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Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability

Jeffrey Manns

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RATING RISK AFTER THE SUBPRIME MORTGAGE CRISIS: A USER FEE APPROACH FOR RATING AGENCY ACCOUNTABILITY*

JEFFREY MANNS**

This Article argues that an absence of accountability and interconnections of interest between rating agencies and their debt-issuer clients fostered a system of lax ratings that provided false assurances on the risks posed by subprime mortgage-backed securities and collateralized debt obligations. It lays out an innovative, yet practical pathway for reform by suggesting how debt purchasers—the primary beneficiaries of ratings—may bear both the burdens and benefits of rating agency accountability by financing ratings through a Securities and Exchange Commission (“SEC”)-administered user fee system in exchange for enforceable rights. The SEC user fee system would require rating agencies both to bid for the right to rate debt issues and to assume certification and mandatory reporting duties to creditors. The Article suggests that empowering creditors to seek capped damages against rating agencies for gross negligence, while reserving enforcement discretion with the SEC to pursue negligence actions, would create incentives for rating agency compliance, yet pose a manageable burden.

INTRODUCTION	1013
I. THE POTENTIAL FOR BENEFICIARIES TO HEIGHTEN GATEKEEPER ACCOUNTABILITY	1019
A. <i>The Potential and Challenges of Gatekeepers</i>	1019
1. The Appeal of Enlisting Gatekeepers	1019
2. The Challenges Posed by Gatekeeper Responsibility Without Accountability	1022
3. The Limits of Public Oversight of Gatekeepers	1024
B. <i>Creating Accountability Between Gatekeepers and Their Beneficiaries</i>	1026

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1.	The Potential Contours of Private Monitoring of Gatekeepers	1026
2.	How Beneficiaries of Screening Roles May Be Enlisted to Hold Gatekeepers Accountable	1029
3.	The Virtues of a User Fee Approach.....	1031
4.	The Purpose Behind Capped, Enforceable Rights Against Gatekeepers.....	1033
II.	THE NEED FOR RATING AGENCY ACCOUNTABILITY.....	1035
A.	<i>The Significance of Rating Agencies</i>	1035
B.	<i>The Distinctiveness of Ratings</i>	1036
C.	<i>The Prominent Role of Rating Agencies in Recent Financial Crises</i>	1038
1.	The Role of Rating Agencies in Legitimizing Subprime Debt Instruments.....	1040
2.	The Culpability of Rating Agencies in the Subprime Mortgage Crisis.....	1043
D.	<i>Responsibility Without Accountability in the Rating Agency Context</i>	1047
1.	The Absence of Reputational Constraints	1048
2.	The Market Power of Rating Agencies	1050
3.	The Inherent Conflicts of Interest in Relationships Between Rating Agencies and Issuers.....	1052
4.	The Use of Unsolicited Ratings to Induce Issuer Loyalty	1053
5.	The Virtual Immunity Enjoyed by Rating Agencies	1054
E.	<i>Agents in Search of a Principal</i>	1056
1.	The Federal Government's Role in Transforming Issuers into Nominal Principals	1056
2.	2006 Legislation: A Failed Attempt to Make the SEC the Locus of Accountability	1057
3.	The Plight Facing Creditors	1058
III.	A USER FEE APPROACH TO HEIGHTEN RATING AGENCY ACCOUNTABILITY.....	1059
A.	<i>The Desirability of Preserving Ratings as a Public Good</i>	1059
B.	<i>The Merits of a User Fee Approach</i>	1061
1.	The Contours of an SEC-Administered User Fee System.....	1061
2.	The Tradeoff Between Price Competition Bidding and Cost-Based Government Contracting	1063
3.	The Creditor Committee Complement to a User Fee System	1066

IV. CRAFTING RATING AGENCY DUTIES	1069
A. <i>Redefining Accountability for Rating Agencies</i>	1069
1. The Challenges of Delineating Rating Agency Duties	1069
2. The Scope of a Certification Requirement	1071
3. The Extent of Mandatory Reporting Requirements	1074
B. <i>Oversight Under a Gross Negligence Approach Tempered by Caps and Safeguards</i>	1076
1. The Appeal of Limiting Liability to Gross Negligence	1076
2. Capping Liability Exposure as a Multiple of Rating Agency Fees	1080
3. The Enforcement Roles of Creditor Committees and the SEC	1082
C. <i>The Incentive Effects of Applying Rating Agency Duties to the Subprime Debt Context</i>	1084
CONCLUSION	1089

INTRODUCTION

The subprime mortgage crisis has sparked scrutiny about how rating agencies—the gatekeepers of credit risk—compromised their duties by failing to ring warning bells about a bubble market.¹ A host of private actors also shoulder blame for excessive risk taking and deception. For example, mortgage brokers granted millions of adjustable rate mortgages to high-risk borrowers; commercial and investment banks issued trillions of dollars of subprime residential mortgage backed securities (“RMBS”) and collateralized debt obligations (“CDOs”) that camouflaged the actual risks;² and

1. See, e.g., Allen Ferrell et al., *Legal and Economic Issues in Litigation Arising from the 2007–2008 Credit Crisis* 37–53 (Harvard Law Sch., Harvard Law & Econ. Discussion Paper Series, Paper No. 612, 2008), available at <http://ssrn.com/abstract=1096582> (discussing the legal issues surrounding the extensive subprime litigation, such as Rule 10b-5 actions against banks, ERISA litigation, and litigation against rating agencies); cf. John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1408–09 (2002) (arguing that “the collective failure of the gatekeepers” lay at the heart of the accounting scandals); Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 81 WASH. U. L.Q. 403, 403–07 (2003) (arguing that securities gatekeepers fail the public by not adequately screening for corporate wrongdoing).

2. RMBS and mortgage-based CDOs are debt obligations based on large pools of mortgage loans whose cash flows are based on principal and interest payments from the underlying mortgages. Approximately \$1.7 trillion worth of subprime RMBS were issued from 2001 to 2006. See Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit 2* (Wharton Fin. Inst. Ctr., Working Paper No. 07-43, 2008), available at <http://ssrn.com/abstract=1071189>. The dollar values of subprime

purchasers of these instruments relied excessively on ratings³ as proxies for risk.⁴

What distinguishes the culpability of rating agencies from that of other private actors is that federal and state statutes and regulations deputized rating agencies as gatekeepers by formally recognizing their public role⁵ and mandating that issuers meet rating thresholds to sell debt in a myriad of markets, such as to money market or pension funds.⁶ This Article focuses on how an absence of accountability and interconnections of interest between rating agencies and their clients, issuers of debt, led rating agencies to abrogate their responsibilities as screeners of credit risk. As a result, rating agencies failed to nip the bubble market of subprime debt in the bud. Ratings agencies not only did not identify risks to particular issuers and credit markets as a whole at an early stage, but also did not condition investment-grade ratings on higher levels of diligence

CDOs are harder to pinpoint because of less transparency, but JP Morgan has estimated that over \$600 billion in subprime CDOs were issued over this period. See Jenny Anderson & Heather Timmons, *Why a U.S. Subprime Mortgage Crisis is Felt Around the World*, N.Y. TIMES, Aug. 31, 2007, at C1.

3. Credit ratings serve to indicate relative gradations of risk for credit instruments such as bonds and derivatives. Each rating agency has its own distinctive methodology for making risk assessments and employs their own set of letters and additional signals for indicating the extent and nature of credit risks. See Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 620, 648 n.139 (1999); *infra* Part II.A.

4. See, e.g., Vikas Bajaj, *If Everyone's Fingerpointing, Who's to Blame?*, N.Y. TIMES, Jan. 22, 2008, at C1 (discussing the myriad of suits and countersuits filed among the parties involved in the subprime mortgage crisis); Stuart M. Turnbull et al., *The Subprime Credit Crisis of 07*, at 8–19 (July 9, 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1112467> (discussing the array of market participants who have potential culpability for the subprime mortgage crisis).

5. See Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327–29 (codified in scattered sections of 12, 15, 20, and 23 U.S.C.) (laying out the process for rating agencies to be certified as a Nationally Recognized Statistical Rating Organization (“NRSRO”)).

6. See, e.g., Regulation S-K, 17 C.F.R. § 229.10(c)(1)(i)(A) (2008) (mandating ongoing NRSRO ratings for issuers making filings under the Securities Act of 1933 and the Securities Exchange Act of 1934); see also Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Securities Act Release No. 8236, Exchange Act Release No. 47,972, Investment Company Act Release No. 26,066, 68 Fed. Reg. 35,258, 35,258 (June 12, 2003) [hereinafter SEC Concept Release] (discussing how since 1975 the SEC “has relied on credit ratings from market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the Federal securities laws”); Org. for Econ. Co-Operation & Dev., *Selected Principles for the Regulation of Investments by Insurance Companies and Pension Funds*, 75 FIN. MARKET TRENDS 117, 120 (2000) (noting the ratings requirements for money market funds, insurers, and pension funds to purchase debt securities).

and disclosures by issuers.⁷ This Article lays out an innovative, yet practical pathway to reform by proposing the creation of an SEC-administered user fee system that will enlist the purchasers of corporate debt—the primary beneficiaries of credit risk assessments—as self-interested monitors of rating agencies and complements to SEC oversight.⁸

This Article argues that the challenges of rating agency accountability reflect an inherent conflict posed by interconnections of interest between ratings agencies and their commercial clients and the disconnect between ratings agencies and beneficiaries of their screening roles.⁹ The sole legal and financial relationship that ratings agencies face is with issuers of debt who benefited from systematically lax ratings on subprime debt instruments.¹⁰ In contrast, purchasers of debt, who relied on ratings as proxies of risk in purchasing RMBS and

7. A broad literature has explored enlisting private gatekeepers to perform public enforcement functions. See, e.g., John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308–09 (2004) (describing a gatekeeper as a “reputational intermediary” who “receives only a limited payoff from any involvement in misconduct” compared to the primary wrongdoer); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53, 63 (2003) (defining gatekeepers as parties who “offer a service or sell a product that is necessary for clients wishing to enter a particular market or engage in certain activities”); Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1050–54 (1993) (describing gatekeepers as actors who provide indispensable, or at least extremely useful, services to the targeted wrongdoers, have similar monitoring capacities, and who cannot easily be replaced by wrongdoers); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) (defining gatekeepers as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers”). This Article understands gatekeepers as private actors whose role as suppliers or consumers of lawful goods or services provides them with the cost-effective ability to detect and potentially prevent wrongdoing.

8. Numerous academics have chronicled the SEC’s shortcomings as a regulator, which arguably contributed to the subprime mortgage crisis. See, e.g., Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 21–36, 40–41 (2003) (discussing the behavioral biases within the SEC that limit the agency’s efficacy as a regulator); John C. Coffee & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?* 30 (Columbia Law and Econ. Working Paper No. 342, 2009), available at <http://ssrn.com/abstract=1309776> (arguing that “the SEC was an ineffective monitor of leverage and risk management policies at financial institutions under its jurisdictions” from at least 1990 through the subprime mortgage crisis). In spite of the SEC’s shortcomings, this Article seeks to enlist the SEC (or a subsidiary agency or division) as the administrator of the user fee system, because the SEC already oversees rating agencies and therefore has relevant experience to build on in implementing expanded responsibilities. See generally Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-29, 120 Stat. 1327 (codified in scattered sections of 12, 15, 20, and 23 U.S.C.) (bolstering SEC regulation of credit rating agencies).

9. See *infra* Parts II.C–D.

10. See *infra* Parts II.B–C.

CDOs, have neither a role in the ratings process nor any means to hold rating agencies accountable for their failures.¹¹

The Securities and Exchange Commission has recognized the shortcomings of rating agencies.¹² But instead of tackling the challenges of rating agency accountability, the SEC has embraced a policy of caveat emptor for risk management by proposing new rules that would scale back requirements for issuers to secure ratings in order “to reduce undue reliance on credit ratings.”¹³ The SEC’s proposal ironically ignores the virtues of centralized risk management at a time when the current crisis has underscored the significance of the detection and preemption of excessive risk taking in financial markets.¹⁴

11. See Yalman Onaran, *Banks’ Subprime Losses Top \$500 Billion on Writedowns*, BLOOMBERG NEWS, Aug. 12, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8sW0n1Cs1tY> (discussing the over \$500 billion in writedowns and credit losses from the subprime mortgage crisis).

12. The SEC has recently proposed modest changes that seek to increase transparency in the ratings process and to curb some of the most abusive rating agency practices that fueled the subprime mortgage crisis. Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57,967, 73 Fed. Reg. 36,212 (June 19, 2008) (to be codified at 17 C.F.R. pts. 240, 249b), *available at* <http://www.sec.gov/rules/proposed/2008/34-57967.pdf>; SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 4–5 (2008), *available at* <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

13. References to Ratings of Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-58070, 73 Fed. Reg. 40,088, 40,088 (July 1, 2008) (to be codified at 17 C.F.R. pts. 240, 242, 249), *available at* <http://www.sec.gov/rules/proposed/2008/34-58070.pdf> (proposing the removal of some formal requirements for NRSRO ratings within rule and form requirements under the Securities Act of 1933 and the Exchange Act). The SEC has proposed deemphasizing the significance of rating agencies by formally removing the requirement of NRSRO ratings in a variety of contexts. The premise of these changes is to make it clear that investors should not “place undue reliance on the credit ratings.” *Id.* at 40,089. The emphasis is on the word “undue” as regardless of whether these proposed rules are implemented the problem of rating agency accountability will still exist. Entrenched market practices of soliciting and relying upon ratings are likely to sustain the importance of ratings. *Id.*; see also References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Company Act Release No. 28,327, 73 Fed. Reg. 40,124, 40,124–42 (July 12, 2008) (to be codified at 17 C.F.R. pts. 270 and 275), *available at* <http://www.sec.gov/rules/proposed/2008/ic-28327.pdf> (proposing the removal of some formal requirements for NRSRO ratings under rules pursuant to the Investment Act of 1940 and Investment Advisers Act of 1940); Security Ratings, Exchange Act Release No. 8940, 73 Fed. Reg. 40,106, 40,106–24 (July 11, 2008) (to be codified at 17 C.F.R. pts. 229, 230, 239, 240), *available at* <http://www.sec.gov/rules/proposed/2008/33-8940.pdf> [hereinafter SEC 2008 Proposed Rules] (proposing to change rating requirements for money market funds and investment companies, as well as for registered asset-backed securities).

14. To date, the SEC has shied away from removing requirements for NRSRO ratings and has chosen not to implement this proposal. Instead, the SEC has opted to implement

This Article suggests how debt purchasers may shoulder both the burdens and benefits of gatekeeper accountability by financing an SEC-administered user fee system as a quid pro quo for enforceable rights, yet shows how caps on liability and other safeguards would make gatekeepers' duties manageable.¹⁵ This Article suggests how the SEC would use the proceeds of a user fee imposed on debt purchasers to finance a bidding process in which rating agencies would compete to rate debt issues.¹⁶ Price competition among

its more modest proposed rules designed to reduce conflicts of interest and to heighten transparency of rating agencies' methodologies. See *SEC Issues Rules on Conflicts in Credit Rating*, N.Y. TIMES, Dec. 3, 2008, <http://www.nytimes.com/2008/12/04/business/economy/04sec.html>.

15. Other authors have recognized the shortcomings of rating agencies as gatekeepers. However, this Article is the first to make the case for a user fee approach that seeks to heighten accountability by shifting rating agency duties from issuers to creditors. See, e.g., Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 82-93 (2004) (advocating reduced barriers to entry to encourage new entrants into the ratings industry and arguing against greater government oversight of rating agencies); Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10, 24 (2006) (arguing "that credit rating agencies simultaneously enjoy great success while providing no information of value to the investing public" because "the SEC inadvertently created an artificial regulatory demand for the services of a small number of favored rating agencies when it misguidedly invented the NRSRO designation"); Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65, 74-79 (Richard M. Levich et al. eds., 2002) (emphasizing the government's role in making rating agencies central actors in the securities process and arguing that rating agencies do not serve as effective gatekeepers of credit risk); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 989-91 (2006) (discussing how rating agencies' lax approach fueled each stage of the subprime mortgage crisis and arguing for greater SEC oversight); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 12-21 (arguing that additional regulation of rating agencies by the SEC is unnecessary and probably inefficient because it poses risks of political manipulation); Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* 34-47 (May 3, 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=1027475> (discussing the shortcomings of ratings in failing to reflect the risks of subprime debt instruments).

16. The logic of government-administered user fee systems is straightforward as it constitutes a quid pro quo in which payment of a user fee reflects receipt of a valued service. See, e.g., Clayton P. Gillette & Thomas D. Hopkins, *Federal User Fees: A Legal and Economic Analysis*, 67 B.U. L. REV. 795, 800-12 (1987) (discussing the rationale for creating user fees that facilitate economically efficient allocation of goods and services); Laurie Reynolds, *Taxes, Fees, Assessments, Dues, and the Get What You Pay For Model of Local Government*, 56 FLA. L. REV. 373, 381-82 (2004) (describing the broad range of functions in which governments employ user fees to fund and allocate resources to users who value the services the most); Hugh D. Spitzer, *Taxes vs. Fees: A Curious Confusion*, 38 GONZ. L. REV. 335, 343-51 (2003) (discussing the types of considerations that go into decisions to impose user fees rather than taxes). One alternative to a user fee system to finance gatekeepers would be to impose direct levies on corporations to fund voucher systems under which shareholders individually direct funding to their preferred

bidding rating agencies would be designed both to contain costs and to reduce barriers to entry into the highly concentrated ratings market by leveling the playing field for smaller competitors and new entrants. As importantly, the SEC would also require bidding rating agencies to detail the type and extent of diligence that they would commit to undertake (and/or to impose on issuers), and the SEC would enjoy discretion to condition bids on rating agencies meeting diligence thresholds. The user fee system would serve to create ongoing channels for the SEC and debt purchasers to shape the focus of rating agencies' efforts by bringing risk-related concerns to the attention of rating agencies.

The combination of a user fee system with the creation of rating agency duties to creditors would provide creditors with incentives to hold rating agencies accountable.¹⁷ This Article delineates certification and mandatory reporting duties for rating agencies that would expand and formalize the role of rating agencies as screeners of issuers' disclosures and as the backstop for auditor and lawyer gatekeeping duties.¹⁸ It suggests how limiting liability to creditors to cases of gross negligence, coupled with an earnings-based cap on liability exposure, will constitute a manageable burden for rating

intermediaries such as securities analysts and proxy advisory services to facilitate shareholder activism. See Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 317–23 (2003). As this Article will discuss in detail, the virtue of utilizing a user fee approach as a quid pro quo for enforceable rights against gatekeepers is that beneficiaries would directly internalize the burdens and benefits of gatekeeping and therefore have the clear self-interest in overseeing gatekeeping roles and holding gatekeepers accountable.

17. One temptation policymakers may face is the illusory appeal of creating a government entity that would assume the risk assessment role of private rating agencies. The public dimensions of rating agencies' screening role might make it seem logical to vest this role in a federal agency. However, a public rating agency would be exposed to significant risks of public capture by issuers. A case in point would be the downgrades of automobile companies' debt. While private rating agencies could exercise autonomy to issue downgrades, a public rating agency would likely face tremendous pressure from politicians not to downgrade automobile companies' debt for fear of jeopardizing their constituents' jobs. High-profile instances of capture could swiftly undermine a public rating agency's credibility. As importantly, private rating agencies serve an important political cover role as the threat of debt downgrades by private rating agencies gave politicians' stronger arguments for a multi-billion dollar bailout for automobile companies. See Bill Vlasic, *G.M., Teetering on Bankruptcy, Pleads for a Federal Bailout*, N.Y. TIMES, Nov. 12, 2008, at B1 (noting how rating agency downgrades gave greater urgency to GM's pleas for a federal bailout).

18. Rating agencies' duties could be framed as a product of creditors' contractual privity with the rating agencies under this Article's proposed user fee system or as the creation of a regulation or statute. Either means would advance the same end of crafting a new relationship of rating agency accountability to creditors. See *infra* Part IV.A.

agencies.¹⁹ Lastly, to ensure that this approach does not replace one problem with another by skewing incentives too much in favor of debt purchasers, this Article suggests empowering the SEC with exclusive enforcement discretion to pursue actions for informal sanctions in cases of rating agency negligence.²⁰

Parts I and II of this Article discuss the role that beneficiaries of screening roles may play in holding rating agencies accountable and highlight the absence of effective oversight of rating agencies under the current system. Parts III and IV lay out the contours of the user fee system and the related duties rating agencies would face and suggest how this approach would empower the SEC and creditors to serve as monitors of rating agency compliance.

I. THE POTENTIAL FOR BENEFICIARIES TO HEIGHTEN GATEKEEPER ACCOUNTABILITY

A. *The Potential and Challenges of Gatekeepers*

1. The Appeal of Enlisting Gatekeepers

Gatekeepers, such as rating agencies, serve as appealing substitutes for public enforcement because of their potential to

19. Application of a gross negligence standard would impose liability for rating agencies' failures to identify or engage in diligence of risks of such a nature and degree that the failure constitutes a gross deviation from a reasonable person's standard of care. See, e.g., *Tomczak v. Morton Thiokol, Inc.*, 1990 Fed. Sec. L. Rep. (CCH) ¶ 95,327, at 96,585 (Del. Ch. Apr. 5, 1990) (applying a gross negligence standard gross negligence to corporate directors to determine whether they have sufficiently informed themselves to receive deference under the business judgment rule).

20. Concerns about the political viability of this proposal are understandable given the skepticism that policymakers may have about the ability and willingness of rating agencies to fulfill their responsibilities. As Congressman Sarbanes argued, "why should we trust the same people who ignored these warnings to fix the problem in a way that means it's not going to happen going forward." *Credit Rating Agencies and the Financial Crisis: Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 95 (2008) (statement of Rep. John P. Sarbanes), available at <http://www.oversight.house.gov/documents/20081023162631.pdf> [hereinafter *Credit Rating Agencies and the Financial Crisis*]. For this reason, this Article's proposal does not merely seek to add new wine to old wineskins by focusing solely on reforming the dominant rating agencies. Instead, its focus is twofold: introducing greater competition by reducing the barriers to entry for small rating agencies, such as Egan-Jones, and for foreign rating agencies to compete in the U.S. market; and creating multiple layers of public and private oversight of rating agencies to ensure that rating agencies face more meaningful accountability. This roadmap to reform will not satisfy all critics. But it does offer a middle path for policymakers that avoids the inherent risks from either trusting in rating agencies' willingness to reform themselves or from removing requirements for ratings and relying on equally unfounded faith in the efficacy of caveat emptor for debt purchasers.

monitor clients cost-effectively for unlawful or deceptive uses of their goods or services. But as the discussion of the role of rating agencies in the subprime crisis will underscore, gatekeepers have proven equally adept at obfuscating client misconduct and subverting state-mandated gatekeeping duties in order to retain and expand their business. Policymakers have faced chronic difficulties in holding gatekeepers accountable, yet this Section suggests how it is possible to enlist the beneficiaries of gatekeepers' screening roles as self-interested monitors of gatekeepers and complements to public oversight and accountability.

