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Rating Agency Reform: Presenting the Registered Market for Asset-Backed Securities

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Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities

I. INTRODUCTION

On July 22, 2010, as a flourish from President Obama's pen enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),\(^1\) Ford Motor Credit Company LLC (Ford Credit) sent a letter to the Securities and Exchange Commission (SEC) stating that several credit rating agencies were unwilling to consent to inclusion of their ratings in any registration statements or prospectuses.\(^2\) The rating agencies solicited by Ford Credit were unwilling to consent to inclusion of their rating because of Dodd-Frank's rescission of SEC Rule 436(G),\(^3\) which had previously shielded rating agencies from civil liability as an expert under Section 11 of the Securities Act for inaccurate ratings used in registration statements.\(^4\) Because Ford Credit was unable to obtain any nationally recognized statistical rating organizations' (NRSROs)\(^5\) consent to include their ratings, Ford Credit was unable to comply with Rules 1103(a)(9) and 1220 of


\(^4\) See Securities Act of 1933 §11(b)(3), 15 U.S.C. § 77k (2006) (holding an expert, consenting to be named as such in a registration statement, liable for any untrue statement of a material fact or failure to include a material fact necessary so as not to make a statement misleading. Also, requires an expert to make a reasonable investigation as to whether or not that portion of the registration statement they have certified has a basis in fact).

Regulation AB, "which requires the disclosure of NRSROs and their ratings in securities registration documentation."\(^6\) In response to Ford Credit's letter, the SEC issued a no-action letter\(^7\) until January 24, 2011, granting NRSROs a six-month period to determine how best to comply with the new legislation.\(^8\) The SEC provided the six-month grace period to issuers and rating agencies so that they may not only continue offering asset-backed securities, but also take time to weigh their new exposure to liability before the SEC no-action letter expires on January 24, 2011.\(^9\) In a November 23, 2010 letter, the SEC officially extended its no-action position to give NRSROs time to contemplate and complete the regulatory actions mandated by the Dodd-Frank so that asset-backed security offerings can continue in the registered marketplace without interruption.\(^10\)

This Note will assess the negative effects on securities markets from increased liability for credit rating agencies following the passage of Dodd-Frank.\(^11\) Dodd-Frank eliminates SEC Rule 436(G),\(^12\) which had previously exempted agency ratings from "expert" status under Section 11 of the Securities Act of 1933 when rating a security.\(^13\) Section 11 establishes liability for certain experts who have "prepared or certified" part of a false or misleading registration statement.\(^14\) Eliminating this provision will increase rating agency exposure to litigation from unhappy investors who relied on inaccurate ratings to their financial


\(^7\) July SEC No-Action Letter, *supra* note 2.

\(^8\) Joyce, *supra* note 6.


\(^12\) Id.


\(^14\) See id. at § 11(a)(4).
detriment. Similar to Ford Credit, many issuers of securities are now unable to obtain the ratings needed to put financial products on the market as rating agencies assess their new legal liability. Although the SEC no-action letter buys some time for the rating agencies, they will need to come up with a means to shield themselves from civil liability should the SEC rescind its no-action position in the near future. This Note will analyze the negative effects that heightened liability for NRSROs would have on investment in asset-backed securities and potential responses from large investment banks – the primary issuers of these complex financial products – and the rating agencies who rate their products.

Part II of this Note provides an overview of the history of credit rating agencies and the regulatory treatment of these agencies by the federal government. It will also discuss the First Amendment protections that courts extend to credit ratings used in financial offering registration statements. Part III highlights the role that inaccurate credit ratings of mortgage-backed securities played in the recent subprime mortgage crisis. Part III also discusses ethical breaches by credit rating agencies that cut corners when rating complex financial products. It then addresses the conflicts of interest between rating agencies and institutional investors – rating agencies' primary customers and sources of revenue. Part IV assesses the origination and Dodd-Frank rescission of Rule 436(G).

16. See id.
17. See id.
19. See infra Part II.A.
20. See infra Part II.B.
21. See infra Part III.A-B.
22. See infra Part III.C.
23. See infra Part III.D.
24. See infra Part IV.A.
term. Part V analyzes the ramifications of these new laws for credit rating agencies and what can be done to ensure financial markets remain healthy in our recovering economy. This Part also indicates some of the unintended, paralyzing effects the rescission of SEC Rule 436(G) could have on financial markets. Finally, this Part analyzes the SEC regulatory oversight sanctioned within Dodd-Frank, concluding that increased regulatory oversight is a viable method to increase investor protection, rather than imposing liability on NRSROs for inaccurate credit ratings.

II. HISTORICAL INDUSTRY PRACTICES AND REGULATION OF NRSROs

A. Overview of Credit Rating Agencies

Credit rating agencies began providing rating services to financial markets in the early twentieth century by supplying investors with opinions on the creditworthiness of corporate bonds. As financial markets grew in complexity, credit rating agencies broadened their rating services to include “municipal bonds, mortgage backed securities, and other structured finance bonds.”

