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OBSTACLES TO CREDIT RATING AGENCIES' FIRST AMENDMENT DEFENSE IN LIGHT OF ABU DHABI

Parisa Haghshenas*

There are two superpowers in the world today in my opinion. 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.

INTRODUCTION

The nature of today's financial markets necessitates interconnectedness among various market participants. One participant, the rating agency, has become one of the most influential by providing its perspective, in the form of ratings, on the viability of certain financial products. The fundamental

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purpose of a rating is to ensure market efficiency through the rating agency's description of which products are riskier than others. This creates a shield of investor protection and becomes a source of market confidence. Yet in the current financial crisis, rating agencies have come under attack by investors who claim that the agencies not only failed to protect the investors, but were instrumental contributors to the financial crisis itself. Under attack, the ratings agencies are claiming that their ratings of various financial instruments—analogized to editorials or, more appropriately, restaurant reviews—are entitled to full First Amendment protection. Yet, the agencies' activities have formed a type of institutional commingling that has been exacerbated by the conflicts of interest embedded in the ratings process. As a result, ratings agencies should be denied First Amendment protection.

In an effort to project marketability of their security issuances and themselves, market participants are encouraged, and sometimes obliged, to use the same rating agencies. This results in unavoidable reliance on the agencies and a financial market characterized by a commingling of institutions. The rating agencies' need for self-preservation has shifted the focus from investor protection and market confidence to self-aggrandizement, which results in scores of litigation disputing the level of risk the rating agencies assigned in their ratings. When these ratings have been challenged in litigation, the rating agencies have asserted that their ratings are protected as opinions under the First Amendment. This Note will address the rating agencies' First Amendment defense through the lens of Abu Dhabi Commercial Bank v. Morgan Stanley and will highlight the conflicts of interest embedded in the rating process that should preclude the rating agencies from obtaining such protection.

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3. Id. at 6-7 (noting that the "President's Working Group on Financial Markets . . . criticized the flaws in the rating agencies' assessments of complex products and called them a 'principal underlying cause'" of the recent financial crisis).
Part I of this Note details the Abu Dhabi ruling, which represents one court's reluctance to grant First Amendment protection to ratings issued by a rating agency. Part II traces the history of the rating agencies and the past and present regulatory oversight, or lack thereof, of such agencies. Part III of this Note is a detailed discussion of the Abu Dhabi court's analysis and of the claim that the court's analysis should be applied to all issues rated by the rating agencies, not just those that are private placements. In applying the court's analysis to all ratings issued by the rating agencies, this Note explores the stark contrast between those ratings and the newspaper editorials to which they are often analogized as a defense. The final part of this Note discusses potential regulatory solutions to the issues posed by rating agencies in the current economic crisis, and reiterates the need to regain market confidence and to increase investor protection.

I. Abu Dhabi Commercial Bank v. Morgan Stanley

In 2009, Abu Dhabi Commercial Bank (Abu Dhabi) filed suit against Moody's Investors Service, Inc. (Moody's), Standard & Poor's Ratings Services (S&P) (collectively the "rating agencies"), and seven other defendants for losses incurred from the sale of notes issued by the Cheyne Finance PLC structured investment vehicle (SIV), which were rated by the named rating agencies. The notes were issued via a private placement memorandum and the issuance necessitated the assignment of ratings. The success of the SIVs "depend[ed] directly on the credit quality of the assets

5. Private placements, or "nonpublic offerings," are "securities [that] are offered only to sophisticated investors in a nonpublic manner." COMPTROLLER OF THE CURRENCY ADMINISTRATOR OF NATIONAL BANKS, PRIVATE PLACEMENTS: COMPTROLLER'S HANDBOOK (SECTION 411) 1 (1990), available at http://www.occ.treas.gov/handbook/PrivatePlace1.pdf. Under the Securities Act of 1933, issuers of private placement securities are exempted from registration requirements. Id.

6. Abu Dhabi, 651 F. Supp. 2d at 163 (listing the plaintiffs' theories of recovery as "common law fraud, negligent misrepresentation, negligence, breach of fiduciary duty, breach of contract and related contract claims, unjust enrichment, and aiding and abetting").
acquired by the SIV.” The plaintiffs alleged, among other things, that although the private placements were risky and complex investments, the rating agencies evaluated them as relatively safe investments, and those investments are now worthless. Although this is not the first case to address rating agencies’ liability for ratings assigned to various financial instruments, it does concern the default of residential mortgage-backed securities, which have been called contributing factors to the recent financial crisis.

The defendants filed a motion to dismiss, claiming that ratings are protected as opinions under the First Amendment. Specifically, they asserted that “Rating Agencies gather and analyze information about issuers, form opinions about that information and disseminate their forward-looking opinions to the public.” The court denied the motion, holding that the plaintiffs “sufficiently alleged that the ratings issued by the Rating Agencies on the Rated Notes are actionable misstatements” and cannot be afforded protection under the First Amendment. In denying the defendant’s motion to dismiss on First Amendment grounds, the court relied on a number of factors: the nature of the product sold to investors, the state of mind and knowledge of the rating

7. Complaint at 10, Abu Dhabi, 651 F. Supp. 2d 155 (No. 08 Civ. 7508), [hereinafter First Amended Complaint].
8. Id. at 1-2.
9. See infra Part III.A.
11. Joint Memorandum of Law in Support of the Motion of the Rating Agency Defendants to Dismiss the First Amended Complaint at 1-3, Abu Dhabi, 651 F. Supp. 2d 155 (No. 08 Civ. 2508 (SAS)) [hereinafter Joint Memorandum].
12. Id. at 26.
13. Abu Dhabi, 651 F. Supp. 2d at 176. Applying the standard required in reviewing a Rule 12(b)(6) motion, the court must “accept as true all of the factual allegations contained in the complaint. . . .” Id. at 170 (citing Bell Atl. Corp. v. Twombly, 550 U.S. 554, 572 (2007)).
14. Id. at 175-76.
15. Id.
agencies when they rated the notes, and the conflicts of interest between the rating agency and the issuer of the notes.

The court relied on the nature of the notes as "private placement[s]" as grounds to deny First Amendment protection. Specifically, the court stated that "where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same protection." The court noted further that even if the ratings are classified as "opinions," they are still actionable since the rating agencies had clear knowledge that they were misleading prospective investors.

The court's holding centered on the conflicts of interests that existed between the rating agencies and the issuer of the notes. The court referred to a number of criteria in determining the existence of conflicts of interest: the rating agency's level of involvement with the structuring of the note prior to its issuance, the initial and ongoing fee structures associated with the ratings, and the rating agency's motive to assign higher (and thus better) ratings. Although the court noted that the "existence of conflicts of interest alone typically is not sufficient to establish that defendants 'knowingly' made a false and misleading statement," it is influential in determining the rating agencies' lack of belief in the issued ratings when combined with other factors. The presence of

16. Id at 178-80.
17. Id.
18. First Amended Complaint, supra note 7, at 78. See supra text accompanying note 5.
20. Id. ("[T]he Rating Agencies did not genuinely or reasonably believe that the ratings they assigned to the Rated Notes were accurate and had a basis in fact."); see also id. at 178 (stating further that the rating agencies "knew that [the structured investment portfolio] consisted of 'much more' than fifty-five percent of RMBS . . . [which] made the SIV a risky investment and certainly not deserving of high ratings").
21. Id. at 166-67, 179-80.
22. Id. at 179.
23. Id. Because the rating agencies:
these conflicts of interest highlights the distinction between a rating agency and a journalist, thus supporting the court's decision to deny First Amendment protection to the rating agencies.

The court was justified in denying First Amendment protection to the rating agencies, despite widespread sentiment to the contrary. 24 The apparent depth of the conflicts of interest and the requirement imposed by regulators that institutions use only preapproved rating agencies 25 cast doubt upon the defense that these ratings, like journalists' opinions, should be protected under the First Amendment. In essence, a rating agency is acting like a chef rating his own food, 26 and these conflicts of interest, or the perception thereof, dilute the independence of the rating agencies. In order to grasp the extent of subjectivity embedded in the rating process, a brief history of rating agencies and the changes in their business models is warranted.

knew that the ratings process was flawed, knew that the portfolio was not a safe, stable investment, and knew that Ratings Agencies could not issue an objective rating because of the effect it would have on their compensation, it may be plausibly inferred that . . . the Rating Agencies knew they were disseminating false and misleading ratings.

Id.

24. See Gregory Husisian, What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability, 75 CORNELL L. REV. 411, 453-54 (1990) ("It is apparent, therefore, that bond ratings are indeed the world's shortest editorials . . . courts should grant them the same deference they grant any other protected first amendment publication. Ratings merely provide a simple means for consumers to compare rough levels of risk among varying companies and industries.").

25. See discussion infra Part II.

II. HISTORICAL FOUNDATIONS OF FINANCIAL PRODUCT RATINGS

The idea of rating securities and debt instruments existed in the financial markets as early as 1837. The ratings that emerged soon began to resemble those that are available today. For example, in the early 1900s, John Moody published "Moody's Analyses of Railroad Investments." Moody's continues to publish an updated version of this reference guide. The publication included a list of the U.S. Railroad bonds rated by the company and their corresponding valuations defined in "rating" terms. These terms and their definitions were displayed at the beginning of each publication issued. Moody's and other rating agencies have progressed over the years to rating a number of other financial products. Moody's and most of the other rating agencies maintain the following classification scale in their ratings: AAA, AA, A, BAA, BA, B, CAA, CA, and C. The further right you proceed on


28. See FONS, supra note 10, at 1-2 (discussing the historical background of rating agencies and their current effects on the mortgage industry).


30. See id. (providing an in-depth view of Moody's various ratings and their corresponding definitions, including a discussion of the types of investments rated by the corporation).


this line, the lower the product is rated. These one-to-three-letter terms become crucial to a product’s viability in the marketplace, as investors are often less inclined to purchase—and sometimes forbidden from purchasing—lower-rated products than higher-rated ones. These ratings signify the underlying issuer’s creditworthiness, or how likely or able the underlying issuer is to pay its debts to its creditors and to its investors. Naturally, the higher the rating assigned to a specific financial product, the more attractive it becomes and the easier it is to promote.

Historically, the fee structure instituted by rating agencies was straightforward: the agencies would not charge a fee to rate an issuer or debt instrument, but would raise revenue through advertisements and subscriptions to their publications. This model of amassing revenue is not unlike the process employed by today’s newspaper conglomerates. Yet unlike newspapers, the

cedratingreport0103.pdf [hereinafter OPERATION OF THE SECURITIES MARKETS] (noting that Fitch and S&P ratings “AAA, AA, A, and BBB are investment grade categories; BB, B, CCC, CC, C, and D are considered speculative grade rankings”).