Gatekeepers served as one of the earliest private enforcement tools for advancing public objectives as screeners for prospective wrongdoers at city gates. The modern analogues of literal gatekeepers may control "gates" inasmuch as they supply lawful goods or services that are also essential to perform types of illicit acts or are functionally necessary because of the high cost or drawbacks of alternatives.²¹ What makes gatekeepers a potentially potent enforcement tool is that they may be positioned to observe clients' use of their goods or services and to identify and/or prevent illicit or deceptive use of their services in a cost-effective way. For example, internet service providers may police against the transmission of child pornography; doctors may screen against prescription drug abuse, and securities gatekeepers, such as lawyers, auditors, and rating agencies, may scrutinize disclosures for evidence of corporate fraud or excessive risk-taking.²²

The defining characteristic of gatekeepers is their dual capacity: the services they offer may serve lawful ends, or they may enable

21. See Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 883 (1990) (arguing that a defining feature of a gatekeeper is that the targeted "misconduct cannot occur without the gatekeeper's participation"); Kraakman, *supra* note 7, at 54, 61–63 (arguing that "a specialized good, service, or form of certification that is essential for the wrongdoing to succeed—is the 'gate' that the gatekeeper keeps").

22. Other gatekeepers may create the demand that attracts prospective wrongdoers, such as employers whose attempts to depress wage levels may attract underage workers or undocumented aliens. See Jeffrey Manns, *Private Monitoring of Gatekeepers: The Case of Immigration Enforcement*, 2006 U. ILL. L. REV. 887, 941–44 ("Employers of low-wage workers and undocumented aliens share incentives to find ways around the substance of the verification requirements."). Similarly, American companies may foster illicit activity by outsourcing production facilities to firms in developing countries, which ("unbeknownst" to the American companies) abuse human rights to cut costs or bribe officials to aid their American clients. See H. Lowell Brown, *Parent-Subsidiary Liability Under the Foreign Corrupt Practices Act*, 50 BAYLOR L. REV. 1, 29–35 (1998) (laying out the scope of parent-subsidiary liability under the Foreign Corrupt Practices Act).

wrongdoers to pursue their illegal activity.²³ As a result, policymakers face an enforcement dilemma. Banning the goods or services at issue may cut off avenues for potential wrongdoing (or at least raise the price for wrongdoing by shifting activities underground), yet it comes at a prohibitive cost to both gatekeepers and their law-abiding clients. The government, however, may be ill-equipped to screen gatekeepers' clients for illicit activity in a more nuanced way due to limits in oversight capabilities coupled with resource constraints.

Gatekeepers have the potential to resolve this dilemma by serving as surrogates for public enforcement. Gatekeepers' roles as goods or services providers may give them control over "choke points" that allow them to identify and nip nascent signs of illicit activity in the bud. The ability to withhold goods or services may equip gatekeepers with leverage to demand nonpublic information from users of their services as a condition for access. Gatekeepers' specialized skills may allow them to process and recognize potential illicit activity in cost-effective ways.²⁴ In contrast, public enforcers may lack the ability even to identify prospective wrongdoers, let alone the capability to process information about potential wrongdoing, except at prohibitively high economic and social costs.

The obstacles to direct public enforcement of securities law make the potential of gatekeepers as substitutes for public enforcement particularly important.²⁵ The enormity of the SEC's mandate and the dearth of specialized skills and insider knowledge among SEC officials may make direct oversight of all but a small percentage of potential corporate actors practically infeasible and limit the efficacy

23. If gatekeepers merely provided or demanded illegal services, then their misconduct would fall under accomplice liability or conspiracy to commit criminal acts or civil wrongs. But the fact that the goods or services gatekeepers demand or supply can be used either legally or illegally places gatekeepers in a unique position as potential screeners of wrongdoing, yet makes their culpability more ambiguous.

24. For example, rating agencies may demand insider information as a condition for issuing or amending a rating, a necessary condition for issuing debt. See Kraakman, *supra* note 7, at 61–66 (discussing potential ways that private gatekeepers may complement public enforcement).

25. The more complex the activity, the more prospective offenders may enjoy an advantage over enforcers in obfuscating their activities, a fact which creates the need for gatekeepers. See Donald C. Langevoort, *Technological Evolution and the Devolution of Corporate Financial Reporting*, 46 WM. & MARY L. REV. 1, 3–16 (2004); see also Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 2–6, 18–20 (discussing how "the increasingly widespread problem of complexity" makes it difficult for public enforcers to regulate and oversee "virtually all securitization and derivatives deals and other forms of structured-financing transactions").

of SEC scrutiny even when it can be applied.²⁶ In contrast, the specialized services supplied by rating agencies, lawyers, and accountants provide them with systematic opportunities to detect, prevent, and/or alert the public about risky corporate conduct or fraud.²⁷

2. The Challenges Posed by Gatekeeper Responsibility Without Accountability

Securities gatekeepers have long claimed to serve the above mentioned roles in vouching for the legality and accuracy of their clients' actions to governments and private markets.²⁸ Two interrelated problems, however, make gatekeeping accountability difficult to sustain: interconnections of interest with clients and gatekeeper autonomy. An inherent conflict of interest arises from asking those who seek to serve their customers (and to woo more business) simultaneously to police their customers. The self-interest of gatekeepers may provide strong incentives for them to remain silent in the face of corporate wrongdoing, if not to be willfully complicit in their clients' illicit activity.

For example, while fees from a given company may constitute a small percentage of the revenues of a law firm or accounting firm, a single client may frequently account for the majority of the revenue stream for individual lawyers and auditors.²⁹ Incentive structures

26. For example, as of June 2007, the Securities and Exchange Commission had a staff of approximately 3,600 who "are responsible for overseeing over 10,000 publicly traded companies; over 10,000 investment advisers who manage over \$37 trillion in assets; nearly 1,000 fund complexes; 6,000 broker-dealers with 172,000 branches; and the \$44 trillion worth of trading that's conducted each year on America's stock and options exchanges." *Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 10 (2007) (statement of Christopher Cox, Chairman, SEC).

27. See, e.g., Coffee, *supra* note 7, at 308–09 (describing a gatekeeper as a "reputational intermediary" who "receives only a limited payoff from any involvement in misconduct" compared to the primary wrongdoer); Hamdani, *supra* note 7, at 63 (defining gatekeepers as parties who "offer a service or sell a product that is necessary for clients wishing to enter a particular market or engage in certain activities"); Jackson, *supra* note 7, at 1050–54 (describing gatekeepers as actors who provide "indispensable, or at least extremely useful," services to the targeted wrongdoers, have similar monitoring capacities, and who cannot easily be replaced by wrongdoers).

28. See Schwarcz, *supra* note 15, at 26 (arguing that rating agencies' "reputational motivation is sufficient" and that "[a]dditional regulation of rating agencies thus would impose unnecessary costs and thereby diminish efficiency").

29. See Coffee, *supra* note 7, at 322–23 (discussing how auditing firms as a whole may have a broad set of clients, but arguing that individual auditors who serve a large client such as Enron effectively have their economic interests interconnected with a single client).

within law and accounting firms magnify these interconnections of interest. Lawyers and auditors are frequently awarded a percentage of revenues earned from a client if they win the client's business or secure additional projects from the client, as well as a percentage of the revenues earned by other lawyers that they bring in to work for a given client. The combination of "origination" and "proliferation" credits that partners receive are designed to intertwine their economic interests with their firms, yet they also form a web that binds law and accounting partners more closely to their clients.³⁰ These interconnections of interest may heighten incentives for outright collusion, but the larger concern is that lawyers and auditors may face overwhelming incentives to engage in formalistic compliance with gatekeeper duties and to stand by as corporate wrongdoing takes place.

Autonomy has historically served as gatekeepers' answer to temptations posed by interconnections of interest with clients. Gatekeepers such as rating agencies, auditors, and lawyers have long professed that concerns for their reputations provide robust incentives for their integrity and accuracy in their screening roles and eclipse any short-term gains from turning a blind eye to client misconduct.³¹ As a result, securities gatekeepers have argued that autonomy from their clients is an affirmative good that testifies to their ability to reach independent judgments. Courts have routinely accepted gatekeepers' arguments that their reputations are their business and raised high bars to suits targeting gatekeeper misconduct.³²

30. See Ronald J. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313, 335–39 (1985) (laying out a theory explaining profit sharing incentives within law firms); William D. Henderson, *An Empirical Study of Single-Tier Versus Two-Tier Partnerships in the Am Law 200*, 84 N.C. L. REV. 1691, 1700–03 (2006) (noting the significance of origination and proliferation credit structures within law firms).

31. See, e.g., Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. LEGAL STUD. 295, 312 (1988) (arguing that the reputational costs that accountants may face from failing to detect wrongdoing provide them with adequate incentives to monitor their clients); see also *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (arguing that an accountant's concern for her reputation and exposure to potential loss would make collusion with her clients' accounting fraud irrational).

32. See, e.g., *Fidel v. Farley*, 2004 FED App. 0433P, ¶ 10, 392 F.3d 220, 232 (6th Cir.) (“[A]llegations that the auditor earned and wished to continue earning fees from a client do not raise an inference that the auditor acted with the requisite scienter.”); *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) (holding that allegation that an auditing firm would “put its professional reputation on the line by conducting fraudulent auditing work” in return for “fees for two years’ audits” is irrational).

Unfortunately, gatekeeper autonomy is an illusory virtue, which raises a larger problem of the absence of accountability to any public or private actor. As this Article's discussion of rating agencies will highlight, reputational constraints have waned amidst bubble markets, and broader shifts in the risk-seeking behavior of participants in financial markets have dampened the force of reputational constraints.³³ In the absence of effective reputational constraints, gatekeepers may face strong temptations to underinvest in fulfillment of their duties in order to bolster their profit margins. Alternatively, gatekeepers may shamelessly leverage their autonomy in order to extract greater revenues from their clients and tacitly or willfully abet potential wrongdoers in the process. If the government or private actors cannot hold autonomous gatekeepers accountable, gatekeeper independence may amount to nothing more than a shroud for seeking to extract supranormal profits from clients and sidestepping gatekeeping duties.

3. The Limits of Public Oversight of Gatekeepers

Policymakers face the challenge of how to induce private actors to perform public enforcement roles if reputational concerns do not suffice. The conventional solution is to impose liability for gatekeeper noncompliance and to focus public enforcement on monitoring gatekeepers rather than on their potentially wayward clients.³⁴ In theory, the SEC can more easily focus enforcement efforts on monitoring the compliance of securities intermediaries in order to provide these gatekeepers with incentives to perform oversight. Part of this logic turns on the greater deterrent effect of directing enforcement efforts at gatekeepers rather than on the targeted wrongdoers. For example, although rating agencies are quite profitable,³⁵ they receive a disproportionately small percentage of the fruits of issuer misconduct. Nonetheless, potential exposure to gatekeeper liability may force them to bear disproportionate exposure to a risk of loss.³⁶ Therefore, even a modest number of prosecutions may have substantial deterrence effects in encouraging rating agencies to be more vigilant in monitoring issuers. So long as

33. See Coffee, *supra* note 1, at 1408–09.

34. See Hamdani, *supra* note 7, at 63–64.

35. See Partnoy, *supra* note 3, at 654 (discussing how the operating margins of Moody's and S&P's are estimated to be approximately 30%, a significant return for any industry).

36. See Coffee, *supra* note 7, at 308–09.

gatekeepers have cost-effective ways to fulfill gatekeeping mandates, imposing gatekeeping duties may appear to be an attractive option.

Governments have understandably been enthusiastic about outsourcing enforcement functions to private gatekeepers because this approach promises to enhance enforcement while reducing direct state expenditures.³⁷ The problem is that the appeal of using the threat of liability to enlist gatekeepers belies the challenges that policymakers must confront in designing means for effective oversight of gatekeepers. The more complicated the activity that private gatekeepers are called to oversee, the more necessary the gatekeeping role may appear, yet the more difficult it may be for the government to oversee gatekeeper compliance.³⁸ Securities gatekeepers form a classic case in which the gatekeeping role may be essential for uprooting evidence of fraud or excessive risk-taking. However, imposing gatekeeper duties may merely replace one enforcement dilemma with another in raising the question of who watches the watchmen.³⁹

The threat of sanctions for gatekeeper noncompliance may be toothless in practice, absent effective gatekeeper monitoring. The opaque nature of gatekeeping roles and tightly interconnected relationships between gatekeepers and their clients may frustrate efforts to hold gatekeepers accountable.⁴⁰ Simply ratcheting up the level of sanctions in response to the low probability of detection may be to no avail. Draconian sanctions may elicit public opinion backlashes since gatekeepers are not the primary wrongdoers. The threat of high sanctions may also fall on deaf ears if gatekeepers can effectively cover their tracks and therefore have only a small chance of being detected, because gatekeepers may steeply discount potential sanctions.

Policymakers may end up with a situation in which the absence of accountability leads gatekeepers to engage in merely formalistic

37. See Kraakman, *supra* note 7, at 54–57 (discussing public enforcers' broad enlistment of gatekeepers in a variety of contexts).

38. See, e.g., Schwarcz, *supra* note 25, at 2–6, 18–20 (noting that even sophisticated private investors may have difficulty in understanding detailed disclosures in a reasonable time period because of the complicated nature of corporate transactions).

39. This interface of public and private enforcement tools raises one of the basic challenges of public governance. As Plato framed the issue in *The Republic*, "*quis custodiet ipsos custodes?*" (who will watch the watchmen themselves?), and this tension is particularly sharp when it comes to privatizing enforcement functions. See Juvenal, *Satire VI*, ll. 347–48; Plato, *The Republic*, Book III, 403e.

40. See Kraakman, *supra* note 7, at 61–63.

compliance as a hedge against any anticipated public scrutiny.⁴¹ The irony is that the advantages or skills that make private gatekeepers serve as attractive complements or substitutes for public enforcement may also equip these gatekeepers with the tools to facilitate illicit activity and to obfuscate their malfeasance.⁴² The existence of gatekeepers, such as rating agencies, may serve to legitimize and cover up the very type of wrongdoing the gatekeeper is supposed to police, and public enforcers may be powerless on their own to uncover gatekeeper chicanery.⁴³

B. Creating Accountability Between Gatekeepers and Their Beneficiaries

1. The Potential Contours of Private Monitoring of Gatekeepers

The limitations of both reputational constraints and public oversight suggest the appeal of enlisting private oversight of gatekeepers. Private actors may enjoy informational advantages over public enforcers in monitoring gatekeeper compliance, and leveraging the skills of these private parties may help to enhance gatekeeper accountability.⁴⁴ Policymakers have at their disposal a spectrum of options for overseeing gatekeeper compliance ranging from public enforcement tools, to an array of chimeric public-private strategies, to fully decentralized private enforcement tools.

For example, parties who directly face harm as a result of a gatekeeper's action or inaction may be empowered to sue the

41. The concern is not merely gatekeeper noncompliance, but worse still, that this outcome may foster contempt and embolden subversion of the law. See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 787 (2001) (highlighting the inefficiencies of reputational markets).

42. For example, doctors may be best positioned to discern that patients want prescription drugs for illicit purposes, but may just as easily accept or manufacture "symptoms" that justify granting a prescription, and public enforcers are ill-equipped to oversee this doctor-patient interaction.

43. See Schwarcz, *supra* note 25, at 18–20.

44. See, e.g., Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 54–68 (2002) (assessing the potential of a broad range of private enforcement tools); Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 121–43 (2005) (laying out the potential advantages of a range of private enforcement actions); Barton H. Thompson, Jr., *The Continuing Innovation of Citizen Enforcement*, 2000 U. ILL. L. REV. 185, 185–88 (discussing how environmental nonprofit organizations and individual citizens may play important roles in uncovering information about and prosecuting environmental law violations).

gatekeeper for compensation.⁴⁵ Private actors may be enlisted as qui tam litigants, serving as private attorney generals in exchange for a percentage of the damages, or as citizen suit litigants in exchange for lawyers' fees.⁴⁶ Public enforcers may offer bounties to solicit private informants for intelligence on gatekeeper compliance.⁴⁷ Alternatively, they may offer clemency and other forms of compensation to the primary wrongdoers to come forward and uncover gatekeeper complicity in their wrongdoing.⁴⁸

Each of these private monitoring tools may enable public enforcers to achieve mandates within limited manpower and budget constraints. Private monitors may also have incentives to innovate in uncovering gatekeeper violations because they internalize the monitoring costs and monetary rewards in ways that public monitors do not.⁴⁹ But each of these potential private enforcement paths also entails tradeoffs of economic and social costs for enforcement gains.

45. See Tamar Frankel, *Implied Rights of Action*, 67 VA. L. REV. 553, 556–58 (1981) (discussing the deterrence role that victim suits may play); Stephenson, *supra* note 44, at 108 (arguing that people directly affected by a potential defendant's conduct may be in the best position to detect violations).

46. See J. Randy Beck, *The False Claims Act and the English Eradication of Qui Tam Legislation*, 78 N.C. L. REV. 539, 561–62 (2000) (discussing the features of modern qui tam provisions); Michael S. Greve, *The Private Enforcement of Environmental Law*, 65 TUL. L. REV. 339, 356 (1990) (discussing the features of citizen suits, which allow prevailing plaintiffs to recoup their attorney's fees and expenses); see also Paul E. McGreal & DeeDee Baba, *Applying Coase to Qui Tam Actions Against the States*, 77 NOTRE DAME L. REV. 87, 120 (2001) (describing qui tam actions as "creatures of necessity" for the early American government because of its public enforcement limitations).

47. See Alexandra Natapoff, *Snitching: The Institutional and Communal Consequences*, 73 U. CIN. L. REV. 645, 647–51 (2004) (discussing the incentive effects of bounties for informant information); see also Russell L. Christopher, *The Prosecutor's Dilemma: Bargains and Punishments*, 72 FORDHAM L. REV. 93, 109 (2003) (discussing the government's frequent use of bounties in the criminal law context).

48. See George C. Harris, *Testimony for Sale: The Law and Ethics of Snitches and Experts*, 28 PEPP. L. REV. 1, 46 (2000) (noting how rewards for cooperating witnesses may be necessary to convince them not to exercise their Fifth Amendment rights against self-incrimination).

49. See, e.g., Michael Selmi, *Public vs. Private Enforcement of Civil Rights: The Case of Housing and Employment*, 45 UCLA L. REV. 1401, 1403–04, 1438–39 (1998) (discussing how private litigants have pursued the most challenging and significant discrimination cases); Stephenson, *supra* note 44, at 112–13 (suggesting how private litigants may employ novel strategies and approaches to expand enforcement potential); Thompson, *supra* note 44, at 206–09 (discussing how environmental groups made supplemental enforcement projects aiding the local environment a condition of citizen suit settlements, an approach the Department of Justice has subsequently embraced); Jeannette L. Austin, Comment, *The Rise of Citizen-Suit Enforcement in Environmental Law: Reconciling Private and Public Attorneys General*, 81 NW. U. L. REV. 220, 222–23 (1987) (discussing how citizen suits may force judges to engage in judicial lawmaking to define regulatory requirements that may siphon regulatory power away from administrative agencies).

The downside of any private enforcement approach is that private actors can only be expected to respond to financial incentives so long as the expected value of rewards exceeds the risks and costs of their monitoring, reporting, or enforcement,⁵⁰ which raises the specter of over- or under-enforcement in any given context.⁵¹ Recourse to broad private monitoring tools entails compromises between the value of uncovering private information and the intrinsic inefficiencies of enlisting uncoordinated private actors.⁵² The social costs of enlisting private actors may also cause policymakers to pause. Broad enlistment of private monitors, such as empowering anyone to serve as a *qui tam* litigant against a gatekeeper, may fuel social mistrust. Invasive tactics such as offering rewards for insiders to come forward as informants (as occurs frequently in criminal enforcement) or creating incentives for preemptive plea bargaining to induce insider wrongdoers to report on gatekeepers may have chilling effects on relationships between gatekeepers and their clients.⁵³

Policymakers may temper some of the potential excesses of private monitors by retaining public discretion for enforcement decisions and/or limiting the scope and dollar value of actions brought by private monitors.⁵⁴ But unavoidable tradeoffs may still remain. The broader the net that policymakers cast in eliciting private monitors, the greater the social and economic costs inflicted on society for the sake of enforcement gains. In cases where the monitoring challenges are beyond the capabilities of public enforcers or identifiable groups of victims, policymakers may have to resort to decentralized private monitoring tools to hold gatekeepers accountable.⁵⁵

50. See Mark A. Cohen & Paul H. Rubin, *Private Enforcement of Public Policy*, 3 YALE J. ON REG. 167, 175–76 (1985).

51. See Stephenson, *supra* note 44, at 117–20 (discussing how private enforcement may disrupt cooperative relationships between regulators and regulated entities, dictate enforcement agendas, and eliminate possibilities for discretionary enforcement).

52. See Trevor W. Morrison, *Private Attorneys General and the First Amendment*, 103 MICH. L. REV. 589, 616–17 (2005); Cass R. Sunstein, *Section 1983 and the Private Enforcement of Federal Law*, 49 U. CHI. L. REV. 394, 430–32 (1982).

53. See Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221, 240–41 (1995) (discussing the chilling effects that incentives for whistleblowing may have on lawyer-client relationships).

54. See, e.g., Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 587–91 (2000) (discussing public and private law constraints on private parties' performance of public functions).

55. See Manns, *supra* note 22, at 929–30 (arguing that decentralized private monitoring may merit the tradeoffs when public enforcement and victim suits provide insufficient accountability for gatekeepers). For example, lawyers' relationships with

2. How Beneficiaries of Screening Roles May Be Enlisted to Hold Gatekeepers Accountable

The potential downside of a broad reliance on private enforcement tools suggests the appeal of more focused strategies for enlisting private actors as monitors of gatekeeper compliance. The prime candidates for this role are direct beneficiaries of gatekeepers' screening roles who may form identifiable groups that possess the self-interest and ability to monitor gatekeepers. The absence of any legal or financial relationship between gatekeepers and the beneficiaries of screening roles means that autonomous gatekeepers may face strong temptations to collude with their commercial clients who foot their bills.⁵⁶ Having beneficiaries finance gatekeeping functions in exchange for enforceable rights against gatekeepers offers a way to create greater accountability between gatekeepers and their beneficiaries. Imposing caps on gatekeepers' potential liability may preserve the desirability of enlisting beneficiaries as monitors of gatekeepers, while mitigating risks of overdeterrence.

Gatekeepers' screening roles provide important signals about the legality and/or accuracy of their clients' activities that private actors frequently rely upon to make decisions. The securities context exemplifies this fact as lawyers, auditors, and rating agencies all perform "certification" roles that market participants rely upon in making investment decisions.⁵⁷ In some gatekeeping contexts, the benefits may fall diffusely on the public at large,⁵⁸ but in others, discrete groups of actors may rely on gatekeepers' representations concerning the lawfulness or accuracy of clients' activity and

clients may be so inscrutable that the only parties capable of unraveling lawyer misconduct are insiders, which may justify offering rewards or immunity for corporate wrongdoers to come forward of their own accord and uncover lawyers' complicity.

56. See, e.g., Coffee, *supra* note 7, at 355 ("A serious strategy for converting the attorney into a gatekeeper must also address the tension between the roles of gatekeeper and advocate.").

57. See Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and it Just Might Work)*, 35 CONN. L. REV. 915, 949–54, 966–68 (2003) (discussing the certification roles for auditors and de facto certification roles for lawyers). But see Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235, 252 n.76 (observing that rating agencies routinely make the caveat that "their rating determinations [are] based solely on information provided by the issuer of securities"). As Part IV.A will discuss, formalizing a certification role for rating agencies may be part of the pathway to enhancing gatekeeper accountability.

