely because they are based on concrete information that, in theory, makes them unambiguous assertions of creditworthiness. Under that logic, ratings could be viewed by judges as more than expressions of ideas and instead as products that are representations of established fact.[220]

Next, plaintiffs would have to show that the ratings were defective at the time they were published.[221] This could be proven through discovery, as internal emails revealing analyst fraud might indicate that the ratings were baseless,[222] that the methodologies used by the agencies were critically and obviously flawed, or that the methodologies were simply ignored.[223] These allegations would, if proven, satisfy the Restatement's requirement under subparagraph (a) that the product "departs from its intended design even though all possible care was exercised in the preparation and marketing of the product."[224] Alternatively, plaintiffs could argue that the rating was defective because it failed to contain adequate warnings.[225]

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[217] Winter v. G.P. Putnam's Sons, 938 F.2d 1033, 1034 (9th Cir. 1991).

[218] Blumberg et al., *supra* note 172, at 35.

[219] Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1439.

[220] In *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.*, 888 F. Supp. 2d 431, 454–55 (S.D.N.Y. 2012), a federal court held that ratings were actionable misrepresentations of *fact*, which undercuts CRAs' claims that their ratings are merely opinions based on facts (cited in Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1442–43). *Contra* HAROLD, supra note 8, at 72 ("The conclusion is unavoidable . . . that bond ratings are largely matters of personal judgment rather than accurate and scientific conclusions based upon impersonal observations."); *and* LANGOHR & LANGOHR, *supra* note 2, at 24 ("[T]he big three CRAs all agree that a credit rating is an *opinion* about whether the issuer of a fixed income security will pay amounts due on time and in full.").

[221] RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2.

[222] *E.g.*, Taibbi, *supra* note 23, at 2 (the author quotes an email from an S&P employee that confesses the company was "just . . . mak[ing] it up in order to rate deals . . .").

[223] 2019 SUMMARY REPORT, *supra* note 139, at 18. In the examination of NRSROs released in early 2020, the Office of Credit Ratings reports that it discovered that, in 2019, some rating agencies "did not adhere to their policies, procedures, or methodologies for determining credit ratings." *Id.*

[224] RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2(a).

[225] *Id.* § 2(c).

Then, plaintiffs would have to prove causation: cause-in-fact and proximate cause.[226] Under the standard but-for causation theory of cause in fact, some plaintiffs would have it easier than others. Before Dodd-Frank, the institutional investors that were injured by fraudulently rated financial products could have argued that if the product had not been defective—that is, if the ratings had been correct (i.e., lower for all investment vehicles that were backed by subprime loans)—the plaintiff would not have been hurt because various regulations would have precluded them from making the faulty investment in the first place. In short, the ratings would not have been investment grade and the investors would have been statutorily prohibited from purchasing the related debt. Now that Dodd-Frank has facially removed regulatory reliance,[227] establishing the but-for argument is more difficult, but not impossible. As noted above, there is still lots of room for institutional investors to rely on ratings as part of their credit analysis.[228] Because certain investors are required to disclose to the SEC when they use credit ratings as part of their independent analysis,[229] evidence would exist that the investor relied on the CRA's product. Further, the debt issuers themselves, were they plaintiffs, could argue that the faulty ratings were the but-for cause of their increased liability because the ratings induced many more plaintiffs to invest than otherwise would have with the proper rating.[230]

A successful proximate cause argument would convince the court that the investors injured were foreseeable plaintiffs.[231] Presumably, this would be an easier argument for plaintiffs to make; they would have to show that, from the raters' perspective, it was foreseeable that third parties would rely on the ratings. If the plaintiffs could show that there was any awareness on the part of the rating agencies that the bonds or structured finance products they rated would be subsequently sold to investors, proximate cause would be satisfied. Further, the plaintiffs could point to the same evidence (that the investors relied on the ratings) to argue that the regulatory scheme allows for such reliance by investors and that the rating agencies were on notice.[232]

Finally, plaintiffs would have to show that they were injured by the defective products.[233] For example, if this litigation commenced after a financial meltdown

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[226] *See Id.* § 15.

[227] *See* Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1419.

[228] If plaintiffs today succeeded in showing that faulty credit ratings were the but-for cause of their injuries, courts would have implicitly acknowledged that one of the main goals of Dodd-Frank—to reduce reliance on CRAs—has failed.

[229] Form N-MFP, *supra* note 126, at Items C.10, 14–16.

[230] These arguments assume the ratings are defective because they are too high, because that is what happened in the events leading up to the 2007–08 meltdown and because that is the direction the raters' conflicts of interest tug the ratings.