Credit ratings provide investors with an indication of the likelihood that a given debt obligation will be repaid as well as the expected loss in the event of a default. A credit rating agency issues credit ratings using qualitative and quantitative models and receives fees for its services from issuers, investors, or other

25. See infra Part IV.C.
26. See infra Part V.
27. See infra Part V.A-C.
28. See infra Part V.D.
market participants.\(^{32}\) Moody’s Investor Services, Standard and Poors’s, and Fitch Ratings, collectively termed the “Big Three,” largely dominate the credit rating market.\(^ {33}\) Credit rating agencies are registered with, and regulated by, the SEC as NRSROs.\(^ {34}\)

With the passage of the Banking Act of 1935, the Federal government formally enmeshed the ratings agencies with the regulation of banks.\(^ {35}\) As ratings became increasingly entrenched within securities regulations, credit rating agencies evolved from providers of credit information into regulatory licensing agents of the federal government.\(^ {36}\) Rating agencies developed into regulatory “gatekeepers” of financial markets because federal law requires a credit rating for many financial products.\(^ {37}\) For many investors, credit ratings restrict the types of investments they may purchase.\(^ {38}\) But, as government increased its reliance on NRSRO credit ratings in regulating financial products, direct regulation of the rating agencies was virtually non-existent; despite warnings from periodic financial crises in which rating agencies downgraded


\(^{33}\) See Kathleen L. Casey, Comm’r, Sec. and Exch. Comm’n, Remarks at the Commission Open Meeting (Dec. 3, 2008), http://www.sec.gov/news/speech/2008/spch120308klc.htm#P23_2884 (remarking that, as of December 2008, the “Big Three” issue approximately 98% of all ratings and amass over 90% of the revenues within the ratings industry); Mulligan, \textit{supra} note 29, at 1279 (stating that Moody’s, Standard and Poor’s and Fitch are collectively termed the “Big Three,” issuing over ninety-eight percent of all ratings).


\(^{35}\) See Dennis, \textit{supra} note 30, at 1117 (stating that the Banking Act of 1935 mandated that national banks were now limited to purchasing investment-grade securities, that is, those that are not primarily speculative investments) (quoting \textit{Frank Partnoy, The Paradox of Credit Ratings, in Ratings, Rating Agencies and the Global Financial System} 65, 71 (2002)).


\(^{38}\) See \textit{id.} at 540-541 (explaining that government regulations require that certain institutional investors such as pension funds, money market funds, insurance companies, and banks may only hold securities rated investment-grade).
their ratings just before a collapse – suggesting the ratings were inaccurate in the first place.\textsuperscript{39}

In 1975, the Net Capital Rule was revised to allow banks to base their capital requirements on the quality of the securities they held by subjecting them to lower capital requirements if those securities were rated investment-grade by at least two NRSROs.\textsuperscript{40} Aligning capital margin requirements with ratings cemented NRSROs as de facto gatekeepers of U.S. financial markets.\textsuperscript{41}

Preceding the passage of the Credit Rating Agency Reform Act of 2006 (CRARA),\textsuperscript{42} the government possessed virtually no regulatory power over NRSRO operations.\textsuperscript{43} In clarifying the NRSRO designation, the SEC instituted a clearer NRSRO application process, which simply encouraged disclosure of rating agency methodologies rather than permitting the SEC to aggressively regulate NRSRO practices.\textsuperscript{44}

\textbf{B. First Amendment Protection of Ratings Shields Credit Rating Agencies from Liability}

Until the passage of Dodd-Frank, credit rating agencies enjoyed First Amendment protection of their ratings as opinions.\textsuperscript{45} Thus, they were shielded from civil suits brought by aggrieved investors who relied to their detriment on a misleading rating in purchasing a financial product that was later downgraded or shown to be erroneous.\textsuperscript{46} Standard & Poor's corporate website stresses
that their ratings are "forward-looking opinions" that assess credit and default risk.47

In Compuware, the Sixth Circuit Court of Appeals held that Moody's rating was an opinion and the standard to recover for breach of contract is "actual malice," that is, proof that "the defendant made the statement with knowledge of its falsity or with reckless disregard of its truth."48 The high threshold of the "actual malice" standard explains why the courts generally rule in favor of the rating agency in ratings related litigation.49 In Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Inc., the U.S. District Court for the Southern District of New York recognized typical First Amendment protections for NRSRO credit ratings because they are matters of public concern.50 The court found, however, that First Amendment protections for rating agencies may be unavailable when rating information is made available only to a small group of investors rather than to the general public – reasoning that these protections are not available for ratings intended for a discrete business audience, making them no longer a matter of public concern, and therefore unprotected.51 Thus, even before the Dodd-Frank rescission of SEC Rule 436(G), rating agencies could still lose the First Amendment protection of their ratings as opinions in certain instances.52

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48. Compuware, 499 F.3d at 526.

49. Mulligan, supra note 29, at 1296, 1297 & n.163; See Compuware 499 F.3d at 526.


51. Abu Dhabi, 651 F.Supp. 2d at 176 (finding that ratings were not made publicly available, but rather, were provided in connection with a private placement to a select group of institutional investors). Compare In re Nat'l Century Fin. Enters., Inc., Inv. Litig., 580 F.Supp. 2d 630, 640 (S.D. Ohio 2008) (refusing to apply the First Amendment where Moody's ratings had been disseminated to a "select class of institutional investors"), with Compuware, 499 F.3d at 525 (applying the First Amendment where Moody's had rated a publicly-held corporation).

52. See, e.g., In re IBM Corp. Sec. Litig., 163 F.3d 102, 109 (2nd Cir. 1998) ("[A]n opinion may still be actionable if the speaker does not genuinely and reasonably believe it or if it is without basis in fact.").
C. Structuring and Rating of Mortgage-Backed Securities

Traditionally, an individual could finance the purchase of a home with a mortgage by borrowing money from a lending institution that carried the mortgage as an asset on its balance sheet. Lenders began pooling mortgages and then selling the pool of mortgage loans to a special purpose vehicle (SPV). To profit from the purchase, the SPV organized the mortgage pool into separate levels, or tranches, based on the underlying risk of the mortgages within the pool, and then sold shares from each of these tranches to investors based on the investor's individual risk preference. The tranches allow investors to take advantage of a type of credit enhancement called "subordination," which creates a "hierarchy of loss absorption among the tranche securities." This organizational structure ensures that any losses from interest or principal within the pool are first allocated to the lowest-rated tranche. Once the lowest tranche loses all of its principal, the losses will be allocated to the next to lowest tranche. This process continues all the way through the pool, with the highest rated tranche remaining safe from losses until all lower tranches have fully absorbed all prior losses of principal. Collateralized Debt Obligations (CDOs) are structured similarly to mortgage-backed securities, except CDOs may actively manage their pool to allow their underlying assets to change over time.