34. See OPERATION OF THE SECURITIES MARKETS, supra note 32, at 5 (noting that “the Commission has relied on ratings by market-recognized credible rating agencies for distinguishing among grades of creditworthiness”); Francis A. Bottini, Jr., Comment, An Examination of the Current State of Rating Agencies and Proposals for Limited Oversight of Such Agencies, 30 SAN DIEGO L. REV. 579, 582 (1993) (“An estimated seventy-nine percent of individual investors claim that a rating is the most important factor in their investment decision.”) See also id. (“In addition, major governmental agencies . . . increasingly rely on ratings in promulgating major securities regulations. For example, the SEC recently prohibited the investment of money-market funds in commercial paper with a low rating.” (footnotes omitted)).

35. See Fitch, Inc. v. UBS PaineWebber, Inc., 330 F.3d 104, 106 (2d Cir. 2003) (noting, specifically in reference to Fitch Ratings Insurance Group, that one of the reasons issuers prefer a “favorable rating [is because] that rating makes it easier to sell the security to investors, who rely upon Fitch’s analysis and evaluation”).

rating agencies now charge a fee to the issuers for the ratings they issue, a process which began in the 1970s.\textsuperscript{37} To provide a comparison, this would be like a newspaper journalist charging a high fee to provide an “independent” rating of an exclusive hotel in New York City and then publishing the review in the Travel portion of the newspaper. This publication would be something more than a simple advertisement since the rating is a de facto endorsement of the hotel. Although merely charging a fee for services rendered may not automatically bias the rating, it does create the appearance of improper influence. This characteristic of the new era of rating agencies would soon become a deciding factor in many court decisions as the rating agencies’ appearance of independency diminished.\textsuperscript{38}

By the time the new fee structures were implemented, the Great Depression and a deteriorating economic environment had changed the economic landscape, which was in turn offset by an increasing development of corporate bond structures in the United States.\textsuperscript{39} Furthermore, by the late 1900s, rating agencies were profiled as playing a major role in the financial stability of the markets by “supplementing if not actually taking over functions once performed by investment bankers.” Therefore, “their reputational capital grew.”\textsuperscript{40} As a result of the economy’s sudden dependence on the rating agencies, their ratings became

\textsuperscript{37} Id. at 49. See generally Rhodes, supra note 27, at 308-09 (noting that the “issuer pays” model comprises a large amount of revenue for the rating agencies; “for example, four-fifths of S&P’s [revenue] is derived from issuer fees”) (citing Richard Cantor & Frank Packer, The Credit Rating Industry, 19 FRBNY Q. REV. 1, 4 (1994), available at http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n2article1.pdf).


\textsuperscript{39} See Richard Sylla, An Historical Primer on the Business of Credit Ratings, in RATINGS, RATING AGENCIES, AND THE GLOBAL FINANCIAL SYSTEM 19, 22-23 (Richard M. Levich et al. eds., 2002) (discussing the expansion of credit ratings agencies as a result of the expansion of the U.S. bond market); Two Thumbs Down, supra note 1, at 640, 647 (discussing the financial market crash of 1929 and the Vietnam War’s effect on the financial crisis).

\textsuperscript{40} Sylla, supra note 39, at 22-23 (discussing the expansion of credit ratings agencies as a result of the expansion of the U.S. bond market).
"benchmarks" for investors when choosing among several financial instruments to invest their money.\textsuperscript{41}

As the dependence on the ratings grew among investors—just one sector of market participants—investment banks, financial institutions, and corporate issuers became more reliant on them as well.\textsuperscript{42} It could be argued that at this point the ratings became a "matter of public concern."\textsuperscript{43} Their importance and impact spread across the industry, allowing them to leave a larger footprint on the economy.\textsuperscript{44} Up until the 1970 bankruptcy of the Penn Central Transportation Company, which occurred before the imposition of regulations, a company’s credibility and stature in the marketplace was the driving force behind an investor’s choice to invest in that company. At the time of its bankruptcy, Penn Central Transportation Company had an enormous amount of debt.\textsuperscript{45}

\textsuperscript{41} See John Patrick Hunt, Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, 2009 COLUM. BUS. L. REV. 109, 204-05 (2009); see generally White, supra note 36, at 48 ("The value of the ratings companies for investors was clear: the ratings provided extra voices of expertise and assessment for bond investors as to which companies were good credit risks and which ones were not so good.").


\textsuperscript{43} See Connick v. Myers, 461 U.S. 138, 147-48 (1983) ("Whether . . . speech addresses a matter of public concern must be determined by the content, form, and context of a given statement, as revealed by the whole record.").

\textsuperscript{44} See White, supra note 36, at 49 (noting the increase in “issuers” willingness to pay for the certification of their credit quality that the bond rating companies provided”).

\textsuperscript{45} See Two Thumbs Down, supra note 1, at 647 (discussing the Penn Central bankruptcy and its effects on the reputations of rating agencies: "[I]nvestors began demanding more sophisticated levels of research . . . [but the] rating agencies . . . were not in a position to satisfy this demand . . . ."
When it suddenly became unable to pay those debts, the entire country panicked; this large, reputable company was no longer a prominent and stable feature of the economy. The use of rating agencies became more prevalent at this time, and the need for designation and regulation increased. As a result of this increased dependence, and as rating agencies naturally needed to provide dependable and accurate assessments of an issuer's credit worthiness, the Securities and Exchange Commission (SEC) sought to regulate the agencies' process and output. The idea was

Concern about the failure of the rating agencies to generate accurate and reliable information, especially during a time of crisis, led to public arguments for regulation of the credit rating industry.


47. See Pinto, supra note 45, at 347 (detailing the Penn Central default as a trigger of regulation and increased reliance on rating agencies); see also OPERATION OF THE SECURITIES MARKETS, supra note 32, at 5-6 (“Although the Commission originated the use of the term ‘NRSRO’ in regulation, ratings by NRSROs today are widely used as benchmarks in federal and state legislation . . . [and] for distinguishing among grades of creditworthiness in federal and state legislation.”).

48. See Rhodes, supra note 27, at 302 (discussing the growth of the ratings agencies in the financial world and specifically noting the “importance of ratings to investors and to the marketplace”).

49. See generally OPERATION OF THE SECURITIES MARKET, supra note 32, at 5 (noting that the importance, and “influence,” of the ratings has grown over the years, affecting countries other than the U.S. and “affect[ing] securities markets in many ways, including an issuer’s access to capital, the structure of transactions, and the ability of fiduciaries and others to make particular investments”). See also Hunt, supra note 41, at 133 (noting that the
to create a mechanism by which investors and market participants could regain confidence in the market through the SEC’s outright endorsement of one agency over another.\footnote{50}

The SEC implemented its first regulations,\footnote{51} coining the term “nationally recognized statistical ratings organizations” (NRSRO), which was “designed to ensure that its ratings were credible and reasonably relied upon by the marketplace” and applied to any rating agency that met the status requirements.\footnote{52} Then in 1975, the SEC promulgated Rule 15c3-1,\footnote{53} which established “net capital” requirements for broker-dealers, thereby indirectly instituting formal requirements\footnote{54} for broker-dealers to use agencies that were designated NRSROs.\footnote{55} The net capital rule

NRSRO designation was granted through the “‘no-action letter’ process in which the candidate agency would submit an application to the SEC and wait to receive a ‘no-action letter’ indicating that the agency would be treated as an NRSRO. Apparently the criteria for this determination were unclear and decisions were often a long time coming.”).\footnote{50. See RETHINKING REGULATION, supra note 2, at 4-5 (noting that the designation of NRSRO status led to reliance on the ratings).

51. These regulations came in the form of no-action letters. See THOMAS LEE HAZEN & JERRY W. MARKHAM, CORPORATIONS AND OTHER BUSINESS ENTERPRISES: CASES AND MATERIALS 691 (3d ed. 2009) (“No action letters are SEC staff responses to private requests for indication of whether certain contemplated conduct is in compliance with the appropriate statutory provisions and rules. The SEC’s no action responses are staff interpretations rather than formal Commission action and thus have limited precedential weight.”).

52. See OPERATION OF THE SECURITIES MARKETS, supra note 32, at 5-6. The various criteria required in order to be classified as an NRSRO include, but are not limited to, the “organizational structure of the rating organization” and “the rating organization’s independence from the companies it rates.” Id. at 9-10.

53. Net Capital Requirements for Brokers or Dealers, 17 C.F.R. § 240.15c3-1 (1975).

54. See OPERATION OF THE SECURITIES MARKETS, supra note 32, at 6 n.9 (noting that before the formal requirements were put into place, the nationally recognized securities exchanges used the ratings for “calculating haircuts” and states used them for “limit[ing] the investment discretion”; however, the state would only use ratings issued by agencies that were “designated as reliable by the state”).

55. See generally White, supra note 36, at 48-49 (“[O]nly the NRSRO’s ratings would be valid for the determination of the broker-dealers’ capital
required broker-dealers to "have sufficient liquid assets to satisfy their current liabilities, particularly the claims of customers, as well as a 'cushion' to cover certain market and credit risks." The SEC determined that the requirement to use credible and designated NRSROs to meet the net-capital requirements pursuant to the rule would allow financial institutions to deduct a lesser amount from their net worth when calculating their net capital. This "haircut" is designed to "provide a margin of safety against losses that might be incurred by broker-dealers as a result of market fluctuations in the prices of, or lack of liquidity in, their proprietary positions." In effect, the SEC was protecting the market and attempting to bolster investor protection by regulating ratings it deemed as accurate and reliable indicators of a security's viability and strength. The SEC's designation of NRSRO to a particular rating agency became a rubber stamp that not only endorsed the use of the rating, but made its use obligatory for a reputable financial institution. To analogize, a reader is not obliged to eat at the restaurant profiled in the newspaper. In that context, there is no need to protect the consumer, lending weight to a newspaper's First Amendment defense. Unlike newspaper reviews or editorials, the need to protect the consumer from unregulated ratings (evidenced by the SEC's regulation) suffices to deny ratings the same First Amendment protection.