58. In some contexts, such as employers confirming employment eligibility, it may be very difficult (and quite contentious) to pinpoint a group that benefits from the gatekeepers' activities. This fact may make reliance on more decentralized approaches to gatekeeper monitoring a virtual necessity. See Manns, *supra* note 22, at 941–44.

therefore possess strong self-interest in monitoring gatekeepers. To the extent to which beneficiaries enjoy the ability to scrutinize gatekeepers' conduct, beneficiaries may serve as self-interested monitors of gatekeeper compliance. Small-scale beneficiaries of gatekeeper compliance may lack the ability and means to oversee gatekeepers, but larger entities may routinely use their own internal data and secondary market measures to scrutinize the accuracy of gatekeepers. For example, banks and funds investing in corporate debt use internal analysts and secondary market-based measures to assess the accuracy of ratings.⁵⁹ Creating legal duties that gatekeepers owe beneficiaries offers a way to channel beneficiaries' self-interest and ability to monitor gatekeepers into sustaining gatekeeper accountability.

Framing parties who rely on gatekeeper information as beneficiaries, rather than only as potential victims, highlights the fact that gatekeeping often constitutes an informational windfall for its beneficiaries.⁶⁰ State-imposed gatekeeping duties create or magnify the scope of these windfall benefits.⁶¹ The commercial clients of gatekeepers generally foot the bill for gatekeepers' screening roles (and heightened liability exposure when state mandates are imposed), while the private beneficiaries of screening roles rely on gatekeeping yet have no legal or financial relationship with the gatekeepers. The problem is that gatekeepers' dependence on commercial parties to fund screening roles may magnify existing temptations for gatekeepers to focus exclusively on serving their commercial clients by engaging in formalistic compliance with their duties. For this reason, when feasible, beneficiaries should face both the benefits and burdens of gatekeeping by financing gatekeepers' screening roles in exchange for claims against gatekeepers for noncompliance.

At first glance, having the burdens for financing gatekeeping fall on the shoulders of gatekeepers' commercial clients may appear

59. See Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1041 (2003) (discussing the role of in-house analysts at banks).

60. Extensive literature has documented the distorting incentive effects of windfalls (and the closely related idea of givings) and the challenges of attempting to force beneficiaries to shoulder the costs of their benefits. See, e.g., Abraham Bell & Gideon Parchomovsky, *Givings*, 111 YALE L.J. 547, 590–608 (2001) (detailing the challenges of requiring beneficiaries of state windfalls to pay for at least part of their resulting increase in wealth); Eric Kades, *Windfalls*, 108 YALE L.J. 1489, 1546–57 (1999) (discussing the difficulties facing efforts to recoup public and private windfalls).

61. See Kades, *supra* note 60, at 1531–32 (discussing the potential government roles in creating windfalls).

appealing. After all, having potential wrongdoers pay to clear their names of any suspicion might seem more fair than requiring those directly affected by wrongdoing to shoulder these screening costs. However, having the beneficiaries of screening roles finance gatekeeping functions may help to dampen the inherent tension in gatekeepers' simultaneously policing and serving their commercial clients by creating direct relationships and accountability to beneficiaries.⁶² This approach would place gatekeepers and beneficiaries in ongoing, repeat-player relationships, which would complement more sporadic interaction in adversarial contexts.⁶³ When commercial clients of gatekeepers fund the bills for gatekeeping, they have interests in pushing for systematic underinvestments in screening, and gatekeepers may understandably wish to err on the side of retaining and expanding their business.⁶⁴ In contrast, beneficiaries would have incentives to seek to tie gatekeeper funding to transparency and efficacy in cost-effectively screening out wrongdoers.⁶⁵ Beneficiaries' funding of gatekeeping roles would also heighten the endowment effect, as beneficiaries would have greater reason to scrutinize gatekeepers to ensure that investments in gatekeeping pay off.⁶⁶

3. The Virtues of a User Fee Approach

While in some cases beneficiaries may be able to contract directly with gatekeepers, financing gatekeepers through government-administered user fees may be the most effective way to

62. In some cases, unfunded mandates for gatekeeping may be a practical necessity, as the administrative costs of having beneficiaries fund screening roles may be disproportionately high relative to the costs of gatekeeping. See Kraakman, *supra* note 7, at 61–63 (discussing contexts where gatekeepers can screen for wrongdoers at low cost).

63. See, e.g., Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Action by Auction*, 102 COLUM. L. REV. 650, 711 (2002) (discussing how repeat player interaction enhances the ability of institutions to refine their negotiations); Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1076–78 (1984) (discussing how corporate defendants have considerable experience in litigation and settlements, which gives them leverage as repeat-players over one-shot litigants).

64. See Choi & Fisch, *supra* note 16, at 305–06 (discussing how corporate management may create incentives for securities intermediaries to underinvest in screening roles).

65. But see Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 1000–03 (1994) (discussing how large shareholders may collaborate with management to maximize their returns even at the expense of the shareholders as a whole).

66. See, e.g., Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1179–81 (1997) (discussing how loss aversion can heighten attention dedicated to property and investments).

preserve the cost-saving objectives of gatekeeping.⁶⁷ By pooling the resources of beneficiaries, a user fee approach would provide leverage vis-à-vis gatekeepers by creating a single locus of demand for their screening services.⁶⁸ This leverage may allow the administrators of a user fee system to secure the services of gatekeepers at a lower cost (and at least partly offset administrative costs), to heighten gatekeeper transparency as a quid pro quo for funding, and to coordinate beneficiaries' efforts to avoid needless overlap of both gatekeepers and oversight.⁶⁹ A user fee approach may also be designed to ensure that gatekeepers continue to provide services for smaller beneficiaries who may otherwise be unable to afford them, such as by allocating fees on a pro rata basis of affected assets.

The viability of a user fee approach will turn on the ability to identify the direct beneficiaries of gatekeepers' screening roles, to impose user fees on these beneficiaries, and to contain the administrative costs. By necessity, a user fee approach may entail a more active government role in the provision of gatekeeping services by integrating public and private oversight. Because gatekeeping often takes place before the primary beneficiaries of gatekeeping information are readily identifiable, the government may have to stand in the shoes of these beneficiaries by first financing gatekeeping functions and later by pooling the resources of beneficiaries to pay for gatekeeping. For example, corporate bond holders would not own the bond before initial ratings are issued for corporate debt. For this reason, a government entity would likely have to stand in their place to finance the initial ratings prior to collection of a user fee from corporate bond holders at the time bonds are purchased or thereafter.⁷⁰

67. See, e.g., Gillette & Hopkins, *supra* note 16, at 800–02 (discussing how user fees can facilitate economically efficient allocation of goods and services).

68. This Article's conception of the role of user fees is different than the conventional view. Rather than only valuing the allocative function of user fees in directing the provision of public or quasi-public services, see Spitzer, *supra* note 16, at 343–45, it focuses on how pooling resources in user fee approaches may be used as a basis for collective action by private beneficiaries to hold gatekeepers accountable.

69. One of the ironies of our legal system is that policymakers primarily attempt to overcome collective action problems after disasters have occurred and litigation has arisen, such as through class action suits. See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 8 (1991). In contrast, this Article seeks to embrace a preemptive strategy of leveraging collective action under a user fee approach to make it less likely that there will be a need for litigation.

70. See *infra* Part III.B.

The government's role in a user fee approach may facilitate complementary efforts to temper the potential excesses of private enforcement. For example, participants in a user fee approach may be required to bring suits against gatekeepers within administrative channels rather than through formal litigation.⁷¹ A user fee system may require vetting of potential actions against gatekeepers by vesting discretionary power to allow a suit to proceed in the hands of user fee administrators or a majority of the beneficiaries.⁷² This approach may provide ways to screen out nuisance suits and to ensure that the broader interests of beneficiaries are being served by any given action. A user fee approach may also facilitate corrective action as ongoing relationships between gatekeepers and beneficiaries may provide outlets for remedying shortcomings in gatekeepers' processes without the costs of litigation.⁷³

4. The Purpose Behind Capped, Enforceable Rights Against Gatekeepers

The existence of enforceable rights against gatekeepers with capped liability may serve to heighten incentives for gatekeeper compliance and partly to remedy injuries caused by beneficiaries' reliance on gatekeepers. Conventional victim suits empower private parties harmed by a wrongdoer to bring suit seeking to be made whole.⁷⁴ But the challenge of applying this approach to gatekeepers is that gatekeepers are not generally the primary wrongdoers and therefore full-scale victim suit liability may pose significant risks of overdeterrence.⁷⁵

71. Limiting suits to an administrative process offers opportunities to scale back the costs of proceedings by relying on streamlined procedures. See William H. Simon, *Solving Problems vs. Claiming Rights: The Pragmatist Challenge to Legal Liberalism*, 46 WM. & MARY L. REV. 127, 154 (2004) (comparing the virtues of streamlined administrative procedures to expensive lawyer-dominated litigation).

72. A similar approach takes place under the False Claims Act as government lawyers review and may assume control of qui tam litigation to reduce dangers of over-enforcement by private litigants. The difference in the qui tam suit context is that private litigants may proceed with their case if the government does not take control of the suit. See 31 U.S.C. §§ 3730(b)(2)–(3) (2006).

73. See Avery Wiener Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 COLUM. L. REV. 496, 535 (2004) (discussing how renegotiation costs are low among repeat players).

74. See Stephenson, *supra* note 44, at 108 (discussing the incentives for conventional victim suits).

75. See Hamdani, *supra* note 7, at 115–16 (discussing the dangers of over-deterrence from holding gatekeepers liable for all injuries that flow from their failed screening).

Gatekeepers may at times expressly aid and abet wrongdoer clients in wrongdoing, and existing victim suit provisions, such as Rule 10b-5 class actions, address outright fraud.⁷⁶ The nature of gatekeeping, however, means that gatekeepers' role in wrongdoing will generally be more subtle and instead fall at or near the boundaries of negligent or grossly negligent conduct.⁷⁷ For this reason empowering uncapped suits against gatekeepers could easily expose gatekeepers to liability that is disproportionate to their own culpability.⁷⁸ Applying joint and several liability to gatekeepers could be financially ruinous and drive gatekeepers out of markets in which they perform important screening roles. It may also be difficult to apportion blame in contexts in which the foreseeable injury flows directly from "gates" left open by failed gatekeeping.

Instead, the underlying focus of beneficiaries' rights should be on prospectively motivating gatekeepers to fulfill their duties through a system of capped liability. One of the underlying virtues of enlisting gatekeepers is that they enjoy little of the upside from wrongdoing by their clients.⁷⁹ For this reason the threat of modest potential sanctions may induce gatekeeper compliance while minimizing the risk of driving gatekeepers out of the markets they serve.⁸⁰ Therefore, gatekeeper liability exposure to victims should be based on a system of caps that may bear little relation to the actual injury suffered by those relying on gatekeeper compliance. Caps on liability may admittedly under-deter gatekeepers in some contexts, yet this tradeoff is necessary to ensure that reforms do not end up undermining the gatekeeper markets they are intended to safeguard. While this approach may dampen the incentives of beneficiaries, institutional investors in particular would still be motivated to police compliance, because their broader economic interests are affected by gatekeeping.

76. See 15 U.S.C. § 78j-1 (2006); 17 C.F.R. § 240.10b-5 (2008).

77. See *infra* Part II.A.2-3.

78. See Coffee, *supra* note 7, at 306 ("Gatekeepers simply lack the economic scale to be able to fund significant compensation to investors, particularly in the new era of mega-litigation.").

79. See *id.* at 308-09 (discussing how gatekeepers "receive[] only a limited payoff from any involvement in misconduct" compared to the primary wrongdoers).

80. See Hamdani, *supra* note 7, at 103 (discussing how sanction levels may require policymakers to consider the tradeoff between preventing misconduct and driving gatekeepers and their clients out of the market).

II. THE NEED FOR RATING AGENCY ACCOUNTABILITY

A. *The Significance of Rating Agencies*

Rating agencies reflect both the potential and pitfalls of gatekeepers, and their central role as screeners of risk and shortcomings underscores the need for gatekeeper accountability. Rating agencies serve to bridge an information gap between debt issuers and existing and prospective creditors.⁸¹ Sifting through the myriad of financial and nonfinancial disclosures of issuers may simply be economically infeasible for most creditors, which may limit lending levels and the liquidity of debt markets.⁸² Rating agencies initially arose as subscription-based businesses that mitigated this problem by offering private ratings on the creditworthiness of issuers and debt issues to creditors.⁸³ But starting in 1975, the federal government effectively made ratings a public good by issuing numerous regulations that required issuers to secure ratings concerning their creditworthiness in order to participate in financial markets.⁸⁴

Rating agencies perform a “verification function in . . . fixed-income markets,”⁸⁵ which complements the gatekeeper roles of auditors and lawyers in screening financial and nonfinancial disclosures. Rating agencies process both public disclosures and nonpublic information on issuers and reduce risks to discrete categories for the market to process. This screening role has made rating agencies serve a gatekeeping function from their inception, operating as potential choke points to flag both excessive risk exposure and signs of misconduct or fraud. Federal and state laws and regulations mandate that debt receives the highest ratings to be eligible for purchase by money market funds, insurance companies, and other financial entities, and bond indentures frequently contain

81. See Partnoy, *supra* note 35, at 632–33 (discussing the information asymmetry between issuers and creditors).

82. See George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1110 (1995) (discussing the role of rating agencies and other securities intermediaries in reducing risk by distilling ambiguous information into clearer signals for markets); see also Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613–21 (1984) (discussing the gatekeeping roles of securities intermediaries).

83. See Harold Furchtgott-Roth et al., *The Law and Economics of Regulating Ratings Firms*, 3 J. COMPETITION L. & ECON. 49, 76–77 (2007) (providing an overview of the historical development of subscription-based rating agencies).

84. See SEC Concept Release, *supra* note 6, at 35,258–59.

85. See Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 59–60 (Yasuyuki Fuchita & Robert E. Litan eds., 2006).

trigger provisions that are based on debt's retention of investment grade rating levels.⁸⁶ This fact means that rating agencies enjoy tremendous leverage over their issuer clients as the value of a bond issue may turn on its rating.⁸⁷ The globalization and integration of financial markets, the evolution of financial products with increasing complexity, and the sheer growth of debt markets have heightened the significance of U.S. rating agencies, as they now rate over thirty trillion dollars of debt.⁸⁸

B. *The Distinctiveness of Ratings*

The distinctiveness of ratings turns on the fact that they reflect the long-term, structural creditworthiness of issuers. Ratings are derived through "fundamental credit analysis, which incorporates an evaluation of franchise value, financial statement analysis, management quality, and scenario analysis."⁸⁹ Ratings are designed to reflect a balanced tradeoff between accuracy and stability, which focuses on long-term risks and incorporates both quantitative and qualitative analysis. Formal letter ratings indicate categories of risk exposure, which rating agencies may supplement with additional signals, such as changes in rating outlooks and watchlist designations, that provide additional short-term signals for markets.⁹⁰

This approach means that ratings do not change each minute or day based on every piecemeal bit of information. Other market-based information, such as credit default swaps, serves to fill that role in reflecting the immediate oscillations of the market on every tip of a hat.⁹¹ Credit default swaps serve as an equivalent of insurance against default events as holders of debt pay a "premium" to another party in exchange for compensation if a default event occurs.⁹² The virtue of credit default swaps is that they allow creditors to hedge against loss,

86. See SEC Concept Release, *supra* note 6, at 35,259.

87. See, e.g., L. Paul Hsueh & David S. Kidwell, *Bond Ratings: Are Two Better Than One?*, 17 FIN. MGMT. 46, 47-48 (1988).

88. See S. REP. NO. 109-326, at 3 (2006); see also Partnoy, *supra* note 15, at 65-66 (discussing the scale of rated debt).

89. Richard Cantor & Christopher Mann, Special Comment, *Measuring the Performance of Corporate Bond Ratings* 15, MOODY'S INVESTORS SERVICE, April 2003, <http://ssrn.com/abstract=996025>.

90. *Id.* at 27.

91. The differences between credit default swaps and ratings are similar to what distinguish police officers from building inspectors. Both have an eye on identifying risks and preempting wrongdoing, but the building inspectors focus on structural issues, such as long-term risks, rather than present infractions.

92. See Gretchen Morgenson, *In the Fed's Cross Hairs: Exotic Game*, N.Y. TIMES, Mar. 23, 2008, § 3 (Business), at 1.

and both the initial sale and resale prices for these swaps serve as proxies for risk. Credit default swaps themselves, however, have become speculative instruments as part of a fifty trillion dollar industry that is twice the value of the U.S. stock market.⁹³ The speculative element of these instruments means that credit default swap holders may seek to distort the actual risks of the marketplace and foster a false sense of security or panic to serve their short-term ends.⁹⁴ Credit default spreads also tend to reflect market overreactions and thus lead to a very high rate of reversals of risk assessments.⁹⁵

In contrast, ratings seek to approximate the long-term creditworthiness of issuers. While market-based measures may form useful reference points as snapshots of market sentiment, it would be difficult to hold credit default swap market manipulators accountable for their conduct. Similarly, analysts who offer a cacophony of opinions on issuers also form poor candidates for a liability-backed gatekeeping duty, because they have no relationship with issuers or creditors.⁹⁶ In contrast, the nature of the screening role of rating agencies makes them well positioned to be enlisted as liability-induced gatekeepers.

Another distinctive feature of rating agencies is that they serve as a de facto backstop for existing auditor and lawyer gatekeeping duties. Auditors and lawyers each see slices of a company's risks and potential for fraud, while rating agencies serve as the sole gatekeeper whose role is to look at all issuer disclosures on an ongoing basis in order to make a big picture assessment of risk.⁹⁷ For this reason, this

93. See Gretchen Morgenson, *Arcane Market is Next to Face Big Credit Test*, N.Y. TIMES, Feb. 17, 2008, at A1.

94. See Gillian Wee, *Credit Swaps Show Fear, Not Reality, Executives Say*, BLOOMBERG NEWS, Oct. 3, 2008, <http://www.bloomberg.com/apps/news?pid=20601109&sid=a.o1tHRJoe.k&refer=home> (arguing that "widening credit default swaps show a disconnect between" the actual balance sheets of companies and the fears of panicked investors); see also Edmund L. Andrews, *Treasury's Plan Would Give Fed Wide Power*, N.Y. TIMES, Mar. 29, 2008, at A1 (noting that proposed reforms to overhaul the Federal Reserve's power would not address the distortions speculation has caused in credit default swaps markets).

95. See Cantor & Mann, *supra* note 89, at 27 (highlighting the dramatically higher rate of reversals of risk assessments for credit default swaps compared to ratings).

96. See Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 58 ALA. L. REV. 1083, 1090-95 (2007) (discussing the challenges of imposing duties on analysts and dismissing their role as potential gatekeepers).

97. Investment banks may serve a similar role as screeners of corporate disclosures by providing fairness opinions on proposed transactions. See Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 81 WASH. U. L.Q. 403, 409-16 (2003) (discussing the potential and limits of enlisting investment banks as screeners of corporate wrongdoing).

Article argues that both formalizing and expanding the scope of rating agency duties may provide them with incentives to scrutinize disclosures more carefully and to identify significant risks more accurately.

C. *The Prominent Role of Rating Agencies in Recent Financial Crises*

The significance of rating agencies is underscored by the fact that they have been at the heart of several scandals that have rocked the financial world, such as the turn-of-the-century accounting frauds and the more recent subprime mortgage crisis.⁹⁸ Commentators have attributed these market and regulatory failures to a broad set of causes ranging from excessive risk-seeking in a bubble market,⁹⁹ structural shortcomings of corporate self-governance,¹⁰⁰ lax oversight by the SEC,¹⁰¹ and an erosion of the independence of securities market intermediaries.¹⁰²

But even putting aside concerns that fairness opinions are largely rubber stamps, rating agencies have ongoing roles in monitoring corporate risks, while investment banking scrutiny is often a onetime event as banks are hired for individual transactions. See, e.g., Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 555–57 (2002) (arguing that fairness opinions have “doubtful” value); William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 533–36 (1992) (questioning the value of fairness opinions because of their lack of precision and inability to predict price).

98. See U.S. GEN. ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES AND REMAINING CHALLENGES 3–5 (2002), <http://www.gao.gov/new.items/d03138.pdf> (discussing how approximately ten percent of publicly traded companies issued financial statement restatements from 1997 to 2002); see also George B. Moriarty & Phillip B. Livingston, *Quantitative Measures of the Quality of Financial Reporting*, 17 FIN. EXECUTIVE 53, 54 (2001) (documenting the significant increase in financial statement restatements in the late 1990s).

99. See, e.g., Werner De Bondt, *Bubble Psychology*, in ASSET PRICE BUBBLES 205, 210–12 (William C. Hunter et al. eds., 2003); Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 395–99 (2006) (attributing the breakdowns of Enron’s corporate governance in part to failures by the board of directors to oversee the directors and to police for self-interested relationships in corporate transactions).

100. See, e.g., WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 148–77 (2002), available at <http://f11.findlaw.com/news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf>.

101. See U.S. GEN. ACCOUNTING OFFICE, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES 3 (2002), <http://www.gao.gov/new.items/d02302.pdf> (discussing how the SEC was understaffed and underfinanced, and lacked the ability to offer any semblance of effective oversight of the auditing process).

102. See, e.g., Sean M. O’Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 823–27 (2004) (discussing how the autonomy of auditors from their clients was gradually eroded by both statutes and the auditing process); Sale, *supra* note 1, at 403–07 (arguing that

The defining irony of these market failures is that they stemmed from a changed landscape of market incentives that cajoled securities intermediaries into tacit complicity with their corporate clients in facilitating bubble markets or fraud.¹⁰³ A corporate governance system posited on executives' supposed alignment of interest with shareholders through stock options, coupled with oversight by securities market intermediaries, foundered in the face of economic incentives that rewarded a myopic short-term focus and tacit collusion.¹⁰⁴ For example, executives, financiers, and issuers' hired help of lawyers, accountants, and rating agencies all profited from packaging debt offerings in ever more deceptive ways in disregard of both securities laws and the interests of investors.¹⁰⁵ Executives could cash in stock options, banks could benefit from fees and equity stakes, and lawyers, accountants, and rating agencies all stood to gain greater revenue streams from thin legal scrutiny, dodgy accounting, and dubious ratings.¹⁰⁶ Weak public enforcement tools could do little to stop the consequences of this convergence of interests among corporate executives, directors, and securities market intermediaries.¹⁰⁷

Deferential ratings and inaction by rating agencies have been as integral to facilitating these financial crises as the tacit complicity of auditors and lawyers, because rating agencies form a backstop of oversight for issuers' financial and nonfinancial disclosures.¹⁰⁸ The

gatekeepers, such as accountants, lawyers, and investment bankers, failed the public by not adequately screening for corporate wrongdoing).

103. See Coffee, *supra* note 1, at 1408–09; Sale *supra* note 1, at 403–07.

104. See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 3–12 (2004); Coffee, *supra* note 7, at 312–18.

105. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1341–51 (2002) (discussing “the degree to which Enron dominated its auditor,” Arthur Andersen); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1237–39 (2002) (discussing the interdependence of Arthur Andersen’s auditors with Enron and the internal agency problems that compromised Arthur Andersen’s integrity).

106. For example, in the early 1980s equity-based compensation for executives was virtually nonexistent, but by 2001 two-thirds of the compensation of executives at large corporations consisted of equity-based pay. See Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, 17 J. APPLIED CORP. FIN. 23, 23 (2003).

107. See Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 185–90 (2006) (discussing the limits of the pre- and post-Sarbanes-Oxley disclosure systems for securities regulation).