To rate one of these structured financial products, the ratings agency receives data on the security being offered by the

53. Freeman, supra note 45, at 589.
54. See generally Hosp, supra note 37, at 543 (explaining the structure and function of mortgage-backed securities).
55. See id.
56. See id.
58. See Sy, supra note 39, at 16.
59. SEC SUMMARY REPORT, supra note 57, at 6.
60. See Sy, supra note 39, at 16.
61. SEC SUMMARY REPORT, supra note 57, at 7.
issuer, as well as information and data on the issuer itself. The rating agency will then make a determination on likely future performance of the mortgage pool as a whole by assessing default risk levels associated with each tranche level using past market data and varying stress tests. A rating analyst then evaluates quantitative and qualitative qualities of each tranche of the pool by assessing the tranche payment schedule structure and ensuring that the security can produce sufficient cash flow from the assets in the pool to meet the expectations of investors in the product.

Rating analysts then present their findings and recommended ratings of each tranche to a ratings committee comprised of other analysts who vote on the ratings to be assigned to each tranche within the mortgage pool.

This overview of the ratings process presents a theoretical model of how the ratings process is supposed to work. Insufficient oversight by the SEC, however, led many rating agencies to cut corners in making rating determinations for complex financial products – an issue that will be discussed in further detail in subpart III.C.

III. HOW INFLATED RATINGS FOR SUBPRIME MORTGAGE-BACKED SECURITIES CONTRIBUTED TO THE RECENT FINANCIAL CRISIS

A. How Inflated Credit Ratings Contributed to the Financial Crisis

Credit rating agencies gave inaccurately high ratings to many asset-backed securities, most notably, securities backed by subprime mortgages. Instead of analyzing default risk with

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62. See Hosp, supra note 37, at 546 (highlighting that issuer data will give general background, investment strategy, systems of operation and historical performance information. Security data contains information about the loans within the SPV, including but not limited to: amount of principal, geographical location of the secured property, borrower credit history, type of loan, and the ratio of loan amount to property value).
63. See id. (explaining that stress tests put the assets backing the security under various simulated market conditions to help determine likelihood of default).
64. SEC SUMMARY REPORT, supra note 57, at 7-8.
66. See id. at 546.
67. See infra Part III.C.
68. Piekarski, supra note 18, at 272.
current data, investors discovered that rating agencies were using archaic information and default rate models that failed to account for higher default rates associated with the increased securitization of subprime mortgage products; this lent minimal to no predictive value toward making default-risk assessments. These inaccurate ratings led to inflated investor confidence and accelerated demand for mortgage-backed securities. Regulatory dependence on ratings generated record profits for NRSROs during the subprime mortgage crisis, despite progressively insufficient analysis as the financial products they rated became increasingly complex. This paradox is mainly attributable to a lack of regulatory oversight and accountability, which could have helped to ensure that credit rating agencies took greater care and caution in assigning their ratings to complex financial products.

Inflated ratings on mortgage-backed securities, especially subprime mortgage-backed securities, led to investor overconfidence in the creditworthiness of these complex financial products. Lenders traditionally avoided extending mortgages to subprime borrowers due to their higher risk of default; but as buyers lined up to purchase and package them as securities, original lenders sought to maximize their revenue by making more subprime home loans than ever before. Investors who trusted the ratings became complacent in making independent assessments of the default risk associated with the financial products they purchased. Generally, most investors just trusted the letter grade

69. See Interview with Adam Davidson, Int'l Bus. and Econ. Correspondent, NPR, This American Life Episode Transcript, Program #355 (May 9, 2008) [hereinafter Interview with Adam Davidson], available at http://www.thisamericanlife.org/sites/default/files/355_transcript.pdf; Dennis, supra note 30, at 1124-26 (“Most rating agencies relied upon loan data from 1992 through 2000 in estimating the probability of default and expected magnitude of losses from subprime loans in a given pool. Using this information to estimate more recent subprime mortgages, however, leads to unjustifiably low loss expectations . . . .”).

70. See Piekarski, supra note 18, at 272.

71. PARTNOY, supra note 36, at 5 (“Moody's profit margins were higher than the margins of any other company in the S&P 500 for five consecutive years in the early 2000s.”).

