Ratings Recall: Will New Reform Proposals Make Lasting Impact?

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I. INTRODUCTION

Within the corporate world, credit rating agencies (CRAs) wield great power. One commentator opined that "[t]here are two superpowers in the world. . . . There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."[1] CRAs' influence often transcends national boundaries, which prompted another observer to note that "credit raters often have more sway over foreign fiscal policy than the U.S. government."[2]

In light of the great power they possess, CRAs have historically been subject to surprisingly little regulatory oversight.[3] In the early 2000s, however, CRAs came under fire for their failure to adequately warn investors about the impending problems with Enron, WorldCom, and other troubled companies.[4] In response, Congress passed the Credit Agency Reform Act of 2006 (Reform Act of 2006) to improve the Securities and Exchange Commission's (SEC) ability to create and enforce ratings standards.[5] Since the passage of the Reform Act of 2006, the SEC has promulgated new rules, the last of which took effect in April 2009, and is still considering additional changes.[6] Europe has also

1. JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 283–84 (2006).

2. Alec Klein, *Credit Raters Exert International Influence*, WASH. POST, Nov. 23, 2004, at A1.

3. The SEC deliberately decided not to regulate CRAs in the 1970s. Instead, it created regulations that limited the entities that might become Nationally Recognized Statistics Rating Organizations (NRSROs) and created legal consequences for companies based on the ratings that the NRSROs gave those companies. Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 64 (Yasuyuki Fuchita & Robert E. Litan eds.) (2006) [hereinafter Partnoy, *How and Why*]. In 2006, Congress passed legislation that increased the regulatory oversight of NRSROs following their misleading ratings of companies such as Enron and Worldcom just before those companies declared bankruptcy. Credit Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified as amended in scattered sections of 15 U.S.C.).

4. COFFEE, *supra* note 1, at 285.

5. Credit Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327.

6. The SEC's initial round of regulations took effect in 2007. SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 4 (2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf [hereinafter SEC SUMMARY REPORT]. After the SEC finished a report on the efficacy of its original regulations, it decided that new regulations were necessary. *Id.* at 15; *see also* References to Ratings of Nationally Recognized Statistical Ratings Organizations, 73 Fed. Reg. 40,124 (July 11, 2008) (noting that the SEC proposed at least three rule-making initiatives in 2008). Therefore, the SEC proposed new rules in July of 2008 and formally adopted some of its proposals in February 2009. 17 C.F.R. §§ 240.17g-2 to 17g-5, 249b.300 (2009). The final rules took effect on April 10, 2009. *Id*. The SEC re-proposed other rules to regulate CRAs. Re-proposed Rules for Nationally Recognized Statistics Rating Organizations, 74 Fed. Reg. 6485 (Feb. 9, 2009) (to be codified at 17 C.F.R. pts. 240, 243).

entered into the regulation foray and adopted a new regulatory structure in April 2009.[7]

Despite these important changes to CRA regulation, critics continue to claim that the regulations do not go far enough and that more needs to be done.[8] Some argue that former proposals for reform were superior to those that the SEC ultimately adopted.[9] In any case, the issue of how to effectively regulate CRAs is far from decided. This Note analyzes additional options for regulating CRAs.

Part II provides background information on CRAs and shows how they became powerful players in the U.S. corporate regulatory framework. It then describes the historical problems with the structure of rating agencies, which many critics believe have contributed to CRA failings. It then outlines reforms that the United States and Europe have formally adopted. Finally, it outlines additional options for regulatory reform of CRAs.

Part III analyzes the various regulatory options, pointing out the practical benefits and limitations of each. Specifically, it looks at five important factors that any regulatory reform should include. Based on this framework, it then analyzes reform options set forth by the Securities Industry and Financial Markets Association (SIFMA), the SEC, and others.

Part IV recommends a mix of the SIFMA and European Community (EC) approaches and adds a critical structural feature to ensure consistent enforcement through time. This Part points out that to increase investor confidence, any solution must provide for long-term, consistent enforcement of CRA regulations. It also details some of the important features of the SIFMA and EC approaches that the United States should adopt.

II. BACKGROUND

A. How Rating Agencies Work and Their Role in the Economy

CRAs such as Moody's Investors Services, Inc. (Moody's), Standard & Poor's Rating Services (S&P), and Fitch Investor Services, Inc. (Fitch) earn revenue by analyzing investment products, such as bonds,[10] and distilling their findings into a simple

7. Press Release, European Commission, Approval of New Regulation Will Raise Standards for the Issuance of Credit Ratings Used in the Community (Apr. 23, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/629&format=HTML&aged=0&language=EN&guiLanguage=en [hereinafter EC Press Release]. For the text of the regulation as passed, see *Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies*, COM (2008) 704 final (Dec. 11, 2008), *available at* http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf [hereinafter *EC Proposal*].

8. At least one SEC commissioner has publicly stated that she believes more rules need to be promulgated to adequately protect investors. *See* Kathleen L. Casey, Comm'r, SEC, Remarks before the Exchequer Club (Jan. 14, 2009), *available at* http://www.sec.gov/news/speech/2009/spch011409klc.htm [hereinafter Casey, Remarks] (stating that she "does not believe that [the SEC's] work is done in" reforming the regulation of CRAs and outlining more reforms that are necessary). *See also* Neil Baron, *SEC Rules Don't Go Far Enough*, HUFFINGTON POST, Jan. 13, 2009, http://www.huffingtonpost.com/neil-baron/sec-rules-dont-go-far-eno_b_157609.html (arguing that the new SEC regulations fail to align compensation incentives with the objective to produce accurate ratings).

9. *Reforming the Ratings Agencies: Will the U.S. Follow Europe's Tougher Rules?*, KNOWLEDGE@WHARTON, May 27, 2009, *available at* http://knowledge.wharton.upenn.edu/article.cfm?articleid=2242 [hereinafter *Reforming the Ratings Agencies*].

10. A bond is a type of financial instrument that many companies use to raise capital for projects they

alphabetical rating.[11] The ratings range from triple-A to D.[12] Ratings of triple-B or higher are considered "investment grade,"[13] which signifies that the level of risk is relatively low.[14]

A rating is both practically and legally important for many reasons. Of primary importance to the issuer is the rating's effect on the issuer's cost of capital. All else being equal, a lower rating—which signals higher risk—results in the bond's issuer paying investors higher interest rates for the bond.[15] Low ratings may also make it harder for issuers to sell such bonds because some investors—typically institutional investors and trustees—may only legally invest in "investment grade" products.[16] A favorable rating, by contrast, not only benefits an issuer by reducing its cost of capital and its ability to sell bonds, but also provides certain regulatory benefits. One such benefit is that investment grade ratings boost demand by giving brokers and dealers financial incentives, such as favorable accounting rules, to carry the issuer's bonds.[17] Additionally, investment grade ratings benefit certain investors, such as trustees, by providing them legal protection against breach of fiduciary duty claims.[18]

B. Rating Agency Theories and Their Impact on Regulation

At least two theories attempt to explain the role of CRAs in the economy: the "reputational intermediary" theory and the "regulatory license" theory. The reputational intermediary theory describes the CRAs' role as primarily an information provider.[19] Under this theory, CRAs are neutral third parties that gain access to important, non-public information about an issuer and the issuer's security.[20] The issuer grants CRAs access to such non-public information in the hopes that by doing so its securities will receive more favorable ratings and induce investors to purchase its securities.[21] At the same time, the issuer avoids having to divulge sensitive information to everyday investors, and is therefore able to keep competitors from learning too much about the company.[22]

A second theory, promulgated by Professor Frank Partnoy, describes CRAs as

wish to pursue. Bonds usually require the company to pay a certain amount of interest during its life and repay the principal at the end of the term.