108. See, e.g., Coffee, *supra* note 1, at 1408–09 (arguing that “the true denominator in the Enron debacle” was “the collective failure of the gatekeepers”); Sale, *supra* note 1, at

Sarbanes-Oxley Act sought to address the shortcomings that led to past financial crises by building on the preexisting gatekeeping role of auditors and formalizing a gatekeeping role for lawyers.¹⁰⁹ Congress, however, until quite recently, has all but overlooked meaningful reform of rating agencies' role as gatekeepers.¹¹⁰ This omission ignored how rating agencies embraced the incentives that other securities intermediaries faced, which was to indulge markets' underappreciation of risk by granting lax ratings in exchange for ever increasing amounts of business.

1. The Role of Rating Agencies in Legitimizing Subprime Debt Instruments

The current subprime mortgage crisis has underscored dramatically the significance of rating agencies and the consequences from lax ratings. To put in perspective the role of rating agencies in the current crisis, the primary victims of Enron were equity holders who lost over sixty billion dollars,¹¹¹ while Enron's creditors held thirteen billion dollars of debt at the time of Enron's collapse.¹¹² In contrast, write-downs and credit losses from the subprime mortgage crisis alone are estimated at upwards of one trillion dollars.¹¹³ These

403–07 (arguing that gatekeepers, such as accountants, lawyers, and investment bankers, failed the public); see also Lynnley Browning, *Small Firm at Center of Loan Universe*, N.Y. TIMES, Feb. 1, 2008, at C6 (discussing law firms' roles in the issuance of subprime mortgage collateralized debt obligations of dubious quality).

109. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.); see also David S. Ruder et al., *The Securities and Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103, 1110–12 (2005) (describing the expanded gatekeeper roles for auditors).

110. The notable exception was the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327–29 (codified in scattered sections of 12, 15, 20, and 23 U.S.C.) (expanding opportunities for new entrants to be certified as recognized rating agencies). However, this reform effort did little to change the underlying incentives for rating agencies. See *infra* Part II.D.2.

111. See Stephen Labaton, *Enron's Collapse: The Lobbying, Auditing Firms Exercise Power in Washington*, N.Y. TIMES, Jan. 19, 2002, at A1.

112. See Julie Creswell & Vikas Bajaj, *Bond Raters Make Effort to Repair Credibility*, N.Y. TIMES, Feb. 8, 2008, at C1.

113. In a period of months the estimates of write-downs and credit losses from the subprime crisis has dramatically increased with no clear end in sight. Compare Jody Shenn & David Mildenberg, *Subprime, CDO Bank Losses May Exceed \$265 Billion*, BLOOMBERG NEWS, Jan. 31, 2008, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aCtr4_6NdXdw (noting S&P's estimates that losses may exceed \$265 billion), with Jody Shenn, *Fed Slashes Subprime, Alt-A Mortgage Payment Shocks, S&P Says*, BLOOMBERG NEWS, Mar. 25, 2008, <http://www.bloomberg.com/apps/news?pid=20601009&sid=asN4mOP5mLm4&refer=bond> (noting that losses related to collateralized debt obligations may top \$460 billion), and Yalman Onaran, *Banks' Subprime Losses Top*

are merely the losses out of trillions of dollars of residential mortgage-backed securities and collateralized debt obligations based on subprime mortgages whose minimal risk exposure was vouched for by rating agencies.¹¹⁴

Rating agencies have been at the forefront of the legitimization and expansion of the RMBS and CDO industry, which has grown into a multi-trillion dollar market.¹¹⁵ These debt instruments share many similar features that raise common considerations from a ratings standpoint. RMBS and mortgage-based CDOs are debt obligations based on large pools of mortgage loans, and their cash flows are based on principal and interest payments from the underlying mortgages.¹¹⁶ Both serve as risk-shifting instruments, which enable mortgage banks and brokers and commercial banks to unload mortgage portfolios on secondary markets while shielding themselves from liability.

Sponsors and originators of a RMBS or CDO purchase pools of mortgages, which they in turn sell to a special purpose vehicle (“SPV”), a faceless corporation whose sole purpose is to serve as the formal issuer of the debt instrument in order to form liability buffers between the sponsors and mortgage originators and downstream purchasers. The SPV issues a RMBS or CDO with several tranches of debt.¹¹⁷ Each tranche typically consists of either senior, mezzanine, or subordinated equity, based on their increasing degree of credit risk, and the credit ratings for each tranche reflect this risk with senior and mezzanine tranches typically receiving investment grade and subordinated equity receiving non-investment grade ratings.¹¹⁸ As underlying mortgages default or underperform, the higher credit quality tranches receive priority in payments over the lower quality tranches. RMBS or CDO sponsors or originators typically retain the

\$500 Billion on Writedowns, BLOOMBERG NEWS, Aug. 12, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aSKLfqh2qd9o&refer=worldwide> (discussing \$500 billion in existing writedowns and credit losses from the subprime crisis and over \$1 trillion in likely losses).

114. Shenn & Mildenberg, *supra* note 113 (discussing how “almost half the subprime bonds rated by S&P in 2006 and early 2007 were cut or placed on review” for ratings downgrades in 2008, a fact which suggests rating agencies’ lax approach).

115. See Vikas Bajaj & Mark Landler, *Mortgage Losses Echo in Europe and on Wall St.*, N.Y. TIMES, Aug. 10, 2007, at A1 (discussing the scale of subprime mortgage CDO exposure facing banks and other creditors).

116. See Ferrell et al., *supra* note 1, at 7.

117. See Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 107–08 (2005) (discussing the potential ways that mortgages can be divided into tranches for securitizations).

118. See Ferrell et al., *supra* note 1, at 7–8.

most subordinated equity tranche, but otherwise pass on all of the risk to debt purchasers.¹¹⁹

RMBS and CDOs vary in the composition of their tranches. RMBS typically have a much higher percentage of senior tranches which signal lower risk, while CDOs have a higher percentage of subordinated equity, which reflects the fact that CDOs generally invest in higher risk mortgages. The other primary difference between RMBS and CDOs is that CDOs are often actively managed.¹²⁰ CDOs detail asset classes and investment strategies that are designed to ensure that tranches secure high ratings, but collateral managers of CDOs may enjoy discretion to purchase and sell the underlying assets.¹²¹ CDOs may be tailored to meet investors' needs in terms of maturity and risk levels, which means that CDOs are less likely to be publicly traded than RMBS.¹²²

These debt instruments are structured to secure favorable ratings in order to sidestep regulatory obligations and to enhance their value and market reach. If a debt offering receives ratings that fall within one of the four highest ratings from a nationally recognized securities rating agency (and meets other criteria), then the SPV does not have to register as an investment company under the Investment Act of 1940.¹²³ Investment grade ratings not only may heighten perceptions of a debt instrument's value, but also are effectively required for

119. Originators of a RMBS generally retain only the most subordinated equity tranche at the time of the initial sale, while the extent and amount of debt retained by CDO issuers varies more widely. See Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2200–06 (2007).

120. A RMBS can be registered with the SEC and publicly traded as is typically the case with RMBS sponsored by Freddie Mac and Fannie Mae, federally chartered corporations who serve to enhance liquidity of secondary mortgage markets. Alternatively, investment banks may issue private-label RMBS, which are not registered under the securities laws and do not comply with Freddie Mac and Fannie Mae underwriting guidelines, such as through a Rule 144A offering to qualified institutional investors. Ferrell et al., *supra* note 1, at 29–31.

121. CDOs may directly hold pools of mortgages or purchase mortgage-backed securities (or purchase a broader range of assets). *Id.*

122. Synthetic CDO equivalents exist for subprime mortgages which function as derivatives in having their value turn on the value of underlying subprime mortgage CDOs. The proliferation of these synthetic instruments dramatically magnified the scale of subprime mortgage CDO exposure. STANDARD & POOR'S, GLOBAL CASH FLOW AND SYNTHETIC CDO CRITERIA 14 (2002), available at http://www2.standardandpoors.com/spf/pdf/fixedincome/cdo_criteria2002_FINAL_TOC.pdf.

123. To qualify for the Rule 3a-7 exemption from treatment as an investment company, in addition to securing high ratings, the issuer must issue "fixed-income securities or other securities [whose payments] depend primarily on the cash flow from eligible assets" and comply with both contractual and regulatory restrictions on the acquisition and disposal of assets, as well as oversight of the assets. 17 C.F.R. § 270.3a-7 (2008).

ERISA fiduciaries to purchase RMBS or CDOs in order to avoid liability exposure.¹²⁴ Favorable ratings can dramatically expand the scope of potential purchasers to encompass pension funds and other institutions.¹²⁵

2. The Culpability of Rating Agencies in the Subprime Mortgage Crisis

RMBS and CDOs were designed as means to heighten liquidity in secondary mortgage markets. The problem is that both internal safeguards and external ratings failed to accurately assess risks posed by subprime mortgage portfolios as mortgage originators, issuers, and rating agencies turned a blind eye to excessive risk taking in their desire for quick profits. Subprime mortgages consist of adjustable rate mortgages generally sold to high-risk borrowers, which have a low interest rate for the first two to three years but then adjust to much higher rates based on an interest benchmark (such as the London Interbank Bid Offered Rate or “LIBOR”).¹²⁶ Subprime mortgages generally do not conform to the underwriting standards laid out by the Government Sponsored Enterprises, Fannie Mae and Freddie Mac,¹²⁷ and this fact coupled with risk-seeking behavior, deception, and outright fraud by originators and issuers proved to be a catalyst for a financial crisis.¹²⁸

Mortgage lenders and brokers exploited the RMBS and CDO market by “flipping” subprime mortgages and engaging in lax underwriting practices and even outright fraud that accounted for

124. See Ferrell et al., *supra* note 1, at 14 (discussing restrictions ERISA fiduciaries face concerning purchases of unrated RMBS or CDOs); see also 29 U.S.C. § 1.104(a)(1)(B) (2006) (laying out the “prudent man” standard of care for ERISA fiduciaries).

125. See Org. for Econ. Co-Operation and Dev., *supra* note 6, at 119–20 (discussing the ratings requirements for money market funds, insurers, and pension funds to purchase debt securities).

126. See STANDARD & POOR’S, *supra* note 122, at 4.

127. Ironically, Fannie Mae’s and Freddie Mac’s purchases of subprime mortgages helped to fuel the rapid growth of this market as they purchased \$515 billion of subprime debt from 2003 to 2006. See Carol D. Leonning, *How HUD Mortgage Policy Fed the Crisis*, WASH. POST, June 10, 2008, at A1.

128. While subprime loans have captivated public attention, similar problems have arisen with Alt-A and Jumbo loans that also do not conform with underwriting standards laid out by the Government Sponsored Agencies. Alt-A loans are extended to borrowers with good credit but are based on low underwriting scrutiny, and Jumbo loans are loans to borrowers with good credit that exceed the loan limits placed on the Government Sponsored Agencies. See Ashcraft & Schuermann, *supra* note 2, at 2.

approximately twenty-five percent of subprime losses.¹²⁹ Once lenders sold the mortgages to secondary markets, they were largely shielded from liability, which posed significant moral hazards.¹³⁰ The culpability of RMBS and CDO originators and rating agencies lies in the fact that in their zeal to expedite the flow of these debt instruments to markets and to pad their profit margins, issuers largely stopped using collateral appraisers to engage in due diligence on purchased mortgages.¹³¹ In 2000, collateral appraisers reviewed approximately thirty percent of mortgages in RMBS and CDO pools, but by 2005 approximately five percent of mortgages were being reviewed.¹³² Greed underpinned this shift as it costs about \$350 for review of each underlying mortgage,¹³³ and issuers of RMBS and CDOs did not want to cut into their profit margins when they enjoyed high demand for their products. Issuers may simply not have wanted to know how much risk they were assuming because of disclosure obligations, while turning a blind eye shifted the risk to debt purchasers.¹³⁴ Rating agencies failed to hold issuers accountable by engaging in lax portfolio reviews and not requiring that collateral appraisers review a higher percentage of the portfolios as a condition for ratings.¹³⁵

Rating agencies employed methodologies that failed to reflect the risks of subprime mortgage debt instruments, even as the subprime RMBS and CDO market grew dramatically from 2000 to

129. See Press Release, Fitch Ratings, Fitch: Underwriting & Fraud Significant Drivers of Subprime Defaults; New Originator Reviews (Nov. 28, 2007), http://www.americansecuritization.com/uploadedFiles/Fitch_Originators_1128.pdf. (discussing widespread problems with fraud, poor underwriting, and deceptive practices by mortgage loan originators).

130. See Dennis Hevesi, *Looser U.S. Lending Rules are Protested*, N.Y. TIMES, Apr. 2, 2004, at B4 (discussing how assignee liability applies to mortgages and subprime debt instruments).

131. See Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, at A1.

132. See *id.*

133. See *id.*

134. This problem was particularly pronounced in nonagency originated and issued RMBS, which accounted for over one trillion dollars in 2006 alone. See Ashcraft & Schuermann, *supra* note 2, at 2. The mortgage portfolios in these debt instruments did not conform to underwriting standards laid out by Fannie Mae and Freddie Mac. See Ashcraft & Schuermann, *supra* note 2, at 2. *Id.*

135. Rating agencies have sought to absolve themselves of responsibility through use of the caveat that “their rating determinations [are] based solely on information provided by the issuer of securities,” Schwarcz, *supra* note 57, at 252 n.76, yet this claim overlooks the leverage that rating agencies enjoy in being able to demand that issuers make additional disclosures or satisfy diligence requirements in order to qualify for a high rating.

2006,¹³⁶ and the quality of the underlying mortgages equally rapidly deteriorated.¹³⁷ Instead of engaging in actual diligence of the risks involved, demanding additional issuer disclosures, or scrutinizing collateral appraisers' assessments to justify their conclusions, rating agencies primarily relied on mathematical models that estimated the loss distribution and simulated the cash flows of RMBS and CDOs using historical data. Rating agencies' methods weighed initial expectations of loss heavily in computing the lifetime expected losses for a given subprime debt instrument, and flawed and overly-optimistic assumptions fueled a system of lax ratings which failed to anticipate or reflect the housing market downturn.¹³⁸

Rating agencies' disclosure of their methodologies to issuers allowed issuers to game the system by systematically understating the risks involved, which made individual tranches and these debt instruments as a whole to appear to have dramatically lower risks than they merited.¹³⁹ Banks and other issuers of subprime RMBS and CDOs exploited this approach to profit in issuing trillions of dollars of these debt instruments, because their sole concern was the initial sale, and they faced little to no risk exposure once they passed the debt on to downstream purchasers in the United States and abroad. As the real estate bubble began to burst in 2006 and 2007, flaws in the rating agencies' methodologies began to be exposed on a large scale, but downstream purchasers were left holding the bag on devalued investments that they purchased in reliance on lax ratings.¹⁴⁰

136. For example, firms issued \$508 billion of subprime debt instruments in 2005, compared to \$56 billion in 2000. Michael Hudson, *How Wall Street Stoked the Mortgage Meltdown*, WALL ST. J., June 27, 2007, at A1.

137. The percentage of subprime mortgages that were securitized in RMBS or CDOs increased from 28% in 1995 to 54% in 2001 and 75% in 2006. The percentage of subprime mortgages increased from 8% of the mortgage market in 2001 to 20% in 2006. See Todd J. Zywicki & Joseph D. Adamson, *The Law & Economics of Subprime Lending*, 80 U. COLO. L. REV. (forthcoming 2009) (manuscript at 7–8), available at <http://ssrn.com/abstract=1106907> (discussing the growth of the subprime mortgage securitization market); Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 31–33 (Working Paper Series, 2008), available at <http://ssrn.com/abstract=1020396> (discussing the explosive growth in the subprime mortgage market and the corresponding dramatic deterioration in the quality of subprime mortgage debt).

138. See Ashcraft & Schuermann, *supra* note 2, at 55–60; see also Mark Whitehouse, *Slices of Risk: How a Formula Ignited Market That Burned Some Big Investors*, WALL ST. J., Sept. 12, 2005, at A1 (discussing how the rating agencies' assumptions concerning risk led to widespread reliance on erroneous ratings for subprime mortgage debt instruments).

139. See Partnoy, *supra* note 15, at 77.

140. See Henny Sender, Carrick Mollenkamp, & Michael Mackenzie, *Risky Strategies Take Toll on Traders*, WALL ST. J., May 11, 2005, at C6 (discussing banks' efforts to exploit rating agencies' lax approach).

Rating agencies' lax approach may have arisen in part due to rating agencies' addiction to generous fees for engaging in cursory diligence of dubiously packaged products. For example, "Moody's earned \$884 million in 2006, or 43 percent of [its] total revenue," from rating RMBS and CDOs.¹⁴¹ This number is triple the amount that Moody's earned from these debt instruments only five years earlier,¹⁴² so it is easy to see how rating agencies had little, if any, incentive to stop the gravy train and to scrutinize subprime debt instruments more closely.

Rating agencies not only appear culpable for facilitating the crisis¹⁴³ but also may be grossly negligent, if not willfully complicit, in papering over its magnitude and allowing the bubble market to grow even more. For example, rating agencies largely deferred rating cuts on AAA rated subprime collateralized mortgage obligations, even where upwards of forty percent of the underlying portfolios faced default.¹⁴⁴ This approach allowed bond holders to delay writing off significant portions of the loans and allowed bonds to continue to be sold to money market funds, insurance companies, and other high quality asset holders.¹⁴⁵ Similarly, rating agencies declined to downgrade bond insurers because of concerns that downgrades would trigger a cascade of debt downgrades throughout the financial system.¹⁴⁶ While this approach may have staved off a short-term

141. John Glover, *Regulators May Limit S&P, Moody's Structured Debt Business*, BLOOMBERG NEWS, Feb. 6, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=azu7haZC4x.M#>.

142. *Id.*

143. See John Glover, *CDO Ratings to Fall as Losses Trigger Fitch Overhaul*, BLOOMBERG NEWS, Feb. 5, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aE6fC9jpTXeg#> (discussing how Fitch acknowledges that it was overly optimistic in its default rate and other assumptions in its original CDO methodology, a tacit recognition of the role of its negligence in the subprime crisis).

144. Mark Pittman, *Moody's, S&P Defer Cuts on AAA Subprime, Hiding Loss*, BLOOMBERG NEWS, Mar. 11, 2008, <http://www.bloomberg.com/apps/news?pid=20601109&sid=aRLWzHsF16IY&refer=home> (discussing how rating agencies have declined to issue rating downgrades on hundreds of billions of dollars of subprime debt).

145. See David Evans, *Subprime Infects \$300 Billion of Money Market Funds*, BLOOMBERG NEWS, Aug. 20, 2007, <http://www.bloomberg.com/apps/news?pid=newsarchives&sid=aV5mGtuGGu2E#> (discussing how rating agencies' lax ratings on subprime CDOs exposed money market funds to massive liability exposure on debt that money market funds could not have even bought, but for the conferral of AAA ratings).

146. See Shannon D. Harrington & Christine Richard, *Moody's, S&P Say MBIA Is AAA: Debt Market Not So Sure*, BLOOMBERG NEWS, Feb. 27, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYJDy4utzDo#> (discussing how rating agencies' decisions not to downgrade bond insurer MBIA have prevented \$637 billion of debt backed by MBIA from downgrades and saved banks approximately \$70 billion in losses).

magnification of the crisis, it may have reduced the liquidity of subprime loans because of fears of latent risks and therefore expanded the scope and duration of the crisis in the long run.¹⁴⁷

Rating agencies have had incentives to legitimize financial instruments of increasing complexity by understating the risks involved.¹⁴⁸ This fact has reinforced fears that the subprime mortgage crisis may only be the tip of an iceberg in a debt-driven financial world in which ratings camouflage reckless risk taking.¹⁴⁹ Rating agencies' actions during this crisis suggest that creditors can take little comfort from ratings, which underscores the need for greater accountability.¹⁵⁰

D. Responsibility Without Accountability in the Rating Agency Context

The current gatekeeping role of rating agencies can be summarized as responsibility without accountability, which poses a stark moral hazard for financial markets. This problem is a product of weak reputational constraints, the leverage rating agencies enjoy over issuers, conflicts of interest to favor issuers, and rating agencies' virtual immunity from liability.¹⁵¹

147. The rating agencies' inaction has magnified the impact of other government policies allowing banks to minimize accounting write-downs from the subprime mortgage crisis. See, e.g., Jonathan Weil, *Subprime Lenders Get Big Accounting Break*, BLOOMBERG NEWS, Jan. 30, 2008, <http://www.bloomberg.com/apps/news?pid=20601039&sid=aPSScH5rRBLM&refer=home> (discussing how the SEC has granted holders of subprime mortgage debt instruments an "exemption from the normal rules for off-balance-sheet-accounting" allowing them to exclude most of the write-downs from anticipated losses).

148. See JUSTIN PETIT, UBS, *THE NEW WORLD OF CREDIT RATINGS* 2-3 (2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=593522 (describing the shifts among issuers toward more aggressive financial policies that entailed the embrace of increasingly complex financial instruments with greater risks).

149. See Julie Creswell, *A Nervous Wall Street Seems Unsure What's Next*, N.Y. TIMES, Mar. 31, 2008, at C1 (discussing how fears of latent risks are undermining faith in the integrity of the financial system).

150. See *Credit Rating Agencies and the Financial Crisis*, *supra* note 20, at 206 (executives from rating agencies acknowledging that rating agencies have suffered "serious reputational damage").

151. See, e.g., Dieter Kerwer, *Holding Global Regulators Accountable: The Case of Credit Rating Agencies*, 18 GOVERNANCE: INT'L J. POL'Y ADMIN. & INSTITUTIONS, 453, 455 (2005) (observing that "there seems to be a persistent mismatch between demand and supply of accountability" in the context of rating agencies).

1. The Absence of Reputational Constraints

In the absence of a credible threat of liability, the sole incentive for rating agencies to fulfill screening roles is their reputation.¹⁵² Rating agencies have long embraced the mantle of reputational intermediaries because their economic interest purportedly lies in their accuracy in assessing corporate debt offerings for creditworthiness.¹⁵³ For this reason, rating agencies have claimed that imposing liability on their malfeasance may simply raise the financial exposure of gatekeepers,¹⁵⁴ yet have little effect on heightening incentives for accurate assessments of risk.¹⁵⁵

In reality, the power of reputational constraints appears far weaker than rating agencies claim. Not only do reputational concerns wane for all securities-related actors amidst bubble markets (ironically just when they are needed the most), but also the past generation has witnessed a significant shift in the risk-seeking behavior of participants in financial markets that has dampened the force of reputational constraints.¹⁵⁶ The pendulum may eventually swing when market bubbles inevitably burst and the search for blame begins. Nonetheless, attempts by rating agencies to defuse backlashes through acknowledgments of shortcomings or minor changes to their

152. Policymakers can expect gatekeeper compliance, so long as the expected value of the reputational costs from getting caught not performing their gatekeeping role outweighs the marginal returns from casting a blind eye to wrongdoing. See Black, *supra* note 41, at 787 (arguing that reputational intermediaries are “repeat players who will suffer a reputational loss, if they let a company falsify or unduly exaggerate its prospects, that exceeds their one-time gain from permitting the exaggeration”); see also Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 898 & n.124 (1984) (describing how reputational intermediaries may face analogous incentives to publicly imposed gatekeeper liability because these intermediaries “place established reputations on the line”); Peter B. Oh, *Gatekeeping*, 29 J. CORP. L. 735, 752 (2004) (arguing that “in the long-run, reputational intermediaries will commit fraud if the risk is acceptable either for the firm or its agents”).