The SEC implemented a rule that would directly affect a broker-dealer's calculation of its net worth and yet indirectly show the SEC's "dependence on [the] credit ratings." By doing so, the

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57. OPERATION OF THE SECURITIES MARKETS, supra note 32, at 6.
58. Id.
59. See Rhodes, supra note 27, at 323 ("[A]s the public bond market has grown, the number of rating agencies commanding national presence has increased the number of agencies seeking NRSRO status.").
60. RETHINKING REGULATION, supra note 2, at 4 n.3.
SEC obligated itself to differentiate among agencies by designating those it considered, based on objective criteria, suitable for use by broker-dealers. In its analysis, the SEC noted:

The single most important factor in the Commission staff's assessment of NRSRO status is whether the rating agency is "nationally recognized" in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The staff also reviews the operational capability and reliability of each rating organization.\textsuperscript{61}

In determining which rating agency would achieve NRSRO status,\textsuperscript{62} the SEC examined the rating agency process. Once an assessment was made, the SEC would issue a "no-action" letter detailing its approval of the rating agency and allowing the rating agency to be designated an NRSRO.\textsuperscript{63} The no-action letter had a particularly interesting meaning, as it "promised that the Division of Market Regulation would not recommend enforcement action against any broker-dealer that used the applicant's ratings for determining its capital requirements." This approval procedure not only became a way for the SEC to endorse a particular rating agency, but also imposed an obligation on the broker-dealer to use a particular rating agency. The process employed by the SEC in designating and recognizing NRSROs resulted in the addition of only "four additional firms as NRSROs" between the years of 1975 and 2000, "[b]ut mergers among them . . . reduced the net number of NRSRO firms back to the original three—Moody's, S&P, and Fitch—by

\textsuperscript{61} Operation of the Securities Markets, supra note 32, at 9.


\textsuperscript{63} See Rhodes, supra note 27, at 325-26 (discussing the designation of the NRSRO status by the SEC specifically as it relates to the selection process employed by the regulatory body, which turns upon whether that rating agency's ratings were "commonly used" by those in the financial industry, thereby making the agency "nationally recognized").

\textsuperscript{64} White, supra note 36, at 50.
With so few reputable NRSROs operating in the market, financial institutions were bound—even obligated—to use the same agencies, and investors began to expect issuers to use such agencies.

Although the rating processes vary by rating agency, a holistic view reveals consistency in the industry, specifically in the role played by the agencies’ rating committees. Each committee typically is made up of a lead analyst and senior members of management who decide on a particular rating by a “majority vote.”

The committee requests and analyzes a number of public and private documents, including, but not limited to, the issuer’s financial statements and general benchmark data. Once all information is gathered and reviewed, the members of the committee deliberate and provide their recommendation to the issuer/client. The issuer is then allowed to negotiate with the rating agency and alter the press releases concerning the upcoming ratings decision prior to the releases’ publication; however, exercise

65. Id. See, e.g., Letter from Sean J. Egan & W. Bruce Jones, Egan-Jones Ratings Co. to Jonathan G. Katz, Secretary, United States Securities and Exchange Commission (Nov. 10, 2002), available at http://www.sec.gov/news/extra/credrate/eganjones2.htm [hereinafter Egan-Jones Letter] (stating that the predominantly used ratings agencies for SIVs are S&P and Moody’s and that they maintain a “partner monopoly” in which “the two firms share the market whereby the gain in revenues by one firm does not reduce the revenues of the second firm. Since two ratings are normally needed for the issuance of bonds, the gains of Moody’s do not come at the expense of S&P and vice versa.”).

66. See RETHINKING REGULATION, supra note 2, at 5 (“Without high ratings, bond issuers cannot access certain markets because they do not have a ‘license’ from the NRSROs to comply with NRSRO-dependent regulations.”).


68. OPERATION OF THE SECURITIES MARKETS, supra note 32, at 25.

69. Id.
70. Id. at 25-26.
71. Id. at 26.
of this right must be supported by credible and substantial information, and "the right of appeal is limited both in time and to the submission of new and important information."\textsuperscript{72}

In a clear effort to curb the number of actual conflicts or appearance of conflicts, Congress adopted the Credit Rating Agency Reform Act of 2006.\textsuperscript{73} In large part, the Act was an attempt to develop "transparency," increase disclosure regarding potential "conflicts of interest," and provide a structured mechanism for rating agencies to attain NRSRO status.\textsuperscript{74} However, the Act is insufficient; although any known conflicts of interest must be disclosed pursuant to the Act, it lacks a mechanism or procedure by which to eliminate or mitigate such disclosed conflicts since it allows the agency to obtain "fees from either issuers, investors, or other market participants, or a combination thereof."\textsuperscript{75} Allowing the issuers to compensate the rating agency is an endorsement of the "issuer-pay model" that is in conflict with the "challenge [faced by] credit raters of impartially rating securities of companies that generate their revenues."\textsuperscript{76} Of particular importance is the section entitled "Accountability for Ratings Procedures," which states that the Act will be "narrowly tailored" and that "neither the Commission nor any State . . . may regulate the substance of credit ratings or the procedures and methodologies

\textsuperscript{72} Id.

\textsuperscript{73} Pub. L. No. 109-291, § 2, 120 Stat. 1327, 1327 (2006) (stating that the purpose of the Act is "[t]o improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry."). See also Kettering, \textit{supra} note 45, at 1674 (noting that the Enron debacle was an "impetus" to the need for increased regulatory oversight); Hunt, \textit{supra} note 41, at 125 (noting that a report issued after SEC hearings, which were held specifically to discuss the rating agencies, identified numerous "questions" about the agencies and subsequently the Reform Act was adopted allowing the SEC to promulgate laws affecting the rating agencies).

\textsuperscript{74} § 6, 120 Stat. at 1338. See also Stuart Kaswell et al., \textit{Credit Agency Reform Act Signed into Law}, DECHERT ON POINT, Dec. 2006, 1, 1, http://www.dechert.com/library/fs_update16_12-06.pdf (discussing the purpose and intended effects of adopting the Credit Agency Reform Act of 2006).

\textsuperscript{75} § 3, 120 Stat. at 1328.

\textsuperscript{76} \textit{Rethinking Regulation}, \textit{supra} note 2, at 4.
by which [the rating agency] determines credit ratings.” Yet the Act does not include any substantive terms to mitigate potential conflicts that may become prevalent in the rating process.

Historically, the popularity of rating agencies was as much a function of market shifts as institutional demand. Regulatory oversight followed this demand as various financial crises emerged and as financial markets and investors became more sophisticated. The importance of ratings to individuals and institutional investors would lead to the presumption that the more independent the analysis conducted by a rating agency, the more reliable its ratings. Yet because of their monopolistic nature, historical background, and realigned fee structures (all of which underscore the level of accuracy and unconstrained review required

77. § 15E(c), 120 Stat. at 1332. See generally White, supra note 36, at 52 (discussing the role of ratings agencies and the impact of the Credit Reform Act on the reality of how ratings agencies operate).

78. See Frank Partnoy, Historical Perspectives on the Financial Crisis: Ivar Kreuger, The Credit-Ratings Agencies, and Two Theories About the Function, and Dysfunction, of Markets, 26 YALE J. ON REG. 431, 441 (2009) [hereinafter Historical Perspectives] (“Over time, as the reliance on ratings took hold, ratings became part of investing culture . . . . As private reliance on ratings grew, private actors focused more on letter ratings than on the underlying credit analysis, such as the expected probability of default.”).

79. See Sylla, supra note 39, at 20-24 (discussing the evolving roles of the rating agencies and the effects of national and global economic events on the ratings processes and reputation): see also Kettering, supra note 45, at 1674 (“[T]he dominant rating agencies continued to rate the ordinary debt of Enron Corporation as investment grade until four days before Enron filed for bankruptcy. Enron’s failure was the impetus for a tidal wave of legislative and administrative activity . . . .”)

80. See Rhodes, supra note 27, at 317 (“[A]n agency’s rating is valuable only so long as it is an independent and reliable assessment of the issuer.”).

81. See Egan-Jones Credit Rating Co., Am. Enterprise Inst. Presentation: “How to Improve the Credit Rating Agency Sector” (June 24, 2008), http://www.aei.org/docLib/20080624_EganPresentation.pdf (“According to Moody’s itself, these three companies [Moody’s, S&P, and Fitch] are responsible for 95% of global ratings with shares of 39%, 40%, and 16% respectively.”).

82. See Rhodes, supra note 27, at 300-302 (briefly discussing the role and growth of rating agencies).

83. See id. at 308 (“Most rating agencies presently charge the issuer a fee for the rating service.”).
in the rating assessments), the claim that the ratings are or should be protected as mere opinions or editorials is incorrect; it simply disregards the very nature of these ratings and their control over the financial markets.  

III. FIRST AMENDMENT PROTECTION OF RATINGS IN LIGHT OF ABU DHABI

Individual investors and issuers have targeted rating agencies as major contributors to the recent financial crisis, claiming that the rating agencies categorized the risk of the products inaccurately when they assigned the products' ratings and challenging the presumption that the ratings process is adequate. In lawsuits against rating agencies, plaintiffs have alleged defamation, negligent misrepresentation and libel. Throughout these cases, the rating agencies have continued to argue that their ratings are equivalent to editorials or opinions written by

84. See Abu Dhabi Commercial Bank v. Morgan Stanley, 651 F. Supp. 2d 155, 181 (S.D.N.Y. 2009) ("[T]he market at large, including sophisticated investors, [has] come to rely on the accuracy of credit ratings and the independence of rating agencies because of their NRSRO status . . . .").

85. See Darcy, supra note 26, at 613 (discussing the credit crisis and the role played by the credit rating agencies in "subprime mortgage origination" and "the securities that those mortgages were later packaged into . . . "); John Crawford, Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry, 42 CONNTEMPLATIONS 13, 16 (2009), http://connecticutlawreview.org/documents/CrawfordFinal.pdf (discussing the "reliance" on "highly flawed ratings" as a contributing factor in the real estate meltdown).