11. COFFEE, *supra* note 1, at 284.

12. STANDARD & POOR'S, GUIDE TO CREDIT RATING ESSENTIALS 10 (2009), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/SP_CreditRatingsGuide.pdf [hereinafter GUIDE TO CREDIT RATING ESSENTIALS].

13. COFFEE, *supra* note 1, at 284.

14. GUIDE TO CREDIT RATING ESSENTIALS, *supra* note 12, at 10–11.

15. COFFEE, *supra* note 1, at 284.

16. *Id.* at 294–95.

17. *See* 17 C.F.R. § 240.15(c)(3)-1 (2008) (detailing the write-down that brokers and dealers must give to securities based on their credit rating, with securities that have a higher credit rating requiring less of a write-down than securities with a lower credit rating).

18. COFFEE, *supra* note 1, at 293–94.

19. *Id.* at 287.

20. *Id.* at 287–88.

21. *Id.* at 288.

22. *Id.* at 287.

selling regulatory licenses.[23] Under the regulatory license theory, the CRAs' main role is not as an information provider, but as a gatekeeper. As gatekeeper, CRAs grant legally significant ratings to companies. Those issuers who receive favorable ratings receive a "license" to take advantage of economic and legal benefits, while other issuers may not.[24]

Though the theories have overlapping characteristics, they differ in how they view the CRAs' primary purpose. Both theories have had historical significance,[25] and have helped explain how CRAs are regulated. Furthermore, these theories provide insight into how CRA regulation should be shaped in the future.

C. History of Rating Agencies From the 1800s to the Present

CRAs first appeared in the 1840s, but at that time they primarily focused on rating mercantile organizations.[26] Beginning partly in the mid-1800s, and more prominently in the early 1900s, entrepreneurs began establishing CRAs.[27] During the 1930s, CRAs were extremely valuable because of the faltering economy and fears about companies not paying on their debt securities.[28] Therefore, the rating agencies enjoyed strong growth and prominence.[29] By 1941, there were three primary rating agencies, with S&P and Moody's being the most prominent.[30] During this start-up phase of CRAs, information about corporations was difficult to find, and many investors relied on raters to supply information regarding various issuers' securities.[31] The rating agencies made their revenue from the books that they sold to investors—not from the companies they were rating.[32]

From 1940 through the 1970s, changes in the market and regulatory structure greatly impacted CRAs.[33] With the improved economy and communications systems, institutional investors relied less on CRAs to supply information about debt securities.[34]

23. *See* Partnoy, *How and Why*, *supra* note 3, at 60–62 (arguing that CRAs' ability to issue "regulatory licenses" somewhat shields them from typical market pressures). *See also* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 681 (1999) [hereinafter Partnoy, *Two Thumbs Down*] (explaining that CRAs sell regulatory licenses in addition to their reputational capital).

24. COFFEE, *supra* note 1, at 288.

25. *See id.* (noting that the reputational intermediary theory "has long been the dominant view of the credit-rating process"); *see also* Partnoy, *Two Thumbs Down*, *supra* note 23, at 681 (stating that the regulatory license theory helps explain CRAs' rise in importance between 1930 and the mid-1970s).

26. COFFEE, *supra* note 1, at 292.

27. *Id.* at 292–93.

28. *Id.* at 294.

29. *Id*. at 294–95.

30. In 1860, Henry Poor first published a book of railroad and canal debt securities. *Id.* at 293. Standard Statistics Bureau was organized in 1906, and three years later, John Moody established Moody's Investors Services, Inc. with his landmark book of ratings that was the first to distill all the rating information into a single rating symbol. COFFEE, *supra* note 1, at 293. Other raters, such as Standard's Statistics Bureau and Poor's Publishing Company, later adopted this simple rating style. *Id.* at 294.

31. *Id.* During the 1920s, small banks and investors relied more heavily on CRAs' ratings for investment decisions. *Id.* Large banks and institutional investors relied more on their own risk analysis. *Id.*

32. COFFEE, *supra* note 1, at 295.

33. *Id.*

34. *Id.*

Some academics even questioned the value of bond ratings altogether.[35] Counteracting this reduction in need, however, were favorable changes in the regulatory structure. Most notably was the SEC's change to Rule 15(c)(3)-1 in 1975.[36] The new rule created a designation known as a Nationally Recognized Statistical Ratings Organization (NRSRO).[37] Under the new rule, issuers who received favorable ratings from two raters with NRSRO status could qualify for special regulatory treatment.[38] Because issuers were more likely to seek ratings from agencies designated as NRSROs, CRAs that received the NRSRO label benefited.[39] The SEC, however, created requirements for becoming a NRSRO that effectively limited the status to those firms that had a long history—i.e., S&P, Moody's, and Fitch.[40] Because of the attendant legal benefits of NRSRO ratings, the SEC ensured that Moody's and S&P would maintain their dominating positions within the industry.[41]

A change in the CRA business model was another important development that occurred during the 1970s.[42] Prior to that time, CRAs sold their ratings directly to investors via ratings books.[43] During the 1970s, however, CRAs began charging the issuers to rate their organizations.[44] This change brought with it inherent conflicts of interest that some have argued are at the heart of today's problems.[45]

D. Potential Problems with the Current Business Model of Credit Rating Agencies

Two primary problems plague the credit rating agencies. First, CRAs are inherently conflicted because they are funded by the very organizations to which they purport to assign neutral ratings.[46] Second, the highly concentrated CRA market—long dominated by Moody's and S&P—has demonstrated classic characteristics of monopolistic organizations.[47]

35. *See* George E. Pinches & J. Clay Singleton, *The Adjustment of Stock Prices to Bond Rating Changes*, 33 J. FIN. 29, 42–43 (1978) (concluding that bond ratings provide little new information that is not already incorporated into the bond's price); Frank K. Reilly & Michael D. Joehnk, *The Association Between Market-Dominated Risk Measures for Bonds and Bond Ratings*, 31 J. FIN. 1387, 1398–99 (1976) (concluding that a bond rating has little or no relation to the market risk of the bond, which thereby limits its usefulness to investors as an indication of what interest rates they should expect for assuming a given amount of risk).

36. 40 Fed. Reg. 29,799 (July 16, 1975) (codified at 17 C.F.R. § 240.15(c)(3)-1 (2008)).

37. 17 C.F.R. § 240.15(c)(3)-1 (2008).

38. *Id.* For example, if an NRSRO rates an issuer and grants it an investment-grade rating, this rule allows the broker or dealer to deduct less from its balance sheets than an issuer who does not receive such ratings. *Id.*

39. COFFEE, *supra* note 1, at 289–90.

40. *Id*.

