Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies Led to the Subprime Credit Crisis and the Need for Greater Accountability

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COMMENT
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I. Introduction

October 9, 2007, symbolized the booming opulence of the United States economy, as the Dow Jones Industrial Average soared to an all-time high of 14,164 points. Yet even at that time of apparent growth, analysts were exchanging concerns about the future of the economy and the state of the U.S. mortgage industry. Delinquency rates were rising, home values were falling, and investors were becoming increasingly skittish about remaining in the real estate market. At that time, however, the overall economic picture did not yet reflect these adverse circumstances. So, while many Americans were taking comfort in the seemingly prosperous U.S. economy, the intimate players were discussing the strong possibility of a recession that could bring the market’s artificial prominence to a bitter plummet.

The fears of the knowledgeable few were realized in the months to follow. The covert giant that had been lurking behind the shadows of Wall Street finally revealed itself to the public over the course of the subsequent year. This giant, which fueled both the rise and fall of the modern investment industry, came in the unassuming form of an acronym: RMBSs, or residential mortgage-backed securities.

Within one year of the record high, Wall Street experienced another record event. On September 28, 2008, the Dow Jones Industrial Average dropped 778 points, the largest one-day decline in its history. By this time, the American public was all too familiar with the credit crisis that had developed as a result of subprime mortgage lending. But even today, the majority of

3. See id. at 1, 4.
4. See id.
6. See id.
Americans are likely unaware of how the misapplication of AAA ratings perpetuated the creation of subprime mortgages and repeatedly convinced investors that these mortgages were some of the most secure investments available.

While politicians and media commentators were quick to place blame for the subprime credit crisis on home buyers, “predatory” lenders, investment institutions, and political parties, it took noticeably longer for blame to shift toward the rating organizations that originally gave risk-averse investors the green light (in the form of AAA ratings) to purchase bonds composed of securitized subprime mortgages. Moreover, allocating legal blame to these organizations has proved to be problematic, as many courts have adopted the view that rating agencies receive First Amendment protection, effectively stifling the viability of private actions for investors. This comment argues that while Nationally Recognized Securities Rating Organizations (NRSROs) should not be held to a standard of hindsight accuracy, they should be held liable for negligence in their ratings. This comment further asserts that although changes to the regulations on NRSROs are improvements, the changes are insufficient to avoid a similar financial catastrophe in the future because they focus too heavily on disclosure without providing corrective measures.

Part II of this comment discusses the causes of the subprime credit crisis and how credit ratings facilitated the spread of subprime mortgages. Part III explains the deficiencies in the NRSROs’ practices and the current regulations that exist for NRSROs. Next, Part IV addresses the Securities and Exchange Commission’s proposed and adopted amendments to the NRSROs’ regulations. Part V analyzes the ability of NRSROs to avoid legal liability for the ratings they issue. Part VI argues the importance of accountability for credit rating organizations. This comment concludes in Part VII.

II. The Circumstances Behind the Subprime Credit Crisis

In an attempt to encourage investment and borrowing in the U.S. economy, the Federal Open Market Committee announced on December 11, 2001, that it was lowering its target federal funds rate to 1.75%. This placed the interest


9. See, e.g., Compuware Corp. v. Moody’s Investors Servs., Inc., 499 F.3d 520, 528-29, 533 (6th Cir. 2007); In re Enron Corp. Secs., Derivative & ERISA Litig., 511 F. Supp. 2d 742, 824-26 (S.D. Tex. 2005); see also discussion infra Part V.A.

rate for short-term U.S. treasury bonds at historically low levels. As a result, investors began scouring the market for substitute securities that would provide similar low risk but with more competitive yields. What investors found, and grew an insatiable appetite for, were residential mortgage-backed securities.

A. The Recipe for Residential Mortgage-Backed Securities

A residential mortgage-backed security is created by bundling a typical mortgage with other mortgages (usually numbering in the thousands), slicing the collected cash flow from the mortgages, and then selling the slices in the form of bonds. Generally, RMBSs take the form of unsecured bonds—that is, bonds that are unsupported by collateral. In essence, an unsecured bond is a debt security of an issuer who offers only its reputation as an assurance that the principal and interest will be repaid once the bond matures. Because no collateral is put forth to secure the obligation, the buyer of a bond must rely solely on the creditworthiness of the issuer, which is where credit rating agencies enter the stage.
B. The Role of Rating Agencies in the Financial Market

A rating agency examines a specific bond to determine the likelihood that the security’s issuer will make good on its obligation to pay the purchasers their principal and interest. The agency’s determination about the bond’s respective stability or riskiness is converted into a rating, which ranges from AAA to D. Under Standard & Poor’s rating scale, for example, bonds with ratings that range from AAA to BBB- are considered “investment grade,” which means that they have a relatively high likelihood of repayment. Conversely, bonds with ratings of BB and lower are deemed to be “speculative grade” and are often referred to as “junk bonds.” By analyzing and rating a bond’s creditworthiness—the issuing entity’s ability to meet its financial obligations—credit rating agencies provide investors with valuable information used to determine proper pricing for a bond. Rating agencies are thus essential to the transferability of bonds.

C. How the Hunger for RMBSs Destroyed Financial Prudence

While RMBSs have existed for decades, the integrity behind these bonds dissipated in the early 2000s. Because the Federal Reserve drastically lowered the interest rate for treasury bonds to 1%, compared to average historical rates of between 3% and 7%, investors became increasingly interested in purchasing RMBSs. The RMBSs could offer interest rates ranging from 5% to 9%, while simultaneously promising safety that was comparable to a U.S. treasury bond. Like treasury bonds, RMBSs often received AAA ratings, the rating purported to be “money-good,” or as secure as U.S. money. Unfortunately, when the investing appetite became larger than the number of safe RMBSs available in the market, lenders chose to authorize what have

19. See Bonds Online, supra note 17; see also YAGO, supra note 18, at 4-5.
22. See Giant Pool of Money, supra note 12, at 5, 11.
23. Id. at 11.
since been characterized as “subprime” mortgage loans, which led to record numbers of mortgage defaults and home foreclosures.

1. The Demand for RMBSs

Beginning in 2000, the demand for RMBSs quickly started surpassing the supply. In addition to the diminished appeal of treasury bonds, the amount of global savings had essentially doubled in six years. From 2000 to 2006, the world’s savings increased from its previous high of $36 trillion to a high of $70 trillion. This upsurge pushed an unprecedented amount of money into the financial market in search of investment vehicles, and for their purported risk, RMBSs were offering very attractive terms. In an attempt to keep up with the high demand for RMBSs, mortgage lenders began implementing increasingly unsound lending practices, which allowed more people to qualify for home mortgages, thereby generating more mortgages and RMBSs.

RMBSs are created when individual mortgage lenders sell mortgages to larger investment institutions (such as Fannie Mae or Freddie Mac) that bundle thousands of mortgages together and place those collected mortgages into a trust. Then, pieces of the cash flow from the bundle are issued to investors, and each of these pieces represents an RMBS. Under this method, in contrast to traditional mortgage lending, the original institution that

24. See Brian M. McCall, Learning from Our History: Evaluating the Modern Housing Finance Market in Light of Ancient Principles of Justice, 60 S.C.L. REV. 707, 709-10 (2009). The term “subprime” refers to mortgages containing certain credit risks that enhance the likelihood that the borrower will default on the loan. Id. at 709. Typically, these credit risks relate to factors such as the borrower’s low credit score or the high debt-to-income ratio of the mortgage. Id.