88. See Husisian, supra note 24, at 447 (discussing the various defamation and negligent misrepresentation claims brought against ratings agencies); Crawford, supra note 85, at 19 (noting the various claims brought by rating agencies).
newspaper journalists, and must be afforded First Amendment protection. 89

In Abu Dhabi, the court demonstrates a reluctance to afford ratings First Amendment protection by highlighting various factors embedded in the rating agency process that clearly differentiate an editorial from a rating. 90 Surprisingly, though, some courts in the past were more than inclined to grant rating agencies First Amendment protection; some courts reasoned that the ratings are indeed opinions (and thus protected under the First Amendment) 91 while others reasoned that even if they cannot be classified as opinions, they are not assertions that can be construed as factual. 92

89. The category of speech most applicable to the rating agencies is not opinion, but commercial speech, which garners less First Amendment protection. See Cent. Hudson Gas & Elec. Corp. v. Pub. Serv. Comm'n, 447 U.S. 557, 563 (1980). In Central Hudson, the Court defined commercial speech as “expression related solely to the economic interests of the speaker and its audience.” Id. at 561. The Court further identified the four prong test that became the framework for determining the bounds of government regulation of commercial speech: first, determine if the “speech ... concern[s] lawful activity and [is not] misleading”; second, ask whether the government’s interest in protecting the speech at issue is “substantial.” Affirmative answers to both questions lead to the last parts of the test: third, determine whether the “regulation directly advances the governmental interest asserted”; and fourth, “whether it is not more extensive than is necessary to serve that interest.” Id. at 566. Subjecting rating agencies’ arguments for First Amendment protection to this analysis would demonstrate that government’s interest in regulating such speech—protecting the public—is substantial and any regulations proposed would directly advance that interest.


91. Cf., e.g., Milkovich v. Lorain Journal Co., 497 U.S. 1, 21 (1990) (noting that there is no need to have a separate provision to encompass “‘opinions’ [in the First Amendment] ... to ensure the freedom of expression guaranteed by the First Amendment”).

92. Jefferson County Sch. Dist. v. Moody’s Investor’s Servs., Inc., 175 F.3d 848, 856 (10th Cir. 1999).
A. The Road to Abu Dhabi

In 1985, the U.S. Supreme Court, in *Dun & Bradstreet, Inc. v. Green moss Builders, Inc.*, 93 addressed the limitations of First Amendment protection in defamation actions. 94 The opinion examined matters that are of interest to the general public, an issue that directly correlates to the First Amendment defense held by rating agencies. 95 The Court addressed the issue of whether a false credit report was an issue of public concern, holding that the requirement that the plaintiff show "actual malice" 96 (proof of known falsity) for defamation does not apply in a case in which the matter is of "private concern." 97 The Court referenced the limited

94. *Id.* at 749. Greenmoss Builders, Inc. ("Greenmoss") brought a defamation action against the credit reporting agency, Dun & Bradstreet, Inc., for issuing a false report to its subscribers that Greenmoss was in bankruptcy. Although Dun & Bradstreet is not a credit rating agency, but a credit reporting agency, the importance of this case rests with the dissemination of the material at issue and the Court’s classification of what constitutes “matters of public concern.” *Id.* See also Crawford, *supra* note 85, at 20 (noting that Dun & Bradstreet “is essential to [the holding] in Abu Dhabi Commercial Bank”).

95. *Dun & Bradstreet*, 472 U.S. at 758-59 (“[T]he Court has frequently reaffirmed that speech on public issues occupies the ‘highest rung of the hierarchy of First Amendment values,’ and is entitled to special protection.”) (citing NAACP v. Claiborne Hardware Co., 458 U.S. 886, 913 (1982); Carey v. Brown, 447 U.S. 455, 467 (1980)).

96. New York Times Co. v. Sullivan, 376 U.S. 254, 280 (1964). In Sullivan, the Court noted the plaintiff has the burden of proving that the defendant had ‘actual malice’ prior to issuing the article; i.e., that the defendant knew the material was false or had reckless disregard for whether it was false or not.” *Id.* The publication (a paid advertisement) was not considered ‘commercial’ advertising but instead “expressed opinion, recited grievances, protested claimed abuses, and sought financial support on . . . matters of the highest public interest and concern.” *Id.* at 266. See also Garrison v. Louisiana, 379 U.S. 64, 74 (1964) (defining actual malice as having a “high degree of awareness of their probable falsity”).

97. *Dun & Bradstreet*, 472 U.S. at 758-59 (“[N]ot all speech is of equal First Amendment importance. It is speech on ‘matters of public concern’ that is ‘at the heart of the First Amendment’s protection.’” (quoting First National Bank of Boston v. Bellotti, 435 U.S. 765, 776 (1978)). The Court noted further that the “petitioner’s credit report concerns no public issue. It was speech
number of people to whom the credit report was disseminated as justification that the report was not a matter of public importance and thus not "at the heart of First Amendment's protection." Further, the Court differentiated credit reporting agencies from other firms that should be protected under the First Amendment, noting that reporting agencies which "are in the business of selling financial information to . . . subscribers who have paid substantial fees for their services . . . [are not] the type[s] of media worthy of the First Amendment protection as contemplated by New York [Times Co. v. Sullivan]." This apparent conflict of interest was crucial for the Dun & Bradstreet Court, both in determining whether First Amendment protection encompasses the rating agencies' activities and in differentiating media entities from credit reporting agencies.

The determinations of whether a rating is a matter of public concern and of whether rating agencies are comparable to journalists both depend on the distinction between fact and opinion. In the 1990 case Milkovich v. Lorain Journal Co., the Court addressed this distinction, holding that the First Amendment did not need a separate provision to encompass "opinions" and that labeling a statement as an opinion does not grant the author of the statement full constitutional protection. To prevail in a defamation action, the Court indicated, a plaintiff must demonstrate that (a) the statement can be proven false and (b) the statement can be construed as a factual assertion of the facts and circumstances. Although the test for defamation requires that

98. Id. at 759. See generally Erwin Chemerinsky, Constitutional Law: Principles and Policies 1053 (2006) (discussing the reintroduction of the "matters of public concern" concept first discounted in Gertz.).
99. See Dun & Bradstreet, 472 U.S. at 753 (citing Sullivan, 376 U.S. 254); see also Chemerinsky, supra note 98, at 1054 ("[N]onmedia individuals and entities also can play an important role in informing the public").
100. 497 U.S. 1 (1990) (an action against a journalist for publishing an article accusing the plaintiff of lying under oath at an Ohio High School Athletic Association hearing).
101. Id. at 21.
102. Id. at 2.
the statements be proven false, this test is misplaced in the rating agencies context because the ratings assigned are predictions about future issuances, and intuitively one cannot prove in the present that a prediction of future events is false.

In 1999, the Tenth Circuit relied on *Milkovich* to address the fact/opinion distinction in response to Moody's asserted defense that its ratings were mere opinions and not statements of factual information. The plaintiff in *Jefferson County School District v. Moody's Investor's Services, Inc.* had sued Moody's for defamation, alleging that Moody's voluntary and negative rating of the school district's bonds caused a ripple effect in which "purchase orders ceased, [and] several buyers canceled prior orders . . . thereby causing it to suffer a net loss of $769,000." Moody's claimed that its ratings were not assertions of factual information, but opinions that qualified as protected speech. The court turned to the well-established holding in *Milkovich*: first, "a statement of opinion relating to matters of public concern which does not contain a provably false factual connotation will receive full constitutional protection"; and second, "against media defendants, the First Amendment requires that a plaintiff bear the burden of proving that the statement in question was false and that the defendant had the requisite state of mind.

Most importantly, the court noted a distinction first made by Professor Sowle in the aftermath of *Milkovich* between "evaluative opinions," which cannot be "prov[en] false and thus attach no liability to the opinion's author," and "deductive opinions," which "state or imply assertions that may be proven false" and therefore warrant liability. The reference to Professor Sowle's distinction was a

103. 175 F.3d 848 (10th Cir. 1999).
104. *Id.* at 851.
105. *Id.*
106. *Id.* at 852 (quoting Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990)).
reiteration of the court's holding that the opinion must assert a fact that is "provably false," i.e. deductive.\footnote{Jefferson County Sch. Dist., 175 F.3d at 853.}

With its application of the *Milkovich* standard, the *Jefferson* court held that the ratings were indeed protected under the First Amendment, but noted that merely because Moody's labeled its ratings as opinions did not mean that the rating agency should be "shielded from liability," especially if the "opinion[s] were shown to have materially false components."\footnote{Id. at 856.} Despite its ultimate ruling, the *Jefferson* court's statements in reference to *Milkovich* reveal that the court was becoming less lenient toward the "opinion" defense commonly put forth by rating agencies. The court's assertion that merely labeling something an 'opinion' does not grant it outright acceptance as an opinion for purposes of First Amendment protection is evidence of the court's strict analysis.\footnote{Id. at 856.}

It was not until 2003 that rating agencies failed to demonstrate in court that their ratings were independently-gathered predictors of the future and not factual assertions, thus precluding them from claiming the same protections granted to journalists.\footnote{Id.} *Fitch, Inc. v. UBS PaineWebber, Inc.* involved a subpoena request that a UBS PaineWebber (UBS) client submitted to Fitch in its litigation against UBS.\footnote{Id. at 106.} UBS paid two rating agency firms, Moody's and Fitch, to issue ratings on a number of securities it pooled together for one of its clients.\footnote{Id. at 107.} Pursuant to Office of Thrift Supervision (OTS) regulations, the securities needed to be "investment grade."\footnote{Id. at 107.} When the OTS discovered that the securities did not meet these requirements, the client tried and failed to return the securities to UBS.\footnote{Id.} During discovery, the client learned that Fitch had been involved in structuring the products; specifically, Fitch had recommended "changes to the deal's structure [that] would be required to achieve the desired
rating." The subpoena sparked First Amendment concerns, and the rating agency, refusing to supply the information, called itself a "professional journalist" under the New York Shield Law, which defines a professional journalist as:

one who, for gain or livelihood, is engaged in gathering, preparing, collecting, writing, editing, filming, taping or photographing of news intended for a newspaper, magazine, news agency, . . . or other professional medium or agency which has as one of its regular functions the processing and researching of news intended for dissemination to the public.