41. *Id.* at 289.

42. *Id.* at 295–96.

43. *Id.* at 295.

44. COFFEE, *supra* note 1, at 295–96.

45. *See* Jenny Anderson & Vikas Bajaj, *Ratings Firms Seem Near Legal Deal on Reforms*, N.Y. TIMES, June 4, 2008, at C1 (noting the critics' view that conflicts of interest have affected CRAs' objective judgment in giving ratings since the 1970s and that banks shop around to get the best rating).

46. COFFEE, *supra* note 1, at 286.

47. *Id.* at 284–86.

1. Credit Rating Agencies Are Inherently Conflicted Due to Their Business Model

CRAs' source of revenue has historically been criticized because it is conflicted in two ways.[48] First, CRAs charge the issuers that they rate for the rating that the CRA issues.[49] This business model seems subject to direct conflict of interest problems.[50] Second, CRAs have offered ancillary services to issuers they rate.[51] Because these ancillary services proved profitable, they presented another potential problem in that they gave CRAs incentives to inflate ratings in order to retain the issuers' business.[52]

In response to the conflict-of-interest criticisms, CRAs claim that two factors mitigate the risk of CRAs abusing their relationships with issuers. First, CRAs set their fees at a set percentage—typically two or three basis points—of the debt offering.[53] The theory is that because the revenues are low for each offering, there is little incentive for the CRAs to inflate ratings.[54] Some argue, however, that in large offerings the relatively low percentage can still add up to a large fee.[55]

Second, CRAs claim that the SEC's requirement that two ratings agencies give favorable ratings in order for certain legal benefits to become effective mitigates conflicts of interest.[56] The theory is that because two independent ratings are necessary, neither CRA has an incentive to inflate its rating.[57] Instead, they have reputational pressure to create the most reliable ratings possible.[58]

2. Credit Rating Agencies Lack Incentive to Improve Timing of Ratings Updates

The second problem with CRAs is that their highly concentrated—essentially oligopolistic—position has resulted in the industry demonstrating several characteristics

48. *Id.* at 295.

49. *Id.* at 286.

50. Because CRAs receive payment from those they rate, critics point out the incentive that CRAs have to inflate ratings in exchange for future business, better pay, or some other benefit from issuers. *See* Anderson & Bajaj, *supra* note 45, at C1 (discussing critics' opinions of credit rating agencies).

51. COFFEE, *supra* note 1, at 296–97. During the 1980s and 90s, CRAs began rating complex structured financial products, which required more expertise and resulted in more fees. *Id.* Generally, structured financing takes a pool of indistinguishable debt instruments—such as mortgages—and groups them together to create securities with different levels of risk. STANDARD & POOR'S, STRUCTURED FINANCE COMMENTARY: THE FUNDAMENTALS OF STRUCTURED FINANCE RATINGS 2 (2007), http://www2.standardandpoors.com/spf/pdf/fixedincome/Fundamentals_SF_Ratings.pdf. For example, certain subprime loans will be more risky than loans made to people with good credit. *Id.* at 2–3. Therefore, those who have bad credit pay a higher interest rate. *Id.* By separating these two different types of mortgages and securitizing them, the market can allow investors who want more risk and more potential profits to invest in the subprime mortgages while allowing those who want less risk to invest in the regular mortgages. *Id.* Rating these types of products requires more interaction between the CRA and the issuer, and is more complex. COFFEE, *supra* note 1, at 296–97.

52. COFFEE, *supra* note 1, at 297.

53. *Id.* at 295–96.

54. *Id.* at 296.

55. *Id.*

56. *See id*. (stating that issuers feel pressure to receive two favorable ratings). The SEC requires issuers to receive two favorable ratings for the issuer to receive the favorable benefits. 17 C.F.R. § 240.15(c)(3)-1 (2008).

57. COFFEE, *supra* note 1, at 296.

58. *Id*.

of monopolistic industries.[59] Critics claim that the CRAs' oligopolistic position was in part created or at least reinforced by the SEC's NRSRO requirements, which have effectively precluded competitors from tapping into the market.[60] The result has been that CRAs have had historically large profits—monopolistic profits—and they have appeared unresponsive to requests for more rapid updating of ratings.[61] The gap between a company's financial health and its current rating has been of particular concern to investors.[62]

The events leading up to the collapses of Enron and WorldCom vividly illustrated this problem.[63] In both instances, the ratings agencies had rated the company's bonds at "investment grade" status just days and weeks before the companies declared bankruptcy.[64] Some analysts blamed the lack of competition for the CRAs' slow responses.[65] Others pointed out that the CRAs' slow response was not due to lack of competition, but due to their recognition of the consequences of a downgrade.[66] If CRAs downgrade a rating to below investment grade status, a company's financial stability may be drastically impaired.[67] Because institutional investors often prefer securities with high ratings, a rating downgrade may cause many such investors—who tend to hold large investments—to sell those securities.[68] The large selloff can destabilize the security and potentially the security's issuer.[69]

59. Partnoy, *How and Why*, *supra* note 3, at 64–65.

60. The SEC's requirements for becoming an NRSRO have historically been an elusive set of factors. One critic alleged that "an SEC official told him" that the agency would not disclose the criteria for becoming a NRSRO because if it did, he might have qualified. Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 55 (2004). Another problem is that in order to become an NRSRO, a rating agency must be recognized nationally. *Id.* Rating agencies have found it difficult to gain national recognition, however, without the NRSRO status. *Id.* Therefore, they are placed in a "Catch 22" situation. *Id.* For these reasons, only four companies had become NRSROs as of 2004. *Id.* at 54. Today there are ten NRSROs due to the Credit Rating Agency Reform Act of 2006, but three of those—Fitch, Moody's and S&P—still account for "99% of all outstanding ratings." SEC, ANNUAL REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 35 (June 2008), *available at* http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf [hereinafter SEC NRSRO REPORT].

61. Professor Frank Partnoy estimated Moody's operating margins to be somewhere around 50% from 2000–2004, which was much higher than other firms of similar size and expertise. Partnoy, *How and Why*, *supra* note 3, at 64–67.

62. *See, e.g.*, Edward Wyatt, *Enron's Many Strands: Warning Signs; Credit Agencies Waited Months To Voice Doubt About Enron*, N.Y. TIMES, Feb. 8, 2002, at C1 (reporting that S&P, Moody's, and Fitch each delayed downgrading Enron's credit ratings until just before Enron filed bankruptcy).

63. *Id.*; *see also* David Cay Johnston, *Objectivity of a Rating Questioned*, N.Y. TIMES, Dec. 12, 2006, at C1 (noting that the big three CRAs—S&P, Moody's, and Fitch—all failed to timely downgrade credit ratings for Enron and WorldCom).

64. COFFEE, *supra* note 1, at 285.

65. *Id.*

66. *Id.*

67. *Id.* at 286.