153. See Schwarcz, *supra* note 15, at 26 (arguing that rating agencies’ “reputational motivation is sufficient” and that “[a]dditional regulation of rating agencies thus would impose unnecessary costs and thereby diminish efficiency”).

154. See, e.g., Goldberg, *supra* note 31 at 296–98 (arguing that the reputational costs that accountants may face from failing to detect wrongdoing gives them adequate incentives to monitor their clients); see also *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (holding that an accountant’s concern for her reputation and exposure to potential loss would make collusion with her clients’ accounting fraud irrational).

155. To the extent to which gatekeeper liability would burden rating agencies with liabilities that these actors could not screen for (or only at prohibitive cost), gatekeeper liability may have the perverse effect of raising the costs of their services or causing them to exit the market.

156. See Coffee, *supra* note 1, at 1408–09.

approaches should not obscure the fact that reputational pressures may swiftly fade.

The weakness of reputational constraints is partly a product of the nature of ratings. Rating agencies can hide behind their own approaches to assessing risk in a bucket system of categories whose opaqueness lends itself to being used as a cover for inaccuracy. Rating agencies enjoy the almost elastic ability to spin their failures as a product of the short-sightedness and knee-jerk reactions of markets,¹⁵⁷ because ratings focus on structural, long-term concerns.¹⁵⁸ The degree of truth behind these claims may blunt the force of reputational constraints.

As will be discussed below, another part of the problem is that issuers simply have nowhere else to turn under the current system and have little incentive to exert reputational pressures in the face of lax ratings. The combination of regulatory mandates for issuers to secure ratings and the dominance of a handful of rating agencies means that an oligopolistic group of rating agencies has a virtual lock on the market and faces little potential for pushback based on reputational concerns. Issuers have little interest in encouraging rating agencies to pop market bubbles.¹⁵⁹ Creditors have greater incentives to exert reputational pressures because they bear the consequences of ratings inaccuracies, yet these pressures have proven ineffective except to a limited extent in the immediate aftermath of financial crises.

The irony is that rating agencies' reputations have served as a cover to paper over their noncompliance with gatekeeping roles.¹⁶⁰ As a result, the outspoken reliance of rating agencies on reputational

157. See, e.g., David Evans, *Moody's Implied Ratings Show MBIA, Ambac Turn to Junk*, BLOOMBERG NEWS, May 30, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a0tWb0sTTgu8&refer=home> (discussing how Moody's has sought to rationalize the gap between market-based indicators of the financial health of bond insurers MBIA and Ambac and its actual ratings).

158. Cantor & Mann, *supra* note 89, at 15 (discussing the emphasis on long-term concerns in determining ratings through "fundamental credit analysis").

159. The SEC has recently proposed new rules to deemphasize the significance of rating agencies by formally removing the requirement of NRSRO ratings in a variety of contexts. See SEC 2008 Proposed Rules, *supra* note 13. But regardless of whether these proposed rules are implemented, ratings will continue to play a central role in identifying credit risk and entrenched market practices of soliciting and relying upon ratings are likely to sustain the significance of rating agencies. See *SEC Issues Rules of Conflicts in Credit Rating*, *supra* note 14.

160. See, e.g., Richard House, *Ratings Trouble*, INSTITUTIONAL INVESTOR., Oct. 1995, at 245 (quoting Moody's former president as stating: "We're in the integrity business: People pay us to be objective, to be independent and to forcefully tell it like it is.").

constraints appears to have served more as a pretense to avoid regulation than as an effective incentive for gatekeeper compliance.¹⁶¹

2. The Market Power of Rating Agencies

Other securities intermediaries also appear to have become lax in the face of waning reputational constraints. However, reinvigorating the role of rating agencies as gatekeepers poses distinct challenges from other securities intermediaries because of the market power and autonomy of rating agencies, their virtual immunity from suit, and potential conflicts of interest. The most salient difference is the market power that rating agencies enjoy, which is a product of history, the almost duopolistic dominance of Moody's and Standard & Poor's ("S&P"), and regulatory barriers to entry.¹⁶² Like accounting firms, the dominant rating agencies form a virtual oligopoly whose specialized skills are indispensable for access to capital markets.¹⁶³ The concentration of power in the ratings world, however, is far deeper than that of the "Big Four" accounting firms, as two firms, Moody's and S&P, form a near duopoly in dominating

161. In practice, reputational markets appear inefficient as reputational intermediaries in the securities markets have repeatedly demonstrated by their failures over the past decade. See Coffee, *supra* note 7, at 311–18 (documenting the failures of reputational intermediaries in securities law compliance); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 366–37 (2004); see also Black, *supra* note 41, at 787–89 (arguing that true reputational intermediaries cannot fulfill their role in vouching for disclosure quality and thus reducing information asymmetry in securities markets because of the ability of false reputational intermediaries to free-ride off of true reputational intermediaries' credibility and to provide false or misleading information on securities).

162. References to the almost "duopolistic" dominance of Moody's and S&P or the "oligopolistic" nature of the rating agency industry (when one also takes into account Fitch's) might understandably make the reader think that antitrust law should be enlisted to counter rating agencies' market power. See, e.g., Lynn Hume, *Connecticut AG Sues All 3 Rating Agencies*, BOND BUYER, July 31, 2008, at 1, available at <http://www.bondbuyer.com/article/html?id=200807307EFUPEHX&queryid=26149517&hitnum=49> (discussing the Connecticut Attorney General's lawsuit against the three largest rating agencies alleging unfair and deceptive practices in rating municipal bonds and violations of state antitrust laws). However, to date, antitrust actions against rating agencies have proven to be unsuccessful. More importantly, as the following discussion underscores, under the current system the barriers to entry are so significant that it is unclear whether a successful antitrust action would do much to dislodge the dominance of the leading rating agencies.

163. The fallout from the accounting crises of the 1980s led to a winnowing out of the accounting industry to the "Big Four" of PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young, and KPMG, which share similar revenues that far outstrip their diminutive competitors. See O'Connor, *supra* note 102, at 788–89 (discussing the evolution of the Big Four accounting firms into the dominant players in the accounting industry).

the ratings business (with Fitch's a distant third and other participants holding marginal market shares).¹⁶⁴ While each corporation typically retains one accounting firm, which leaves room for competition, the industry standard is for two rating agencies to opine on each debt issue in the United States. Moody's rates all but a small percentage of new debt issues, and S&P is not far behind.¹⁶⁵

The oligopolistic dominance of Moody's and S&P did not arise by accident, but was in part a product of their building demand for their brands and products over decades and their outmaneuvering and acquiring smaller rivals.¹⁶⁶ But starting in 1975, the federal government and the SEC reinforced the barriers to entry for rating agencies by officially enlisting them as gatekeepers of risk through the Nationally Recognized Statistical Rating Organization ("NRSRO") system.¹⁶⁷ Numerous federal and state laws and regulations made NRSRO ratings a sine qua non for distinguishing among grades of creditworthiness in activities ranging from money markets to bond insurance.¹⁶⁸ Even international regulations, such as the Basel II accord, have made ratings a cornerstone of risk management in financial markets.¹⁶⁹

For much of this period, NRSRO status has been a virtual tautology as the SEC has recognized that "[t]he single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings."¹⁷⁰ If no rating agency could be recognized as a NRSRO unless it was "widely accepted," in practice this standard meant only the existing dominant firms could hope to achieve this status. Legislation in 2006 has partly opened the gates for new entrants by introducing a more open NRSRO certification process, which may lead to greater rating agency competition in the long run.¹⁷¹ The market power of the rating agencies, however, does not

164. See Reiss, *supra* note 15, at 1020–21 (discussing the oligopolistic nature of the ratings industry).

165. See S. REP. NO. 109-326, at 3–4 (2006).

166. See Hill, *supra* note 15, at 46–48.

167. See SEC Concept Release, *supra* note 6, at 35,258.

168. *Id.*; see also Partnoy, *supra* note 15, at 74–78 (describing the increase in ratings-based statutory provisions and regulation).

169. See Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 122 (2008).

170. NRSRO status was previously achieved in practice through the SEC's no-action letter process. See SEC Concept Release, *supra* note 6, at 35,258.

171. See Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327–29 (codified in scattered sections of 12, 15, 20, and 23 U.S.C.).

turn on their regulatory imprimatur alone.¹⁷² As will be discussed below, rating agencies have many weapons at their disposal to maintain a stranglehold on the ratings marketplace regardless of whether other entities are formally awarded NRSRO status.

3. The Inherent Conflicts of Interest in Relationships Between Rating Agencies and Issuers

In addition to market power, rating agencies also enjoy a symbiotic relationship with their issuer clients that may compromise their objectivity. An inherent conflict of interest exists since issuers pay rating agencies to monitor them, because the gatekeepers are paid by the very actors that may burst through the gates of financial propriety. This fact means that rating agencies may have incentives to give the companies they are monitoring the benefit of the doubt or not to push for additional information for fear of jeopardizing their relationship.¹⁷³ This concern may be especially prominent in shaping the reluctance of rating agencies to downgrade ratings as shifts from investment to non-investment grade ratings could lead to a cascade effect of market reactions and contractual obligation triggers that could significantly harm issuers' financial status.¹⁷⁴

The problem of potential rating agency bias is magnified by lucrative consulting relationships between issuers and rating agencies, which raise red flags of potential conflict of interests.¹⁷⁵ What passes for efforts to strengthen the internal procedures of issuers and ratings disclosures may easily serve as a cover for implicit payoffs between the monitored and the monitors.¹⁷⁶ The Sarbanes-Oxley Act

172. For a contrary view that solely emphasizes the significance of regulatory barriers to entry, see Partnoy, *supra* note 3, at 681–82 (“[C]redit ratings are valuable not because they contain valuable information, but because they grant issuers ‘regulatory licenses.’ . . . [O]nce regulation is passed that incorporates ratings, rating agencies begin to sell not only information but also the valuable property rights associated with compliance with that regulation.”).

173. See Roy C. Smith & Ingo Walter, *Rating Agencies: Is There an Agency Issue?*, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 289, 302–04 (Richard M. Levich ed., 2002) (discussing the potential for rating agencies to compete by offering more favorable ratings to issuers than other rating agencies).

174. See Jonathan R. Macey, *A Pox on Both of Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 342–43 (2003) (discussing the reluctance of rating agencies to downgrade their issuer clients because of concerns about the far-reaching effects of downgrades).

175. See Hill, *supra* note 15, at 50–52 (discussing the potential for consulting revenues to impair rating agency objectivity).

176. Rating agencies have erected formal walls of separation between these different segments of their business to dampen the salience of the conflicts, but the potential for

recognized how the allure of consulting fees on top of accounting fees could ensnare accountants in conflicts of interests with their clients and therefore abolished these potential side payoffs.¹⁷⁷ Adopting a similar reform for rating agencies could dampen incentives to compromise their integrity for the sake of their pocketbooks.¹⁷⁸ But even in the absence of express consulting fees, issuers will still have a strong interest in tilting the scales of ratings in their favor. So long as issuers finance rating agencies, rating agencies will continue to have incentives to minimize screening and to do their part to ensure that their business with issuers continues to grow.

4. The Use of Unsolicited Ratings to Induce Issuer Loyalty

Rating agencies also have ready weapons at their disposal to ensure the loyalty of their issuer clients, a fact which underscores the scope of rating agencies' autonomy and market power. Moody's and S&P already profit from the fact that they serve as a "gold standard" for ratings and that the omission of ratings from these rating agencies may be interpreted as a reflection of the quality of a debt issue.¹⁷⁹ But

conflicts is clear. See SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 43 (2003), *available at* <http://www.sec.gov/news/studies/credratingreport0103.pdf>; *see also* STANDARD & POOR'S RATING SERVICES, CODE OF CONDUCT 6-7 (2007), http://www2.standardandpoors.com/spf/pdf/fixedincome/SP_RatingsServicesCodeOfConduct_June2007.pdf (describing the procedures put in place to separate the rating and consulting portions of S&P's business).

177. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

178. Rule 17g-5 requires disclosure of ancillary consulting services provided for rated companies, but the SEC has not moved to ban these services as a conflict of interest. See 17 C.F.R. § 240-17g-5 (2008) (implementing provisions of the Credit Rating Agency Reform Act of 2006); *see also* SEC Concept Release, *supra* note 6, at 35,258 (recognizing the concern about conflicts of interests from rating agencies' ancillary consulting services). Similarly, a recently proposed settlement between the New York Attorney General's Office and rating agencies has called for greater transparency in having rating agencies charge for each stage of the rating process and disclose all companies they were asked to rate, even if the issuer chose to hire another rating agency. See Jenny Anderson & Vikas Bajaj, *Rating Firms Seem Near Legal Deals on Reforms*, N.Y. TIMES, June 4, 2008, at C1.

179. See, e.g., Floyd Norris: Notions of High and Low Finance, If You Don't Like Your Grade, Fire the Teacher, <http://norris.blogs.nytimes.com/2008/03/08/if-you-dont-like-your-grade-fire-the-teacher/> (Mar. 8, 2008, 11:35 EST) (discussing how the absence of one of the key rating agencies may be interpreted as a signal of excessive risk exposure or other issuer problems). This point is analogous to the power of the "Big Four" accounting firms as Fortune 1000 companies may fear that using a smaller auditor who offers cheaper services could be viewed as signaling to the market that they have potential accounting issues. See U.S. GOV'T ACCOUNTABILITY OFFICE, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION, GAO-08-163, at 20-22 (2008), *available at* <http://www.gao.gov/new.items/d08163.pdf> (explaining the views of Fortune 1000

Moody's, in particular, attempts to assert market influence even when it is not paid by issuing unsolicited (and unpaid) ratings covering much of the small percentage of ratings it is not paid to cover.¹⁸⁰ This practice might sound innocuous at first glance because it serves to provide more information for creditors to make investment decisions. But in practice, unsolicited ratings may serve as a veiled threat against issuers who do not pay for their services.¹⁸¹ Since unsolicited ratings by definition can only be based on what information is publicly available, they appear likely to be lower than solicited ratings because of conservative assumptions concerning nonpublic information. The potential financial impact from the threat of low ratings may serve to deter issuers who may be tempted to go elsewhere with their business.¹⁸²

This threat not only functions as an offensive weapon to threaten issuers into cooperation with the dominant rating agencies, but also it serves as a defensive tactic. By issuing unsolicited ratings, Moody's can more plausibly claim it is a purveyor of opinion, rather than a hired gun of issuers. This appearance of journalistic neutrality may help to support rating agencies' arguments that they deserve to be shielded from liability exposure on First Amendment grounds.¹⁸³

5. The Virtual Immunity Enjoyed by Rating Agencies

Rating agencies are not only free from accountability to issuers, but also enjoy virtual immunity from any other stakeholders.¹⁸⁴ Rating agencies have long waged campaigns inside and outside of courtrooms claiming that their ratings are journalistic opinions protected by the First Amendment. Issuers can claim that a rating agency's report constitutes libel, alleging that the ratings constitute

companies on why the Big Four Accounting firms control ninety-eight percent of the Fortune 1000 firms' audit market).

180. See Partnoy, *supra* note 15, at 79.

181. See S. REP. NO. 109-326, at 3 (2006).

182. See Alec Klein, *Spitzer Examining Debt Ratings by Moody's*, WASH. POST, July 30, 2005, at D1 (discussing how Moody's issued unsolicited ratings of Hannover Re, a German reinsurer, after the company refused to hire Moody's and detailing how the issuance of a below investment grade ratings resulted in \$175 million in losses).

183. This practice has been upheld as constitutional in spite of the potential for the threat of unsolicited ratings to serve as a cover for pay to play extortion on the part of rating agencies. See, e.g., *Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Serv., Inc.*, 175 F.3d 848, 850 (10th Cir. 1999) (upholding unsolicited rating as protected opinion in case where Moody's issued negative rating for bond issue after school district passed over Moody's in favor of other rating agencies).

184. See Partnoy, *supra* note 15, at 78 (discussing how rating agencies are largely immune to civil liability).

assertions of facts rather than protected opinions.¹⁸⁵ It is possible that rating agency reports may include opinions intertwined with false facts that may be sufficient to overcome the presumption of First Amendment protection.

The problem, however, is that issuers are generally treated as public figures for First Amendment purposes and must show that the rating agencies relied on falsehoods because of actual malice and had actual knowledge or reckless disregard for the truth or falsity of their claims.¹⁸⁶ This First Amendment hurdle has made it extraordinarily difficult to establish that rating agencies engaged in libel and has left issuers without legal recourse except in outlier cases. Courts have come out on both sides of the question of whether ratings universally enjoy First Amendment protection, but issuers still face significant hurdles in pinning liability on the shoulders of rating agencies.¹⁸⁷ What is clear is that rating agencies face little to no accountability to issuers and generally have no liability exposure to creditors or other financial market participants.¹⁸⁸ Rating agencies appear to have a free hand in issuing ratings (whether solicited or unsolicited), so long as they have established some basis for their ratings.

185. See Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. 341, 352–54 (2006).

186. See Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1688–92 (2008).

187. See *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 758 (1985) (noting in dicta that the commercial nature of rating agencies “speech” suggests that it does not require heightened First Amendment protection); *Lowe v. SEC*, 472 U.S. 181, 210 n.58 (1985) (noting in dicta that “it is difficult to see why the expression of opinion about a marketable security should not also be protected”); *Quinn v. McGraw Hill Co., Inc.*, 168 F.3d 331, 336 (7th Cir. 1999) (affirming dismissal for failing to state a claim, where plaintiff could not show the reasonableness in relying on the rating of the agency); *Newby v. Enron Corp.*, 511 F. Supp. 2d 742, 818–19 (S.D. Tex. 2005) (holding that ratings enjoyed “qualified” First Amendment protection in a case alleging rating agencies failed to exercise reasonable care in changing their ratings because they had rated Enron’s debt as investment-grade in December, 2000); *In re Pan Am. Corp.*, 161 B.R. 577, 580 (S.D.N.Y. 1993) (holding that rating agencies are protected by the First Amendment in spite of their profit motive). But see *In re Fitch*, 330 F.3d 104, 111 (2d Cir. 2003) (per curiam) (distinguishing rating agency functions from that of a journalist for First Amendment purposes); *Compuware Corp. v. Moody’s Investors Serv., Inc.*, 324 F. Supp. 2d 860, 860 (E.D. Mich. 2004) (holding that ratings are protected under a state reporter privilege statute); *Am. Sav. Bank, FSB v. UBS PaineWebber, Inc.*, No. M8-85, 2002 U.S. Dist. LEXIS 24102, at *2–3 (S.D.N.Y. Dec. 16, 2002) (rejecting a rating agency’s claims of entitlement to “journalist privilege” protections for its ratings).

188. See STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., *FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE SECTOR WATCHDOGS* 105 (2002); 17 C.F.R. § 230.436(g)(1) (2008) (exempting rating agencies from potential liability exposure based on the role of ratings in the registration process).

*E. Agents in Search of a Principal***1. The Federal Government's Role in Transforming Issuers into Nominal Principals**

As the discussion of conflicts of interest has highlighted, issuers paradoxically serve as the nominal principal over the rating agencies that assess their credit risk. Two issues merit attention, how this relationship arose, and how fundamentally flawed it has become, because government policy, rather than markets, led to this development. The irony is that rating agencies historically served as agents to prospective purchasers and owners of debt. Rating agencies arose through subscription businesses that marketed their services toward creditors.¹⁸⁹ The businesses were created as vehicles to minimize creditor risks, and the debt issues that rating agencies chose to review were based on their economic value to their creditor clients.

Starting in 1975, the federal government and the SEC initiated a fundamental transformation in how rating agencies conduct business, which has had far-reaching effects in terms of rating agency accountability.¹⁹⁰ By mandating that issuers secure the services of at least one NRSRO rating agency (which as a matter of market practice swiftly developed into securing the services of at least two rating agencies), the federal government effectively turned the market for ratings upside down.¹⁹¹ In a rapid period of time, the targets of rating agencies became the clients, and the erstwhile customers became the targets of information rather than the customers. Through an ever increasing number of laws, rules, and regulations that tied NRSRO ratings to the ability of issuers to issue debt, the federal government and the SEC changed the landscape of debt offerings to make issuer-purchased ratings a virtual necessity.¹⁹²

The virtue of these rules and regulations is that they transformed ratings into a de facto public good. This change was a beneficial step for the marketplace in that both small and large debt offerings had to pass by the eyes of rating agency gatekeepers. But policymakers did not anticipate the consequences of flipping accountability from creditors to issuers. The combination of the market power of rating

189. See Furchtgott-Roth, et al., *supra* note 83, at 76–77 (providing an overview of the historical development of subscription-based rating agencies).

190. See 17 C.F.R. § 240.15c-1 (2008) (authorizing NRSRO ratings to be used in implementing the net capital requirements for broker dealers).

191. See Claire A. Hill, *Rating Agencies Behaving Badly*, 35 CONN. L. REV. 1145, 1146–47 (2003) (describing the requirements issuers face in securing ratings).

192. See SEC Concept Release, *supra* note 6, at 2.

agencies and the conflicts of interest inherent in the relationship between rating agencies and issuers left rating agencies unaccountable.

2. 2006 Legislation: A Failed Attempt to Make the SEC the Locus of Accountability

The Credit Rating Agency Reform Act of 2006 (the “2006 Act”) sought to narrow the accountability gap between rating agencies and creditors by shifting the locus of rating agency accountability to the SEC.¹⁹³ The irony is that Congress’s “solution” to the problem came on the eve of the subprime mortgage financial crisis, yet this law’s inadequacies did little to nothing to address the underlying problems of a lack of gatekeeper accountability. The 2006 Act sought to foster accountability, transparency, and competition among rating agencies. Few could quarrel with these laudable goals, but it is easy to find fault with the half-measures that were put in place to further these objectives.

The 2006 Act asserted the SEC’s authority over NRSRO registration and oversight, delineated the criteria for NRSRO certification, and mandated greater disclosure of ratings methodologies and conflicts of interest.¹⁹⁴ The one significant reform entailed opening the door for new entrants into the field of rating agencies by creating a more clear process and criteria for recognition of NRSROs. But while this reform may spur greater competition in the long run, it does not change the market power that the dominant rating agencies currently enjoy. The mere fact that other entrants may enter into the rating agency market may mean little given the ability of the dominant rating agencies to pressure issuers to retain their services.¹⁹⁵

As significantly, while the 2006 Act spoke of greater oversight of rating agencies, it fell far short of its aspirations as it does not create any meaningful accountability for rating agencies. The 2006 Act’s approach falls within the scope of the free-market-driven reforms of the last generation in relying on transparency as an ostensible elixir and nominal oversight by the SEC that lacks teeth.¹⁹⁶ Taking the first

193. See Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327, 1327–29 (codified in scattered sections of 12, 15, 20, and 23 U.S.C.).

194. *Id.*

195. See *supra* Part II.D.

196. This approach parallels the Sarbanes-Oxley Act’s creation of the Public Company Accounting Oversight Board (“PCAOB”), whose mandate includes “establish[ing] . . . auditing, quality control, ethics, independence, and other standards relating to the

step toward greater competition among rating agencies and clarifying the SEC's oversight role represents progress, but policymakers sidestepped more meaningful reforms.