72. See id.

73. See Mulligan, supra note 29, at 1289.


75. See Gretchen Morganton, BB? AAA? Disclosure Tells Us More, N.Y. TIMES,
rating, looking primarily to rating agencies for informational guidance for which products were safe bets.\textsuperscript{76} Reasonable or not, the reality is that investors relied heavily on NRSRO credit ratings in making their investment decisions.\textsuperscript{77} Part of investor over-reliance on credit ratings stems from the growing complexity of the financial products offered in the present market.\textsuperscript{78} In \textit{Abu Dhabi Commercial Bank v. Morgan Stanley & Co., Inc.}, the court concluded that the plaintiff, a sophisticated institutional investor, adequately pled reasonable reliance on Moody's and Standard & Poor's credit ratings.\textsuperscript{79} The court based its finding on widespread market reliance on the accuracy of credit ratings from NRSROs and rating agency access to non-public information that even sophisticated investors, such as the plaintiff, could not obtain.\textsuperscript{80} The regulatory entrenchment of rating agencies forces market participants to rely on NRSRO ratings, even though they possess limited means to perform their own due diligence concerning how or why a particular rating was assigned.\textsuperscript{81} Investor dependency on credit ratings necessitates heightened accountability and transparency in the methods used by ratings agencies when determining the default risks of financial products.\textsuperscript{82}

\textbf{B. Effects of NRSRO Reluctance to Downgrade Ratings}

Federal regulators should have been on alert that something was awry with the rating agencies in 2001, as rating agencies waited to downgrade Enron's credit rating until four days before it filed for bankruptcy.\textsuperscript{83} Despite public outcry against the

\begin{footnotesize}
\textsuperscript{76} See Interview with Adam Davidson, \textit{supra} note 69.
\textsuperscript{78} See Mulligan, \textit{supra} note 29, at 1289 (explaining that many structured financial products, such as CDOs or credit default swaps, are so complex that even many institutional investors are not sure exactly how they work).
\textsuperscript{80} Id.
\textsuperscript{81} See Hosp, \textit{supra} note 37, at 567.
\textsuperscript{82} See Freeman, \textit{supra} note 45, at 559.
\textsuperscript{83} Mulligan, \textit{supra} note 29, at 1284.
\end{footnotesize}
rating agencies' failure to recognize warning signs of trouble within Enron, Congress neglected to provide any additional meaningful oversight of credit rating agency operations. Credit rating agencies themselves began to cast doubt on their initial rating methods by downgrading a sizeable number of previously investment-grade rated mortgage-backed securities.

Credit rating agencies are slow to downgrade their ratings of financial products for much the same reason they give inflated ratings to these products: they want to avoid invoking antagonism from their primary clients—large investment banks. When these mortgage-backed securities approach a default, a rating downgrade may accelerate the default, resulting in even greater losses to both issuers and investors. Thus, it is easy to see why rating agencies, always mindful of the rating needs (and wants) of their powerful clientele, would hesitate to downgrade securities and risk losing market share.

C. Insufficient Resources Led to Cutting Corners in Assessing New Financial Products

The rapid increase in demand for mortgage-backed securities and CDOs in the early 2000s led rating agencies to exploit the absence of meaningful regulation by pumping out ratings to meet rising demand with little regard for accuracy. Not only were rating agencies shielded from civil liability, but they also had little competitive pressure to maintain their reputation within the credit rating market with the Big Three controlling a dominant stake in the marketplace.

84. See id.
86. Piekarski, supra note 18, at 275.
87. See id. (stating this flows from the logical presumption that a rating downgrade of a debt security will generally precipitate a fall in the market value of that underlying debt security).
88. See id.
89. See Dennis, supra note 30, at 1133.
90. See id. (noting that since demand was so high for mortgage-backed securities and CDOs at this time, the negative reputational cost of an inaccurate rating was an insufficient deterrent compared to the benefit of generating quick profits).
In 2001, Mr. Raiter, an employee of Moody’s asking for “collateral tapes” to assess the creditworthiness of home loans backing a CDO, was met with this e-mailed response from the managing director Richard Gugliada: “Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don’t have it and can’t provide it. Nevertheless we MUST produce a credit estimate. . . . It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so.”

This anecdote exemplifies how insufficient human resources contributed to an overall absence of due diligence by rating agencies in assessing these highly complex financial instruments. Despite a considerable increase in the number and complexity of the mortgage-backed securities NRSROs were rating from 2002 to 2006, the SEC discovered at least two unidentified agencies that failed to maintain staff increases to match their increases in deal volume. They asked analysts to engage in willful ignorance by assigning unmerited ratings to CDOs of subprime mortgage-backed securities without having the necessary documentation or time to make an accurate determination as to the underlying default risk. If an effective regulatory body for NRSRO activity had been present, rating agencies would not have been tempted to cut corners simply to generate more ratings for issuers, and ultimately, more revenue for themselves.

92. SEC SUMMARY REPORT, supra note 57, at 25 (finding that internal documents within two rating agencies revealed a struggle to adapt human resources to the growing number and complexity of the structured finance deals they were asked to rate).
93. Id. at 12.
94. See id.
95. Id. at 17-20.
D. Conflicts of Interest Inherent in the “Issuer Pays” Model

In most cases, the issuer of a security rated by an NRSRO will directly compensate the rating agency that assigns the rating.96 The “issuer pays” model is especially problematic when considering that the complex structured financial products behind the subprime mortgage crisis, such as CDOs, were extremely complicated and thus only issued by a small number of investment banks.97 The “issuer pays” model was far less troublesome before the advent of complex financial products as historically there were a larger number of entities issuing traditional bonds.98 The larger number of customers generating revenue for the rating agencies prevented consolidation of market power in the hands of a few customers, as is the case with investment banks in our present financial system.99 Thus, refusing to grant investment bank customers the highest rating possible for their structured financial product could result in a rating agency losing one of its largest sources of revenue.100 In his remarks at the Dodd-Frank Conference Committee on June 15, 2010, Rep. Brad Sherman (D - California) likened the rating agencies to a baseball umpire and the issuers to a home team paying that umpire $1 million per game.101 “You can be sure the umpire would call balls and strikes to secure future lucrative employment.”102 This perversion led rating agencies to lower their rating standards as analysts were made aware of the business interests involved in each of the products they were charged with analyzing.103

Another conflict of interest arises when rating agencies assist investment bank issuers in structuring these highly complex