68. Hill, *supra* note 60, at 53.

69. COFFEE, *supra* note 1, at 285.

E. The Enron Aftermath and the Reform Act of 2006

In the aftermath of the Enron and WorldCom failures, Congress introduced various reform bills that aimed to "fix" the failures contributing to the problem.[70] Among these bills was the Reform Act of 2006,[71] which took effect on June 26, 2007.[72] The Reform Act of 2006 was important because it codified the requirements for becoming an NRSRO and gave the SEC more oversight over the ratings process, thus opening the door for more competition and transparency.[73]

F. Financial Crisis and Reforms

Since the corporate scandals of Enron and WorldCom in the early 2000s, CRAs have faced additional regulation. In 2008, critics again blamed CRAs for substandard due diligence, particularly with respect to the failing mortgage-backed securities that prompted the worldwide credit crisis.[74] The criticism prompted a wave of regulatory reforms for CRAs, both in the United States and in Europe.[75]

In April 2009, the SEC adopted a number of reforms and outlined additional reforms it planned to consider.[76] The SEC's new rules focused primarily on increasing

70. Bills that arose largely in response to Enron and Worldcom and that impacted CRAs included H.R. 3763, which later became the Sarbanes Oxley Act of 2002, and H.R. 2990, which later evolved into the Credit Rating Agency Reform Act of 2006. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 702,116 Stat. 745, 797–98 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.). Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified as amended in scattered sections of 15 U.S.C.).

71. Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified as amended in scattered sections of 15 U.S.C.).

72. SEC NRSRO REPORT, *supra* note 60, at 1.

73. The purpose of the Reform Act of 2006 is to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry." *Id.* at 2.

74. *See* Anderson & Bajaj, *supra* note 45, at C1 (noting that the CRAs played a "critical" role in the mortgage problems by awarding triple-A ratings to mortgage-backed securities that turned out to be risky investments).

75. For a list of the reform proposals then presented, see SEC. INDUS. AND FIN. MKTS. ASS'N, RECOMMENDATIONS OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION CREDIT RATING AGENCY TASK FORCE 1 (July 2008), *available at* http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf [hereinafter SIFMA RECOMMENDATIONS] (outlining the contours of the proposed rule and regulatory changes for SEC oversight of CRAs); EUROPEAN COMMISSION, PROPOSAL FOR A REGULATORY FRAMEWORK FOR CRAS (2008), *available at* http://ec.europa.eu/internal_market/consultations/2008/securities_agencies_en.htm [hereinafter EC FRAMEWORK PROPOSAL] (outlining proposals for CRA regulatory changes in Europe); EUROPEAN COMMISSION, POLICY OPTIONS TO ADDRESS THE PROBLEM OF EXCESSIVE RELIANCE ON RATINGS 2–5 (2008), *available at* http://ec.europa.eu/internal_market/consultations/docs/securities_agencies/consultation-overreliance_en.pdf [hereinafter EC RELIANCE PROPOSAL] (outlining ways to decrease reliance on CRA ratings). Both the U.S. and the European Commission eventually adopted some of the reforms stated in the proposals. *Compare* SIFMA RECOMMENDATIONS, *supra*, at 4 (recommending increased disclosure of ratings methodologies), *with* Amendments to Rules for Nationally Recognized Statistical Ratings Organizations, 74 Fed. Reg. 6456, 6483 (Feb. 9, 2009) (increasing disclosure of CRA rating methodologies by requiring them to give a general description of those methodologies); *compare* EC FRAMEWORK PROPOSAL, *supra*, at 31–32 (proposing to require CRAs to release a transparency report on a periodic basis), *with EC Proposal*, *supra* note 7, at 41 (requiring CRAs to issue a transparency report).

76. 17 C.F.R. §§ 240.17g-2 to 17g-5, 249b.300 (2009).

transparency through disclosure and decreasing conflicts of interest within CRAs.[77] The SEC rules increase disclosures by, among other things, (1) requiring that CRAs post online a random sample of ratings they issue to paying clients in each ratings class of instrument in which the CRA has 500 or more paying customers;[78] (2) supplying additional financial reports to the SEC;[79] (3) providing a general description of its ratings methodology;[80] and (4) describing processes and procedures related to monitoring and updating ratings, issuing ratings, interacting with issuers, and using third-party ratings of underlying assets.[81] The SEC rules decrease conflicts of interest by (1) prohibiting CRAs from giving issuers advice about legally structuring themselves;[82] (2) separating ratings analysts from those who negotiate fees;[83] and (3) prohibiting gifts to CRA analysts worth more than $25 in the aggregate.[84]

The SEC's proposed rules aim to increase disclosure of issuer-paid ratings and improve the quality of structured financial product ratings.[85] Under the new proposals, CRAs would be required to publicly post any changes they make to issuer-paid ratings.[86] CRAs would also have to share information about certain structured financial products they rate with other CRAs, thereby giving another CRA an opportunity to rate the same product and provide an additional check on the accuracy of any rating.[87]

Despite these most recent changes in the regulations, some argue that more still needs to be done.[88] The SEC seems to agree with this view, as demonstrated by its actions in proposing additional regulations. The next Part analyzes whether more regulation is needed, sets forth a framework for evaluating new proposals, and then analyzes various reform options based on that framework.

III. ANALYSIS

Given the relatively short time since the last CRA regulatory changes took effect,[89] the first question regulators should analyze is whether additional regulations are necessary. One recent study demonstrated that there is a theoretically optimal level of regulation within the CRA industry.[90] The study points out that additional regulations

77. *Id.*; *see also* 74 Fed. Reg. at 6456 (Feb. 9, 2009) (stating that the rules are intended to increase transparency of ratings methodologies, increase disclosures, decrease conflicts of interest, and increase recordkeeping requirements).

78. 17 C.F.R. § 240.17g-2(d) (2009).

79. *Id.* § 240.17g-3.

80. *Id.* § 249b.300.

81. *Id.*

82. *Id.* § 240.17g-5.

83. 17 C.F.R. § 240.17g-5 (2009).

84. *Id.*

85. Re-proposed Rules for Nationally Recognized Statistics Rating Organizations, 74 Fed. Reg. 6485, 6506–07 (Feb. 9, 2009) (to be codified at 17 C.F.R. pts. 240, 243).

86. *Id.* at 6507.

87. *Id.* at 6508.

88. Casey, Remarks, *supra* note 8.

89. The Credit Rating Agency Reform Act took effect on June 26, 2007. SEC NRSRO REPORT, *supra* note 60, at 1.

90. *See* Josef Forster, *The Optimal Regulation of Credit Rating Agencies* (Univ. of Munich Dept. of Econ. Discussion Paper 2008-14, 2008), *available at* http://epub.ub.uni-muenchen.de/5169/1/

impose additional social costs.[91] If the goal of regulation is to maximize social welfare, then regulators should cap regulations at the point at which adding one additional dollar of regulatory expense prevents less than a dollar of investment losses due to poor credit ratings. The result is that "the optimal rating standard is lower than the first-best rating quality."[92]

If regulators find additional regulation necessary, the second question they should ask is what changes will be most effective and efficient both now and in the future. When analyzing this second question, regulators should analyze two types of changes: regulatory rule changes and regulatory structure changes. The following Parts analyze both of these questions and point out some of the issues to consider when analyzing any new regulatory proposals impacting the CRAs.