The court held, however, that Fitch did not establish that "the information it sought to protect was gathered pursuant to the newsgathering activities of a professional journalist." The court based its holding on the rating agency's two conflicts of interests: (1) Fitch does not issue ratings on securities for which it is not compensated; and (2) Fitch was intimately involved in the "planning of the transactions." The Fitch court was reluctant to automatically accept the agency's denomination of its ratings as opinions, deciding instead to review the totality of circumstances comprising the relationship between the issuer of the securities and the rating agency. The court recognized the conflicts entrenched in this relationship as two-fold: 1) the level of interaction between the rating agency and the issuer of the securities in the structuring of the product; and 2) the fact that the rating agency is being paid to rate the securities. The presence of these conflicts suggests that the process lacked independence based on the role of the rating agency. Analogizing, the Fitch court noted that "[u]nlike a business newspaper or

117. Id.
118. Id. at 109.
119. Id. (quoting N.Y. CIV. RIGHTS LAW § 79-h(a)(6)).
120. Id. at 111 ("Whether Fitch, or one of its rivals, could ever be entitled to assert the newsgathering privilege is a question we leave for another day.").
121. Id. at 109-10.
122. Id. at 110-11.
123. Id. at 111.
magazine, which would cover any transactions deemed newsworthy, Fitch only ‘covers’ its own clients. We believe this practice weighs against treating Fitch like a journalist.” Fitch’s ratings were denied First Amendment protection again in 2004. In *Commercial Financial Services, Inc. v. Standard & Poor’s*, the court reasoned that the compensation received for the ratings adversely affected the rating agency’s duty to the company (its client) and its investors. Commercial Financial Services, Inc. collected bad debts and placed them in a pooled fund, which was then sold to a trust that, in turn, sold to investors securities that were “secured by” these “pooled bad debts.” The rating agencies were responsible for rating the securities issued by the trust. The securities received top-notch investment grade ratings, indicating that the corporation was credit-worthy, when in fact it was not. In denying First Amendment protection to the rating agencies based on their compensation for the ratings, the court drew a comparison to a journalist “hired . . . to write a company report,” who would not be covered under the First Amendment. The court was clear in noting that the relationship between the paying


125. 94 P.3d 106 (Okla. 2004). Fitch was one of several named defendants in the case.

126. *Id.* at 110-11.

127. *Id.* at 108.

128. *Id.*

129. *Id.*

130. *Id.* at 110.
issuer and the rating agency is unequivocally different from that between the journalist and the newspaper.\textsuperscript{131}

In \textit{Compuware Corp. v. Moody's Investor Services},\textsuperscript{132} a 2007 case, Compuware brought a defamation claim against Moody's after the rating agency downgraded Compuware to one of its poorest creditworthiness ratings.\textsuperscript{133} In exchange for its ratings, Moody's fees amounted to a $25,000 initiation fee and a $200,000 ongoing fee.\textsuperscript{134} During its ongoing monitoring of Compuware, "Moody's published a statement indicating that Compuware's credit rating was under review for a 'possible downgrade.'"\textsuperscript{135}

Amid fears that it would be issued a downgrade and suffer adverse consequences, Compuware reduced its credit loan by $400 million.\textsuperscript{136} Once the ratings statement was issued, and putting aside the fact that Compuware presented a viable balance sheet, the ratings report reflected negatively on the corporation's financial future.\textsuperscript{137} The \textit{Compuware} court noted that Moody's provides a mere prediction about the financial future and does not communicate a "provably false factual connotation . . . [and] such inferences could not be proven false because of the inherently subjective nature of Moody's ratings calculation."\textsuperscript{138}

Overall, claims against rating agencies have imposed on courts an obligation to test the boundaries of the Constitution through an analysis of the rating agencies' defense of First Amendment protection. Although precedent, such as \textit{Abu Dhabi}, has identified the conflicts of interest embedded in the rating agency process, such as the fee structure and operational

\textsuperscript{131. Id. (noting that the relationship between the paying issuer and the rating agency "is more analogous to that of a client and the client's certified public accountant").}

\textsuperscript{132.} 499 F.3d 520 (6th Cir. 2007).

\textsuperscript{133.} Id. at 523.

\textsuperscript{134.} Id. at 522-23.

\textsuperscript{135.} Id. at 523.

\textsuperscript{136.} Id.

\textsuperscript{137.} Id. at 524 (citing Milkovich v. Lorain Journal Co., 497 U.S. 1, 20 (1990)).

\textsuperscript{138.} Id. at 529 (citation omitted). In arriving at its conclusion, the court applied the actual malice standard from \textit{New York Times Co. v. Sullivan}, 376 U.S. 254 (1964).
involvement, the tests that a rating must be "provably false" and a "matter of public concern" create too high a standard and provide too narrow an interpretation, respectively.

B. Abu Dhabi

The Abu Dhabi court held that the rating agencies could not claim First Amendment protection for the high ratings they assigned to private placement securities, which were primarily invested in residential mortgage-backed securities.\(^\text{139}\) Although it restricted its holding to these particular types of financial instruments, the court further solidified the "matter of public concern" test applied to determine First Amendment protection.\(^\text{140}\) It also implicitly recognized that the ratings process may not be entirely objective.\(^\text{141}\) Crucial factors for the court included the size of the audience to which the rating is targeted, the fee payouts, and the rating agencies' level of active participation in the structuring of the securities being rated.\(^\text{142}\) Of these factors, two are related to potential conflicts of interest: the rating agencies' compensation arrangement and level of involvement. The court alluded to the subjective nature of the ratings process as a result of a confluence of these conflicts of interest and wholly disregarded whether subjectivity was intentional on the part of the rating agencies.

It is the existence of these conflicts that surrounds the debate about denying First Amendment protection to rating agencies. However, the rating agencies' financial interest in each


\(^{141}\) Abu Dhabi, 651 F. Supp. 2d 155.

\(^{142}\) An additional conflict is the obligation of investors, pursuant to statute, to purchase certain investment grade securities. See RETHINKING REGULATION, supra note 2, at 4 ("Regulators now mandate that institutions of all types pay heed to NRSRO credit ratings as a necessary step for regulatory compliance. Some rules require that certain investors can only buy bonds with high ratings.").
rating transaction precludes an assessment of whether the First Amendment applies, as the public policy interest in protecting investors and restoring market confidence far outweighs the interests of the rating agencies in sustaining market power.

1. Is a rating a “matter of public concern”?

Although the Abu Dhabi court was justified in denying the rating agencies’ First Amendment protection, its focus on whether the financial instrument was a matter of public concern is too restrictive a test to apply for two reasons. First, this test does not allow for a holistic assessment of the effects all ratings have on those who are not direct purchasers of the rated products. Second, if the courts are willing to deny First Amendment protection merely because a few investors were harmed, they should be more inclined to regulate ratings that harm the general public. As a result of the change in the rating business model, where the issuer now pays for the rating, the transaction between the issuer and the rating agency in rating any financial instrument now has a negative effect on the public because the interaction between the parties is constrained by mutual pecuniary interests. The fundamental fee structure of the private contract has not changed just because the target audience of the securities is different.

The rating agencies have claimed that their ratings are matters of public concern and thus should be protected by the First Amendment.

143. See Darcy, supra note 26, at 620-21 (discussing the downgraded securities’ effect on the real estate crisis); see also Rosenblatt v. Baer, 383 U.S. 75, 86 (1966) (“Society has a pervasive and strong interest in preventing and redressing attacks upon reputation. . . . The thrust of New York Times [v. Sullivan] is that when interests in public discussion are particularly strong . . . the Constitution limits the protections afforded by the law of defamation.”); Huisian, supra note 24, at 456 (“To ensure the free ordering of private affairs based on efficient information disclosure, we traditionally regulate publications only where there are significant third party effects.”).

144. See Kettering, supra note 45, at 1687 (discussing the inherent conflict created by the issuer pays model).
Amendment. In response, courts have analyzed the target audience of the ratings, specifically examining the number of investors to whom the rating is disseminated. In Abu Dhabi, for example, the court denied a claim for First Amendment protection because the securities were private placement issuances (only marketable to distinct eligible investors and not to “the public at large”) and therefore were not “matters of public concern” worthy of First Amendment protection. Like the court in Abu Dhabi, the court in Dun & Bradstreet concluded that the credit report was not a matter of public concern and did not “involve[]

145. See David Segal, A Matter of Opinion?, N.Y. TIMES, July 18, 2009, at BU6 (discussing Floyd Abrams’s argument on behalf of S&P: “The major similarity here is that both the newspaper and S.&P. are offering opinions on matters that people can and do disagree about.”).

146. See, e.g., Newby v. Enron Corp., 511 F. Supp. 2d 742, 810 (S.D. Tex. 2005) (discussing the various cases in which courts have looked primarily to the number of investors directly affected by the rating agency’s dissemination as support for the claim that the rating agency is discussing a matter of public importance).


148. Abu Dhabi, 651 F. Supp. 2d at 175. See also Dun & Bradstreet v. Greenmoss Builders, Inc., 472 U.S. 749, 761 (1985) (“[whether] . . . speech addresses a matter of public concern must be determined by [the expression’s] content, form, and context . . . as revealed by the whole record.” (citations omitted)); Approaches to Improving Credit Rating Agency Regulation: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, 111th Cong. 33 (2009) (statement of Eugene Volokh, Gary T. Schwartz Professor of Law, UCLA School of Law) available at http://www.house.gov/apps/list/hearing/financialsvc_s_dem/volokh.pdf at 1, 5 (hereinafter Volokh statement) (“[L]ower courts have made clear that ‘the relevant concern need not be of paramount importance or national scope’ to qualify.” (quoting Levinkys’s, Inc. v. Wal-Mart Stores, Inc., 127 F.3d 122, 132 (1st Cir. 1997))). Professor Volokh states that it is unnecessary to determine whether the rating agency is a member of the press since the “broad” interpretation of First Amendment Law protects speech without having to delve into the definition of “media.” Id. Volokh further notes that “[c]redit rating agencies are speakers, and their evaluations, opinions, and factual assertions are speech.” Id.
any ‘strong interest in the free flow of commercial information’” because it was only available to five individuals and was of “individual interest [to] the speaker and its specific business audience . . . who, under the terms of the subscription agreement, could not disseminate it further.”

The courts’ adherence to this target-audience test is evident in *LaSalle National Bank* v. *Duff & Phelps Credit Rating Co.*, where the court held that the rating at issue, assigned to a product disseminated via private placement, was not protected under the First Amendment because it was not of general interest to the public. The court went further, however, and explicitly recognized the conflicts of interest that were embedded in the rating process by analogizing to the court’s holding in *In re Taxable Bond Securities Litigation*. In that case, the court noted that since the rating agency (S&P) was hired for its services and aware that the ratings it issued would be distributed via private placement memoranda, its membership in the “financial media” would neither protect it under the First Amendment nor prevent it from being subject to “generally applicable laws” such as those relating to insider trading. To conclude, that Court noted that “S & P stands in no better position from the perspective of First Amendment defenses than any other participant in the bond transactions.”