27. Id. at 3-4.

28. Id. at 4.

29. See id. at 4-6.

30. See id. at 6-7.


33. See id.
established the terms of the mortgage is no longer concerned about the potential for the mortgagor to default on the loan. Instead, the lender originates the mortgage knowing that it will simply pass the loan onto one of the many anxiously awaiting secondary institutions from whom it will receive a sizable fee. The originator, therefore, has no incentive to maintain prudent lending standards, since its profits derive solely from transactional fees, and not from the eventual repayment of the mortgage. The reduced need to properly underwrite, coupled with the large number of eager RMBS investors, created competition among mortgage lenders over which broker could generate the most mortgages.

The fight over mortgage volume caused originating lenders to extend risky mortgage loans to people who were, by traditional standards, generally unqualified for approval. This practice drove lenders to invent a series of increasingly imprudent loans. One of the first of such loans was the “stated income, verified asset” loan, which waived prior paycheck and W-2 form requirements if a borrower could demonstrate sufficient savings. This loan gave way to the “stated income, stated asset” loan, which merely required a borrower to represent that she had a certain income and assets to a loan officer. Rather than referring to W-2 forms or pay stubs to verify that figure, the lender would merely confirm the person’s employment. Once the employment was verified, the lender would then consult an accountant only to determine whether it was possible for the mortgagor to earn the alleged income. At no time in the loan process, however, would the mortgagee ever substantiate the mortgagor’s stated assets.

34. See id. at 36216.
35. See id.
36. The term “underwrite,” as used here, means to assess the eligibility of the mortgagor for the particular loan being given. Compare MEGAN DORSEY, FINANCING RESIDENTIAL REAL ESTATE 252 (2005), with BLACK’S LAW DICTIONARY 1665 (9th ed. 2009).
38. Giant Pool of Money, supra note 12, at 7.
39. Id. The “stated income, verified asset” loan represented a departure from historical underwriting standards requiring a sizeable downpayment in addition to stringent income and asset verification. See id. Though providers of “stated income, verified asset” loans were expected to verify the mortgagor’s assets, subprime lenders routinely relaxed the verification practices. SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 127 (2010). Indeed, it seems that certain lenders referred to the loans as “no income, verified asset” loans. See Giant Pool of Money, supra note 12, at 7.
40. Giant Pool of Money, supra note 12, at 7.
41. Id.
42. Id.
43. See id.
The other loans subsequently developed by lenders were only more egregious and included lending novelties such as the “no income, no asset” loan—a loan that did not require the mortgagor to even state an income. A mortgage buyer who worked for one of the largest private mortgage banks in the state of Nevada described the approval process of the “no income, no asset” loan as requiring nothing more than “a credit score and a pulse.” The indiscretions in mortgage lending practices continued to mount and reached their peak in 2006, just before the credit flaws were realized in the market.

As a further means of capitalizing on the popularity of RMBSs, investment firms also began using subprime mortgage loans as backing for collateralized debt obligations (CDOs). RMBS-backed CDOs are simply securitized products with RMBSs as their underlying assets. CDOs operate and are transferred in much the same way as RMBSs, though one major distinction is that a CDO may be “actively managed such that its underlying assets change over time,” while the bundle of loans constituting an RMBS remains static. The significance of the creation of CDOs backed by subprime RMBSs is that it allowed the toxic mortgages to infiltrate the market on an even deeper level.

The mortgage deficiencies that existed in both forms of financial products caused overwhelming defaults and the abrupt downgrade of countless mortgage-backed bonds. In fact, within the first four months of 2008, rating downgrades on CDOs alone resulted in devaluations of approximately $357 billion of securities. In many instances, the NRSROs would significantly lower the ratings of numerous bonds in one fell swoop, which provided investors with no notice or opportunity to reassess their investments before the value of their securities disintegrated. Thus it was that numerous RMBSs,
previously rated as “money-good,”\textsuperscript{53} were unexpectedly declared almost overnight to be no more valuable than “junk bonds.”\textsuperscript{54}

2. Creative Financial Structuring and AAA Ratings

Traditionally, the AAA rating has protected investors by assuring them that they were pursuing only the most secure bonds.\textsuperscript{55} Precisely for this reason, the majority of institutional investors (including many mutual funds, hedge funds, insurance companies, and municipal funds) are strictly required to place money only into AAA rated bonds.\textsuperscript{56} Similarly, most fiduciary funds are prevented from authorizing investments in low-rated “junk bonds.”\textsuperscript{57}

Because ratings of less than AAA often preclude large investors from purchasing a security, issuers have considerably more difficulty in transferring lower-grade RMBSs.\textsuperscript{58} To combat this difficulty, bond issuers go to aggressive lengths to ensure that their bonds receive the highest ratings.\textsuperscript{59} To this end, new methods of financial engineering have evolved to allow otherwise lower-grade RMBSs—composed of subprime mortgages—to qualify for the highest possible investment rating.\textsuperscript{60}

The process of \textit{subordination} is the most common method of enhancing the creditworthiness of RMBSs.\textsuperscript{61} Collections of bundled mortgage loans exist in

\textsuperscript{53} See supra text accompanying note 23.
\textsuperscript{54} See Siew, supra note 50.
\textsuperscript{56} See Greg Farrell, SEC Slams Credit-Rating Agencies Over Standards, USA TODAY, July 11, 2008, http://www.usatoday.com/money/markets/2008-07-08-sec-report_N.htm. Theoretically, this safeguard should have prevented such funds from purchasing risky mortgage-backed securities; however, these securities’ misleading “investment grade” ratings permitted purchases by institutional investors. See id. Unfortunately, the AAA safeguard simply did not prove effective in the subprime disaster. See id.
\textsuperscript{57} Gregory Huisian, Note, What Standard of Care Should Govern the World’s Shortest Editorials?: An Analysis of Bond Rating Agency Liability, 75 CORNELL L. REV. 411, 422 (1990). The term “fiduciary funds” refers to assets that are held in a trustee or agent capacity on behalf of an outside party. See GORDON B. BATY & MICHAEL S. BLAKE, ENTREPRENEURSHIP: BACK TO BASICS 78 (reprint 2003) (1990). Pension funds are a classic example. See id.
\textsuperscript{58} See Unterman, supra note 1, at 63-64.
\textsuperscript{59} See id. at 61.
\textsuperscript{60} See id. at 60-63.
independent, bankruptcy-remote entities called special purpose vehicles (SPVs). A key aspect of operating SPVs involves the allocation of cash flows among the various classes of mortgages, called tranches, collected in the bundle. Subordination operates to “create[] a hierarchy of loss absorption” among these tranches. Tranches are organized in an SPV with the highest tranche enjoying a right to payment that is superior to that of the lower tranches; as a result, the highest tranche is deemed least likely to suffer if some of the underlying mortgages default. Meanwhile, the lowest tranche stands last in line for payment and is thus considered the most vulnerable to losses stemming from default. Between the highest and lowest tranches are all the intermediate tranches, arranged in order from the most secure payments to the least secure payments. When a mortgagor defaults on a loan, the SPV’s subordination scheme allocates the payment loss to the lowest tranche in the bundle until that tranche loses its entire principal. Any additional losses are then allocated to the next lowest tranche, and this cycle repeats itself until each tranche in the SPV loses its principal. The result of subordination is that the highest tranche does not experience any principal loss until every lower tranche has exhausted its claims to principal.