A. Need for Additional Regulation

Because the Reform Act of 2006 has been in effect since only June 2007 and the newest SEC regulations since only April 2009, one must ask whether additional regulatory proposals may be premature. The SEC itself does not appear to believe that the current regulations are sufficient, as evidenced by its action in proposing additional rules.[93] Additionally, at least one SEC commissioner has stated publicly that more needs to be done to adequately protect consumers from CRA abuses.[94] Assuming that new rules do indeed have societal costs and should be curbed when their costs outweigh their benefits,[95] another question important to this inquiry is: What is the risk of loss if the current regulations are insufficient? The role that CRAs played in both the Enron and WorldCom scandals, as well as the role they played in the credit crisis, seems to suggest that insufficient regulation of CRAs can be extremely costly.

A look at the SEC's rules and proposed rules (collectively "SEC Rules") and their impact also confirms the idea that more reforms are necessary. Although the current rules help to improve CRAs' methodologies, ratings integrity, and surveillance procedures, they do very little to address the issues of global integration and consistency of enforcement over time. These two considerations are important because of the risks they create if not addressed properly. First, it is important that any regulation have a process

Forster_CRA_Regulation.pdf (analyzing the optimal level of regulation within the CRA industry and concluding that the optimal level of regulation should be based on a consideration of regulatory costs and their corresponding benefits).

91. *Id.* at 4.

92. *Id.*

93. Re-proposed Rules for Nationally Recognized Statistics Rating Organizations, 74 Fed. Reg. 6485 (Feb. 9, 2009) (to be codified at 17 C.F.R. pts. 240, 243). As a further example, in 2008, just one year after the SEC's initial ratings went into effect, the SEC proposed the regulations that went into effect in April 2009. *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,124, 40,124 (July 11, 2008) (noting that on June 16, 2008, the SEC released two proposals to reform CRA regulations and stating that this July release also aimed to regulate CRAs). Others also recommended additional reforms that same year. SIFMA RECOMMENDATIONS, *supra* note 75. These additional regulations were largely in response to deficiencies that the SEC found within its own regulatory framework. *See* SEC SUMMARY REPORT, *supra* note 6, at 1–2 (listing various deficiencies that the SEC found in CRA rating procedures despite the current regulation).

94. Casey, Remarks, *supra* note 8.

95. Forster, *The Optimal Regulation of Credit Rating Agencies*, *supra* note 90, at 4.

for analyzing its impact and consistency with regulations elsewhere because disparate and potentially conflicting regulations may "fragment world capital markets" and could create a "barrier to the integration of world capital markets."[96] The SEC Rules do not require the agency to consider the impact on other countries, nor do the Rules establish a process for dealing with such matters.

A second problem with the SEC Rules is that they rely too heavily on the agency itself for consistent enforcement. The SEC Rules address enforcement consistency by (1) providing a mechanism by which other CRAs can perform ratings on structured financial products and thereby provide an independent opinion on the rating,[97] and (2) giving the SEC enforcement power over the regulations. The problem with relying on the SEC for enforcement is that the SEC's budget is subject to change with new administrations and relying solely on the Commission may result in inconsistent enforcement. Although the SEC Rules do provide a check on CRAs' ratings of structured financial products,[98] they do not create a general enforcement solution.

B. Analytical Framework for Evaluating Regulatory Options

Assuming that additional regulatory changes are necessary, this Note considers which regulatory changes would provide the most efficient CRA oversight, both immediately and in the future. In dealing with this question, regulators should consider both the goals of CRA regulation and the mechanisms best suited to achieve those goals. For CRA regulation to be successful, it must (1) ensure that CRAs are using effective ratings methodologies,[99] (2) ensure that the initial rating has integrity—i.e., the rating is solely the product of effective rating methodology,[100] (3) ensure that ratings are updated in a timely manner ("surveillance"),[101] (4) be sensitive to the global impact of CRA regulation,[102] and (5) ensure that the enforcement of regulations is consistent over time.[103] This Note weights the first three considerations in this analytical framework

96. *Reforming the Ratings Agencies*, *supra* note 9, at 2.

97. Re-proposed Rules for Nationally Recognized Statistics Rating Organizations, 74 Fed. Reg. 6485, 6508 (Feb. 9, 2009) (to be codified at 17 C.F.R. pts. 240, 243).

98. A re-proposed SEC rule requires CRAs to allow their competitors access to the same information they had in rating a structured financial product and encourage competitors to do an independent rating of those products. *Id*. at 6492.

99. Effective methodologies and algorithms are essential to give any meaning to the final ratings. No amount of good oversight can correct a flawed algorithm.

100. The mere existence of good methodologies is meaningless unless those using it do so in accordance with the proven methodology.

101. Because ratings are only snapshots into how a company is doing at a particular moment, CRAs must continuously monitor the issuers to check for changes in circumstances that would impact the integrity of the rating and update the rating to indicate those changed circumstances.

102. CRAs' power often crosses national borders. For instance, in 1995, Moody's placed Canada's debts "on review for a possible downgrade." Klein, *supra* note 2, at A1. Upon taking this action, the Canadian dollar dropped in value by a half-cent against the American dollar. *Id.* As a result, investors sold Canadian bonds and Canada had to spend millions of dollars to repurchase its bonds to prevent a further slide in its currency's value. *Id.* Because of the global consequences a rating can have, it is important for CRA regulators to adequately consider how regulation will impact other nations.

103. Investors need to be assured that their retirement is secure both now and 30 years from now when circumstances have changed. If regulation is irregularly enforced, investors may rightfully lack confidence in the financial system.

more heavily than the latter two because the former bear a more direct relation to a rating's purpose, which is to provide investors an indicia of risk. Additionally, any proposed regulatory regime would have to be politically feasible. The following Part analyzes the European Union's regulatory framework as well as other regulatory proposals with an eye toward creating the most effective regulatory environment for both now and the future.

C. Regulatory Options

1. The European Commission's Approach

In April 2009, the European Parliament adopted a proposal from the European Commission (EC Proposal) that significantly increased the regulation of CRAs.[104] The EC Proposal attempts to streamline the enforcement of CRA regulations among its member states by coordinating their actions under the Committee of European Securities Regulators (CESR). The European Parliament's actions in passing the regulation made Europe one the world's toughest CRA regulators.[105]

i. Methodology, Rating Integrity, and Surveillance

Like the SEC's regulatory framework, the EC Proposal focuses on improving methodologies, rating integrity, and surveillance procedures of CRAs. As for ensuring good ratings methodologies, the EC Proposal goes beyond the SEC Rules by requiring CRAs to disclose ratings "methodologies, models, and key assumptions."[106] For more complex structured finance ratings, CRAs must disclose any downgrades they give to ratings that other rating agencies issued on underlying assets.[107] CRAs are also required to differentiate structured financial product ratings and label them as such.[108] Finally, CRAs are required to disclose any changes in their methodologies, models, or key assumptions.[109] These requirements, made more explicit by the EC Proposal, are important in helping to make sure investors know the quality of information used in assessing the offering.