[231] Blumberg et al., *supra* note 171, at 37.

[232] Form N-MFP, *supra* note 126, at Items C.10, 14–16.

[233] RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 1.

like that of 2007, plaintiffs could easily point to extensive losses as their investments suddenly became worthless and their own market values began to drop. In spite of plaintiffs' clear losses, CRAs would likely defend on the grounds that the injuries sustained constitute pure economic losses and thus are "excluded from the realm of tort law even where the plaintiff has no contractual claim."[234]

The pure economic loss rule operates to preclude damages where plaintiffs' losses only result from damage to the product itself, or where the damage is to a small product that is deemed part of a larger integrated whole.[235] Further, recovery is sometimes precluded for consequential losses stemming from the product's defect.[236] The former limitation would not affect plaintiffs because they would not be suing to recover for the damage to the rating itself—that is, the defective product. Issues would only arise under this limitation if courts decided that ratings and the bonds or structured finance products to which they are attached are all part of one "integrated whole,"[237] which would lead them to conclude that damages to the investment vehicle caused by the rating are damages to the product itself.

It seems more likely that this rule would affect plaintiffs under the latter consequential loss limitation. CRAs would argue that their ratings, if found to be defective, only caused losses that were causally separable from the bad ratings. The argument would be: Even if the rating is a defective product, its defect is only that it did not accurately predict the default of certain loans; by contrast, the harm plaintiff is attempting to recover for is directly attributable to those consumers who failed to pay what they owed, not to the bad credit rating. In other words, the plaintiffs are trying to recover for the product's failure to meet expectations, which is a harm covered by contract law.[238] Of course, most investors are not in contractual relationships with the CRAs themselves, which would block them from recovering on contractual grounds, and the CRAs would again escape liability.[239]

Investors could argue, however, that these were not causally distinct consequential losses because a declaration of the likelihood of default was exactly what they were purchasing; whether the investors defaulted or not was irrelevant: they would not have made the investments if the ratings had been accurate. Further,

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[234] *Id.* § 21 cmt. a.

[235] *Id.* § 21 cmt. e.

[236] *Id.* § 21 cmt. d.

[237] *Id.* § 21 cmt. e.

[238] This argument succeeded in *Seely v. White Motor Co.*, 403 P.2d 145, 147–51 (Cal. 1965), where the plaintiff's new hauling truck had a defective brake system that caused it to overturn. The court held that the plaintiff could not recover on a theory of strict products liability for the cost of repairs, money already paid for the truck, and lost profits related to the truck's defect. *Id.* The court held that allowing recovery for a business loss due to a product's failure to meet economic expectations would extend tort law too far. *Id.* at 150–51.

[239] *See* Blumberg et al., *supra* note 171, at 34–35 for a brief discussion of the limits of contractual liability for CRAs to third-party beneficiaries.

investors could argue that their "other property" was damaged by the defective ratings, which would not be precluded under the economic loss rule.[240] Essentially, plaintiffs' claims would be that while their investment losses were directly related to, for example, falsely rated subprime mortgages, they had also made many other investments in other types of debts that were lumped in with the defectively rated mortgages.[241] When the subprime mortgage market crashed, then, and those parts of CDOs and other investment vehicles that were based on residential mortgages lost value, it caused the value of all of the other investments in the financial vehicle to lose value too.[242] Those other investments were other property that was harmed by the defective rating pertaining to the sub-prime mortgage debt.

Ultimately, if plaintiffs could convince the courts to accept strict products liability for injury caused by faulty credit ratings, investors would be better able to recover when CRAs fail to rate credit risk accurately. Of course, raters would likely clamor that this makes their business untenable and would consequently threaten to stop rating.[243] However, because they arguably have less leverage over the markets now due to reduced reliance,[244] they would have to resume selling ratings again or go bankrupt. The potential liability would ensure that raters perform their due diligence and not succumb to the moral hazard of the issuer-pays model.

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[240] See *Saratoga Fishing Co. v. J. M. Martinac & Co.*, 520 U.S. 875, 877 (1997), where a third party bought a boat from the defendant manufacturer and then added various equipment to it. The plaintiff then bought the boat from the original buyer. When the defective hydraulic system sank the boat, the Supreme Court held that the plaintiff could recover in tort for the property added by the previous owner because it was "other property," distinct from the defective product the manufacturer "place[d] . . . in the stream of commerce[.]" *Id.* at 879. The Court reasoned that subsequent buyers are poorly positioned to share risks with manufacturers and that subsequent sellers are also poorly positioned to provide a warranty for the products. *Id.* at 882. Importantly, the Court rejected the defendant's argument that this holding would expose manufacturers to an unreasonable scope of tort liability by identifying existing limits on tort liability like foreseeability and the economic loss doctrine. *Id.* at 884.