96. Piekarski, supra note 18, at 273.
97. See id.
98. See Freeman, supra note 45, at 601.
99. See id.
100. Piekarski, supra note 18, at 273.
102. Id.
103. See SEC SUMMARY REPORT, supra note 57, at 25 (noting that analysts had open communication with marketing personnel who would inform analysts when their suggested rating would conflict with business interests).
financial products.104 “Rather than rating a security after the structure of the tranches is determined, the rating agencies are now actively engaged with the investment banks in determining the proper structures to maximize ratings – thus lowering the interest rate paid to investors and the resulting cost of capital.”105 Reports from insiders at rating agencies suggest that upper management was unwilling to put resources into developing updated methodologies to rate these new complex financial products.106 Hopefully, following the passage of Dodd-Frank, increased oversight will compel rating agencies to invest their resources in the production of more reliable credit assessments for investors.107

IV. REGULATORY ACTION AND SHORT-TERM RATING AGENCY REACTIONS

A. SEC Concept Release on Possible Rescission of SEC Rule 436(G)

In a 2009 concept release, the SEC sought comment on whether or not it was still appropriate to exempt NRSROs from civil liability under Sections 7 and 11 of the Securities Act via SEC Rule 436(G).108 Section 7 states that “experts” named as assisting in the preparation or certification of a registration statement must provide written consent to be filed by registrants in conjunction with their registration statement.109 Section 11 holds an “expert” liable for false, misleading, or omitted statements associated with their respective contributions to the registration statement.110

104. See Freeman, supra note 45, at 602.
105. Id.
106. See Dennis, supra note 30, at 1125 (“[T]he models used to predict the loss estimates for subprime mortgage-backed securities issued after 2002 failed to anticipate the higher default rates associated with the increased securitization of non-traditional subprime mortgage loans.”).
109. See 15 U.S.C. § 77g (2006) (These experts are traditionally accountants, auditors, and lawyers who play an active role in preparing the registration statement).
In 1977, the Commission published a concept release addressing whether or not it would be appropriate to subject an NRSRO to the consent requirements under Section 7, which would subject the NRSRO to liability under Section 11. In that release, the SEC also announced its consideration to now permit disclosure of credit ratings in official documents filed with the SEC. NRSROs indicated they would not consent to being named in the registration statement due to uncertainty over the scope of liability. In a 1981 concept release, the SEC announced a shift in pre-existing policies to permit inclusion of credit ratings in registration statements. The SEC also proposed Rule 436(G), providing that NRSROs would not be subject to Section 11 liability for inclusion of their credit ratings in a registration statement. The SEC enacted Rule 436(G) to allow issuers to include NRSRO credit ratings in their registration statements, while allaying the NRSROs fear of increased liability for inaccurate ratings. The SEC knew of the practical limits facing issuers seeking NRSRO consent to inclusion of their ratings in registration documents. At that time, the SEC felt that NRSROs were already subject to sufficient liability under the antifraud provisions of the securities laws. In 1982, the SEC officially enacted rule 436(G).

In 2009, the SEC issued a concept release seeking comment on the potential effects flowing from the rescission of Rule 436(G). The SEC cited four primary reasons in support of rescinding Rule 436(G): (i) historical shift in the need for 436(G);
(ii) investor reliance on "expert" NRSRO assessment; (iii) investor protection and greater NRSRO accountability; and (iv) elimination of the distinction between NRSROs and non-NRSRO credit rating agencies. The SEC noted that, because disclosure of credit ratings would now be required in registered documents, the rationale of encouraging disclosure of credit ratings cited when the rule was first passed was no longer relevant. The SEC received both positive and negative feedback on the possible rescission of Rule 436(G). Those in support of the rescission of the rule argued that rating agencies have managed to escape accountability for inaccurate ratings as a result of their preclusion from liability under Rule 436(G). Supporters of rescinding Rule 436(G) liken ratings to other "expert" opinions subjected to Section 11 liability, such as legal assessments or audit reports. The rating agencies predictably provided negative feedback on the proposed rule change. Moody's highlighted that, unlike all other experts subject to Section 11 liability, rating agencies do not participate in the preparation of the registration statement, nor do they certify any representations made by the issuer. Moody's also cautioned that increased exposure to liability could force rating agencies to supply rating services exclusively to more capitalized and creditworthy issuers that are more capable of absorbing the increased built-in costs and less

121. See id. at 53,117-18.
122. See id. at 53,117.
124. See id.
125. See id.
likely to default, thus limiting the ability of small to medium size firms to obtain access to credit markets through the public offering mechanism.\textsuperscript{128}

Although there is no direct statement by the SEC as to why they declined to rescind Rule 436(G) following their concept release, it is likely they wanted to avoid a potential freeze in the issue of securities requiring NRSRO rating and consent, which rating agencies said they would be unwilling to provide given the uncertainty over their potential liability under Section 11.\textsuperscript{129} They may have also desired to let Congress take action regarding an expansion of NRSRO liability as “experts,” as they gladly did with the inclusion of Section 939G in Dodd-Frank.\textsuperscript{130}