To help ensure the integrity of ratings, the EC Proposal requires CRAs to disclose both current and potential conflicts of interest, including the CRAs' compensation agreements with their clients.[110] The EC Proposal goes beyond mere disclosure, however, by requiring CRAs to have a supervisory board with three members who are independent from company management and whose salaries are not tied to the company's earnings.[111] Additionally, the EC Proposal requires CRAs to disclose all entities from which they derive more than five percent of earnings and requires additional disclosures

104. *See* EC Press Release, *supra* note 7 (noting that the European Parliament adopted the Commission's proposal). For the text of the proposal, see *EC Proposal*, *supra* note 7.

105. *Reforming the Ratings Agencies*, *supra* note 9, at 1.

106. *EC Proposal*, *supra* note 7, at 21–22.

107. *Id.*

108. *Id.* at 22.

109. *Id.*

110. *Id.* at 35.

111. *EC Proposal*, *supra* note 7, at 35–36.

of CRA clients whose business resulted in rapidly growing revenues for the CRA.[112] Finally, CRAs must file an annual transparency report detailing the CRAs' procedures for managing conflicts of interest, quality control systems, executive rotations, and record-keeping.[113] These requirements, particularly those related to the supervisory board, represent a much stronger approach than the SEC Rules because they impact the very makeup of the organization.

As for the surveillance of ratings, the EC Proposal requires CRAs to monitor and review credit ratings. One way the regulation accomplishes this is by requiring CRAs to establish procedures to monitor the effects that macroeconomic and market changes may have had on the models or key assumptions upon which ratings were based.[114] If the assumptions have changed, the CRA must promptly disclose which ratings may be impacted and re-rate all impacted ratings.[115]

Additionally, the EC Proposal sets up a list of other mandatory periodic disclosures aimed at helping both regulators and investors uncover potentially damaging information about both issuers and CRAs.[116] For instance, on a biannual basis, the EC Proposal requires CRAs to disclose the default rates of securities in each of their rating categories.[117] This requirement would allow investors to determine the reliability of CRAs' ratings over time and could prompt CRAs to be more diligent in their surveillance procedures.

ii. Global Impact and Enforcement Consistency

With respect to considerations of global impact and enforcement consistency, the EC Proposal is lacking. Despite the Commission's acknowledgment that the ratings business is global in nature and thus it is important to have "comparable" regulatory regimes,[118] the regulations fail to set up any systematic process for considering the global impact of regulatory decisions. Rather than setting up a "comparable" regulatory framework, the framework that the European Commission created is, in the words of one scholar, "quite different from standards in the rest of the world."[119] Thus, there is the potential that the regulation would create an isolated financial market in Europe that would be difficult to compare with markets elsewhere.[120]

Another problem with the EC Proposal is that it fails to provide mechanisms to ensure consistent future enforcement. Under the EC Proposal, CRAs would register to do business within the European Union through a national authorization organization, the

112. *Id*. at 36. Each CRA must disclose the names of clients whose business in the prior year (1) constituted at least 0.25% of the CRA's revenue and (2) grew at a rate, as measured in revenues, of 1.5 times that of the CRA's growth rate. *Id.* at 41.

113. *Id*. at 41.

114. *Id*. at 21–22.

115. *EC Proposal*, *supra* note 7, at 21–22.

116. *Id*. at 40–41.

117. *Id*.

118. *Id.* at 3.

119. *Reforming the Ratings Agencies*, *supra* note 9, at 2.

120. *See id*. (noting that some scholars fear that Europe's system will create "barrier[s] to the integration of world capital markets").

CESR.[121] The CESR then works in connection with certain "competent authorities" in each member state to enforce the regulation.[122] Ultimately, the enforcement of the regulation is dependent upon the individual member state's ability to enforce the regulations. The problem with such a regime is that it makes consistent future enforcement subject to the turbulent seas of political expediency, with regulations being enforced when the politics call for it and not enforced when expediency says otherwise. Because CRA regulations can have global impact, the less those regulations are subject to a single political regime, the more confidence they will produce in investors here and abroad.

iii. General Feasibility and Other Considerations

Though the EC Proposal has strengths over the SEC Rules, some of its provisions would not likely work in the United States. Procedurally, the EC Proposal would not work because of its federal governance model.[123] In the United States, the SEC regulations that make CRA ratings legally important are federal regulations, and thus it would not make sense to grant states discretion in how to enforce those regulations. Substantively, there are issues with implementing the EC Proposal's new rating symbol requirements that require special symbols for structured finance products.[124] Some argue that creating new ratings symbols for certain products will make it difficult to compare those products with others.[125] It is unclear at this point whether such a system would be overly confusing and reduce the utility of ratings.

2. The SIFMA Proposal

Another option for regulatory change that has not been enacted is the proposal recommended by the Securities Industry and Financial Markets Association (SIFMA) in July 2008. During the heat of the credit crisis, the President's Working Group invited SIFMA's Credit Rating Agency Task Force to develop recommendations for improving CRA regulation.[126] SIFMA's recommendations embody proposed rule changes that would increase CRA disclosure requirements, add ratings modifiers to the current ratings symbols, and create a Global Credit Ratings Advisory Board.[127] Additionally, SIFMA recommends that investors use CRA ratings in conjunction with other means of risk analysis, thus reducing their dependence on CRAs for ratings.[128]

i. Methodology, Rating Integrity, and Surveillance

Overall, SIFMA's recommendations appear effective in fulfilling the objectives of ensuring good methodology, rating integrity, and ongoing surveillance. Of particular

121. *EC Proposal*, *supra* note 7, at 24.

122. *See id*. at 27–28 (noting that competent authorities need only "consider" the CESR's advice before taking any regulatory action).

123. *Id.* at 24–28.

124. *Id.* at 22.

125. *Reforming the Ratings Agencies*, *supra* note 9, at 4.

126. SIFMA RECOMMENDATIONS, *supra* note 75, at 1.

127. *Id.* at 2, 11.

128. *Id.* at 16.

importance are SIFMA's proposed rule changes dealing with the disclosure of ratings methodologies and due diligence information.[129] Both of these recommendations would help to increase the integrity of the initial rating by giving CRAs an incentive to accurately rate an initial offering. Under SIFMA's recommendations, CRAs would disclose both the quantitative and qualitative data they used in assessing an offering, the due diligence procedures they followed or relied upon, and any concerns they had while conducting the due diligence.[130] Furthermore, SIFMA recommends disclosure of a CRA's ongoing surveillance procedures, including their extent and timing.[131] Together, these rules would greatly enhance both the integrity of the initial rating and the accuracy of that rating going forward.

ii. Global Impact and Enforcement Consistency

SIFMA's regulatory proposal demonstrates mixed results in coordinating global ratings and fostering consistent future enforcement. On the global-coordination issue, SIFMA's proposal appears strong. SIFMA proposes to create a Global Credit Ratings Advisory Board to advise regulators about credit rating issues.[132] SIFMA's board would not have any regulatory or enforcement power.[133] Making the global board's recommendations binding could prove politically untenable or practically inflexible to differing circumstances.