A second method of credit enhancement is over-collateralization. “Over-collateralization” refers to “the amount by which [an SPV’s] loan pool exceeds the principle [sic] amount of securities issued.” The remaining asset value, over and above the debt principal, acts as an additional buffer for losses. A specific RMBS can also increase its credit protection by taking out bond insurance and establishing liquidity agreements, which operate to advance funding in the event that the RMBS fails or buyers for the RMBS cannot be found.

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62. See John Patrick Hunt, Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, 2009 Colum. Bus. L. Rev. 109, 117; Unterman, supra note 1, at 59. The SPVs used to create RMBSs frequently took the form of trusts. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. at 36214.
63. See Hunt, supra note 62, at 118; see also SEC SUMMARY REPORT, supra note 61, at 6.
64. SEC SUMMARY REPORT, supra note 61, at 6.
65. See id.
66. See id.
67. See Unterman, supra note 1, at 61; see also SEC SUMMARY REPORT, supra note 61, at 6.
68. See id.
69. Id.
70. See id.
71. Unterman, supra note 1, at 62; see also SEC SUMMARY REPORT, supra note 61, at 6.
72. See Unterman, supra note 1, at 62.
73. See id. at 62-63; see also Proposed Rules for Nationally Recognized Statistical Rating
“Excess spread” is the term used to describe the third type of credit enhancement. 74 Excess spread is similar to over-collateralization except that it refers to the amount of excess interest, not principal, that a mortgage bundle has with respect to the interest payments due to holders of the RMBS. 75 As with over-collateralization, this excess amount of interest can be used to offset delinquent interest payments owed to the RMBS. 76

In theory, these various forms of credit enhancement—formed by collecting risky loans, combining them with secure loans, over-collateralizing the bundle, and then cutting the bundle into small securities—were intended to result in the creation of several stable securities. 77 This belief, however, drastically underestimated the pervasive presence of loans with high risk of default. 78 Yet NRSROs bought into the claims of financial engineers without properly examining the actual riskiness of the RMBSs. 79 This impropriety of the NRSROs’ handling of the RMBS products contributed to mortgage-related losses surpassing $1.1 trillion. 80 If only the credit rating agencies had more closely scrutinized the effectiveness of these credit enhancements on RMBSs, such devastating financial repercussions would not have been possible.

III. How the Operations of NRSROs Failed to Ensure Reliable Ratings

Since the early 1900s, rating agencies have operated to inform investors about a bond issuer’s credit risk. 81 In 1975, the Securities and Exchange Commission (SEC or the Commission) began classifying certain credit rating agencies as Nationally Recognized Statistical Rating Organizations. 82 The

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74. See SEC SUMMARY REPORT, supra note 61, at 6.
75. See id.
76. See id.
77. Unterman, supra note 1, at 63-64.
78. See id. at 58 (explaining that the “loans that were driving record levels of foreclosures were mostly part of investments receiving the highest credit rating available”).
79. See discussion infra Part III.C-D; see also Farrell, supra note 56.
80. See Elisa Martinuzzi, Credit Crisis Cost Tops $1 Trillion with Morgan Stanley’s Loss, BLOOMBERG, Dec. 17, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aJjiHQgPEw&refer=home (explaining that the more than $1 trillion in losses “reflect[s] writedowns of mortgage assets that aren’t subprime, as well as losses taken on leveraged-loan commitments”)
NRSRO designation conveyed to investors that the agency had been recognized by the SEC as a reliable source for credit ratings.83

A. The Ratings Process

Each NRSRO employs essentially the same set of procedures for determining a bond’s rating. The ratings process is governed by an in-house committee that comprises a group of analysts who make decisions regarding a given RMBS bundle based on the recommendations of the lead analyst assigned to that bundle.84 Through this lead analyst, the issuer of a bond (together with the underwriter managing the offer) provides the committee with specific data regarding the bond, which the committee analyzes.85 The ultimate determination of a bond’s rating is then made by vote of the committee members.86

The data used in the rating evaluation involve both public and nonpublic information. The public information generally “includes filings with the [SEC], news reports, industry reports, bond and stock price trends, data from central banks, and proxy statements.”87 The nonpublic information can include anything from “credit agreements, acquisition agreements, [and] private placement memoranda, [to] business projections and forecasts.”88

The traditional approaches for rating a security do not easily translate to RMBSs and CDOs. Historically, bonds were issued by governments, municipalities, or corporations.89 Because RMBSs and CDOs are their own corporate entities with no personnel or actual products/services but instead only thousands of individual home mortgages, there can be no examination of SEC filings or acquisition agreements to aid NRSROs in determining an appropriate credit rating.90 Accordingly, NRSROs have developed a distinct method for evaluating RMBSs and CDOs that involves analyzing the data

83. See id.
84. SEC SUMMARY REPORT, supra note 61, at 7.
86. See SEC ROLE AND FUNCTION REPORT, supra note 85, at 9.
87. See id. at 26.
88. Id.
89. See generally Richard Scylla, An Historical Primer on the Business of Credit Rating, in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 19 (Richard M. Levich et al. eds., 2002)
relating to the individual loans themselves, including the “principal amount, geographic location of the property, credit history and FICO score of the borrower, ratio of the loan amount to the value of the property[,] and type of loan.”

B. Rating RMBSs and CDOs

In determining the proper credit rating for an RMBS, an NRSRO’s lead analyst begins by reviewing the loan bundle and predicting how many loans in the RMBS will default under various adverse situations. This assessment involves utilizing expected loss models in conjunction with assumptions about how much principal is recoverable after foreclosure on a given loan. These “stress tests” attempt to establish how much credit enhancement is needed for the tranches within the RMBS to receive a specific level of credit rating.

Next, the analyst evaluates the proposed capital structure—the tranches—of the RMBS and compares it to the requirements of certain ratings. If, after critiquing the structure of the RMBS, the analyst determines that the RMBS will not satisfy the standards established for the rating sought, the analyst will notify the issuer. The issuer is then given an opportunity to restructure the subordination scheme of the RMBS in order for the highest tranche to receive the most elevated rating. In restructuring the RMBS, the NRSRO actively advises the issuers regarding which structure and which credit enhancements will yield the highest rating.

Finally, the analyst examines the RMBS’s cash flow scheme. This entails using cash flow models that postulate numerous “stress scenarios” to determine the sustainability of the RMBS in light of the principal and interest payments expected to be derived from the mortgagors each month. The results of these tests are compared to the payments owed to each level of the...

91. SEC Summary Report, supra note 61, at 7. The SEC Summary Report explains that the “type of loan” refers to whether the loan at issue is a “first lien, second lien, primary residence, secondary residence,” etc. Id.