B. Dodd-Frank and the Rescission of Rule 436(G)

Congress mandated a broad range of new regulatory measures pertaining to credit rating agencies in Dodd-Frank.\textsuperscript{131} This comprehensive law covers several functions and problems with credit rating agencies such as: conflicts of interest in the issuer-pays model, the need for increased accountability for inaccurate ratings, and greater transparency in the ratings process.\textsuperscript{132} This Note, however, will focus primarily on the rescission of SEC Rule 436(G) and the corresponding expanded liability for rating agencies.\textsuperscript{133} Section 939G of Dodd-Frank provides that Rule 436(G) of the Securities Act of 1933 “shall have no force or effect,” meaning that rating agencies can now be held liable as “experts” for false or misleading ratings that could have been avoided with a reasonable investigation.\textsuperscript{134}

\begin{enumerate}
\item 128. See Sharma, \textit{supra} note 126.
\item 131. See generally id. sec. 932, § 15E (to be codified at 15 U.S.C. 78o-7) (outlining several new regulatory goals and mandates applying to credit rating agencies and their employees).
\item 132. See id.
\item 133. Dodd-Frank Act § 939G, 124 Stat. at 1890.
\item 134. Id.
\end{enumerate}
Congress found the services of rating agencies to be "fundamentally commercial in nature," and therefore, should be subject to the same standards of liability imposed upon auditors, securities analysts, and investment bankers. In a June 15, 2010 House-Senate Conference Committee Hearing, lawmakers weighed the pros and cons of rescinding Rule 436(G) and holding NRSROs to a higher standard of liability for inaccurate credit assessments. Proponents of the change felt that asking rating agencies not to be grossly negligent in making credit assessments seemed a fair burden to place on rating firms. Supporters of the rescission also pointed to an Investors Working Group study stating that the rescission of Rule 436(G) would make NRSROs more accountable for their ratings and increase their diligence in performing their credit risk analysis. Rep. Mary Jo Kilroy (D-Ohio) presented data on the overwhelming number of previously AAA-rated securities backed by subprime mortgages rated in 2007 that have now been downgraded to junk status. Opponents of the change accurately predicted the refusal by NRSROs to permit their ratings to be used in registration statements and SEC filings. In particular, Senator Christopher Dodd posited that NRSROs refusal to consent to inclusion of their ratings would inevitably result in less information for investors, which runs counter to the primary aims of the goals of Dodd-Frank.

Section 933 of Dodd-Frank will also loosen the pleading standards in any future fraud action investors might pursue against rating agencies. The new standard provides that pleading the requisite state of mind now requires showing that the rating

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137. *Id.* at 74 (statement of Rep. Mary Jo Kilroy).
139. *Id.* (statement of Rep. Mary Jo Kilroy) (indicating that junk status is below a BBB- rating).
140. *Id.* at 70-71 (statement of Rep. Jeb Hensmarling).
142. *Dodd-Frank Act § 933* (to be codified at 15 U.S.C. § 78u-4(b)(2)).
agencies “knowingly or recklessly” failed to base their ratings on reasonable investigations or verifications of the issuer-supplied data from independent sources. Section 933, in conjunction with the repeal of Rule 436(G) in Section 939G, will potentially make rating agencies more vulnerable than ever to civil liability for inaccurate ratings.

C. Rating Agencies’ Short Term Reactions

Rating agencies responded to the increased exposure to civil liability by refusing to allow their ratings to be used in the issuance of new financial products. Though the SEC avoided a standstill in the asset-backed securities marketplace with their no-action letter to Ford Credit, they will evaluate the best course of action in relation to Rule 436(G) and heightened liability standards for rating agencies. The repeal of SEC Rule 436(G) has also led rating agencies to modify their contractual arrangements with issuers of debt securities in an attempt to further insulate themselves from exposure to liability from aggrieved investors.

Moody’s use of indemnification clauses in its contracts with bond and security issuers exemplifies one tool rating agencies may use in the future to harbor themselves from civil liability. Moody’s claim the use of indemnification clauses in their engagement letters with issuers is not a new practice. However, the extent to which NRSROs are now seeking indemnification appears greater than it had been prior to the enactment of Dodd-Frank. Rating agencies are now including much stronger

143. Id. § 933(b)(2)(B).
144. Id. § 939G.
147. See Joyce, supra note 6.
149. See id.
150. See id. (commenting on the effect of increased liability for ratings in Dodd-Frank on rating agencies’ willingness to be named in registration statements, thus exposing themselves to greater potential liability).
language in their indemnification clauses with issuers, detailing all of the legal costs and damages they would recover from issuers in the event of a civil suit arising in relation to their credit rating within a registration statement.\footnote{151} We have yet to see all of the fallout from Dodd-Frank, but it is likely that rating agencies will continue to avoid liability, leading to a potential freeze in the issue of new securities requiring their NRSRO seal of approval should the SEC ever decide to end its no-action position.\footnote{152}

V. FALLOUT FROM THE RESCISSION OF SEC RULE 436(G) IN JANUARY OF 2011

\subsection*{A. Stagnant Bond and Asset-Backed Securities Markets}

Congress intends for the rescission of SEC Rule 436(G) to make ratings agencies more accountable for failures to perform due diligence, ultimately rebuilding investor confidence in NRSRO ratings and securities markets.\footnote{153} However, after Dodd-Frank, rating agencies refused to consent to use of their ratings in new bond issuances.\footnote{154} NRSRO refusal to consent to use of ratings in prospectuses and initial security offerings restricted the market for asset-backed securities because the SEC requires these financial products to have NRSRO ratings included in their official documents.\footnote{155} Fed Chairman Ben Bernanke voiced his concern that this development could further stifle access to sources of credit that is already difficult for private enterprise to secure in the present conservative marketplace.\footnote{156}