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149. *Dun & Bradstreet*, 472 U.S. at 761-62 (quoting Virginia Pharmacy Bd. v. Virginia Citizens Consumer Council, Inc., 425 U.S. 748, 764 (1976)) (additional citation omitted). Extending the argument that a rating is a matter of public concern, precedent requires that in order for a plaintiff to prevail in its claim that a rating agency should not be afforded FA protection, the plaintiff must demonstrate that the agency acted with “actual malice.” This analysis is unnecessary, though, since the confluence of the conflicts of interest should preclude application of the test.


151. *Id.* at 1096.


Since the inception of the ratings business, the types of financial instruments rated progressed from the railroad bonds in the 1900s to numerous complex structured products. As a result, the ratings assigned no longer affect only the direct purchasers of the products rated, but instead affect all those who have an interest in the financial sector. This occurs in any transaction between the issuer and the rating agency where their private contract, clouded with motivation (by both parties) for financial benefit, invites the presumption that the rating is not an accurate, independent assessment of the underlying risk and thereby can have detrimental effects in the marketplace.

These effects can best be seen in the current credit crisis. One author’s depiction of this effect on the current credit crisis supports the argument that regardless of the number of investors solicited to purchase the top rated bonds and other instruments, the negative impact of these failing instruments reverberates across the world:

A welter of regulator reports on the crisis asserts that high credit ratings on novel financial instruments helped induce investors to purchase these instruments. When the instruments started to appear much riskier than traditional investments carrying similar ratings, investors lost confidence in the ratings . . . triggering adverse consequences for the global financial system.

The effects of ratings are not only linked to the product rated but are extended to the rating agencies’ counterparts in the global financial markets. The relationship between monoline

155. See RETHINKING REGULATION, supra note 2, at 4 (discussing the role credit rating agencies played in the aftermath of 1929 economic crash).
156. See supra text accompanying notes 148-51.
157. See Crawford, supra note 85, at 15 ("[O]verly excessive ratings contributed to excessive liquidity. . . . This helped feed the real estate bubble. When the bubble burst, the breakdown in investor confidence in ratings helped the crisis spread to the broader financial system."); RETHINKING REGULATION, supra note 2, at 4 (same).
158. Hunt, supra note 41, at 112-13 (emphasis added).
insurers and rating agencies broadens the impact of rating agencies and exposes the crux of the conflicts of interests cultivated by the institutional commingling that has saturated the global financial industry.\textsuperscript{159} Monoline insurers provide credit insurance to issuers of securities to protect against the possible default of the issuer.\textsuperscript{160} The monoline insurers are rated by the same rating agencies that rate financial products—the very products that are issued by institutions that obtain monoline insurance.\textsuperscript{161} Thus the conflict of interest is further solidified: the rating agency has an incentive to issue higher ratings for both the issuer and the monoline insurer since it is being compensated by both. A corporate issuer of financial products presumably is more likely to select a monoline insurer with a higher credit rating than one with a lower credit rating, all the while aware that the same rating agency selected to rate its own product may have rated the monoline insurer. Further, the corporate issuer is inclined to select a monoline insurer that has a higher rating since that will make its own product more marketable. Note that the effect is the same, even in the circumstance where a different rating agency (from one that rated the issuer) rated the monoline insurer, since the virtual monopoly held by the three top rating agencies and their standard fee

\begin{itemize}
\item[\textsuperscript{159}] See James P. McNichols, Monoline Insurance \& Financial Guaranty Reserving, Casualty Actuarial Society Casualty Loss Reserve Seminar 231, 234 (2003), http://www.casact.org/pubs/forum/03fforum/03ff231.pdf (“[Monoline] insurance provides investors with guaranteed payment of timely interest and ultimate principal in the event that a debt issuer is unable to meet its financial obligations.”).
\end{itemize}
structure allow for very little differentiation among these three agencies.\footnote{162}

It is foreseeable that a rating agency could assign a higher rating (while under the pressure of financial gain) to both the issuer and the monoline insurer. This would increase the risk of systemic default, since investors rely on ratings to choose the issuer and the issuer relies on ratings to choose its monoline insurer.\footnote{163} “[The] potential conflict of interest arises when the ratings . . . are contingent on the agency’s own rating of a monoline insurer that provides credit enhancement to . . . these structures.”\footnote{164} In fact, the relationship between the rating agencies and the monoline insurers had severe consequences, being instrumental in the origins of the current financial crisis: “the rating agencies relied much too confidently on credit enhancement provided by monoline insurers . . . [and] the size of the obligations underwritten by these monolines . . . have today made them effectively insolvent.”\footnote{165}

\footnote{162. See Hunt, supra note 41, at 132 (“[S]ome have described the credit-rating market as effectively a ‘partner monopoly’ shared by Moody’s and S&P.”).

163. See McNICHOLS, supra note 159, at 235 (“The most important strengths of the primary monoline insurers are their ratings.”).

164. ROLE OF RATINGS, supra note 160, at 27-28 (“In some structured credits, the monoline’s AAA or AA rating will be integral to or constitutive of the rating of highly rated liability tranches.”).

165. Turmoil in the U.S. Credit Markets: The Role of the Credit Rating Agencies, Hearing Before the S. Comm. on Banking, Housing and Urban Affairs 4 (2008) (testimony of Professor John C. Coffee, Jr., Adolph A. Berle Professor of Law, Columbia University Law School) [hereinafter Coffee testimony], available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=94ccc2ab-8401-4e4c-a1b2-71f36a9fd25b. See also, e.g., Robin J. Powers, Monoline Insurers: Confusion and Chaos in the Credit Default Swap Market, DERIVATIVES, Jan. 2008, 1, 1, available at http://www.sutherland.com/files/Publication/f6344cc2-beec-48d4-9b4f-203028829b35/Presentation/PublicationAttachment/e1863c80-321b-46de-92fe-22dbaa94ef2f/TDVN-POWERS%252008-03-03.pdf (noting that the effects of downgrading a monoline insurer can be catastrophic to all parties involved, regardless of the type of instrument: “Ambac [lost its] AAA rating and has . . . recorded potential losses of $1 billion. The rating agencies [review] the entire group of insurers . . . reflecting the [market’s] concern that the insurers do not have enough capital to stem losses flowing from downgrades of the securities they guaranteed.”).}
Consider First Amendment attorney Floyd Abrams's argument in defense of the rating agencies in Abu Dhabi: "[I]t shouldn't change the legal dynamics that rating agencies are more important, or play a greater role, or are looked to by this or that element of the marketplace." But the problem is not merely that the rating agencies participate in the market to a greater degree; rather, it is the depth of their involvement in the marketplace and the massive level of impact their categorization of risk has on the public at large. If rating agencies have become the ticket to entry into the market and are the "keys" to success for all market participants, the target-audience test is too simplistic and prosaic a benchmark to apply. In fact, the test is inapplicable to the analysis since the rating process is inherently flawed by conflicts of interest that impose barriers to the objectivity of a rating. These barriers should preclude the target-audience test from applying because the compensation between the rating agency and the issuer is still the same: an issuer seeks and pays for a rating that will benefit that issuer. In essence, the ratings are tarnished by the conflicts of interest existing when they are produced, and this tarnishing of information should defeat a First Amendment defense, regardless of who comprises the audience that uses the ratings.

A possible alternative approach to the "matter of public concern" test in determining whether rating agencies should be afforded First Amendment protection is to extend this global effects inquiry in a manner that promotes what should be the primary focus of courts and legislatures: protection of the public. In fact, the Securities Act of 1933 (Securities Act) performs this

166. Segal, supra note 145.
167. See ROLE OF RATINGS, supra note 160, at 29 ("[The] Working Group cannot rule out the possibility of distressed [downgraded] monolines helping to propagate and thus exacerbating the severity of low-probability systemic events.").
168. See RETHINKING REGULATION, supra note 2, at 3-4 ("Over time . . . rating agencies have shifted from selling information to selling ‘regulatory licenses,’ keys that unlock the financial markets . . . [and as] financial gatekeepers with little incentive to ‘get it right,’ credit rating agencies pose a systemic risk.").
function—it regulates public offerings of securities by mandating, among other things, that specific content be inserted into the securities’ “registration statements and prospectuses.” The Securities Act was established during the New Deal era in response to the negative economic impact of the Great Depression. President Roosevelt’s justification for the Securities Act was “to [add to] the ancient rule of caveat emptor, the further doctrine ‘let the seller beware.’ It puts the burden of telling the whole truth on the seller.”

The focus of the Securities Act is “the disclosure of information for the purpose of ‘letting in the light’ to reveal the facts of issuers’ affairs and their overall business health.” Requiring the issuer to disclose information on public issuances through registration statements and prospectuses is a way to provide this enhanced protection to investors through transparency of the issuer’s business. Registration statements must include, at a minimum, “[f]ees promised to developers and/or promoters,” “[a] detailed statement of capitalization,” and “[c]opies of legal opinions on matters related to the issue.” The Securities Act has been deemed constitutional even though it regulates financial

169. See HAZEN & MARKHAM, supra note 51, at 602 (describing the Securities Act of 1933 as one of the main federal securities laws and the law that governs “disclosure of material information about companies that sell their stock to the public” through the publication of registration statements and prospectuses).


171. Id. at 44.

172. Id. at 42. See also Michael E. Schoeman, The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933, 41 BUS. LAW. 377, 381 (1986) (“Two related but separable government interests are suggested by the Act’s 1933 legislative history: the promotion of market efficiency and the prevention of fraud or deception.”).

173. GART, supra note 170, at 43.

instruments that affect the general population and are of public concern. Thus, the Act demonstrates a concrete hesitation to employ the First Amendment when the underlying issuer is involved in practices harmful to the public—such as exaggerated capitalization and harmful fee structures—by requiring registration statements and prospectuses that achieve greater transparency. Even a public policy-oriented approach may warrant outright regulation of rating agencies (and thus outright denial of First Amendment protection) in light of the current financial crisis, which, in some respects, can be equated to the Great Depression.176

2. Is the rating process objective?

In general, the potential for hindering objectivity is particularly high if there is an appearance of bias or actual conflict of interests. The credit rating process is embedded with conflicts of interest that have the potential to saturate it with subjectivity, and these very conflicts have formed the backbone of the litigation


175. The connection between the Securities Act and the rating agencies prompts an argument that rating agencies be construed as “underwriters” pursuant to the Securities Act, which defines “underwriter” as “any person who . . . has a direct or indirect participation in any such undertaking, or participates . . . in the direct or indirect underwriting of any such undertaking.” Securities Act of 1933 § 2(a)(11), 15 U.S.C. § 77b(a)(11) (2009). The argument here is based on the premise that ratings have been instrumental to the structuring and subsequent marketing of the product to investors. See Joseph R. Mason & Joshua Rosner, Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions 14 (May 3, 2007) (Hudson Inst. Working Paper), available at http://wp.hudson.org/files/publications/Hudson_Mortgage_Paper5_3_07.pdf (discussing how rating agencies could be considered underwriters of securities and thus subject to the rules and regulations mandated by the Securities Act of 1933).