[241] *See supra* Section III; Heggen, *supra* note 20, at 1748.

[242] *See* FINANCIAL CRISIS INQUIRY COMMISSION, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS OF THE UNITED STATES (2011).

[243] This is an argument CRAs have made several times in the past, in response to the repeal of Rule 436(g) under the Securities Act of 1933 in 2010 and in 1977, when increased liability was also threatened. Carbone, *supra* note 153, at 1–2; SEC Concept Release, *supra* note 151, at 53,115; *see supra* Section V; *supra* note 153.

[244] *See supra* Section V (describing Dodd-Frank's goal of reducing federal regulatory reliance on credit ratings and the at least nominal improvements some agencies have made).

C. Criminal Sanctions

As with regulatory and civil theories of liability, criminal liability for credit raters is difficult to achieve and seldom attempted.[245] In fact, in the wake of the financial crisis, there were no criminal prosecutions of individuals in the credit rating industry, despite public perception of their complicity.[246] Though there are valid and compelling incentives to prosecute the bad actors in the industry,[247] existing theories of criminal liability are not well-suited for such actions. As with tort liability, the causal links between rating agencies and injuries of investors are quite attenuated.[248] These links are even more attenuated in criminal suits, where the focus is on the conduct of individual actors rather than the agency as a whole.[249]

Also, like with securities regulation, the mens rea requirements for fraud actions are simply too difficult to prove.[250] Without overt, affirmative admissions of intent, prosecutors would struggle to prove the requisite intent or knowledge required in such cases,[251] even if discovery revealed damning internal admissions. The statements would have to yield the inference that the makers knew of the fraudulent nature of the ratings at the time the ratings were issued.[252] Further, criminal charges would also falter in the face of mistake-of-fact defenses, as analysts could negative

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[245] David A. Maas, *Policing the Ratings Agencies: The Case for Stronger Criminal Disincentives in the Credit Rating Market*, 101 J. CRIM. L. & CRIMINOLOGY 1005, 1007 (2011) (arguing that "existing criminal law is not providing a sufficient check on the ratings agencies").

[246] *Id.* at 1007–08.

[247] *Id.* at 1008–09 (arguing that a utilitarian approach to punishment would see prosecutions in the wake of the financial crisis as a prime means of general and specific deterrence to similar future actions, and that retributive principles supported prosecution even more due to the immense destruction the crisis caused around the world). In this section the author does not discuss rehabilitative theories of punishment, perhaps because the CRAs came through the crisis relatively unscathed, and because the typical goals of rehabilitation—self-improvement and treatment of the underlying causes of criminality—are less easily applied to corporate actors and better achieved through regulation. *See* Partnoy, *What's (Still) Wrong with Credit Ratings?*, *supra* note 16, at 1426–27.

[248] Maas, *supra* note 245, at 1023.

[249] *Id.*

[250] *Id.* at 1023–24.

[251] *Id.* at 1024 ("There is nothing in the actions of a CRA analyst or executive in rating a debt instrument that would help establish *mens rea*, aside from any outright admission of knowledge or intent.").

[252] This not to say that at least *some* charges could have been levelled under the existing framework. In Taibbi, *supra* note 23, at 2, the reporter details multiple statements revealed through investigations that were arguably indicative of knowledge of the fraudulent nature of the ratings at the time they were made. The larger problem is that the only people subject to prosecution would have been those unfortunate enough to get caught admitting such intent or knowledge in writing; everyone else, though they may have known, would be clear.

mens rea elements by claiming they believed, at the time of the rating, that the models on which the ratings were based were accurate.[253]

Legislation is required to bridge the gap between criminal law and credit ratings misconduct.[254] Under David Maas' proposed criminal statute, each rating would need to be approved by at least one management-level employee and kept on record (including who certified the rating) for at least ten years.[255] In addition, the statute drops the mens rea requirement to recklessness for liability for rating fraud.[256] Maas believes that this "will help solve the proof problem that prosecutors face" and that it will at least encourage more charges to be brought.[257] Moreover, it will actively deter both analysts and their managers by requiring them to physically sign on to the rating, and the ten-year recordkeeping requirement should outlast whatever latency period a fraudulent rating has before it impacts the market.[258]

Though any increase in liability for CRA actors is helpful to deter misconduct, Maas' proposal is flawed in the same way as other modern securities regulations: it sets the mens rea bar too high. Under a recklessness standard, indicted actors can defeat charges simply by negativing one half of the recklessness mens rea. The Model Penal Code defines recklessness as a "conscious[] disregard [of] a substantial and unjustifiable risk that [a] material element [of a crime] exists" and that such "disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation."[259] Recklessness has a subjective and an objective requirement.[260]