92. Id. at 7-8.

93. Id.

94. Id. at 8.

95. Id.

96. Id.

97. Id.

98. See id.; see also In re Fitch, Inc., 330 F.3d 104, 110 (2d Cir. 2003) (examining issuer-NRSRO correspondence and concluding that the defendant NRSRO “played an active role in structuring the transaction”). Recall that credit enhancements operate to provide an initially low-rated RMBS with a higher rating without requiring better quality underlying assets within the RMBS. See discussion supra Part.II.C.2.

tranche hierarchy to establish whether certain of the over-collateralization and excess-spread features will allow the RMBS to meet its payment obligations to bond holders.\(^\text{100}\)

**C. Problems with the Rating Practices**

In July 2008, the SEC issued findings from an investigation it conducted on the three major NRSROs responsible for rating RMBSs and CDOs: Moody’s, S & P, and Fitch.\(^\text{101}\) The SEC’s report identified a series of shortcomings in the NRSROs’ rating practices for both RMBSs and CDOs backed by RMBSs.\(^\text{102}\) These deficiencies included the use of ineffective models, the implementation of certain unexplained adjustments to ratings in spite of model projections, the application of undisclosed ratings methodologies, and the inability to manage workloads due to severe understaffing.\(^\text{103}\)

1. **Model Failures**

The NRSROs committed several errors in their application of rating models. Perhaps the most prominent flaw identified by the SEC was that the NRSROs were using old models to assess new forms of bonds.\(^\text{104}\) These old models failed to appreciate the complexity of the RMBSs, which resulted in inaccurate loss projections.\(^\text{105}\) In fact, the models used did not address basic and crucial issues related to “the investment decision process, including the price, term, likelihood of prepayment, liquidity risk or relative valuation of particular securities.”\(^\text{106}\)

In addition, many of the risk assumptions made by the NRSROs were based on historical records rather than current data.\(^\text{107}\) The NRSROs’ models, therefore, did not sufficiently account for the riskier forms of loans that were

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100. *Id.* at 8-9.
101. *Id.* at 1.
102. *See id.* at 10-31.
103. *See id.* While this comment does not address all of the problems discovered by the SEC in its evaluation of the NRSROs’ RMBS ratings practices, the failures discussed herein represent the primary causes of the inaccurate ratings. Additionally, the SEC has responded to these particular deficiencies by way of amendments and proposed amendments. *See discussion infra* Part IV.
104. *See SEC SUMMARY REPORT, supra* note 61, at 11.
105. *See id.*
being generated, such as adjustable rate loans and “no income, no asset” loans. 108 Yet, while continuing to utilize the old models, NRSRO analysts criticized the models for their lack of reliability. One email exchange recovered by the SEC described a ratings analyst’s fears that the models failed to account for even “half” of the risk associated with a bond. 109 This analyst went on to explain that a bond’s poor structure was ultimately irrelevant for the NRSRO’s purposes because, as she stated, “it could be structured by cows and we would rate it.” 110

2. Model Deviations

Another significant factor that led to the ineffective use of models was the NRSROs’ failure to document how the models generated the ultimate ratings. 111 At least two of the rating agencies frequently made uncharacteristic “out of model adjustments” without retaining records that explained why the adjustments were made. 112 For instance, one NRSRO repeatedly lowered loss projections on certain RMBSs in deviation from the suggested output generated by the models but never documented its reasoning. 113 Similarly, another NRSRO made ad hoc modifications to its cash flow models’ determinative ratings criteria without disclosing or formally adopting such modifications. 114

3. Undisclosed Methodologies

During the SEC’s investigation, the NRSROs also openly admitted that they were using undisclosed models in arriving at some of their ratings 115—in violation of the Credit Agency Reform Act of 2006. 116 Specifically, at least one NRSRO did not disclose the use of “matrices to adjust model outputs for second lien loans.” 117 Further, this rating agency, while purporting to operate

108. See Unterman, supra note 1, at 74 (explaining that the “vast majority” of mortgages that later defaulted were adjustable rate); see also supra notes 38-46 and accompanying text (discussing the risky mortgages that lenders developed to increase the number of mortgages originators could generate).
109. SEC SUMMARY REPORT, supra note 61, at 12.
110. Id.
111. See id. at 13-17.
112. Id. at 14.
113. Id.
114. Id.
115. Id. at 13.
117. SEC SUMMARY REPORT, supra note 61, at 13.
from a published “criteria report,” had changed its rating practices without supplementing the previous report or issuing a new list of criteria.\(^\text{118}\)

4. Blind Ratings

On top of the NRSROs’ misuse of risk models, certain internal documents obtained by the SEC indicate that at least two of the three NRSROs were struggling to keep up with the increased volume and complexity of the RMBSs.\(^\text{119}\) These documents suggest that the agencies were grossly understaffed, with analysts’ average workweeks regularly exceeding the sixty hours presumed in the agencies’ staffing models.\(^\text{120}\) One email described the situation as characterized by “too much work, not enough people, pressure from company, quite a bit of turnover and no coordination of the non-deal ‘stuff.’”\(^\text{121}\) These conditions caused NRSROs to conduct more cursory examinations of the bonds.\(^\text{122}\)

The substantial time constraints within the agencies also led to a relaxation of analytical standards. A document recovered from an NRSRO’s deal file summarized an unresolved problem by stating, “We didn’t ha [sic] time to discuss this in detail at the committee, so they dropped the issue for this deal due to timing.”\(^\text{123}\) Another memorandum from an NRSRO file explained that a concern of analysts had been “poorly addressed” and that it needed to be “checked in the next deal.”\(^\text{124}\) These documents suggest that NRSROs accepted less than complete analyses of bonds in order to keep pace with the issuers’ high-volume demands.

In spite of the incomplete and deficient risk assessments, the NRSROs continued to publish favorable ratings for RMBSs while conscious of the increasingly risky lending practices employed to create the underlying mortgages.\(^\text{125}\) Still worse, some emails exchanged within the NRSROs suggest that certain rating agencies continued to give positive ratings while fully aware of the RMBSs’ riskiness and the damage they might cause the economy.\(^\text{126}\) For example, an email between two analytical managers described how the rating agencies were creating an “even bigger monster—the CDO market.”\(^\text{127}\)

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118. \textit{Id.} at 14.
119. \textit{Id.} at 10, 12.
120. \textit{Id.} at 12.
121. \textit{Id.}
122. \textit{See id.}
123. \textit{Id.} at 12 n.7.
124. \textit{Id.}
125. \textit{See id.} at 12.
126. \textit{See id.} at 12 n.8.
127. \textit{Id.}
The manager further commented, “Let’s hope we are all wealthy and retired by the time this house of cards falters.” In failing to conduct more prudent examinations, the credit rating agencies committed willful acts of blindness at the expense of unknowing investors.

Ultimately, whether because of unchecked ignorance or knowing greed, it is clear that the NRSROs, like other market participants, hastened to reap the immediate profits that the RMBS and CDO markets offered. In doing so, the NRSROs cavalierly assigned investment-grade ratings to complicated financial products that they had not taken the necessary time and effort to understand.

D. Conflicts of Interest

A security’s rating is critical to the issuer because it dictates the interest rates that the issuer will need to pay its investors. The higher the credit rating, the more eager the investors, and the lower the interest rate; likewise, the lower the credit rating, the more hesitant the investors, and the higher the interest rate. Because the profitability of an RMBS depends so heavily on the credit rating, issuers typically pressure NRSROs to provide them with the highest rating possible.