176. See GART, supra note 170, at 33-37 (describing the effects of the Great Depression and noting what seems to resemble the foundations of our current economic crisis: “The more actively these financial institutions piled assets on a shaky foundation of faith and credit, the less thoroughly they researched or acknowledged the underlying values of those assets.”).
against the rating agencies. The two conflicts of interest addressed in Abu Dhabi—the compensation received by rating agencies and the level of the agency's participation in structuring certain products—distinguish rating agencies from journalists and justify the denial of First Amendment protection to rating agencies.  

This conclusion does not prevent rating agencies from asserting other possible defenses. Yet because of the existence and potency of the conflicts of interest embedded in the rating process, basing a defense on First Amendment grounds skirts the bedrock principles of free communication that the First Amendment is intended to uphold and is, thus, an improper defense.

The fees charged and obtained by the rating agencies in Abu Dhabi demonstrate one conflict of interest that may, in fact, prejudice rating agencies' assessments and distinguish them from editorials. The compensation structure in Abu Dhabi was based on the "launch" of the product, where the rating agency would receive fees "in the range of 10 or more basis points (or one tenth of 1 percent) at the 'launch' of the [product]. Assuming a $3 billion launch value, the Rating Agencies would have been paid $6 million." In defense against the plaintiffs' claim that the rating agencies "stepped far outside their historical role of gathering information and publishing independent unsolicited ratings," the defendants relied on precedent established in Compuware, which

177. Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 166-67 (S.D.N.Y. 2009). See also GART, supra 170, at 11-12 (discussing the various conflicts of interest embedded in the rating process and potential solutions to eliminate and/or mitigate these conflicts).

178. First Amended Complaint, supra note 7, at 15.

179. Id. Additionally, ongoing fees would be paid to the rating agency, some in the form of annual fees. This factor is not confined to the types of securities noted in the Abu Dhabi case, although it may be higher with SIVs, but the fees are charged regardless of the type of security. See Husisian, supra note 24, at 425-27 (detailing the "economics" of the ratings agency business as it relates to the various financial products).

180. Plaintiffs' Memorandum of Points and Authorities in Opposition to Defendants' Motions to Dismiss at 37, Abu Dhabi, 651 F. Supp. 2d 155 (No. 1:08-cv-07508).
afforded the rating agency First Amendment protection. However, this reliance is misplaced since the Compuware holding targeted the rating agencies’ burden of proving actual malice in assigning the rating rather than targeting corollary elements of the rating process, such as the compensation structure.

Because the issuer (as opposed to the investor) pays the agency, questions inevitably arise as to whether the rating agency is motivated by profit and whether that profit is the driving force behind the ratings it issues. This potential for exploitation of the ratings process for profit may be a result of a rating agency’s ability to “exercise market power,” where “dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally,” thereby acting as a mechanism to attract more issuers to use that rating agency. Furthermore, assigning a lower rating will most likely prevent issuers from selling the product to many investors, which would presumably provide a greater incentive to issue a higher rating in

181. Compuware Corp. v. Moody’s Investor Servs., 499 F.3d 520 (6th Cir. 2007).
182. Id. at 533-34.
183. See supra Part II; see also ROLE OF RATINGS, supra note 160, at 14-16 (discussing the current fee structure wherein the issuer approaches the rating agency and pays a fee for the rating of its particular financial product; a clear shift from the "investor pays" model); White, supra note 36, at 49 (same).
184. See OPERATION OF THE SECURITIES MARKETS, supra note 32, at 41 n.111 (discussing a corollary to the fees conflict arising "in the context of underwriters attempting to influence the credit rating process. A large percentage of bond offerings are underwritten by a few large firms, and the potential exists . . . to rate a particular underwriter’s clients more favorably in return for future business.").
185. White, supra note 62, at 17-18 (detailing the revenues amassed by Moody’s between 1995-2000. During that period, Moody’s net income was $88.2 million and total assets were $217.8 million, values which the author termed “breathtaking”). See also ROLE OF RATINGS, supra note 160, at 25 (“Issuer-paid fees may thus encourage rating agencies to act in the issuer’s rather than the investors’ interest, resulting in initial ratings being more favourable or downgraded less often than they otherwise should be.”).
186. OPERATION OF THE SECURITIES MARKETS, supra note 32, at 41.
order to amass profits. The conflict created by this compensation structure becomes more prevalent because the rating analysts' compensation is tied to revenue growth. As the Managing Director of the Structured Finance Department at R.W. Pressprich & Co. stated in his testimony before the Senate Committee on Banking, Housing and Urban Affairs, "whenever a rating analyst is supervised by a manager whose compensation is determined by market share or revenue growth (rather than ratings accuracy), the objectivity of ratings is compromised."

Although a rating agency's First Amendment rights cannot be denied solely because it charges a fee for its services or because of the resulting conflict of interest, this compensation structure does place a dagger in the common defense that rating agencies are comparable to journalists, since journalists are not paid fees by their subjects.

Addressing the conflict of interest created by rating agencies' payment for their services, the Abu Dhabi court also referred to the rating agencies' involvement in structuring the product through their assistance in determining the level and amount of financial investment needed for the issuer to obtain the highest rating. As the court noted, the rating agencies'
involvement in the "structuring" of the notes presented another stark contrast to the role played by journalists, since this type of involvement clearly demonstrated a clear departure from the traditional "role as an unbiased reporter." Specifically, the rating agencies had the responsibility to "(1) oversee the [issuer's] investments; (2) facilitate the purchase of safe and highly-rated assets; [and] (3) acquire and manage the [note's] underlying portfolio [in order to justify] the high credit ratings assigned."

The level of the rating agencies' participation in assigning a rating to a structured product, like that in Abu Dhabi, is in the "[d]eal origination . . . [which] involves obtaining implicit structuring advice by the rating agencies . . . and subsequently engag[ing] in an iterative dialogue with the agencies in order to finalize these structures." This type of involvement in structured product transactions occurs through the rating of the individual "tranche . . . , [which] reflects a judgment about both the credit quality of the underlying collateral asset pool and the extent of credit support that must be provided through the transaction's structure in order for the tranche to receive the rating targeted by the deal's arrangers."

192. Id. at 166.
193. Id. at 167.
194. ROLE OF RATINGS, supra note 160, at 2. The report discussed the main differences between the ratings process for structured products and other securities. In a structured product, "each tranche reflects a different position in the deal's capital structure . . . . As a result, rating agencies . . . and investors need to understand not only the default risk embodied in the collateral pool but also other, 'non-default' risks . . . that are unrelated to defaults . . . but which affect the credit risk of the tranches—arising from the transaction's structure." Id. at 14. See generally TIMOTHY J. RIDDIOUGH & RISHARNG CHIANG, COMMERCIAL MORTGAGE-BACKED SECURITIES: AN EXPLORATION INTO AGENCY, INNOVATION, INFORMATION, AND LEARNING IN FINANCIAL MARKETS I, 7 (2003) ("Instead of assuming a passive credit quality certification role, the rating agency actively controls security architecture and [is] instrumental in determining product design standards . . . . Rating agencies actively control security design through their determination of subordination levels required to achieve particular security rating outcomes.").

195. ROLE OF RATINGS, supra note 160, at 2. The report also noted "[s]tructured finance instruments can be defined through three key characteristics: (1) pooling of assets . . . (2) tranching of liabilities that are
This conflict was highlighted by the court in *Fitch* and, most importantly, was analogized to the journalist—the extent and concentration of the credit rating agency’s participation in the structuring, as it related to the issuer’s product and subsequent rating, was a clear indication that the relationship would be considered *atypical* if applied to media.\(^{196}\) Even assuming as true the claim that the rating agency’s objective in assigning a rating is not influenced by its participation in the creation of the product, the fact that the agency has a reputational risk attributable to the rating\(^{197}\) leads to the same conclusion: a rating is not objective. Unlike a journalist, the rating agency becomes *involved* in the means to achieve the ends, and its reputational risk is tied to the product.\(^{198}\) If a viable argument is to be made that a rating is like an editorial and should be afforded protection under the First Amendment, then the characteristics of the rating process should be similar to, if not the same as, those of the editorial process: void of innate conflicts of interest that can visibly hinder impartiality.

Alternatively, by extending the argument that the rating agency is intimately involved in the construction of a structured backed by the asset pool . . . (3) *de-linking* of the credit risk of the collateral asset pool from the credit risk of the originator . . . .” *Id.* at 1. Furthermore, the credit rating of these structured products, and their corresponding investment tranches which are individually rated, has been dominated by three rating agencies: Moody’s, Fitch, and Standard & Poor’s. *Id.* at 2. *See also* Darcy, *supra* note 26, at 616 (“Securities [are divided] into senior, mezzanine, and subordinated/equity tranches according to credit risk to provide securities that match the varying risk preferences of different investors. Typically, the issuer pays a [credit rating agency] to rate the senior and mezzanine tranches.”).


197. *See Sy*, *supra* note 161, at 6 (noting that rating agencies “stress the paramount importance of safeguarding their reputation for issuing objective and credible ratings. They claim that reputational concerns should reduce issuer influence . . . .”).

198. *See Grais & Katsiris*, *supra* note 124, at 3, n.22 (“*[T]he most important factor in determining whether [Moody’s] is qualified to assert the journalist’s privilege is the nature of [Moody’s] relationship with the alleged ‘source.’” (citing Compuware Corp. v. Moody’s Investors Servs., Inc., 324 F. Supp. 2d 860, 862 (E.D. Mich. 2004)).
product, a claim could be made that since the rating agency is assisting the issuer to achieve a higher rating, it is in effect *advertising* its rating. Professor Eugene Volokh, in his testimony to the House Subcommittee on Capital Markets, Insurances, and Government Sponsored Enterprises, briefly entertained this argument: it could be plausible to deny or limit First Amendment protection to ratings agencies if they are deemed to be engaging in commercial advertising.\textsuperscript{199} Specifically, Professor Volokh notes that if the advertisement is "in exchange for positive coverage," it can be construed as commercial advertising and therefore less deserving of First Amendment protection.\textsuperscript{200} Standard & Poor's has stated that its "ratings and commentary do not propose commercial transactions, but instead offer opinions."\textsuperscript{201} However, if the rating agency is involved in the financial product's construction to the extent that it suggests all possible means to achieve the highest rating (thereby attracting more investors and more revenue), then the issuer, in a sense, is paying to obtain a *positive* rating, regardless of whether the rating is an accurate risk assessment based upon the information provided by the issuer. Further, the issuer amasses more revenue as a result of the positive rating, thereby ensuring the

\textsuperscript{199} Volokh statement, *supra* note 148, at 5. See also Central Hudson Gas & Elec. Corp. v. Public Servs. Comm'n, 447 U.S. 557, 566 (1980) (noting the adoption of a four-part test in analyzing "commercial speech cases": first, is it protected under the First Amendment in that it is "lawful" and "not misleading"; second, is the "governmental interest . . . substantial"; third, does the regulation promote "the governmental interest asserted"; and fourth, is the regulation "more extensive than is necessary to serve that interest").