The SIFMA proposal's primary disadvantage is that it lacks structural mechanisms to ensure consistent future enforcement of the rules.[134] SIFMA's proposal presumably depends on the SEC's continued, diligent oversight to operate effectively. Historically, however, budget cuts, administrative changes, and environmental circumstances have caused SEC oversight to be inconsistent.[135] Indeed, one could argue that the SEC's ineffective oversight of CRAs is the primary impetus for the current regulatory reform proposals. If the SEC either does not or cannot adequately enforce the rules, there are no structural protections that will prevent future abuses.

iii. General Feasibility and Other Considerations

Finally, SIFMA's proposal is beneficial because it is a relatively low-cost, easy-to-implement reform. From the CRAs' perspective, the SIFMA proposals are relatively low

129. *Id.* at 3–7.

130. *Id.*

131. SIFMA RECOMMENDATIONS, *supra* note 75, at 8.

132. *Id.* at 11–12.

133. *Id.* at 11.

134. The SIFMA proposals presumably rely on the SEC for enforcement. *See* SIFMA RECOMMENDATIONS, *supra* note 75, at 2 (listing SIFMA's recommendations, which rely solely on the SEC for enforcement of the rules). Because new administrators or congressional budgetary cuts could impact the SEC's enforcement of regulations, there is a possibility that enforcement will not be consistent over time.

135. For a general review of the SEC's inconsistent reliability in regulating the stock exchanges, see Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347, 1383–84 (2004) (noting that the SEC's jurisdiction is broad and it has only focused on, for example, stock market regulation when the markets have problems). For example, the SEC's ability to monitor other organizations, such as the stock exchanges and accounting industry, has proven inadequate. *Id*.

cost because they merely require disclosure of procedures and methodologies.[136] From the SEC's perspective, the reforms are relatively easy to implement because they merely require the SEC to engage in rule-making rather than seeking legislative amendment of the Reform Act of 2006.[137]

3. Other Options

In addition to the SEC Rules, the EC Proposal, and SIFMA's recommendations, there are myriad other possibilities for regulatory reform. One option could be to open CRAs up to liability by creating private causes of action for fraud. Historically, CRAs have avoided liability by asserting various defenses,[138] one being that their rating is merely an opinion protected by the First Amendment.[139] However, courts have recently appeared more willing to at least hear such cases.[140]

Granting individuals a private cause of action would serve the objectives of ensuring a good ratings methodology, integrity of the ratings, and continuing surveillance by exposing CRAs to potentially large class-action lawsuits for failing to do so. This option also has the benefit of helping to ensure consistent enforcement. By giving private parties a concurrent right with the SEC to enforce the SEC's regulations, enforcement of those regulations would not depend upon the SEC's enforcement budget or its policy agenda.

This option also has disadvantages. First, it does nothing to address the global coordination of securities regulation.[141] Second, by opening CRAs up to private litigation, the costs of ratings are sure to increase.[142] Third, CRAs might, as a result of the great exposure to increased litigation, retreat to granting overly conservative ratings.[143] Fourth, and most importantly, the CRAs may find the small profits they make off each rating unreasonably disproportionate to the large potential for liability and decide either not to rate certain products or to get out of the business altogether.[144]

A second option, a hybrid of those discussed above, would be to give the SEC

136. Presumably, the only cost of disclosing this information would be to publish it, and that could be done through the CRAs' websites.

137. Agency authority to create rules must come from the agency's enabling statute. MICHAEL ASIMOW ET AL., STATE AND FEDERAL ADMINISTRATIVE LAW 222 (1998). Therefore, an agency cannot make rules if its enabling statute does not authorize it to do so. *Id*. To expand its rulemaking authority requires Congress to increase its authority, thus taking the issue out of the agency's control. *See id*.

138. Courts have accepted at least two different types of defenses made by CRAs: (1) that those who rely on ratings do not do so reasonably, and (2) that the ratings CRAs give are merely opinions that are protected by the First Amendment. Hill, *supra* note 60, at 56. *See also* Quinn v. McGraw-Hill, 168 F.3d 331, 336 (7th Cir. 1999) (holding that the plaintiff could not have reasonably relied on an S&P rating because he had received materials that indicated the risks involved with the securities); Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc., 988 F. Supp. 1341, 1345 (D. Colo. 1997) (holding that Moody's unfavorable rating of the school district's bonds was merely an opinion that was protected by the First Amendment and that issuers may not sue CRAs for defamation based on the ratings).

139. *Jefferson County*, 988 F. Supp. at 1345.

140. *See, e.g.*, *In re* Nat'l Century Fin. Enter., Inc., Inv. Litig., 580 F. Supp. 2d 630, 639 (S.D. Ohio 2008) (stating that opinions can be the basis of a securities fraud complaint).

141. Because this option is solely a recommendation that private parties be able to sue CRAs for fraud or negligence, it contemplates no formalized global coordination of regulation.

142. COFFEE, *supra* note 1, at 303.

143. *Id.*

144. *Id.*

"primary jurisdiction"[145] over enforcement, but allow plaintiffs to sue in court if the SEC fails to act. This option adds an essential element to the SIFMA proposal and cures that proposal's primary defect: the lack of features ensuring future consistent enforcement. The essence of such a feature is that investors who believe they were misled by the CRA would first have to file a complaint with the SEC. If the SEC failed to take any action after a specified number of days, investors could then bring their suit in court.

Adding a primary jurisdictional element has proven to be very effective in other contexts. In Iowa, for example, such a feature was used to facilitate enforcement of the Iowa Civil Rights Act of 1965 (Civil Rights Act).[146] Though the Civil Rights Act gave the Civil Rights Commission enforcement authority, the Commission's actual enforcement was inconsistent from administration to administration.[147] To ameliorate this problem, Iowa amended its statute in 1978 to include a private cause of action.[148] Under the amended statute, a complainant must first ask the Commission to enforce the Civil Rights Act.[149] If, within 60 days, the Commission does nothing—i.e., it neither dismisses the claim nor initiates an adjudicatory action—the complainant may then seek to move his claim to district court.[150] Since Iowa passed its Civil Rights Act amendment, Iowa's enforcement agency has more consistently enforced the Act's provisions.[151]

Just as Iowans need their state to consistently enforce its Civil Rights Act, the U.S. financial markets need the SEC to consistently enforce its CRA regulations. Giving the SEC primary jurisdiction over the issue and allowing the plaintiff to sue in court if the SEC does nothing ensures consistent enforcement that is largely immune to political pressure. This option also has the benefit of giving CRAs more incentive to follow good rating methodologies while not exposing them to excessive levels of liability to private individuals. Unlike the option of allowing both the SEC and private individuals to consecutively enforce the regulations, this proposal creates a buffer between the CRAs and private litigants. By forcing litigants to first seek redress from the SEC, it limits CRAs from a potential flood of class-action suits. At the same time, it also protects investors from lapses in SEC oversight if the SEC fails to take action on potential CRA wrongdoing.

145. Primary jurisdiction exists when the courts and an agency have concurrent jurisdiction to hear certain types of cases. MICHAEL ASIMOW ET AL., *supra* note 137, at 703–04. Generally, the plaintiff will need to take her complaint first to the agency, and then if the agency does nothing, she can take the case to court. *See generally id.* at 703–05 (discussing primary jurisdiction and giving insights into issues involved with such jurisdiction).