\begin{footnotes}
\item[152] See Nov. SEC Order, supra note 10 (referencing and extending the July 22, 2010 no-action letter issued on behalf of Ford Credit to the benefit of all issuers of asset-backed securities).
\item[154] Nov. SEC Order, supra note 10.
\item[156] See Kevin Carmichael, One day in, Wall Street Overhaul Hits First Snag, GLOBE ADVISOR.COM (July 23, 2010), https://secure.globeadvisor.com/servlet/ArticleNews/story/gam/20100723/FINALECONOMYBERNANKEATL.
\end{footnotes}
Due to the NRSROs' unwillingness to consent to inclusion of their ratings in registration statements, the Ford Motor Credit Company found itself unable to comply with Regulation AB in relation to a new issuance of asset-backed securities. On July 22, 2010, Ford Motor Credit Company issued a written request to the SEC to not recommend enforcement for their failure to include ratings in their offering statements for a temporary time period. To facilitate continued offerings of asset-backed securities, the SEC issued a no-action letter that stated they would not recommend enforcement action should an asset-backed issuer omit the requisite rating disclosures from their registration statements. The SEC initially slated this temporary relief to expire on January 24, 2011. However, on November 23, 2010, the SEC decided to extend the no-action position until further notice so that it may assess the regulatory actions needed to fulfill the goals of Dodd-Frank. In support of this decision, the SEC acknowledged that had it not extended this relief, NRSROs would not grant consent for their ratings to be included in registration documents or prospectuses, rendering it impossible for offerings of asset-backed securities to continue through registered channels.

Part of the rationale supporting the SEC's decision to extend no-action relief to asset-backed issuers stems from the desire for these offerings to take place in the registered markets, rather than through private market channels. NRSROs would consent to inclusion of ratings used in offerings used in private transactions, but not in those registered through the SEC, since private offerings are exempt from Regulation AB requirements.

158. Id.
159. Id.
160. Id.
161. Nov. SEC Order, supra note 10 (referencing and extending the July 22, 2010 no-action letter issued on behalf of Ford Credit to the benefit of all issuers of asset-backed securities).
162. Id.
164. See Shrivastava, supra note 129; ORRICK, HERRINGTON & SUTCLIFFE LLP, FINANCIAL MARKETS UPDATE: SEC ADOPTS DODD-FRANK IMPLEMENTING
Meredith Cross, director of the SEC’s division of corporate finance, stressed that the SEC felt better about allowing these offerings to continue on registered markets as opposed to through private channels.\(^{165}\) In a June 16, 2010 press release, Standard and Poor’s stated that, should Congress repeal Rule 436(G), it would explore alternative avenues outside the registration statement to continue supplying ratings for use in debt markets.\(^{166}\) Permitting these offerings to move to the more expensive private market would eliminate the protections afforded to investors through SEC oversight, a result the SEC would like to avoid given the exigency for investor protection following the recent financial crisis.\(^{167}\)

**B. Inefficient Allocation of Resources**

Elevating credit agency liability for inaccurate ratings will increase the time and effort necessary to rate a new security, delaying the issue of securities requiring NRSRO ratings from reaching the market.\(^{168}\) In light of their new exposure to liability, rating agencies will likely devote additional resources to lawyers and analysts so they may find an optimal method to continue providing rating services in the face of increased liability for their credit assessments.\(^{169}\) Standard and Poor’s noted elevated liability will force litigation costs onto rating agencies, even if they are ultimately successful in their defense.\(^{170}\) Rating agencies will likely pass the increased transaction costs on to their customers, thereby increasing the overall cost of rating services and potentially diverting resources away from producing quality ratings.\(^{171}\)

Exposing the NRSROs to increased liability seems unfair for those agencies performing the appropriate level of diligence in making their rating determinations. Because investment-grade

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\(^{165}\) Mulholland, *supra* note 163.

\(^{166}\) Shrivastava, *supra* note 129.

\(^{167}\) *See* id.

\(^{168}\) *See* Joyce, *supra* note 6.

\(^{169}\) *See* Mulligan, *supra* note 29, at 1297.

\(^{170}\) *See generally* Sharma, *supra* note 126.

\(^{171}\) *See* Mulligan, *supra* note 29, at 1297.
ratings are optimistic "forward-looking opinions" on credit default risk, rather than guarantees of repayment, investors with the advantage of hindsight may be able to sue NRSROs for honestly determined ratings prove inaccurate.\textsuperscript{172} Moody's highlighted its concern that the crutch of a civil remedy may further decrease investor due diligence and increase reliance on credit ratings.\textsuperscript{173} Fear of civil liability may impel rating agencies to take greater care and time in making their initial rating determination, thereby reducing the benefit of their services to disseminate credit risk information quickly to market participants.\textsuperscript{174} In addition, Standard and Poor's has indicated it may respond by undervaluing initial credit default assessments; a tactic it feels will give it a greater cushion to avoid litigation and downgrades.\textsuperscript{175} Increased regulatory oversight of the NRSROs would encourage greater accuracy and transparency in the rating process without unduly limiting the ability of NRSROs to efficiently disseminate their ratings to the investing public and keep credit markets flowing.\textsuperscript{176}

\textbf{C. Unintended Impediment to New Rating Agencies}

Although it is undisputed that the threat of liability could impel rating agencies to provide more accurate ratings to investors, rescission of Rule 436(G) may disproportionately hinder the progress of smaller credit rating agencies that already face an uphill battle for market share against the dominance of the Big Three.\textsuperscript{177} Rescission of SEC Rule 436(G) means that both

\textsuperscript{172} \textit{Standard and Poor's Definitions}, supra note 47.

\textsuperscript{173} See Madelain, supra note 123, at Sec. F (stating that investors with knowledge of a civil remedy safety net will foster even greater over-reliance on ratings -- precisely what lawmakers have stated they would like to diminish).

\textsuperscript{174} See generally Sharma, supra note 126 (indicating that since NRSROs are not involved in the structuring of the registration statement as are other experts, they are not capable of providing a timely due diligence review of the registration document to shield themselves from the liability arising from their consent to be named as an expert).