Recently proposed SEC rules have sought to heighten transparency in the ratings process and to curb some of the most abusive rating agency practices that fueled the subprime mortgage crisis.¹⁹⁷ But instead of tackling the deeper challenges of rating agency accountability, the SEC has also proposed trying to legislate the problem away by rolling back the extent to which SEC rules require issuers to secure ratings.¹⁹⁸ The degree to which these changes would alter market reliance on ratings is an open question. The irony of this approach, however, is that the SEC appears to be embracing a philosophy of caveat emptor at a time when the failures of rating agencies have underscored the importance of rating agencies' accurate and timely screening of risk to the health of financial markets. The SEC's approach may be understandable given the inadequacies of public oversight of rating agencies, yet it overlooks the fact that creditors may be equipped with the potential means to hold rating agencies accountable.

3. The Plight Facing Creditors

Under the current system creditors rely on ratings for assessing issuer creditworthiness, yet are left out of the equation when it comes to any ability to hold rating agencies accountable.¹⁹⁹ Creditors rely on the accuracy of rating agencies in making investment decisions, and rating agencies' assessments of default risk may directly impact their bottom line. For example, distinctions between investment-grade and non-investment grade debt and other indicators of default-risk help

preparation of audit reports for issuers." Sarbanes-Oxley Act of 2002 § 101, 15 U.S.C. § 7211(c)(2) (2006). But while the PCAOB has some tools at its disposal to enforce its mandate, the SEC is vested with responsibility to regulate rating agencies, yet lacks the means to uphold its oversight role.

197. See, e.g., Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,211 (proposed June 25, 2008) (to be codified at 17 C.F.R. pts. 240 and 249b), available at <http://www.sec.gov/rules/proposed/2008/34-57967.pdf>; SEC, *supra* note 12, at 4–5.

198. See SEC 2008 Proposed Rules, *supra* note 13. However, the SEC has opted in the short term to focus on addressing rating agencies' conflicts of interests and heightening transparency and has not implemented the proposed rules on removing requirements for ratings. See *SEC Issues Rules on Conflicts in Credit Rating*, *supra* note 14.

199. See Unterman, *supra* note 169, at 121–22 (describing how pension funds are required by law to hold debt that is at least investment grade).

creditors determine the risks they are assuming.²⁰⁰ While large banks may supplement ratings with input from in-house or other independent analysts, the reliance interest appears at its strongest in the case of smaller creditors who may have fewer alternatives to ratings.

In spite of the interest of creditors in ensuring that rating agencies perform their job accurately, the lack of any relationship between rating agencies and creditors means that rating agencies owe creditors no duties. The actors with the greatest interest in holding rating agencies accountable are left holding the bag when rating agencies are asleep at the wheel and defaults occur without any warning from the gatekeepers. While government requirements for ratings pursued a worthy end of expanding the coverage of ratings, by transforming issuers into employers of rating agencies, this mandate removed the financial linkage between rating agencies and creditors and the potential for accountability created by subscription-based services.²⁰¹ Restoring a system of financial accountability between creditors and rating agencies has the potential to give creditors incentives to monitor rating agencies and to hold rating agencies accountable for their failures.

III. A USER FEE APPROACH TO HEIGHTEN RATING AGENCY ACCOUNTABILITY

A. *The Desirability of Preserving Ratings as a Public Good*

Turning back the clock to a world in which rating agencies were accountable to creditors could be as simple as eliminating the requirements that issuers secure NRSRO ratings.²⁰² Given the SEC's recently proposed rules to scale back requirements for ratings, this is more than a merely theoretical question.²⁰³ However, market practices and contractual relations have developed around the provision of ratings, and issuers would likely feel strong pressures to

200. Issuing public "ratings" of the rating agencies' performance represents the closest creditors have come in seeking to heighten rating agency accountability. See Jody Shenn, *Moody's is Least Accurate Subprime-Bond Rating Firm*, BLOOMBERG NEWS, Apr. 2, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=abqrFE4LNOd4&refer=home> (discussing UBS' ranking of rating agencies based on their accuracy in rating subprime debt).

201. See Kerwer, *supra* note 151, at 466.

202. Furchtgott-Roth et al., *supra* note 83, at 76-77 (providing an overview of the historical development of subscription-based rating agencies).

203. See, e.g., SEC 2008 Proposed Rules, *supra* note 13.

continue to secure ratings even in the absence of federal, state, and international mandates.²⁰⁴

One virtue of shifting to a ratings world centering on subscriptions is that it would open up the door to more meaningful competition. As noted earlier, the 2006 Act enabled new rating agencies to acquire NRSRO status more easily, yet the dominance of the market leaders may make this amount to a hollow opportunity.²⁰⁵ But in a subscription-driven world, smaller rating agencies and new entrants would not face an all or nothing game of being one of two rating agencies of a given issuer, a status that may be hard to win because they are not as established. Instead, smaller rating agencies and new entrants could target their efforts on securing creditor clients and on tailoring their coverage and rating styles to fit clients' needs.²⁰⁶ This decentralized approach to ratings would also potentially heighten the value of ratings because ratings would be private (at least to the pool of a given rating agency's subscribers).

The downside of a subscription approach is that it would eliminate the one significant contribution of government rating requirements, which was to make ratings become a public good providing near comprehensive coverage of debt offerings.²⁰⁷ Ratings squarely fit within understandings of what constitutes a public good. First, the "consumption" of ratings is nonrival, that is, once the good is produced, there is no marginal cost to expand its scope of proliferation. Second, nonpayers of ratings cannot easily be excluded from gaining access to this information, as once a rating is issued, it becomes widely disseminated.²⁰⁸

The fundamental challenge facing public goods is that in the absence of government intervention, the good will either not be produced or it will only be produced and disseminated for those who can afford it.²⁰⁹ The necessity of managing credit risk means that ratings would continue to be produced, at least for those parties who

204. See Schwarcz, *supra* note 15, at 7–8 (discussing the scope of market reliance on ratings).

205. See *infra* Part II.D.2.

206. See Creswell & Bajaj, *supra* note 112; Gretchen Morgenson, *Wanted: Credit Ratings. Objective Ones, Please*, N.Y. TIMES, Feb. 6, 2005, § 3 (Business), at 1 (discussing how Egan-Jones adopted this strategy of targeting on particular market sectors and building its business through subscription sales prior to being recognized as an NRSRO rating agency).

207. See Schwarcz, *supra* note 15, at 8–10.

208. See Carol Rose, *The Comedy of the Commons: Custom, Commerce, and Inherently Public Property*, 53 U. CHI. L. REV. 711, 718–20 (1986) (providing an overview of what is generally understood to constitute public goods).

209. See Gillette & Hopkins, *supra* note 16, at 802–03.

could afford it, even in the absence of a government mandate. But a subscription approach could enhance the disparity between the haves and the have-nots of financial information. While large banks may have the financial means to pay for rating agencies' subscription services or to create in-house equivalents,²¹⁰ smaller creditors would face difficult choices concerning whether to sign up for rating subscriptions or to rely on other proxies of risk. Alternatively, to the extent that ratings would still become leaked to the public, the quality and supply of this information may be affected as rating agencies may have less economic incentive to invest in diligence to perform their gatekeeping role.²¹¹

B. The Merits of a User Fee Approach

An SEC-administered user fee system has the potential to overcome the shortcomings of both the current "issuer pays" system and subscription-based alternatives. A user fee system would address collective action problems in financing ratings and coordinating the monitoring efforts of debt purchasers to avoid needless overlap of both gatekeepers and oversight. It would also provide leverage for eroding the dominance of rating agencies by consolidating demand for ratings and creating a bidding process for rating agencies to serve as screeners for debt issues.

1. The Contours of an SEC-Administered User Fee System

The creation and administration of a user fee system would necessarily entail a more active government role in the ratings process. The simplest means would be to have the SEC (or a sub-agency)²¹² serve as the administrator of a user fee system for creditors to finance the solicitation of ratings through a competitive bidding process.

One virtue of a user fee approach is the ability to overcome coordination problems among creditors, which market-based approaches may not be able to address.²¹³ For example, prior to the issuance of debt, each potential creditor would have an interest in

210. See Fisch & Sale, *supra* note 59, at 1041 (discussing the role of in-house analysts at banks).

211. See Gillette & Hopkins, *supra* note 16, at 803.

212. The new sub-agency could be called the Ratings Accountability Division or "RAD," a potentially colorful name for a somber field.

213. See Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 861-68 (1982) (discussing the collective action problems that face creditors outside of bankruptcy).

securing accurate ratings, yet there may be little incentive for potential creditors to pool resources because they may have widely disparate interests. In contrast, after debt is purchased, creditors would share a more uniform interest in securing accurate ratings to gauge their credit exposure and may have greater incentives to work together to ensure ratings are regularly reviewed and updated. This self-interest may arise too late in the credit process as creditors need both to secure ratings prior to the issuance of debt and throughout the life of the debt.²¹⁴

A user fee system could resolve this gap by creating a mechanism to pool creditors' resources to secure ratings before debt is issued.²¹⁵ The SEC would be in the position to leverage the centralization of demand for ratings to contain the costs of ratings and to require rating agencies to assume greater responsibilities as a condition of winning the bid. The use of a pay-as-you-go approach would allow the SEC to solicit ratings prior to the issuance of debt and then to pay for these expenses and related administrative costs through a user fee imposed on the purchasers of the debt. Popular images of pay-as-you-go systems have been distorted by debates over Social Security and Medicare where the demographic gap between recipients and a declining pool of contributors has raised questions about these programs' financial viability.²¹⁶ In contrast, both the costs and the creditor beneficiaries of debt offerings would be easily identifiable in any given case. The costs of ratings could be recouped within a very short time frame after the initial ratings are issued (rather than many years later as in the case of social welfare programs). In cases where companies fail to issue rated debt at the eleventh hour, the SEC could be empowered to impose the user fee on the issuers themselves since in those cases they would be the only readily identifiable beneficiaries of information on their creditworthiness.

User fees could be financed by imposing a flat fraction of a percentage fee on the initial purchases of debt offerings to finance ratings and the SEC's administrative fees for soliciting and overseeing rating agencies.²¹⁷ This approach would mirror the current system in

214. See Schwarcz, *supra* note 57, at 253–54.

215. See Reynolds, *supra* note 16, at 380 (discussing how user fees are imposed in local government contexts well before consumption of the underlying good or service).

216. See, e.g., MICHAEL J. GRAETZ & JERRY L. MASHAW, *RETHINKING AMERICAN SOCIAL INSURANCE: TRUE SECURITY* 5–18 (1999) (providing an overview of the merits and shortcomings of the current pay-as-you-go systems of social insurance).

217. The conventional approach in most user fee contexts is for the user fee to approximate the opportunity cost for producing the good, and the combination of the cost

which issuers typically pay rating agencies a fee of three to four basis points (i.e., three or four hundredths of a percent) of the face amount of the debt offering.²¹⁸ The SEC could finance ratings on a rolling basis with the ratings for a given debt issue being secured before the issuance of the debt. Then the SEC could recoup these expenses through a set ratings user fee on the initial purchasers or a smaller user fee that applies to both initial purchase and subsequent resales. For reasons of simplicity in administration and monitoring it would likely prove easier to have a one-time fee at the initial sale which is designed to cover the lifetime of ratings for the debt.

2. The Tradeoff Between Price Competition Bidding and Cost-Based Government Contracting

One of the most significant challenges facing the user fee system would be delineating the criteria for a competitive bidding process. The bidding process would potentially serve three functions: containing the costs for ratings through price competition, eroding the dominance of a handful of rating agencies by leveling the playing field for smaller competitors and new entrants, and balancing the desirability of market-based assessments of risk with a greater role for the SEC in defining rating agencies' responsibilities.²¹⁹

The simplest approach would be to have bidding based solely on the price of the rating agencies' services with the SEC selecting the lowest bidder who also meets the SEC's requirements to serve as a NRSRO (and any other conditions that the SEC details *ex ante*).²²⁰ The virtue of this approach is administrative efficiency as it would allow the SEC to process a myriad of bids for rating debt issues in short order. By centralizing market demand for ratings, the user fee system could leverage that power to secure ratings at lower cost. Rating agencies would be repeat players in their interaction with the SEC because they would not only be rating existing debt issues, but also would be making bids for new debt issues on an ongoing basis. Ratings agencies would therefore have significant incentives to assess risks accurately for fear of potentially facing limits on future bids.

of private bids from rating agencies plus the administrative costs of running the user fee system would approximate this figure. See Gillette & Hopkins, *supra* note 16, at 796–99.

218. See Partnoy, *supra* note 15, at 72.

219. See Competition in Contracting Act, 41 U.S.C. §§ 251, 253 (2000) (laying out the scope and nature of competitive government contracting processes).

220. See VERNON J. EDWARDS, SOURCE SELECTION ANSWER BOOK 11–12 (2000) (discussing the default rules for price competition in government contracting).

The potential concern about this approach is that price competition may create perverse incentives for underinvestment in actual diligence of issuer risks. Rating agencies may be tempted to invest as little as possible in assessing issuers while grading them harshly to create the appearance that they are more thoroughly scrutinizing risks. This concern would be mitigated by the enactment of substantive certification and mandatory reporting duties for rating agencies, as well as the check of potential liability exposure to creditors for gross negligence or the threat of informal sanctions imposed by the SEC for negligence.²²¹ Much of the success of bidding based solely on price would ultimately turn on the degree of efficacy of the SEC and creditors in monitoring rating agencies' conduct.

The other alternative would be to utilize a cost-based government contracting method for the bidding process.²²² This approach envisions rating agencies competing not merely on price but also on the types and extent of diligence they propose to undertake in assessing a class of debt, as well as on the types of diligence and disclosures they would demand from issuers as a condition for ratings. While a cost-based approach may prove to be more expensive, one of the problems raised by the subprime crisis is the systematic underinvestment in risk assessment.²²³ Therefore, shifting from a world in which three of four basis points (i.e., hundredths of a percent) of the value of debt are dedicated to rating risks to one in which marginally higher investments are made to scrutinize risks could be a tradeoff that is worth making. Rating agencies already lay out their qualitative and quantitative methodologies to debt issuers, and it would not be a huge leap to have them delineate the diligence steps that they would be making or imposing on issuers as a condition for granting ratings. A cost-based approach would seek to weave market-based approaches into assessing risk with a regulator's discretion in shaping the criteria for rating. Since the SEC may face difficulties anticipating distinctive risks posed by new forms of debt on its own, a cost-based approach would give the SEC flexibility to shape risk management without resorting to direct regulations.

221. See *infra* Parts IV.A-B.

222. See Stephanie A. Dunne & Mark A. Loewenstein, *Costly Verification of Cost Performance and the Competition for Incentive Contracts*, 26 RAND J. ECON. 690, 691-93 (1995) (detailing the features of cost-based government contracting and discussing the challenges and costs of monitoring compliance with cost-based contracts).

223. See Bajaj, *supra* note 4 (discussing how attributions of blame have sought to cover the absence of effective risk management during the bubble market).

The potential Achilles' heel of a cost-based approach is the question of whether the SEC would be well equipped to choose between rating agencies' competing approaches. Part of the challenge would be addressing the sheer number of debt issues as the SEC could easily be overwhelmed in time-intensive efforts to assess cost-based bids by rating agencies and to monitor the results. But even putting aside concerns about the SEC's ability to process large numbers of bids, the larger issue is that the SEC may be far better positioned to select low bidders and to set floors for rating agency diligence than to engage in more difficult and subjective choices concerning what rating agency approaches are preferable.

Concerns about administrability suggest the desirability of having the bidding process center on price competition. However, in selecting the lowest bidders, the SEC could still simultaneously require rating agencies to detail the type and extent of diligence that the rating agency would commit to undertake (or to impose on issuers as a condition for ratings). In this way rating agencies' commitments would form a backdrop for understanding the scope of rating agencies' certification and mandatory reporting duties and the potential basis for actions by creditors or the SEC, topics which the following Section will discuss.²²⁴ Additionally, the SEC could be given discretion to reject low bids that fail to meet the agency's minimal thresholds of diligence requirements or to condition bids on satisfying such thresholds. Rating agencies' self-interest as repeat players would create significant incentives to be responsive to the SEC and creditors' concerns raised both during and after the bidding process.

The virtue of either approach is that implementing a bidding process to secure ratings would allow the SEC to open up participation to a far broader pool of rating agencies and potentially level the playing field for new entrants.²²⁵ Smaller rating firms that could not hope to compete with Moody's or S&P in offering ratings for every conceivable issue could leverage expertise in the risks involved in particular sectors of the economy to compete in terms of

224. See *infra* Parts IV.A–B.

225. This approach would not rely on speculative hopes of the creation of new rating agencies. There are approximately sixty-four rating agencies worldwide, and all the SEC would need to do to create more competition is to convince experienced overseas rating agencies to participate in a more open U.S. market. See *Credit Rating Agencies—Globally*, http://www.defaultrisk.com/rating_agencies.htm (last visited Apr. 9, 2009).

both price and quality.²²⁶ While issuers currently may be afraid of defecting from Moody's for fear of retribution in the form of unsolicited, negative ratings,²²⁷ the SEC could open up the markets for ratings. This approach would seek to have a user fee system largely pay for itself both in terms of diminished costs and higher value in terms of greater accuracy of ratings.

3. The Creditor Committee Complement to a User Fee System

The SEC's role in administering a user fee system is only part of the appeal of a user fee model as it would also create an ongoing relationship between creditors and rating agencies. The SEC would play an indispensable role in the process of securing the services of rating agencies in the period prior to creditors' purchase of the debt at issue. But following creditors' purchase of debt, creditors would be in a position to monitor rating agencies and complement SEC oversight.

Corporate law has rarely considered the potential for joint efforts by creditors outside of the bankruptcy context.²²⁸ Under the current system creditors' rights are solely defined by their contractual relationships with issuers. Creditors are treated as essentially atomistic in nature with no concept of horizontal privity among creditors based on their relationship with a given issuer.²²⁹ Since creditors have a variety of potentially conflicting interests in the direction of a corporation, academics have generally assumed it is impractical to empower creditors to intervene in any context save the reorganization or liquidation of an issuer.²³⁰

226. See Morgenson, *supra* note 206 (discussing Egan-Jones' use of a similar market niche strategy under the current system).

227. See *infra* Part II.D.4.

228. See, e.g., Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1350-59 (2007) (discussing the challenges of extending corporate duties to creditors outside of the Chapter 11 bankruptcy process).

229. See, e.g., Jo Ann J. Brighton & Mark N. Berman, *Second-Lien Financings: Enforcement of Intercreditor Agreements in Bankruptcy*, AM. BANKR. INST. J., Feb. 2006, at 38-39 (discussing how intercreditor agreements generally consist of alliances of lenders or homogeneous subsets of creditors, rather than creditors as a whole); C. Edward Dobbs, *Negotiating Points in Second Lien Financing Transactions*, 4 DEPAUL BUS. & COM. L.J. 189, 190-93 (2006) (discussing the challenges facing efforts to negotiate intercreditor agreements).

230. See Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 860-64 (1996) (discussing the conflicts of interest which may arise among creditors as issuers approach insolvency); see also Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1237-38 (2005) (providing empirical data

A user fee system creates the potential for challenging the conventional wisdom by crafting new relationships among creditors vis-à-vis the rating agencies. The creation of creditor committees would serve as a complement to a user fee system by providing a channel for creditors to monitor ratings and to assert limited rights against rating agencies. This approach would build on the model of creditor committees that are used in bankruptcy contexts to represent the interests of creditors.²³¹

One challenge of assembling a creditor committee in a bankruptcy context is balancing the representation of different categories of creditors with potentially divergent interests.²³² One of the many reasons that creditors generally have no rights (outside of contractual rights) in the management of a corporation is that the varying level of protection they enjoy may lead to divergent incentives for how they may seek to influence corporate policies.²³³ The more similar the debtholder's interests are to an equityholder, for example, a preferred stockholder, the more they may support equity maximizing strategies, and the weaker the protection the more debtholders may want to push for risk-averse investment decisions.²³⁴ Similar problems may present themselves in the rating agency context as different categories of creditors may be impacted more severely by rating downgrades from investment-grade to non-investment-grade or a default event.

Creditor committees in the bankruptcy context seek to address the challenges of potentially conflicting interests by having representation of each class of creditor and requiring their consent to court-approved reorganizations.²³⁵ Building off of the creditor

from the bankruptcy context which supports the concern about conflicts of interests among creditors).

231. See 7 COLLIER ON BANKRUPTCY ¶ 1122.01 (rev. 15th ed. 2007) (discussing the centrality of creditor committees and committees representing other stakeholders in the bankruptcy reorganization process).

232. See Henry T.C. Hu, *Buffett, Corporate Objectives, and the Nature of Sheep*, 19 CARDOZO L. REV. 379, 392–95 (1997) (discussing how conflicts within different categories of stakeholders may shape their priorities in corporate risk taking).

233. See Hu & Westbrook, *supra* note 228, at 1353–54, 1361–63 (discussing how divergent interests among creditors may cause them to push for different corporate strategies if they enjoy a measure of control over the issuer).

234. See Hu, *supra* note 232, at 392–95.

235. See 11 U.S.C. § 1102(2)(i) (2006) (“The United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders.”); see also § 1109(b) (noting that in a bankruptcy proceeding “a party in interest . . . may raise and may appear and be heard on any issue in a case under this chapter”); Hu & Westbrook, *supra* note 228, at 1370 (discussing governance issues in bankruptcy).

committee concept in the rating agency context would be simpler than in the bankruptcy context. Regardless of the divergent economic interests among creditors, creditors all benefit from clear and accurate gauges of risk and timely warnings of potential defaults. Each creditor is impacted by rating agencies' fidelity to their duties, and therefore considerations of representation (and the weighing of representation) of different categories of creditors would likely be far less important.

The simplest way to construct a creditor committee would be to have it consist of representatives of the initial purchasers of debt who would reflect a cross-section of the classes of creditors with holdings above a set threshold. The composition of the creditor committee would change as subsequent resales of debt took place, and the committee's composition would be limited to current debtholders. Bankruptcy law provides a template for the selection process for creditor committees as creditors of each class of debt could nominate a class representative by "voting" their pro rata share of the debt.²³⁶ Nominations would all be subject to SEC approval, which would only be withheld in extraordinary circumstances.

The word "committee" may conjure up an image of a cumbersome new layer of bureaucracy. But the objective of creating creditor committees is the opposite: to complement the need for ongoing oversight of rating agencies by the SEC with a mechanism for coordinating creditor monitoring of rating agencies. The creditor committee would serve as a channel for creditors to pool resources in monitoring and holding rating agencies accountable. In the event that rating agencies breach duties owed to the creditors, creditor committees would serve as the representative for creditors in any potential actions against rating agencies and would preempt actions brought by individual creditors.

The use of a creditor committee would also serve as a safeguard against potential capture of regulatory oversight by the SEC (or a subsidiary body).²³⁷ One challenge facing regulated industries is the ingenuity of regulated parties to manipulate the political process to influence regulators.²³⁸ Placing a creditors' committee in a position of

236. See Hu & Westbrook, *supra* note 228, at 1370–72.

237. See Schwarcz, *supra* note 15, at 27 (voicing concern that regulation of rating agencies could lead to political capture).

238. See Nicholas Bagley & Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUM. L. REV. 1260, 1284–85 (2006) (discussing public choice theory and risks of political capture of regulated industries).

oversight would mitigate this risk by making accountability rest in part with beneficiaries rather than solely with political appointees.²³⁹

IV. CRAFTING RATING AGENCY DUTIES

A. *Redefining Accountability for Rating Agencies*

1. The Challenges of Delineating Rating Agency Duties

A user fee system would create opportunities for accountability by forging ongoing relationships between rating agencies, the SEC, and creditors, yet the efficacy of accountability will largely turn on balancing incentives for the SEC and creditors to monitor rating agencies with manageable gatekeeper duties and liability exposure. This Section delineates certification and mandatory reporting duties for rating agencies modeled after duties facing auditors, which would expand and formalize the role of rating agencies as screeners of issuer disclosures and as the backstop for auditor and lawyer gatekeeping duties. It suggests how limiting financial liability to creditors to cases of gross negligence, coupled with an earnings-based cap on liability and other safeguards, will constitute a manageable burden for rating agencies, while still creating incentives for creditor monitoring. Lastly, this Section suggests how vesting enforcement discretion in the SEC for negligent conduct would help to ensure that liability exposure to creditors would not skew rating agencies' incentives too far in favor of creditors.