146. Iowa Civil Rights Act of 1965, IOWA CODE ANN. §§ 216.1–216.20 (2008).

147. Interview with Professor Arthur Earl Bonfield, Allan Vestal Chair and Assoc. Dean for Research, Univ. of Iowa Coll. of Law, in Iowa City, Iowa (Oct. 29, 2008). Professor Bonfield helped to write the original 1965 version of the Civil Rights Act as well as its amendment in 1978. *Id.*

148. *Id.*

149. Iowa Civil Rights Act § 216.16 (amending the Amendment to the Iowa Civil Rights Act of 1965, ch. 1179, §1, 1978 Iowa Acts 851, 851). The original amendment gave the agency 120 days to act on the complaint before the petitioner could sue in court. Amendment to the Iowa Civil Rights Act of 1965, ch. 1179, § 1, 1978 Iowa Acts 851, 851 (1978).

150. Iowa Civil Rights Act § 216.16.

151. Interview with Professor Bonfield, *supra* note 147.

IV. RECOMMENDATIONS

Any structure for regulation of CRAs needs to be planned with an eye to long-term effectiveness. The history of the credit-rating industry demonstrates that conflicts of interest have and likely will continue to present possibilities for abuse by CRAs.[152] The legal importance that ratings have, the potential for ratings inflation, and the large losses possible when ratings are inaccurate make it clear that effectively regulating CRAs is necessary and current regulations should be revised, if required, to achieve that objective. Many agree that current SEC regulations are not sufficient and recommend additional changes. This Note argues that additional reforms are necessary to prevent future widespread losses and recommends that the hybrid option, consisting of (1) additional rules requiring more disclosure, (2) a global advisory group, (3) SEC oversight, and (4) a private cause of action should the SEC choose not to act is the most efficient and effective way to proceed.

First, the SEC should adopt the EC Proposal's requirement that forces CRAs to disclose the methodologies, models, and key assumptions in rating a security. Such disclosure is necessary for users of credit ratings to know whether the CRAs have done an adequate job. Likewise, disclosure of information regarding the due diligence procedures that CRAs use to extract the data upon which their ratings are based is also important. Not only are such rules important for investors to make an informed judgment as to the credibility of the resulting rating, but that information is also necessary for private litigation purposes if investors challenge CRAs in a negligence suit. Another important rule that both SIFMA and the EC Proposal have promulgated is a rule requiring CRAs to disclose their surveillance procedures.[153] In general, the SIFMA proposal is preferable on this topic because it provides detailed instructions on what exactly CRAs must do. The EC Proposal's requirement that CRAs perform an annual review of their methodology should also be incorporated.[154] These rules are important because they allow investors to make important judgments about the reliability and timeliness of ratings. Also, issuers would need to disclose their rating procedures if Congress gives investors a private cause of action.

Second, Congress should enable the SEC to create a global advisory organization to help coordinate international regulatory regimes internationally. This is one area in which the SIFMA proposal is clearly superior to that of the EC. The SIFMA proposal, unlike the EC Proposal, calls for an independent group of securities experts to coordinate international regulatory action.[155] Such a group is desirable, if not necessary, because CRAs' actions can have global impact, and regulation impacting the CRAs may impact other countries indirectly. For example, if Moody's downgrades Canada's government

152. As noted in Part II.C, the CRA industry has a nearly 40-year history of working within a business model where conflicts of interest are inherent.

153. *See* SIFMA RECOMMENDATIONS, *supra* note 75, at 8 (stating that surveillance procedures should be disclosed and should include how frequently updating will occur, what the nature of the review will be, how quickly the CRA will update ratings upon receiving new information, what the review process is, and whether or not the reviewing analysts will include people who originally rated the issuer); *see also* EC FRAMEWORK PROPOSAL, *supra* note 75, at 17 (noting that CRAs should monitor issuers on an "ongoing basis" and "be responsive to changes in financial conditions").

154. EC FRAMEWORK PROPOSAL, *supra* note 75, at 17.

155. SIFMA RECOMMENDATIONS, *supra* note 75, at 11–12.

bonds, the downgrade can trigger a selloff of Canadian bonds and thus destabilize that country's financial system.[156] Through regulation, the SEC's rules and enforcement policy directly impacts the timing and reliability of Moody's actions, and thus can indirectly impact Canada's financial system.[157] Though the SEC should not be obligated to act or refrain from acting based on foreign influence, the SEC should have processes to ensure it is informed about the effect of its decisions on foreign stakeholders. SIFMA's proposal provides such a system that adequately balances U.S. sovereignty and global responsibility.

The area where both the SIFMA and the EC Proposal falls short is that neither adequately addresses the problem of consistent enforcement over time. The SEC should have primary jurisdiction and courts should have secondary jurisdiction over enforcement of SEC rules. Because Congress has given the SEC specific authority to create and enforce rules governing the regulation of CRAs, it should have the primary jurisdiction over investor claims alleging either fraud or negligence by CRAs. Private investors who believe that a CRA is acting negligently or fraudulently would first need to request that the SEC take action against the CRA. If the SEC does not respond within a certain time frame by either dismissing the claim or starting adjudication procedures, then the private investor could litigate in court. If, however, the SEC did take action, then the investor would be obligated to accept the SEC response or appeal its decision through the standard administrative adjudicatory process.

By granting primary jurisdiction to the SEC and secondary jurisdiction to the courts, investors would be better protected because such a system would ensure consistent enforcement over time. This type of system would stabilize the enforcement of CRA regulation by giving the SEC added incentive to enforce its regulations, regardless of the current political policies. More importantly, this enforcement structure would give investors more confidence in the rating system and would help restore efficiency to the financial markets.

Although there is some risk that such a system would result in needless litigation, regulators can address such concerns by adjusting the pleading requirements for lawsuits. The increased disclosure requirements about methodologies, surveillance, and quality of information would give investors the tools to meet these pleading requirements. Considering the benefits of increased investor confidence and regulatory stability, these risks are acceptable.

V. CONCLUSION

The Reform Act of 2006 and the SEC regulations that followed took a necessary first step in creating a solution to protect investors by increasing the quality of CRA ratings. The financial crisis, which soon became a worldwide phenomenon, demonstrates the importance of stability and reliability within the financial sector. To achieve long-term regulatory stability and increase investor confidence, further adjustments must be made to the reforms described in the Reform Act of 2006.

Specifically, increased disclosure requirements regarding CRAs' rating

156. *See* Klein, *supra* note 2, at A1 (noting that Moody's review of Canada's bonds for a possible downgrade triggered a selloff of those bonds).

157. *Id.*

methodologies, surveillance policies, and rating processes are an important starting point, but they are not enough. CRAs' ratings have a global impact and thus regulation affecting their processes should be created and enforced with sensitivity to the consequences of such activities on other nations. Most importantly, SEC enforcement of regulation must be consistent to provide investors confidence in the financial markets both now and in the future after memories of the current crisis have faded.

The United States should no longer content itself with sporadic, feverish reaction to financial problems. Instead, it should build into any solution a check on the SEC's enforcement power so as to ensure consistency over time. By giving investors a private cause of action for cases in which the SEC does nothing, investors will be protected both now and in the future. After all, most investment advisers encourage people to invest for the long term. Those who invest for the long term should know that their investments are protected for the long term, and not just until the people elect a new administration.