To defeat prosecutors' charges of recklessness, defendants under Maas' statute could escape liability if they could convince a factfinder that they were unaware of the "substantial and unjustifiable risk"[261] that they were certifying a falsely inflated or depressed rating. This would still require prosecutors to inquire into the defendant's level of knowledge about the methodology and status of the debt that was defectively rated. The recklessness mens rea would thus still involve engaging the rating agencies in discovery and tie up prosecutorial resources in document review, and violators would still go free when evidence of their knowledge of the risk was insufficient. In fact, this might *disincentivize* analysts from bringing potential problems to their supervisors' attention, as documentation of the encounter could later serve as evidence against them in a trial about the false rating.

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[253] Maas, *supra* note 245, at 1027.

[254] *See id.* at 1028–30.

[255] *Id.* at 1028.

[256] *Id.*

[257] *Id.* at 1028–29.

[258] *Id.* at 1029.

[259] MODEL PENAL CODE § 2.02(2)(c) (AM. LAW INST., Proposed Official Draft 1962).

[260] *Id.*

[261] *Id.*

As with tort liability and securities regulations, a negligence standard for criminal liability would be much more effective because it only requires proof of breach of an objective standard of care. Under the Model Penal Code, "a person acts negligently with respect to a material element of an offense when [they] should be aware of a substantial and unjustifiable risk that the material element exists or will result from [their] conduct" and that the failure to perceive the risk "involves a gross deviation from the standard of care that a reasonable person would observe in the actor's situation."[262] Under the negligence standard of culpability, it matters not what the actor knew, because the objective reasonableness standard asserts that they should have known regardless. A negligence standard would properly encourage analysts and managers to conduct their due diligence, report flaws or inconsistencies in their models, and ensure that the rating is as accurate as possible.

The one question that a negligence standard raises is what the objective reasonableness standard for CRA actors would look like. The Model Penal Code anchors the reasonableness standard to what a similarly situated person would do,[263] which indicates that standards for each individual CRA could be informed by the specific policies, procedures, and ratings methodologies they proscribe. However, a series of different standards across the industry would be confusing for prosecutors and actors who move between different CRAs. Instead, regulators should compose a reasonableness standard derived from principles common to every CRA: an industry standard.[264] This would keep industry actors on notice of their duty under the statute, and would enable prosecutors to bring cases without having to search for evidence of what the actor had in their mind at the time they made the rating.

VII. CONCLUSION

The financial crisis of 2007 and 2008 was facilitated by the CRAs who, through regulatory reliance, could act with impunity in search for massive profits. American regulation of the industry had rendered the rating agencies quasi-governmental entities, and through legislative barriers to entry, had established a de facto oligopoly of the three largest firms. After the crash, legislators sought to erase the broad reliance of various industries and markets on CRAs through the passage of Dodd-Frank, which amended a host of securities laws and forced other federal agencies to remove facial references to credit ratings. However, because of the limited scope of

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[262] MODEL PENAL CODE § 2.02(2)(d).

[263] *Id.*

[264] This may require CRAs to develop a set of common rules akin to the Generally Accepted Accounting Principles, which is a codified, authoritative series of standards that, among other things, "[m]itigate[s] the risk of noncompliance" with industry quality. FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING STANDARDS CODIFICATION: ABOUT THE CODIFICATION 5 (2014), https://asc.fasb.org/imageRoot/71/58741171.pdf.

Dodd-Frank, reliance on CRA ratings persists in state laws and the government has not ameliorated the conditions that led to the crash of 2007.

Dodd-Frank failed to expand CRA liability to deter future misconduct and rating agencies still retain statutory protections. To prevent future misconduct by the still-robust ratings industry, CRA liability can and should be expanded under securities regulation through the creation of private causes of action under the statutes amended by Dodd-Frank and with an imposition of civil liability for negligent ratings. Further, tort liability can be pursued more aggressively with claims sounding in negligent misrepresentation. A lower standard for tort liability could even reasonably be pursued under theories of strict products liability for defective ratings. Finally, specific bad actors in the industry must be generally and specifically deterred through prosecution of individuals. In criminal actions, a mens rea standard of negligence is appropriate to simultaneously encourage the creation of a standard of reasonable behavior across the industry and to facilitate successful prosecution. If the existing liability regime for CRAs does not change, we leave the economy susceptible to interference by under-regulated, profit-motivated private companies with little competition who are largely shielded from culpability.