Policymakers could make rating agency duties to creditors a contractual condition of rating agency funding or a regulatory condition for NRSRO eligibility. The SEC could require all contracts with rating agencies under the user fee system to detail duties that rating agencies owe to their creditors, to delineate the potential liability exposure for breach of these duties, and to channel adjudication of any disputes over alleged breaches to an SEC administrative process.²⁴⁰ Alternatively, the SEC could exercise its

239. See Stephenson, *supra* note 44, at 110–11 (discussing how private enforcers may overcome enforcement slack by public agencies, due to political pressure, enforcers' sloth or inaction, or lobbying).

240. Although the SEC does not currently adjudicate claims through an administrative process, the Commodity Futures Trading Commission ("CFTC") has extensive experience in adjudicating claims. For example, the CFTC provides opportunities for customers of commodities brokers with opportunities to seek damages against brokers for violations of the Commodity Exchange Act or other CFTC regulations, as well as adjudicates counterclaims arising out of the same transaction(s) or occurrence(s). See Commodity

regulatory authority in granting NRSRO status to make acceptance of rating agency duties to creditors a requirement for rating agencies' continued NRSRO status. Currently, there are no strings attached to NRSRO status, but there is no reason that the conferral of the privilege or "property right" that NRSRO status entails could not be linked with the acceptance of duties.²⁴¹

In crafting gatekeeping duties, reformers must confront two types of problems: the need to delineate rating agency duties that balance credible commitments to impose liability on wayward rating agencies with manageable burdens and the need for incentives for monitoring by creditors. The crux of the first problem is that there are inherent ambiguities in the rating process. Just as the nature of auditing and legal functions makes it difficult to delineate the lines between good lawyering or auditing and facilitation of corporate wrongdoing,²⁴² the nature of assessing risk exposure means that it is difficult to scrutinize rating agencies' decisions. One needs only glance at the alphabet soup of formal letter ratings and the different methodologies used by rating agencies to understand that the "bucket

Futures Trading Comm'n v. Schor, 478 U.S. 833, 836–37, 856–57 (1986) (upholding the CFTC's jurisdiction over state-law counterclaims raised in its adjudicative process, so long as the counterclaims are "necessary to make the reparations procedure workable" for the underlying federal claim).

241. To the extent that a reader is not persuaded by the merits of a user fee approach, it is worth noting that this linkage of "the bitter with the sweet" in granting rating agencies NRSRO status could also serve as an independent basis for this Article's focus on shifting accountability from issuers to creditors.

242. The gatekeeper responsibilities introduced by the Sarbanes-Oxley Act spurred extensive debate about the potential and pitfalls of auditor and lawyer gatekeeper duties. See, e.g., Coffee, *supra* note 7, at 336–37 (arguing that the gatekeeping duties created by the Sarbanes-Oxley Act do not adequately address the incentives that accounting gatekeepers have to acquiesce to irregularities); Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 789–98 (2004) (highlighting the shortcomings of the gatekeeping duties for lawyers); Sung Hui Kim, *The Banality of Fraud: Re-situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983, 1052–54 (2005) (criticizing the disclosure rules for lawyers as not going far enough and proposing ways to make disclosures more effective by enhancing the independence of corporate counsel); Steven L. Schwarcz, *Financial Information Failure and Lawyer Responsibility*, 31 J. CORP. L. 1097, 1100–12 (2006) (arguing that proactive lawyer monitoring would produce only marginal benefits for fraud, mistake, and interpretation, and have no impact on GAAP errors causing the informational failure); Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1, 6–8 (2005) [hereinafter Schwarcz, *The Limits of Lawyering*] (arguing for a limited gatekeeper duty that so long as lawyers neither know nor should know that their opinions will be used to facilitate accounting fraud they may deliver legal opinions).

system” of rating risk by categories obfuscates the rating process and the degree of accuracy of individual ratings.²⁴³

This Section will suggest that the best way to resolve these challenges is to have certification and mandatory reporting requirements, which are subject to a negligence standard, serve as the centerpiece for rating agency gatekeeper duties. However, while rating agencies could be subject to informal action by the SEC for negligent conduct, this proposal would limit financial liability exposure to creditors to cases of gross negligence in order to mitigate risks of over-deterrence.

2. The Scope of a Certification Requirement

Certification and mandatory reporting duties for auditors under the Sarbanes-Oxley Act form a template for constructing a workable system of gatekeeping duties and liability for rating agencies.²⁴⁴ Although these duties would assume a different form in the context of rating agencies, rating agencies could be required to certify on a quarterly basis that they have exercised reasonable care in conducting due diligence of issuers’ financial and nonfinancial disclosures to make accurate assessments of risk exposure.²⁴⁵ Similarly, rating agencies could be required not only to flag incipient signs of fraud for their creditor clients to gauge risk exposure, but also to notify both creditors and the SEC when rating agency requests for issuers to provide additional information are stymied with nonresponses.²⁴⁶

The underlying appeal for imposing a certification duty is that it would formalize the status of rating agencies as the sole gatekeeper that scrutinizes both financial and nonfinancial disclosures.²⁴⁷ The Sarbanes-Oxley Act effectively created a system in which gatekeeping duties apply to looking at each half of the elephant, yet no gatekeeper is accountable for assessing the whole. Auditors must certify the

243. See Hill, *supra* note 15, at 47–49.

244. See, e.g., Coffee, *supra* note 7, at 337–40.

245. See 15 U.S.C. § 78j-1(a)–(e) (2006). The Sarbanes-Oxley Act also introduced a similar certification requirement for the chief executive and financial officers of public companies who must vouch that each disclosure report fairly presents the financial conditions and results of the company in all material respects. See 18 U.S.C. § 1350(b) (2006).

246. While not the focus of this Article, a parallel reform would be to bar rating agencies from offering consulting services to issuers. This approach would mirror the Sarbanes-Oxley Act’s prohibition of auditors from hawking ancillary consulting services to their clients because of concerns about auditor independence. The Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(g).

247. Cf. Sale, *supra* note 1, at 411–20 (discussing the potential and limits of enlisting investment banks as screeners of corporate wrongdoing).

financial disclosures of issuers, and Sarbanes-Oxley took the first step toward having lawyers certify diligent review of the nonfinancial disclosures.²⁴⁸ But nothing stops issuers from continuing to subvert these gatekeepers by farming out work to auditors and lawyers in a way that ensures that no one has a big picture view of what is happening.²⁴⁹

Rating agencies are uniquely positioned to assume responsibility for a more global view of issuers. In theory, they already perform this role in assessing risks, yet the lack of liability, regardless of the degree of thoroughness or accuracy (or lack thereof), makes it a hollow obligation.²⁵⁰ Imposing a certification duty on rating agencies backed by the threat of liability may create incentives for rating agencies to scrutinize issuer disclosures more closely for fraud risks and creditworthiness. A certification obligation would not be tantamount to requiring rating agencies to pour through every disclosure from a given issuer.²⁵¹ However, they would have incentives to develop more transparent processes for analyzing issuer disclosures and assessing credit worthiness. A certification obligation would also encourage rating agencies to articulate clearer reasons for their ultimate decisions on risk exposure. In the long run, this approach would not only enhance the value of corporate disclosures to investors, but also would strengthen the significance of ratings themselves as a proxy for issuer risk exposure.

However desirable a certification duty may appear, defining the contours of that duty may be more difficult for rating agencies than for auditors. The analogy between the certification roles of an auditor and rating agency is admittedly an imperfect one because of the different functions they perform. The greater precision of accounting rules means that auditors may be capable of achieving a far greater degree of certainty in examining financial data than rating agencies can achieve in assessing the risk exposure of issuers.²⁵² As a

248. See Cunningham, *supra* note 57, at 949–54, 966–68.

249. See POWERS et al., *supra* note 100, at 3–10 (discussing the piecemeal way in which Enron doled out its legal work to prevent securities intermediaries from appreciating the deception that was afoot).

250. See *supra* Part II.D.

251. See Coffee, *supra* note 7, at 354–57 (discussing the nature of auditor certification roles and the potential nature of lawyer certification roles).

252. See Cunningham, *supra* note 57, at 949–54 (discussing the responsibilities and challenges which auditors face).

result, auditors can make an affirmative certification that financial disclosures conform with GAAP.²⁵³

In contrast, rating agencies assume a much broader responsibility and are likely not as privy to the internal goings on of issuers as are issuers' lawyers and accountants.²⁵⁴ That being said, rating agencies do enjoy leverage to demand additional nonpublic information from issuers in order to grant or maintain a rating.²⁵⁵ This fact means that rating agencies' certification duty should be commensurate with their ability to acquire additional information and the need for rating agencies to exercise due care in deciding whether or not to press issuers for additional information.

Given the balance of challenges that rating agencies may face, a modified negative assurance approach is appealing. In short, a negative assurance approach would require rating agencies to certify that their conclusions are based on diligence of the disclosures and risk factors that are reasonably available.²⁵⁶ Rating agencies could satisfy this negative assurance certification duty by attesting that they engaged in reasonable care in reviewing the issuer's disclosures and requesting additional information that is sufficient to support their conclusions about risk exposure and the absence of signs of fraud.²⁵⁷ Additionally, they would have to attest that they have no knowledge or belief that other material information relevant to the disclosures has been withheld by the issuer or excluded from the rating agencies' analysis.²⁵⁸ This certification would constitute both a formalization and an expansion of the role of ratings agencies and provide a legal backdrop for efforts to hold rating agencies accountable.

253. See AM. INST. CERTIFIED PUB. ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS § 110.01 (2003).

254. Given these limits, policymakers may not want rating agencies to face as onerous a set of certification requirements as accountants. A similar concern would apply in considering the scope of a formal certification requirement for lawyers because their ability to make a certification is also more narrow than auditors. Lawyers' diligence efforts largely focus on the legality and internal consistency of the types of documents their clients present for review.

255. See Kraakman, *supra* note 7, at 61–66.

256. See Coffee, *supra* note 7, at 356–57 (pointing out the potential virtues of negative assurance certifications in the lawyer context).

257. Framing the duty in terms of reasonable care would be designed to focus rating agencies on creating reliable benchmarks of risk. As the following section will discuss, rating agencies' financial liability to creditors would be limited to cases of gross negligence to avoid risks of over-deterrence, while the SEC would have leeway to impose nonfinancial sanctions in cases of ordinary negligence.

258. See Coffee, *supra* note 7, at 356–57.

3. The Extent of Mandatory Reporting Requirements

Mandatory reporting requirements for rating agencies could also be constructed to parallel the mandatory reporting requirement for auditors.²⁵⁹ Auditors must investigate and disclose potential signs of fraud to the management and audit committee if they are merely aware of evidence that an “illegal act . . . has or may have occurred,” even if it is not perceived to be material.²⁶⁰ If the auditor concludes the illegal act has a material effect and believes that appropriate remedial action has not been taken, the auditor must file a formal report about the illegal act both with the client’s board of directors and the SEC.²⁶¹

Both the mandatory nature of and triggers for disclosures of evidence of fraud are relevant for constructing similar duties for rating agencies. Under the current system a rating agency could always use perceived evidence of illicit activity or fraud as a basis to downgrade the rating of an issuer. After all, signs of fraud may reasonably be perceived to be the tip of the iceberg of corporate cultures gone awry, a tale the Enron saga captured. But shifting to a mandatory disclosure system would formalize a rating agency’s duty to disclose this information when incipient signs of illicit activity arise.²⁶² This duty would seek to ensure that another set of eyes watch the issuer, which may be particularly important when auditors and lawyers are either expressly or tacitly complicit with their clients’ wrongdoing.

Requirements for timely disclosure of signs of wrongdoing could be far simpler under a user fee approach. Since creditors would be the clients of rating agencies, it flows logically that rating agencies have a duty to disclose immediately any evidence that an illegal act has or may have occurred, regardless of its materiality. This swift

259. See 15 U.S.C. § 78j-1 (2006).

260. See 15 U.S.C. § 78j-1(a)–(b). In contrast, lawyers must only report potential violations to their client’s officers or board of directors if the lawyers encounter credible evidence of material violations, a much higher standard which may justify inaction. See 17 C.F.R. § 205.3 (2008).

261. See 15 U.S.C. §§ 78j-1(b)(2)–(3). In contrast, SEC guidelines for lawyers allow for permissive, rather than obligatory, disclosure of evidence of material violations under certain circumstances. 17 C.F.R. § 205.3(d)(2)(ii). In other words, the rules allow lawyers to blow the whistle, but in practice lawyers would have strong incentives not to risk their relationship with their client and instead to wash their hands of the matter after notifying the client of the problem.

262. Although some commentators have argued that rating agencies cannot practically screen for signs of fraud, see, e.g., Schwarcz, *supra* note 15, at 6, rating agencies implicitly have an obligation to disclose evidence of fraud that they are aware of since it would constitute a significant credit risk.

disclosure of even non-material information to creditors would be relevant for investment decisions and therefore should be made available at the time it is known in order to minimize risks of insider trading. To the extent that a rating agency determines material effects may flow from signs of fraud, the rating agency should be obliged to make immediate, detailed disclosures to the SEC and creditors in order to expedite enforcement action and to mitigate potential losses.

Some may object that a mandatory reporting requirement could compromise the willingness of issuers to make nonpublic disclosures available to rating agencies and therefore thwart the gatekeeping role. But it is not clear that mandatory disclosure requirements would significantly change the incentives of issuers to disclose information to rating agencies. Rating agencies would continue to enjoy leverage over issuers because of their ability to withhold or downgrade ratings. Permissive reporting of signs of fraud has always been an option for rating agencies.²⁶³ Lawyers are far more restricted in making disclosures to the SEC because of the nature of the attorney-client relationship, but even they have always had permissive disclosure exceptions in contexts such as preventing present or future criminal fraud.²⁶⁴ Both lawyers and their clients enter into relationships appreciating the fact that their confidentiality may be compromised if exceptional third-party or judicial interests are at stake,²⁶⁵ and there is little empirical evidence that suggests that disclosure rules have compromised information flows between issuers and lawyers.²⁶⁶ The experience of lawyers suggests that there is little to fear as the incentives for cooperation would likely remain strong in the rating agency context.

Additionally, shifting from permissive to mandatory disclosure rules may actually strengthen the ability of rating agencies to press for further information. The threat of liability hanging over the heads of

263. Similarly, permissive reporting to the SEC is supported by both ABA rules and state ethics laws in the overwhelming majority of states. See THOMAS D. MORGAN & RONALD D. ROTUNDA, 2003 SELECTED STANDARDS ON PROFESSIONAL RESPONSIBILITY, ATTORNEYS' LIABILITY ASSURANCE SOCIETY, ETHICS RULE ON CLIENT CONFIDENCES 161-68 (2003) (providing an overview of state ethics rules on disclosure of client's confidential information and noting that a minority of states even *require* disclosure of confidential information to prevent a client's fraud and permit lawyers to disclose confidential information to address past fraud by clients).

264. See *id.*

265. See Fred C. Zacharias, *Rethinking Confidentiality*, 74 IOWA L. REV. 351, 376-79 (1989).

266. See Cramton et al., *supra* note 242, at 789-98, 814-16.

both the issuer and rating agencies may provide a more compelling reason for rating agencies proactively to request additional materials and for issuers to provide additional information than under the incentive structure of the current system.²⁶⁷

B. Oversight Under a Gross Negligence Approach Tempered by Caps and Safeguards

1. The Appeal of Limiting Liability to Gross Negligence

The combination of certification and mandatory reporting requirements would provide rating agencies with more clear responsibilities in overseeing issuer disclosures. Limiting rating agencies' financial liability to cases of gross negligence, coupled with an earnings-based cap on liability and other safeguards, would provide rating agencies with incentives for compliance without jeopardizing their financial viability. The SEC could complement this approach by having enforcement discretion to impose nonfinancial sanctions in cases of negligent conduct.²⁶⁸

A gross negligence approach would impose liability for rating agencies' failures to identify or engage in diligence of risks of such a nature and degree that the failure constitutes a gross deviation from a reasonable person's standard of care.²⁶⁹ This approach would

267. *See id.* at 816.

268. One alternative to imposing sanctions for negligence and gross negligence would be to treat ratings as expert opinions that would be primarily subject to Rule 10b-5 and section 11 liability. *See* 15 U.S.C. § 77(k) (2006); 17 C.F.R. § 240.10b-5 (2008). The virtue of the expert opinion approach is that it would piggyback off of existing liability schemes that courts have considerable experience in applying. The problem is that Rule 10b-5 would likely be too under-inclusive in covering only fraudulent conduct (and requiring causation and scienter), while the heart of the problem with rating agencies appears to be a matter of negligence or gross negligence in failing to reasonably scrutinize risks and to demand additional information. In contrast, section 11 liability would likely overdeter in imposing near strict liability for material misstatements or omissions, which could prove to be such an exacting standard that it may drive rating agencies out of the business or dramatically raise the costs of rating agencies' services to cover the higher liability exposure.

269. There are numerous definitions of gross negligence, which appear to coalesce around the concept of the absence of the failure to exercise even slight care or diligence. For example, Delaware courts apply a standard of gross negligence to determine whether corporate directors have sufficiently informed themselves to receive deference under the business judgment rule, and they define gross negligence as " 'reckless indifference to or a deliberate disregard of [the interests of] the whole body of stockholders or actions which are 'without the bounds of reason.' " *Tomczak v. Morton Thiokol, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,327, at 96,585 (Del. Ch. Apr. 5, 1990) (quoting *Allaun v. Consol. Oil Co.*, 147 A. 257, 261 (Del. Ch. 1929)); *Gimbel v. Signal Cos.*, 316 A.2d 599, 615 (Del. Ch. 1974), *aff'd per curiam*, 316 A.2d 619 (Del. 1974)); *see also*

admittedly impose greater costs on rating agencies, yet be designed not to constitute an unreasonable financial burden. The existence of this potential liability would heighten the already substantial leverage that rating agencies have to demand additional information before agreeing to certify ratings, and provide both rating agencies and issuers with incentives to spend more time examining disclosures more thoroughly. This approach may partly pay for itself due to the deterrent value against issuers and rating agencies, the heightened probability that rating agencies will flag misleading disclosures at an earlier point, and the greater reliability of both ratings and issuer disclosures to the public.

The dilemma that public enforcers face is that rating agencies have specialized skills and somewhat opaque methods that may allow them to obfuscate the degree of issuer risk exposure, which makes it very difficult to delineate a clear standard of conduct.²⁷⁰ While active complicity with issuers is possible, the nature of ratings would make it hard to identify intentional wrongdoing except in the very rare cases of a “smoking gun” e-mail. In reality, suspect rating agency activity will likely fall within a spectrum of negligent, grossly negligent, reckless, or severely reckless conduct.

The temptation is to seek to impose strict liability in order to provide the SEC or beneficiaries with a powerful weapon for cutting through the haze of rating agency lingo that may be designed to obscure the degree of compliance.²⁷¹ The strict liability approach would shift the burden of determining optimal compliance levels into the laps of rating agencies,²⁷² and would save courts and public

Saunders v. Sullivan, No. 3731991, 1992 WL 53423, at *2 (Del. Feb. 26, 1992) (“Gross negligence is the failure to perceive a risk of such a nature and degree that the failure to perceive such risk constitutes a gross deviation from the standard of care exercised by a reasonable person.”). Black’s Law Dictionary defines gross negligence as “a manifestly smaller amount of watchfulness and circumspection than the circumstances require of a person of ordinary prudence” that “falls short of being such reckless disregard of probable consequences as is equivalent to a willful and intentional wrong.” BLACK’S LAW DICTIONARY 1033 (6th ed. 1990).

270. See Black, *supra* note 41, at 790.

271. See Coffee, *supra* note 7, at 350–53 (advocating that auditors face modified strict liability for corporate disclosures with a cap on liability based on a multiple of their expected revenue streams from a given client); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 540–46 (2001) (advocating the imposition of strict liability on all gatekeepers, including investment banks, accountants, and lawyers, for material misstatements and omissions in offering documents).

272. It is important to note that strict liability would only theoretically force gatekeepers to internalize the cost of their misconduct. Even an optimal standard and

enforcers the costly and difficult tasks of ferreting out subtle distinctions between good-faith compliance and subversive obfuscation by rating agencies.²⁷³ Strict liability, however, may overdeter by punishing good-faith efforts to comply even in cases where there was no way (or at least no reasonably cost-effective way) that rating agencies could have identified wrongdoing.²⁷⁴

This problem is compounded by the fact that there are intrinsic limits in the ability of rating agencies to assess risk exposure and signs of issuer fraud. However much policymakers might want rating agencies to internalize the costs of failure, there are disclosures that may be so deceptive that even the issuer's auditors and lawyers could not recognize them.²⁷⁵ Applying strict liability in these cases would result in a deadweight loss on society, and worse still could threaten to undermine the financial viability of rating agencies for no enforcement gain.²⁷⁶

The other extreme would be to make the trigger for liability be recklessness or severe recklessness, which is the standard applied to establishing auditor fraud. For example, establishing auditor scienter for fraud under the Private Securities Litigation Reform Act ("PSLRA") requires a showing of "severe recklessness," which is "not merely simple or even inexcusable negligence, but an *extreme departure* from the standards of ordinary care."²⁷⁷ In the auditor context "[t]he [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to *no audit at all*, or an egregious refusal to see the obvious, or to investigate the doubtful."²⁷⁸

sanction would bear little fruit if the probability of enforcement were low. See Coffee, *supra* note 7, at 322–23.

273. See STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 5–17 (1987) (providing a comprehensive overview of the merits of strict liability versus negligence liability).

274. *But see* Partnoy, *supra* note 271, at 510–16 (discussing the costs that imposing negligence liability on gatekeepers may inflict).

275. See Carl Pacini, Mary Jill Martin & Linda Hamilton, *At the Interface of Law and Accounting: An Examination of a Trend Toward a Reduction in the Scope of Auditor Liability to Third Parties in the Common Law Countries*, 37 AM. BUS. L.J. 171, 215–17 (2000) (discussing the gap that exists between the aspirations of public policymakers for auditing and auditors' actual ability to screen for securities fraud).

276. See Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Revisited*, 8 STAN. J.L. BUS. & FIN. 39, 41–42 (2002).

277. *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1264 (11th Cir. 2006) (emphasis added) (quoting *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1282–83 (11th Cir. 1999)).

278. *PR Diamonds, Inc. v. Chandler*, 2004 FED App. 0318P, ¶ 34, 364 F.3d 671, 693 (6th Cir.) (emphasis added); *see also In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994) (making the same point).