Under the current ratings structure, NRSROs are paid by the very institutions whose bonds they are rating. In the past, rating agencies derived the majority of their profits from the publication of ratings. But now, the revenues generated from subscriptions have been superseded by the profitability of issuer fees. The increased dependence on issuer fees has placed rating agencies in the position of seeking to meet the issuers’ expectations in order to receive payments for future analyses. Such a relationship interferes with the NRSROs’ ability to objectively critique a bond’s worth and thus frustrates the function of a rating agency.

This conflict of interest is perpetuated by the process used for establishing a bond’s rating. If, after performing the appropriate test, an NRSRO’s analyst determines that an investment-grade rating is not available, the analyst can notify the issuer of the bond’s insufficiency. The issuer then has the

128.  Id.
129.  See Unterman, supra note 1, at 57.
131.  See Hill, supra note 82, at 50.
132.  Id.
133.  Id.
134.  See Lucchetti & Ng, supra note 130.
opportunity to restructure the RMBS.\textsuperscript{136} For example, by “shifting the required amount of principal from the senior tranche to a lower tranche” in a certain way, the issuer can transform the once-deficient RMBS into an AAA-rated RMBS.\textsuperscript{137} Thus, while nothing fundamental changes in the RMBS’s asset bundle, the reorganized debt obligations can prompt a higher credit rating. This process provides issuers with the benefit of constructing an RMBS based on ratings-specific trial and error.

The opportunity to retrospectively tailor the RMBS’s structure even extends beyond the forgiving hierarchy of any single NRSRO, as issuers are free to take their bonds to other rating agencies if they cannot receive a satisfactory rating from the initial NRSRO.\textsuperscript{138} On Wall Street, such “ratings shopping” is referred to by less connotative terms such as “best execution” or “maximizing value.”\textsuperscript{139} But “[i]t [is] always about shopping around” for higher ratings, explains former Moody’s managing director, Mark Adelson.\textsuperscript{140} Thus, despite the more respectable names, the practice of soliciting NRSROs for favorable ratings has created an environment in which agencies are incentivized to lower their ratings standards.

Providing issuers with multiple opportunities to receive a favorable credit rating on a bond is contrary to the notion that a bond’s rating is a fair and accurate representation of its creditworthiness. Perhaps even more alarming is the fact that the initial insufficiency of a bond and its subsequent restructurings is never reflected in the rating, nor is it disclosed to investors through any other means.\textsuperscript{141} By allowing the issuer to superficially alter the bond’s ability to receive a desired rating, while never conveying the history of the rating to investors, NRSROs supply issuers with a hidden advantage. As a result, the very process of evaluating the bonds hinders the credibility of the ultimate rating.

\textit{E. Current Regulations}

In an attempt to bolster investor trust following the 1970s credit crisis, the SEC began formally designating qualified credit rating agencies as NRSROs.\textsuperscript{142} For more than thirty years, the SEC did not codify requirements

\begin{itemize}
\item \textsuperscript{136} See Unterman, supra note 1, at 61 n.26; see also supra notes 97-98 and accompanying text.
\item \textsuperscript{137} Unterman, supra note 1, at 61 n.26.
\item \textsuperscript{138} See Lucchetti & Ng, supra note 130.
\item \textsuperscript{139} Id.
\item \textsuperscript{140} Id.
\item \textsuperscript{141} See SEC SUMMARY REPORT, supra note 61, at 9 (explaining that only “final ratings reports are published” (emphasis added)); see also discussion infra Part IV.A.2.
\item \textsuperscript{142} Hill, supra note 82, at 53-54.
\end{itemize}
for the designation process. Instead, the SEC conferred NRSRO status on a small number of agencies by examining certain suggested factors. These factors included (1) an organization’s structure; (2) the financial resources at an organization’s disposal; (3) the size, experience, and training of the staff; (4) the organization’s autonomy from the institutions it rated; (5) the rating procedures used; and (6) the “internal procedures to prevent misuse of nonpublic information and whether those procedures were followed.”

The registration process for NRSROs did not become formalized until September 29, 2006, when Congress passed the Credit Rating Agency Reform Act of 2006 (the Reform Act). The purported purpose of the Reform Act is to “improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.” Thus, the Reform Act is designed to enable the SEC to implement reporting regulations for NRSROs and further authorizes the SEC to conduct examinations of ratings activities.

Most notably, the Reform Act requires NRSROs to provide information regarding their rating methodologies and procedures, annually certify that the submitted application documents remain accurate, and disclose conflicts of interest. The Reform Act lists five types of conflicts requiring disclosure, including being paid by the issuers or underwriters of a bond who are seeking to have the bond rated. The Reform Act also requires the identification of “business relationships, ownership interests, or any other financial or personal” relationships between members of the NRSROs and the bond issuers or underwriters.

Additionally, the Reform Act specifically prohibits certain practices. An NRSRO is entirely prohibited from entering into arrangements “conditioning or threatening to condition the issuance of a credit rating” on the issuer’s agreement to purchase certain services or products; “lowering or threatening

143. Id. at 54.
146. See SEC SUMMARY REPORT, supra note 61, at 4.
149. Id. at 7-8, 10.
151. Id. § 78o-7(b)(2)(A).
152. Id. § 78o-7(b)(2)(C).
153. Id. § 78o-7(i)(1).
Unfortunately, however, the Reform Act specifically restricts the SEC from regulating “the substance of the credit ratings or the procedures and methodologies” used by NRSROs. This limitation prevents the SEC from exercising meaningful oversight of the NRSROs. By prohibiting the establishment of minimum methodological standards for the ratings process, Congress has effectively rendered the SEC little more than a quasi regulator of NRSROs.

IV. Proposed and Adopted Regulatory Changes

In June 2008, under the authority of the Reform Act, the SEC proposed several amendments to the regulations governing NRSROs. The SEC has since considered and adopted several of the proposed changes.

A. Implementing Greater Disclosure

Throughout its examination report regarding the NRSROs’ ratings practices, the SEC expressed concern over the NRSROs’ relative autonomy within the market. Accordingly, a major aim of the SEC’s reforms is to heighten the degree of transparency in the ratings process. In furtherance of this aim, many of the SEC’s changes are focused on enhancing the number and type of disclosures required by the NRSROs. Specifically, the new regulations seek to provide outside NRSROs with access to information used by issuer-paid NRSROs, require NRSROs to disclose the ratings history of certain RMBSs and CDOs, mandate that NRSROs maintain records of out-of-model

154. Id.
155. Id. § 78o-7(c)(2); see also Senate Hearing, supra note 106, at 48, 48 (prepared statement of Christopher Cox, SEC Chairman).
158. See generally SEC SUMMARY REPORT, supra note 61.
159. See Final Amendments II, supra note 157, at 63832.
160. Id. at 63833-34; Final Amendments I, supra note 157, at 6457.
adjustments, and differentiate between ratings of structured-finance bonds and traditional bonds.