\textsuperscript{200} Volokh statement, *supra* note 148, at 3. Volokh refers to the holding in *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748 (1976) and related cases. *Id.* The pharmacist in *Virginia State Board of Pharmacy* was merely advertising the prices of prescription medication and not medication that he had a hand in developing. The Court concluded that the First Amendment protects "commercial speech" but did "not hold that [commercial speech] can never be regulated in any way." *Virginia State Bd. of Pharm.*, 425 U.S. at 770. See also *supra* note 99 and accompanying text.

\textsuperscript{201} Memorandum from Cahill Gordon & Reindel LLP on Behalf of Standard & Poor's 10 (July 2005), *available at* http://www2.standardandpoors.com/spf/pdf/media/Exhibit_2.pdf (addressing the constitutionality of the Credit Rating Agency Duopoly Relief Act, H.R. 2990, 109th Cong. (2005)).
return of the issuer to the same rating agency for its next financial product rating. If the rating agency is so intensely involved, how can it not be endorsing a commercial transaction in which it has a financial benefit? If this is the case, then not only could the ratings be deemed commercial advertising, but the journalist analogy is further attenuated.

In his testimony, Professor Volokh concluded that “[s]o long as the payment isn’t buying a positive evaluation—so long as the speaker isn’t proposing a commercial transaction in which it itself has a financial interest . . . the evaluation will remain fully constitutionally protected.”202 The negative implication of Professor Volokh’s testimony is clear: if the payment is buying a positive evaluation, then that is considered commercial advertising, which is less deserving of protection under the First Amendment.

The process that rating agencies use in determining the viability of a product in case of default is saturated with the effects of two distinct conflicts of interest that cloud the objectivity of the rating. Allowing the rating to be subjectively assigned, even unintentionally, can prove detrimental not only to the direct purchaser of the product but also to the global financial market if the assigned risk is deemed inaccurate. It is this impact on the public that warrants a denial or limitation on ratings’ First Amendment protection.

IV. POTENTIAL SOLUTIONS

Rating agencies have demonstrated that they are integral to the inner workings of the financial sector by issuing useful, and even necessary, information to investors and issuers.203 As a result of this reliance on ratings, particularly high ratings,204 the few rating

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203. See Two Thumbs Down, supra note 1, at 629-30 (discussing the “supply” of the ratings issued by the credit ratings agencies to counter of the “demand” investors and issuers).
204. See supra text accompanying notes 39-44.
agencies that are predominantly used\textsuperscript{205} have formed a monopoly. This barrier to entry is further buttressed by the SEC's "NRSRO" designation. The labeling of certain ratings agencies as NRSROs has cultivated public reliance on the three main rating agencies.\textsuperscript{206} Concurrently, achieving NRSRO status ensures transparency in the rating agency process in light of the conflicts of interest. The shift to the issuer-pays model\textsuperscript{207} (the most prominent conflict in the rating process) has sparked the strong presumption that rating agencies' pecuniary interest has outweighed their objective to provide transparent, accurate, and independent credit analysis.\textsuperscript{208} The most pragmatic response to this conflict, as well as the conflict created by the rating agencies' involvement in structuring the product, is not to facilitate private rights of action; instead, the SEC should continue on the path of regulation by implementing more stringent safeguards that will increase market accountability and reinforce investor confidence. The safeguards suggested below can be implemented by way of the Wall Street Reform and Consumer Protection Act (WSRCPA) passed by the U.S. House of Representatives in December 2009.\textsuperscript{209}

\textsuperscript{205} See Egan-Jones Letter, supra note 65 (stating that the only ratings agencies predominantly used for SIVs are S.&P. and Moody's, which thereby hold a "partner monopoly").

\textsuperscript{206} See Operation of the Securities Markets, supra note 32, at 24 ("Fitch complained that S&P and Moody's were attempting to squeeze them out of certain structured finance markets by engaging in the practice of 'notching'—lowering their ratings on, or refusing to rate, securities issued by certain asset pools . . . unless a substantial portion of the assets within those pools were also rated by them. Fitch suggested, as a possible solution, that NRSROs be required to recognize the ratings of other NRSROs as their own for purposes of rating these asset pools.").

\textsuperscript{207} White, supra note 36, at 49.

\textsuperscript{208} See Husisian, supra note 24, at 424 ("In short, while the rating is a distilled, independent judgment as to the creditworthiness of a particular debt issue, it is not an audit. The information is an important part of an investor's information, but it does not by itself provide a quick route to high, risk-free returns.").

Certainly a rating agency is in the best position to administer its ratings processes; however, allowing an impartial external party, which has no financial interest in the transaction between the issuer and the rating agency, to evaluate and recommend enhancements to the process can only further mitigate the potential for abuse and impede possible systemic default that could result from inaccurate categorizations of risk. One solution is to remove the provision in the Credit Rating Agency Reform Act of 2006 prohibiting the SEC from "regulat[ing] the substance of credit ratings or the procedures and methodologies by which [the NRSROs] determine[] credit ratings." True, this provision does increase transparency by keeping the requirement that the rating agencies disclose their methodologies to the SEC; however, it does not solidly further the objective of regulating and monitoring the rating agencies' methodologies and procedures (which are the very processes of assessing the viability of the underlying issuer's creditworthiness).

The WSRCPA attempts to solve this problem by mandating annual SEC audits of "each registered credit rating agency's ratings, policies, procedures, and methodologies." Another way to increase market accountability and restore public confidence is to implement more concrete requirements, such as requiring the rating agencies to adopt internal operational audits and issue a final report that would detail, at a minimum, the

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211. See generally Kaswell et al., supra note 74 (providing an overview of the objectives and effects of the Credit Rating Agency Reform Act of 2006 and noting that one of the goals of the Credit Agency Reform Act was to increase transparency). Rating agencies can be expected to claim that this is akin to the Federal Communication Commission regulating television news, but in reality, the more apt comparison is to the Federal Trade Commission's recent regulation of the disclosure that bloggers must provide regarding their financial ties to products they review.

212. See DAVIS POLK, supra note 209, at 27.
adequacy of the ratings procedures. These audits could prove instrumental in uncovering potential inconsistencies in the ratings process and identifying potential conflicts of interest. The provisions set forth in the WSRCPA that support this solution require that "rating agencies . . . establish, maintain, and enforce written procedures and methodologies and an internal control system . . . to ensure that ratings are clear and consistent."

As noted, the consequences of the shift to the "issuer pays" model have allowed for the potential of subjectivity to cloud the rating process. As Professor John Coffee stated before the Senate Committee on Banking, Housing, and Urban Affairs, "agencies are a watchdog paid by the persons they are to watch." To address this conflict, regulations could be implemented that limit the amount of compensation received by the issuer, or that impose heightened disclosure requirements (to investors and the SEC) when fees exceed a certain dollar amount. Facing a cap on the amount of revenues that can be obtained from an issuer in any given year, the rating agencies will be less inclined to assist the issuers in obtaining a higher rating in exchange for their services. Once again, the WSRCPA addresses this concern, requiring the agency to institute "extensive conflicts of interest guidelines, including certain revenue disclosure . . . and a prohibition on certain non-rating products or services." Further mitigating the conflict

213. This process would equate to that which is imposed upon Registered Investment Advisers. Investment Advisers Act of 1940, Compliance Procedures and Practices, 17 C.F.R § 275.206(4)-7.
214. See DAVIS POLK, supra note 209, at 29.
217. See OPERATION OF THE SECURITIES MARKETS, supra note 32, at 41 ("[T]he dependence of rating agencies on revenues . . . could induce them to rate issuers more liberally, and . . . [t]his potential conflict could be exacerbated by the rating agencies' practice of charging fees based on the size of the issuance, as large issuers could be given inordinate influence with the rating agencies.").
218. See DAVIS POLK, supra note 209, at 28.
imposed by the compensation arrangement, the Act allows for “[r]egistration exemption[s] . . . to any credit rating agency that does not provide credit ratings to issuers for a fee and issues credit ratings only in certain publications of general and regular circulation.” 219

Although the WSRCPA has not yet been passed by the Senate, it is a huge step toward market efficiency, accountability, and transparency—all characteristics essential to investor protection.

CONCLUSION

There is no question that rating agencies must expose and assign risk to financial instruments. In the current economic crisis, in which many investors suffered losses as a result of investing in financial instruments with incorrectly categorized risk ratings, it has become natural to assign blame to anyone remotely connected to the creation and dissemination of those financial products, including ratings agencies. In response to these attacks, the agencies have claimed First Amendment protection for the ratings they have issued.

Yet suits brought against rating agencies have demonstrated that it is debatable whether agencies can truthfully provide impartial assessments of risk while being heavily compensated for their services or, at times, being involved in the structuring of the products they are hired to rate. Further, although it may be instinctive to blame a rating agency, since it can be perceived as the authority on the riskiness of a product, like any other corporation, it has a reputation to uphold, one that is positively correlated to the accurate ratings it issues. The resulting litigation surrounding these ratings reveals that courts have taken opposing stances on whether to grant First Amendment protection to the ratings. However, as a matter of normative law, extending First Amendment protection to ratings has placed, and continues to place, our financial infrastructure at risk.

219. See id. at 27.
The First Amendment is not the appropriate tool with which to address the concerns posed by rating agencies, particularly taking into consideration that these agencies are indeed regulated (even if inadequately) by the SEC. The solution to these issues is heightened regulation. Yet, until an appropriate context is adopted, the public will continue to feel the burden that the current irresolution places prospectively upon the vitality of the global economy and retrospectively upon the historical underpinnings of the First Amendment itself.