\textsuperscript{175} See id.

\textsuperscript{176} See infra Part V.D.

\textsuperscript{177} \textit{Government Accountability Office Report to Congressional Committees}, GAO-10-782, \textit{Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures} 75 (2010) (reporting that newer rating agencies may need years to build reputational capital with institutional investors and reference to specific NRSROs in private contracts
NRSROs and ratings agencies that are not NRSROs will face the same potential liability under Section 11 of the Securities Act in connection with any of their ratings used in official registration statements. Thus, smaller rating agencies with fewer resources may not be able to afford the transaction costs of drafting indemnification agreements or defending their rating decisions in protracted civil suits.

D. Alternative Solution: Increase Regulatory Oversight

Rather than miring down the securities market by threatening NRSROs with private rights of action for inaccurate default risk assessments, lawmakers should focus their regulatory efforts on Dodd-Frank's broad grant of power to the SEC. In conjunction with the rescission of SEC Rule 436(G), Dodd-Frank also grants the SEC far greater regulatory authority to ensure NRSRO compliance with the main goals of the Act: transparency and accountability.

Dodd-Frank establishes a new SEC Office of Credit Ratings to administer prospective rules pertaining to NRSROs. Dodd-Frank grants broad rule-making authority to this new arm of the SEC to "issue such rules as may be necessary to carry out this section." The Office of Credit Ratings is to administer annual examinations of each NRSRO to determine whether or not to assess penal action for failure to comply with any of the goals of Dodd-Frank. Through the Office of Credit Ratings, the SEC could protect investors by maintaining its no-action position with respect to the issuance of asset-backed securities, thereby refusing to expose NRSROs to heightened liability standards for their also prevents market penetration).

179. Id. at 53,118.
183. Id. § 15E(p)(4)(B).
inaccurate ratings. An effective government watchdog with the power to assess monetary fines and NRSRO registration-stripping sanctions for inaccurate ratings should supplant increased liability for NRSROs that would simply clog up dockets with a multitude of incensed investors looking to recover for their losses on inaccurately rated financial products. Unlike civil lawsuits, which only provide retroactive penalties, increased regulatory oversight provides constant surveillance intended to prevent unethical rating practices before they can harm investors. Regulatory fines for irresponsible rating practices provide an efficient substitute for civil liability by allowing for swifter penal action while preventing potential lawsuits from further crowding court dockets.

VI. CONCLUSION

Instead of opening up the courtroom doors to aggrieved investors looking to recover against the rating agencies for detrimental reliance on ratings that resulted in failed investments, regulators should look for ways to increase oversight and transparency as a means to hold rating agencies more accountable for their ratings. This would serve the dual purpose of both insulating investors from inaccurate and careless ratings made by rating agencies and preventing credit markets from suffocating in a cloud of litigation. To facilitate credit access to issuers of asset-backed securities, the SEC should maintain their no-action position until such a time that either Regulation AB has been amended or Dodd-Frank has been amended to exclude section

186. See id. § 932(a)(8).
187. Id. § 932(a)(8).
188. See DAVIS POLK & WARDELL LLP, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 75 (Jul. 21, 2010), available at http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf.
189. See Black, supra note 85, at 77 (“For too long, policymakers have thought that some investors are so smart that regulators should not stand in their way, for fear of stifling innovation and investment opportunities.”).
190. See Mulligan, supra note 29, at 1305.
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939G, thus repealing of SEC Rule 436(G). Otherwise, rating agencies have made it clear they will not consent to be named as "experts" and supply their required rating for the registration statement. Until such a time that lawmakers can extricate rating requirements from registration statements, the rating agencies will undoubtedly use their leveraged position as the de facto "gatekeeper" to the marketplace to ensure the continuation of the SEC's no-action position.

The Office of Credit Ratings within the SEC, once staffed, will wield the power to assess monetary penalties on rating agencies for irresponsible rating practices. This should provide rating agencies with a clear incentive to issue more objective and accurate default predictions, and hinder their ability to pump out inflated ratings to appease their client issuers and maximize market share. Credit rating agencies should not be punished merely because their ratings turn out to be "wrong," rather, they should be held accountable for failure to make a good faith effort to calculate a reasonably accurate assessment of default risk using relevant and impartial data. Congress must follow through on Dodd-Frank's commitment to investor protection by approving SEC funding to establish and staff the new Office of Credit Ratings.

The "Big Three" are deeply embedded in the operation of global financial markets due to regulatory reliance on their credit ratings. Their "AAA" stamp of approval provides access to a multitude of investments and investors within financial markets.

192. Id.
194. See Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act: Dates to be Determined, SEC (Dec. 02, 2010), http://www.sec.gov/spotlight/dodd-frank/dates_to_be_determined.shtml [hereinafter SEC.gov Dates TBD] (listing the creation of the Office of Credit Ratings as one of several SEC activities that have been temporarily put on hold for budgetary reasons).
196. See id.
197. See SEC.gov Dates TBD, supra note 194.
198. See Mulligan, supra note 29, at 1304-05.
199. See Hosp, supra note 37, at 553 (highlighting the regulatory encouragement of
Because the "gatekeeper" function of the rating agencies does not seem to have a viable replacement in the short term, regulators must increase their efforts to adhere to the commitments made in the body of Dodd-Frank – to increase the regulation, accountability, and transparency of NRSRO operations.\textsuperscript{200}

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\textsuperscript{200} See Dodd-Frank Act, sec. 932, §15E (to be codified at 15 U.S.C. § 78o-7).