1. Disseminating the Information Relied on by NRSROs

One adopted proposal involves the SEC’s amendment of 17 C.F.R. § 240.17g-5 to allow NRSROs to obtain information about RMBSs and other structured-finance products that other NRSROs are hired to rate. The amendment stipulates that any time an NRSRO rates a structured-finance product, the information provided by the issuer for purposes of the rating must be accessible to nonhired NRSROs, which have certified that the accessed information will be used only for determining a credit rating.161 The amendment supplements an already existing disclosure requirement,162 which mandates that NRSROs report to the public any instances in which they are “paid by issuers or underwriters to determine credit ratings with respect to securities or money market instruments they issue or underwrite.”163

The change seeks to resolve the potential conflict that arises between particular arrangers of structured-finance products and NRSROs when current and future business is conditioned upon the rating agencies’ issuance of favorable ratings.164 Unlike the prior 17 C.F.R. § 240.17g-5 regulations, which merely required that NRSROs disclose the existence of a conflict of interest,165 the new rule indirectly provides the public with a means of assessing the basis of a credit rating.166 One rationale behind the additional disclosure is that the NRSROs will be less likely to intentionally issue inaccurate ratings if other NRSROs have access to a bond’s constitutive information.167 Theoretically, if an NRSRO inappropriately rates a bond in an attempt to generate future issuer fees, the impropriety will be exposed to the public by means of more discerning, independent credit ratings.168

The SEC has explained that, in addition to encouraging the effective monitoring of conflicts of interest, the rule change has the further objective of promoting competition among rating agencies.169 Specifically, the

161. See Final Amendments II, supra note 157, at 63843-46, 63864-65 (to be codified at 17 C.F.R. § 240.17g-5(a)(3) (2010)).
162. Id. at 63844.
165. 17 C.F.R. § 240.17g-5(a).
166. See Final Amendments II, supra note 157, at 63844, 63864.
167. See id. at 63844.
168. See id.
transparency required by the new amendment makes it viable for smaller-market players to analyze the proper creditworthiness of bonds without incurring significant expenses relating to due diligence.\textsuperscript{170}

The SEC anticipates that the information disclosed will relate to the characteristics of the assets underlying RMBSs and CDOs. The disclosures will include the type of loans that make up the bond, the principal amount paid on the loans, the loan-to-value ratios, the mortgagors’ credit scores, and the location of the mortgaged property.\textsuperscript{171} In order to maintain the confidentiality of such asset-descriptive disclosures, the amendment provides that only rating agencies that have been designated as NRSROs through the formal SEC application and certification process will have access to the information through password-protected websites.\textsuperscript{172} Issuers seeking credit ratings will, however, be expected to disseminate information that depicts the structure of the RMBS or CDO.\textsuperscript{173}

Critically, the amendment requires the issuer to disclose only the information that was given to the hired NRSRO “for the purpose of determining the initial credit rating.”\textsuperscript{174} Thus, the SEC leaves it to the issuer, with the help of the NRSRO, to establish what information is needed to evaluate a bond’s credit rating.\textsuperscript{175} This leaves open the possibility that bond issuers will provide relatively little information in order to limit the amount of information that is disseminated to nonhired NRSROs and the public, thus pressuring NRSROs to conduct bond analyses that are even more cursory than before.\textsuperscript{176} As a result, NRSROs that issue ratings on the basis of minimal

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\textsuperscript{170} See id.

\textsuperscript{171} Id. at 36220.

\textsuperscript{172} See Final Amendments II, supra note 157, at 63845-46, 63864-65.

\textsuperscript{173} See id. at 63846-47, 63864-65.

\textsuperscript{174} See id. at 63846, 63865.

\textsuperscript{175} See id.; see also Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. at 36220.

\textsuperscript{176} The SEC acknowledged this potential pitfall in the 2008 Proposed Rules but maintained that the incentive for NRSROs to use less information about the bond to arrive at its ratings will be mitigated by public expectations about the disclosures. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. at 36220. The Commission explained that “[a]n NRSRO that requires less than the standard level of information would need to convince users of credit ratings, most notably investors, that its ratings process was credible.” Id. This rationale, however, perpetuates the erroneous assumption that the market will cause NRSROs to self-regulate, thus preventing abuses in the ratings process. Such a supposition fails to appreciate that the NRSROs’ potential to make large profits lies more in the number of issuer fees it can generate than in the subscription fees that it receives from publishing the ratings. See Hill, supra note 82, at 50; see also text accompanying note 133. Moreover, due to the extremely complicated characteristics of RMBSs and CDOs backed by RMBSs, it is unlikely that investors will recognize when the information
information could receive increased business by bond issuers who desire less public examination of the rating.\textsuperscript{177} Such a dynamic would go directly against the purpose of the amendment. Instead of promoting transparency, the disclosure requirement would have the perverse effect of rewarding NRSROs that performed a less substantive examination of a bond’s creditworthiness before issuing a rating.

The SEC could prevent this abuse by specifying the type of information to be published under the amendment. While still acknowledging that the specific data to be examined can vary from bond to bond, the SEC should be able to prescribe certain minimum requirements for disclosure. Unfortunately, the SEC is restricted from establishing such reporting standards, because to do so would violate Congress’s prohibition on SEC regulation of the substance of ratings by NRSROs.\textsuperscript{178}

Admittedly, the likelihood that the amendment will indirectly promote cursory examinations designed to decrease the amount of information accessible to outside NRSROs may be small. Because the NRSROs’ potential to make large profits lies more in the number of issuer fees it can generate than in the subscription fees that it receives from publishing ratings,\textsuperscript{179} it is unlikely that independent NRSROs will take the time and effort to establish independent credit ratings for bonds that would only generate subscription fees. Indeed, the lack of incentive for nonhired NRSROs to provide independent bond ratings demonstrates another possible deficiency in the new regulation. While requiring the disclosure of information used by the agencies when rating structured finance products is a step in the right direction, the undefined nature of the required disclosures and the limited nature of the publications themselves makes it uncertain whether the actual implementation of the amendment will remedy the existing problems.

In spite of its shortcomings, the amendment helps to enhance the public’s ability to understand and oversee the credit ratings process. Given that the SEC is prohibited from interfering in the methodology used to establish a credit rating,\textsuperscript{180} the proposal creates a circumstance in which the NRSROs will be subjected to more public oversight of their analyses, at least theoretically. But in part because the current congressional authorization prevents the SEC from determining the information that the NRSROs use in assessing a bond’s

\begin{footnotes}


\textsuperscript{179} See Hill, supra note 82, at 50; see also supra text accompanying note 133.

\textsuperscript{180} See 15 U.S.C. § 78o–7(c)(2).
\end{footnotes}
credit rating, the amendment curtails the NRSROs’ conflicts of interest only to a limited extent.

2. Disclosing the Bond’s History

The SEC has also amended 17 C.F.R. § 240.17g-2 to require NRSROs to retain records of the history of a bond’s credit ratings, including records of its initial rating, any upgrades or downgrades to the bond, and any instances in which the NRSRO has placed a bond’s rating on watch for potential upgrade or downgrade. Under this amendment, NRSROs will also need to make available the ratings’ histories of a random sample of 10% of issuer-paid bonds. The amendment seeks to heighten the accountability of NRSROs by providing a more transparent ratings process. The SEC further maintains that the amendment operates to “create the opportunity for the marketplace to use the information to develop performance measurement statistics that [will] supplement those required to be published by the NRSROs themselves.”