Policymakers may understandably want to set an extremely high bar for proving auditor fraud,²⁷⁹ but applying a recklessness or severe recklessness standard to rating agencies may have little deterrence value because it would very rarely apply. Instead, the focus of rating agency accountability is on their diligence in assessing risks, which is why negligence or gross negligence seems a more appropriate standard. But while adoption of negligence-based liability could open the floodgates to litigation about the contours of reasonable care in the ratings context, the lighter touch of applying a gross negligence approach may offer a better balance of incentives for gatekeeper compliance and monitoring by creditors. There remains a danger that rating agencies may still be overly cautious if they face significant uncertainty concerning what constitutes compliance.²⁸⁰ A degree of overdeterrence may be unavoidable because of the risk of error by both the rating agencies and adjudicators in interpreting the scope of duties.

Rating agencies may respond to both these uncertainties and higher risk exposures on the margins by exiting or selectively reducing their exposure to markets. However, rating agencies would only have to show slight care or diligence in identifying and assessing risks to avoid liability for gross negligence, which is a modest standard to satisfy.²⁸¹ There may be legitimate concerns that a shift to liability for gross negligence would drive up the fees that rating agencies would charge for their services. Rating agencies would have both the interest and the leverage to demand additional disclosures from issuers and to invest more resources in fulfilling their diligence requirements. They would also demand higher fees to offset these costs and the greater risk of litigation.

Nonetheless, as discussed earlier, the creation of a user fee system could at least partly offset these pressures by centralizing demand for ratings in a single clearinghouse and driving down the

279. Part of the reason for setting a high bar on auditor fraud is because a basic premise of financial reporting is that the company—not the auditor—is responsible for the company's financial statements. AM. INST. CERTIFIED PUB. ACCOUNTANTS, *supra* note 253, § 110.03. The auditor's role is to opine on whether the financial statements fairly present, in all material respects, the company's financial position and accord with Generally Accepted Accounting Principles. *See id.* § 110.01.

280. *See* Louis Kaplow & Steven Shavell, *Accuracy in the Determination of Liability*, 37 J.L. & ECON. 1, 10–14 (1994) (discussing how varying interpretations by courts concerning what constitutes good-faith compliance may lead to excessive caution by potential defendants).

281. *See, e.g.,* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 862–63 (1994).

leverage that rating agencies would enjoy over their creditor clients. Increased compliance costs and demands for information would likely produce complaints from issuers, but would not radically change the economics for these services.²⁸²

One paradox of applying liability for gross negligence is that it may accentuate the incentives of rating agencies to equivocate to preserve defenses of reasonableness and therefore dampen the value of their services. For example, third-party opinions offered by lawyers are already notorious for being known more for their numerous caveats and thickness than for their substance.²⁸³ Rating agencies could similarly be expected to use equivocation as a shield to respond to greater threats of liability.

2. Capping Liability Exposure as a Multiple of Rating Agency Fees

A significant concern with certification and reporting requirements is that they may expose rating agencies to potentially ruinous liability, even in the case of a single breach.²⁸⁴ One way to mitigate this risk is to cap the liability exposure of rating agencies to a multiple of their annual fees and to require rating agencies to carry insurance or to meet self-insurance requirements to guard against this risk.²⁸⁵ A user fee system could easily impose these requirements by integrating them into the contractual relationships among the SEC, creditors, and the rating agencies, or alternatively this approach could serve as a regulatory condition for conferral of NRSRO status.

Since rating agencies only receive a small percentage of the value of bond issues as compensation, the threat of capped damages at a multiple of annual fees would still have significant deterrent effects. This approach would seek to balance the desire to heighten incentives for rating agency compliance with the need to avoid exposing rating agencies to “nuclear” liability that could bankrupt the rating

282. See Deborah Solomon & Cassell Bryan-Low, *Companies Complain About Cost of Corporate-Governance Rules*, WALL ST. J., Feb. 10, 2004, at A1.

283. See Schwarcz, *The Limits of Lawyering*, *supra* note 242, at 6–8.

284. A number of leading academics have made the case for a modified strict liability standard on auditors because of their essential role in safeguarding the financial stability of corporations in spite of these risks. See, e.g., Coffee, *supra* note 7, at 350–52; Partnoy, *supra* note 271, at 540–46.

285. Professor Ronen introduced an analogue of this idea by calling for issuers to purchase insurance for their financial statements, and Professor Coffee has refined this concept by calling for auditors to take out insurance that is a multiple of their revenue stream. See Coffee, *supra* note 7, at 350–52; Ronen, *supra* note 276, at 41–42.

agencies.²⁸⁶ Exposing rating agencies to unlimited liability as a joint tortfeasor with corporate issuers such as Enron or Bear Stearns could impose a burden that rating agencies simply could not bear and may make rating agencies exit significant segments of the ratings industry.²⁸⁷ In contrast, adopting liability caps of double the annual fees from their coverage of a given issuer or debt issue would serve deterrence purposes in a more measured way. A system of caps on liability exposure could also allow for the imposition of a higher multiple of annual fees in the case of repeated or willful breaches of duty, creating a bounded punitive damage exception that would be consistent with a deterrence strategy.²⁸⁸

Caps on liability exposure would also facilitate the ability of rating agencies to secure insurance coverage for their potential liability. Given that rating agencies appear effectively immune from liability risks under the current system, this mandate would provide incentives for the creation of a new insurance market. While this approach may constitute a significant departure from past practices, insurance markets (and their derivative analogues) cover an ever increasing set of risks, and the cap approach would make rating agency exposure a more measurable risk that could be insured.²⁸⁹ In the alternative, rating agencies could bypass the need for formal insurance if their capital levels and diversification of risks are high enough that they are effectively self-insured.²⁹⁰

Requiring minimum insurance levels would impose a financial burden on rating agencies, who would in turn seek to pass it on to

286. See Macey, *supra* note 174, at 342 (discussing how applying “nuclear” liability can warp the incentives for securities intermediaries).

287. See Coffee, *supra* note 7, at 306 (discussing how gatekeepers simply lack the financial ability to provide significant compensation to investors through victim suits).

288. An alternative to a system of capped damages would be to embrace a citizen suit model and to grant prevailing private litigants attorneys’ fees and expenses. See Greve, *supra* note 46, at 356. In the citizen suit context, the expected value of suit is always negative because at most the plaintiff can cover its expenses, which means that there is a built in disincentive against abuse of the legal process. The potential shortcoming of applying a citizen suit approach in the rating agency context is that rating agencies could be exposed to significantly higher liability which could raise concerns of overdeterrence. Nonetheless, should this Article’s proposal for capped damages for gross negligence fail to attract many plaintiffs, a citizen suit approach would be worth consideration as a means of incentivizing greater private oversight of rating agencies.

289. See, e.g., Jeffrey Manns, Note, *Insuring Against Terror?*, 112 YALE L.J. 2509, 2516–20 (2003) (documenting the emergence of private terrorism insurance and other catastrophic loss insurance in spite of far greater uncertainties of liability exposure).

290. See Rory A. Goode, *Self-Insurance as Insurance in Liability Policy* “Other Insurance” Provisions, 56 WASH. & LEE L. REV. 1245, 1250–55 (1999) (discussing self-insurance as a substitute for commercial policies).

their creditor clients. While this approach would entail significant economic costs, it would provide a transparent set of financial incentives for rating agency compliance, yet mitigate the risks that liability exposure would cause them to exit or limit their market exposure.

3. The Enforcement Roles of Creditor Committees and the SEC

One potential pitfall of a gross negligence standard is that it may prove to be an invitation for private suits which seek to exploit the indeterminacies of gross negligence for its settlement value. For this reason, it may make sense to have creditor committees weed out frivolous suits and to have litigation of claims fall within the exclusive purview of an SEC adjudicative process.

Creditor committees would serve as a mediating structure to represent the interests of creditors in SEC actions. They would centralize rating agency monitoring efforts, coordinate litigation strategy for SEC adjudications of their claims, and provide a framework for determining the degree of compensation for each creditor class. Creditor committees would not only serve to overcome collective action problems but also to stymie opportunistic unilateralism.²⁹¹ Any individual creditor could provide information on gatekeeper noncompliance directly to the SEC, but requiring that potential actions against rating agencies receive the support of creditors committees would serve as a screening mechanism for frivolous or nuisance suits against rating agencies.

Requiring that all suits be brought within an SEC adjudicative process may provide the SEC with more leeway to use a range of financial and reputational sanctions to secure compliance with gatekeeper duties. This approach is particularly relevant under a system of liability for gross negligence as there may be many cases where the action or inaction of rating agencies may merit informal sanctions and responses, yet the evidence would not constitute gross negligence.²⁹²

291. See *infra* Part III.B.2.

292. See, e.g., Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.) (significantly curtailing the ability of private plaintiffs to use class action litigation in securities suits through means such as creating a heightened pleading standard for establishing securities fraud and abolishing state court class actions for securities fraud); see also Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.) (limiting the ability of private plaintiffs to bring class action securities suits in state courts by creating national standards).

While the SEC should allow financial sanctions when the gross negligence of rating agencies inflicts harm on creditors, the SEC should have the disciplinary powers to heighten deterrence even in cases where evidence of negligence comes to light which has not harmed creditors. Pursuing a “broken windows” strategy of imposing nonfinancial disciplinary sanctions in cases when lesser breaches come to light may allow the SEC to leverage reputational concerns to heighten incentives for compliance.²⁹³ For example, the SEC can already impose disciplinary measures of barring or censuring auditors if they engage in “[a] single instance of highly unreasonable conduct” or “[r]epeated instances of unreasonable conduct” which breach professional standards.²⁹⁴ The ability to impose disciplinary sanctions is inherent in the SEC’s ability to restrict access to securities markets,²⁹⁵ but expressly vesting disciplinary power in the SEC to impose nonfinancial sanctions on negligent rating agencies, such as limits on the ability to participate in future bids for ratings, would complement efforts to deter through liability exposure to creditors for gross negligence.²⁹⁶

An additional virtue of equipping the SEC, rather than creditors, with discretion to pursue informal sanctions in cases of negligence is that it would place closer calls for enforcement in the hands of public regulators. Policymakers may be concerned that empowering creditors to sue rating agencies may supplant current incentives for marginally high ratings that favor issuers with a system in which rating agencies face incentives for marginally low ratings that favor creditors. While imposing rating agency liability to creditors in cases of gross negligence is designed to reduce incentives for unjustifiably high ratings, vesting enforcement discretion in the SEC in cases of negligence seeks to temper countervailing incentives for low ratings by making accountability in these closer cases rest with public actors

293. See Robert C. Ellickson, *Controlling Chronic Misconduct in City Spaces: Of Panhandlers, Skid Rows, and Public-Space Zoning*, 105 YALE L.J. 1165, 1171–82 (1996) (discussing the “broken windows” strategy of focusing on small offenses for their broad deterrence value). See generally James Q. Wilson & George L. Kelling, *Broken Windows*, ATLANTIC, Mar. 1982, at 29 (laying out the “broken windows” thesis as a deterrence strategy).

294. See 17 C.F.R. § 201.102(e)(1)(iv) (2008).

295. See Coffee, *supra* note 7, at 359–60.

296. See Jim Frederick, *Japan’s Regulators Get Tough*, TIME, May 15, 2006, <http://www.time.com/time/magazine/article/0,9171,1194088,00.html> (discussing how the Japanese government suspended an affiliate of PricewaterhouseCoopers from performing auditing services for two months as a penalty for its role in accounting fraud).

who do not possess the self-interest to push for systematically high or low ratings.

This approach would not preclude creditors committees or individual debt purchasers from requesting the SEC to investigate conduct by rating agencies that merely constitutes negligence. The underlying idea would be that policymakers would want creditors to provide streams of information on rating agency noncompliance. However, they would seek to mitigate the costs of formal administrative proceedings initiated by creditors by limiting these actions to contexts where the case is already well developed and more easily proven.

Policymakers may also be concerned that the possibility that the SEC could resort to nonfinancial sanctions to discipline wayward rating agencies could dampen creditors' incentives to invest in monitoring rating agencies. While it is true that creditors would ideally want to be made whole from grossly negligent conduct by rating agencies,²⁹⁷ this plan is posited on the assumption that the interest of creditors—especially institutional investors—in rating agency compliance extends well beyond any monetary compensation as their main priority is preserving their investment. Even receipt of the full cap of potential liability would likely represent modest compensation for creditors, compared to the impact on their investments, yet creditors would still have strong incentives to hold gatekeepers accountable.

C. *The Incentive Effects of Applying Rating Agency Duties to the Subprime Debt Context*

The subprime mortgage crisis provides a useful backdrop for thinking about how the implementation of gatekeeper duties could change the incentives facing rating agencies. Different facets of this crisis capture each of the critical junctures in which action or inaction by rating agencies could constitute grossly negligent noncompliance with material effects on creditors. It is true that any downgrade could have significance for both issuers and creditors.²⁹⁸ However, the principal concerns, which were highlighted in the subprime crisis, are rating downgrades from the highest rating AAA which may trigger money market funds' obligations to sell the security, downgrades

297. See A. Mitchell Polinsky & Steven Shavell, *Should Liability be Based on the Harm to the Victim or the Gain to the Injurer?*, 10 J.L. ECON. & ORG. 427, 429–31 (1994) (noting that the logic that a wrongdoer who inflicted an injury should restore victims to their state prior to the injury is an underlying premise of tort law).

298. See Macey, *supra* note 174, at 342.

from investment grade to non-investment grade (whose common name “junk bond” speaks for itself), and downgrades in the vicinity of default events where the risk to creditors is the greatest because of the possibility of nonpayment.²⁹⁹ Timing is a key consideration in each of these types of rating decisions as inaction by rating agencies could amount to gross negligence in exposing creditors to risks that far outstrip the nominal ratings’ risk.

Action and inaction by rating agencies suggest they were grossly negligent during a number of critical junctures amidst the subprime mortgage crisis. What is most striking is the role of rating agencies in legitimizing subprime debt instruments by granting baseless AAA ratings that qualified the debt for purchase by money market funds, insurers, and pension funds.³⁰⁰ Rating agencies systematically incorporated overly-optimistic assumptions into their methodologies, which in turn allowed individual RMBS and CDO tranches and these debt instruments as a whole to appear to have much higher ratings than they merited.³⁰¹ Erroneous models failed to consider risks in the underlying mortgage assets or the need for additional information from issuers.³⁰² The dearth of actual diligence of the underlying bundles of mortgages may serve as *prima facie* evidence of gross negligence in itself, especially in the face of widespread gaming of the ratings methodologies by issuers to inflate ratings.³⁰³ Rating agencies might reply that it would be unrealistic to expect them to assess bundles of mortgages one by one. But reasonable sampling of the actual risk factors involved, coupled with requirements that collateral appraisers review higher percentages of the underlying mortgages, would likely have led to different ratings for these debt instruments.

If certification and mandatory reporting requirements had been in place, rating agencies would have good reason to pause before rubber stamping subprime debt instruments. The nature of a certification duty entails affirming that a rating agency engaged in

299. See Hill, *supra* note 15, at 48–51.

300. See Demyanyk & Van Hemert, *supra* note 137, at 24–25 (discussing the explosive growth in the subprime mortgage market and the corresponding dramatic deterioration in the quality of subprime mortgage debt).

301. See Ashcraft & Schuermann, *supra* note 2, at 55–60; see also Glover, *supra* note 143 (noting that “Fitch is acknowledging that it was overly optimistic in its default rate and other assumptions in its original CDO methodology,” a tacit recognition of the role of its negligence in the subprime crisis).

302. See Whitehouse, *supra* note 138 (discussing how the rating agencies’ assumptions concerning risk led to widespread reliance on erroneous ratings for subprime mortgage CDOs).

303. See Partnoy, *supra* note 15, at 73–74; see also Sender et al., *supra* note 140 (discussing banks’ efforts to exploit rating agencies’ lax approach).

reasonable diligence of disclosures and risk factors that are reasonably available, actions which the rating agencies simply did not appear to perform in any meaningful way. The skeptic might say that the sole difference under a certification requirement would be that rating agencies would have manufactured a better paper trail to substantiate that they were not grossly negligent in reviewing disclosures and in requesting additional information that is sufficient to support their conclusions. However, requiring rating agencies to engage in this diligence, coupled with the liability exposure, would have changed the landscape of incentives and forced rating agencies to confront the intrinsic risks involved in these instruments at an earlier point.³⁰⁴ Even modest sampling of risks of the underlying mortgages would likely have required rating agencies to solicit additional information from issuers and changed the body of material information on risk available to both rating agencies and the public. The institutions that purchased subprime debt instruments would arguably have the ability to identify grossly negligent acts and establish loss causation from the lax ratings process.³⁰⁵

The culpability of rating agencies did not end in legitimizing the design of subprime debt instruments, but rather was underscored by their grossly negligent inaction as their awareness of both the degree and magnitude of risks and defaults rose amidst the bubble market. As incipient evidence of growing risks and even fraud came to light, rating agencies should have alerted investors of the changing risks, but instead they held back for months from downgrading RMBS and CDOs. Rating agencies chose to defer cuts on AAA-rated subprime debt instruments, even when significant percentages of the portfolio were in default.³⁰⁶ This fact allowed the holders of the bonds to delay write offs of significant portions of the loans and facilitated their continued sales to money market funds, insurance companies, and other entities restricted to holding high quality assets.³⁰⁷ The combination of certification and mandatory reporting rules could easily have altered the rating agencies' treatment of subprime debt instruments once the growing evidence of excessive risks and fraud came to light. Rating agencies would have faced the choice of opening themselves up to significant liability through inaction or

304. See Coffee, *supra* note 7, at 356–57.

305. See Sender et al., *supra* note 140.

306. See Pittman, *supra* note 144.

307. See Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Exchange Act Release No. 8236, 80 SEC Docket 1003 (June 4, 2003).

taking measures to alert the investing public of changed circumstances and downgrading these securities.

The best illustration of these shortcomings is the failure to downgrade bond insurers MBIA, Inc. ("MBIA") and Ambac Assurance Insurance, Inc. ("Ambac"), whose financial guarantees for subprime debt instruments far outstripped their ability to live up to their obligations. Rating agencies failed to act on what cursory diligence would have indicated was necessary even months after the writing was on the wall, because they feared that downgrades to bond insurers would automatically cause downgrades of debt insured by these actors.³⁰⁸ While one could make the case that the SEC or Federal Reserve needed to bail out the bond insurers to prevent this chain of events from occurring, this inaction was simply not the rating agencies' judgment call to make.³⁰⁹ Certification requirements would have forced rating agencies to choose at an early point between willful defiance of their duties to creditors or to downgrade the bond insurers to reflect the underlying risk exposure. Creditors purchasing debt whose value was artificially inflated by rating agencies' inaction toward bond insurers would have plausible claims that they suffered injury due to the rating agencies' gross negligence.

Lastly, the collapse of Bear Stearns provides a window on rating agency inaction when debt approaches the vicinity of default. Bear Stearns' plunge to oblivion occurred in part as a product of its complicity in producing and marketing subprime debt instruments.³¹⁰

308. See Harrington & Richard, *supra* note 146; see also Christine Richard, *Ambac's Insurance Unit Cut to AA from AAA by Fitch Ratings*, BLOOMBERG NEWS, Jan. 19, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=asLtTQyLRQOs&refer=home> (noting at the time that Fitch was the sole rating agency to downgrade a AAA bond insurer, even as Moody's and S&P declined to do so for Ambac and other AAA-rated bond insurers).

309. The irony is that Moody's own implied-ratings group, which provides alternatives to Moody's ratings by relying on information such as credit-default swaps, had found that MBIA and Ambac were junk bonds in significant danger of defaulting on their debts. In spite of this fact Moody's continued to grant MBIA and Ambac top ratings to facilitate their access to capital. See Evans, *supra* note 157; see also Christine Richard, *MBIA, Ambac Credit Ratings Under Threat at Moody's*, BLOOMBERG NEWS, June 4, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aAS6o7QliF8U&refer=home> (noting that Moody's was finally considering downgrading MBIA and Ambac about a year after the onset of the subprime mortgage crisis). Almost a year after the subprime mortgage crisis began, Moody's finally downgraded MBIA and Ambac from their AAA rating status. See *Stocks Drop as Bank Woes Continue*, L.A. TIMES, June 21, 2008, <http://articles.latimes.com/2008/jun/21/business/fi-markets21>.

310. See Julia Werdigier & Landon Thomas Jr., *HSBC and Bear Stearns Increase Loan Write-Downs*, N.Y. TIMES, Nov. 15, 2007, at C4 (detailing the many problems that helped contribute to Bear Stearns' ultimate collapse).

Both the collapse of the subprime industry and potential liability from Bear Stearns' involvement in it were significant factors in the company's buyout at a bargain-basement price by J.P. Morgan.³¹¹ But even as the evidence mounted for almost a year that Bear Stearns' existence could be imperiled due to the scope of its involvement in the subprime crisis, rating agencies failed to change the ratings to warn creditors about the imminent risk of default exposure.³¹² While the eleventh hour bailout by J.P. Morgan spared creditors exposure to a Bear Stearns' default,³¹³ it appears implausible that any paper trail could support the rating agencies' inaction in the face of such mounting risks.

The incentives for proactive monitoring and rating changes created by a certification duty would at minimum have forced rating agencies to justify their inaction and to provide reasons why Bear Stearns' long-term prospects merited retention of its rating. Ironically, had rating agencies assumed this role, the collapse of Bear Stearns might have been prevented as the silence of rating agencies did nothing to quell fears concerning Bear Stearns' risk exposure. Because the buyout averted most of the potential injury to creditors, these facts fits squarely within the category in which informal SEC actions may be needed to underscore to rating agencies the scope and nature of their mandate.

Certification and mandatory reporting duties might not have prevented the subprime mortgage crisis from arising given the risk-seeking behavior that swept over the market. However, these duties certainly would have given rating agencies reason to pause before lending their names to legitimize deceptive subprime debt instruments. These duties would also have provided rating agencies with incentives to serve as more proactive watchdogs at a much earlier point in flagging the growing risks in order to save their own skins and to pop the market bubble.

311. See Landon Thomas Jr. & Eric Dash, *Seeking Fast Deal, JPMorgan Quintuples Bear Stearns Bid*, N.Y. TIMES, Mar. 25, 2008, at C1.

312. See Nelson D. Schwartz & Julie Creswell, *What Created this Monster?*, N.Y. TIMES, Mar. 23, 2008, § 3 (Business), at 1 (detailing the rating agencies' inaction in the face of Bear Stearns' collapse).

313. See Morgenson, *supra* note 92 (detailing how Bear Stearns' bondholders had their interest preserved through the J.P. Morgan buyout, while Bear Stearns' shareholders lost most of their equity stakes).

CONCLUSION

This Article has demonstrated how the creation of a user fee system to finance ratings could transform the landscape of rating agency accountability. Under the current system rating agencies have had little reason to take their gatekeeping role seriously and instead have legitimized excessive risk taking by their nominal principals, issuers of debt. The creation of an SEC-administered user fee system offers the potential to reinvigorate gatekeeping roles, to foster competition and new entrants into the oligopolistic ratings industry, and to create meaningful oversight roles for the SEC and debt purchasers. The implementation of certification and mandatory reporting duties for rating agencies, with capped liability exposure to creditors limited to cases of gross negligence, will provide a framework for accountability, yet pose a manageable burden for rating agencies.

At the moment, policymakers are in “crisis mode” trying to deal with the fallout from the subprime debt markets, the full scope of which remains unknown. But this Article suggests that rather than pointing the finger of blame, policymakers need to look forward and construct an incentive system for rating agencies that will help ensure that a crisis of this magnitude does not occur again with rating agencies asleep at the switch. While the creation of a user fee system to finance ratings is not a panacea, this Article’s blueprint for change serves as a foundation for reform of a rapidly changing financial world in which the need for accurate risk assessments has never been more clear and pressing.