The SEC believes that independent analysts can use the information required to be disclosed under the amendment as a means of “comparing how the NRSROs differ in their initial ratings and their monitoring for different types of asset classes.” An outside analyst could thus detect an NRSRO that is on the margins of ratings determinations by recognizing that its assessments are either atypically conservative or optimistic.

The random disclosure of ratings activity should also allow investors to better “analyze the actual performance of the credit ratings the NRSROs issue in terms of accuracy in assessing creditworthiness.” The public should, therefore, have a better opportunity to examine which NRSROs provide the most thorough ratings analyses and which ratings institutions release timely ratings information. As a result, the amendment enriches the current regulations by providing investors with the ability to see how accurately or inaccurately the previous credit ratings assessed the riskiness of the security. The amendment, however, falls short of providing a comprehensive

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181. See Final Amendments I, supra note 157, at 6460, 6482 (to be codified at 17 C.F.R. § 240.17g-2(a)(8) (2010)).
182. Id. at 6460, 6482 (to be codified at 17 C.F.R. § 240.17g-2(d)). These credit rating histories are required to be posted on the NRSROs’ websites. Id.
184. Id. at 36228.
185. Id. at 36229.
186. See id. at 36228-29.
187. Id. at 36228.
188. See id.
assessment vehicle to investors, because the public disclosure is limited to merely a 10% sample.\(^\text{189}\)

3. Records for Out-of-Model Adjustments

Another action taken by the SEC was to amend 17 C.F.R. § 240.17g-2 to require NRSROs to keep records of every adjustment that deviates from their quantitative models.\(^\text{190}\) Records must only be kept, however, when the quantitative models serve as a “substantial component” in the ratings process for structured-finance products and when the adjustment results in a “material difference between the credit rating implied by the model and the final credit rating issued.”\(^\text{191}\) Simply stated, under this amendment, NRSROs are responsible for retaining documentation that explains why out-of-model adjustments are made by analysts.\(^\text{192}\) The amendment is designed to assist the SEC in evaluating the NRSROs’ adherence to their self-imposed ratings procedures.\(^\text{193}\)

The SEC, however, has failed to establish when a model operates as a “substantial component” and has further failed to explain when an adjustment causes a “material” deviation from that model.\(^\text{194}\) Instead, the SEC makes it the responsibility of the NRSROs to elicit meaning from these provisions,\(^\text{195}\) thereby providing NRSROs with an unnecessary degree of discretion. While the SEC has stated that it “believes the expected loss and cash flow models used by the NRSROs to rate RMBS and CDOs are substantial components of the ratings process,”\(^\text{196}\) nothing in the new rule mandates that NRSROs adopt such an interpretation.

Though the SEC has yet to explain its reasons for leaving these terms undefined, its decision was likely based on the fact that the models used by NRSROs vary from agency to agency. Yet even assuming some variation in risk-assessment models, the SEC could still require each NRSRO to establish definitions and then make those definitions subject to scrutiny and approval by the SEC. Such a process would allow different NRSROs to tailor their

\(^{189}\) Final Amendments I, supra note 157, at 6460, 6482; see also supra note 182 and accompanying text.

\(^{190}\) Final Amendments I, supra note 157, at 6463, 6482 (to be codified at 17 C.F.R. § 240.17g-2(a)(2)(iii) (2010)).

\(^{191}\) Id. at 6463.

\(^{192}\) Id.

\(^{193}\) Id.

\(^{194}\) See id.

\(^{195}\) Id.

\(^{196}\) Id. at 6463 n.66.
guidelines to their own methodologies while also allowing the SEC to ensure that the suggested definitions sufficiently implicate the necessary adjustments.

By failing to supervise the NRSROs’ interpretations, the SEC has created an amendment whose effectiveness is entirely dependent on the discretion of the NRSROs. It is therefore unlikely that the rule will make much practical difference regarding NRSROs’ arbitrary deviations from their models.

4. Differentiating Structured-Finance Bonds

One disclosure change the SEC has proposed but not yet adopted, would require NRSROs to issue a special report to accompany any credit rating on a structured finance bond. If adopted, the proposal would modify 17 C.F.R. § 240.17g-7(a) to require that these reports describe “how the credit ratings procedures and methodologies and credit risk characteristics for structured finance products differ from those of other types of rated instruments such as corporate and municipal debt securities.” These reports would explain how the credit rating analyses used for RMBSs and CDOs are more complicated, and thus more speculative, than the analyses used when rating a traditional bond. Similarly, the reports would identify the heightened risks associated with instruments that derive from asset bundles and mortgage-backed securities. The purpose of the proposed amendment is thus to inform investors that the process of rating structured-finance products is necessarily less straightforward than that used to rate traditional bonds.

The effectiveness of this recommendation is somewhat questionable, given that the majority of Americans often disregard such cautionary statements as “boilerplate.” The SEC’s Proposed Rules recognize the possibility that the proposed warnings could be disregarded by investors. Nevertheless, the SEC maintains that the existence of such a report, where there previously was none, would provide investors with important information that could alert them to some of the risks associated with structured-finance products. The hope is that if investors were informed of the potential problems that accompany the ratings of RMBSs and CDOs, they would be prompted to conduct independent investigations of structured bonds.

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198. Id.
199. See id.
200. Id.
201. See id.
202. Id.
203. Id.
204. Id.
appears to believe that the change would curtail over-reliance on credit ratings by encouraging the public to perform their own examinations of RMBSs’ creditworthiness.

As an alternative to a full report accompanying each individual rating issued, the SEC asserts that something as simple as the attachment of a distinctive symbol to the standard ratings of structured finance products might accomplish the same objectives, while also “foster[ing] greater independent analysis by investors.”

The Commission explains that this less labor-intensive requirement could suffice because “[t]he differentiated symbol would alert investors that a structured product was being rated and, therefore, raise the question of how it differs from other types of debt instruments.”

While the notifying symbol might spur investors to research how an RMBS differs from a traditional bond, such a result is uncertain. Without requiring that the RMBS’s rating be accompanied by a report that sets forth the differences between the ratings process for such bonds, the SEC is relying on investors to appreciate the differences almost sua sponte and to then investigate the differences for themselves. The probability that investors would fully recognize the importance of the differentiated symbol, and be able to successfully investigate its meaning, is minute. Even if prompted to perform an investigation into the distinctions between the types of bonds, it is improbable that most investors would be able to find answers that sufficiently depict how the ratings analyses differ.

Because it is unnecessary to make investors conduct these examinations, especially when it is uncertain whether their investigations would generate accurate and comprehensive explanations, the SEC should simply require NRSROs to provide informational reports that accompany their ratings. Alternatively, NRSROs could provide investors with information about how to access such reports from their websites, which would reduce the NRSROs’ burden while better furthering the objective of transparency.

Though requiring NRSROs to prepare and publish explanatory reports does not necessarily diminish the degree to which investors rely on NRSROs, the purpose of the SEC’s regulations should not be to decrease investor reliance. Instead, the purpose of the SEC’s regulations of NRSROs should be to ensure that the information propagated by the credit rating agencies is correct and thereby worthy of investor reliance. After all, the initial objective for establishing nationally recognized credit rating organizations was to assure

205. Id.

206. Id.

207. It seems more probable that an investor would take note that the bond consists of—or is backed by—bundled assets, but likely the investor would end the examination there.
investors that they could rely on such designated agencies for complete, credible analyses of securities.208

The availability of a report that identified the disparities between structured-finance products’ ratings and the ratings of traditional bonds would be integral to increasing clarity within the bond market. While it would certainly be possible for people to ignore the supplemental warning, a requirement that such a warning exist would at least provide investors with the opportunity to increase their understanding of the riskiness of RBMSs and other asset-backed securities. Obviously, the SEC cannot control the degree of attention that is focused on any given information disclosure, but it can ensure that the public has access to the information.

To be sure, a lack of transparency has been identified as a primary cause of the credit crisis.209 The stifled flow of communication not only prevented the public from seeing the misconduct that was taking place but also allowed the parties perpetuating the inappropriate practices to maintain a degree of willful blindness.210 Thus, it stands to reason that the disclosure requirement itself should not be left virtually unenforced based solely on a concern that the disclosures might not be fully acknowledged by the public. Unfortunately, this fear has caused the SEC to take the teeth out of the proposal by accepting a mere symbol differentiation as a substitute for the disclosure report.211 Because the SEC has chosen to dilute its own rule, the ultimate result is a proposed amendment that appears to make little realistic progress toward solving the current transparency problem.

B. Prohibiting Certain Conflicts of Interest

As previously discussed, the very nature of the “issuer-pay” compensation model creates numerous conflicts of interest for NRSROs.212 In light of the NRSROs recent shortcomings, the SEC has set out to eliminate some of the most overtly problematic conflicts of interest.213 In particular, the amendments aim to temper concerns of impropriety by restricting analysts involved in structuring a bond from determining that bond’s rating, removing analysts from fee discussions, and prohibiting analysts from receiving gifts from issuers.

208. See Hill, supra note 82, at 53-54.
209. See SEC SUMMARY REPORT, supra note 61, at 2, 4, 30.
210. See discussion supra Part III-C-D.
212. See discussion supra Part III-D.
213. See Final Amendments I, supra note 157, at 6464-69, 6483.
1. Preventing Active Participation by NRSROs

During the SEC’s investigation of the NRSROs’ ratings practices, it was discovered that NRSROs would periodically make “recommendations to the obligor or the issuer, underwriter, or sponsor of the security . . . about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security.”214 In effect, this put NRSROs in the position of simultaneously acting as both financial advisors and bond raters. In an attempt to remedy this clear conflict of interest, the SEC has expanded 17 C.F.R. § 240.17g-5(c) to prohibit any NRSRO from issuing credit ratings in instances where either the NRSRO or its affiliate has advised issuers, underwriters, or bond arrangers about the proper structure for the RMBS to receive a particular credit rating.215

With this amendment, the SEC takes a stronger position than with the aforementioned changes because the new regulation operates to limit the scope of an NRSRO’s potential clients. The amendment thus acts as a specific restriction on NRSRO practices and not as a simple disclosure requirement. While the SEC does not have the authority to actively supervise the substance of credit ratings,216 this particular regulation is possible because Congress has allowed the SEC “to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization.”217

An across-the-board prohibition on NRSROs’ ability to both structure and rate a given bond is an appropriate and necessary measure. There is no benefit to the public in allowing this conflict of interest to persist, and the regulation does not overly restrict an NRSRO’s ability to conduct a profitable business. Accuracy is the objective of a credit rating, yet there is nothing about an NRSRO’s assistance in structuring a bond that promotes a more reliable credit rating process. In other words, NRSROs receive no greater insight into a bond’s creditworthiness by maintaining such a dual role. On the other hand, without regulation, there is a significant likelihood that an NRSRO analyst’s rating will not be sufficiently impartial if that analyst contributes substantive advice regarding the proper structuring of the bond. Consequently, any benefits that the concurrent duties would provide to the accuracy of ratings are strongly outweighed by the potential for biased determinations.

215. Final Amendments I, supra note 157, at 6465-67, 6483 (to be codified at 17 C.F.R. § 240.17g-5(c)(5) (2010)).
One difficulty exists, however, in applying the SEC’s new rule. The problem comes in distinguishing between when an NRSRO is explaining its reasoning for giving a bond a particular rating and when an NRSRO is actually making a recommendation to an issuer about how the bond should be structured. The SEC appropriately places special importance on fostering open communication between NRSROs and bond issuers. The SEC maintains that such communication helps generate more accurate ratings while also increasing transparency in the ratings process. Accordingly, the SEC’s amendment seeks to protect NRSROs’ ability to provide explanations to issuers about the use of model outputs, NRSROs’ assumptions regarding various types of credit enhancement, and other factors that are considered for determining a bond’s rating. Because the distinction between explanation and advisement is so narrow, it is unclear how the new prohibition will actually operate. Moreover, the amended rule does not address the means by which the Commission will enforce this requirement, which suggests that the rule change may provide little regulatory value. On the other hand, by restricting NRSROs from both structuring and rating a bond, the SEC enables itself to suspend or revoke an agency’s NRSRO status if an agency is found in violation of this rule. The amendment, therefore, marks an important advancement for the regulation of NRSROs because it increases the likelihood that ratings agencies will render impartial credit ratings.

2. Removing Analysts from Fee Discussions

Similarly, the SEC has added a requirement that NRSROs separate credit rating analysts from issuer-fee negotiations. The amendment will prevent individuals who develop and approve the NRSROs’ analytical procedures and methodologies from establishing issuer fees. Obviously, NRSROs may still make decisions regarding their own revenues from services to issuers, but the ratings analysts are now restricted from participating in such decisions. The SEC believes that this change will promote ratings objectivity by eliminating

219. See Final Amendments I, supra note 157, at 6466. The SEC suggests that if issuers have an understanding of how the NRSROs’ models evaluate risk, the issuer can independently structure RMBSs in a way that enhances their creditworthiness. See id.
220. See id. at 6465-69, 6483.
221. 15 U.S.C. § 78o-7(d).
222. Final Amendments I, supra note 157, at 6467, 6483 (to be codified at 17 C.F.R. § 240.17g-5(c)(6) (2010)).
223. Id.
224. See id. at 6467.
the opportunity for bond examiners to be influenced by a desire to increase fees.\textsuperscript{225}

Surprisingly though, the SEC’s rule does not prohibit internal discussion about fees between analysts and other employees within an NRSRO.\textsuperscript{226} Thus, prohibited analysts can still indirectly participate in fee negotiations by channeling the communications through non-analysts. Nevertheless, the establishment of barriers between analysts and fee negotiators should decrease the opportunity for NRSROs to engage in such internal communications. Ultimately, the amendment to exclude analysts from fee negotiations is a minimum requirement to any semblance of objectivity in ratings, but it may not provide the level of safeguard necessary to prevent the undeserved quid pro quo for ratings.

3. Barring Analysts from Receiving Issuers’ Gifts

Finally, the SEC has added a prohibition on the receipt of gifts by NRSRO analysts issuers, underwriters, or sponsors of any bond undergoing a ratings examination.\textsuperscript{227} The only exception to this rule allows analysts to receive typical de minimis business items, including pens and minor refreshments, when such articles do not exceed $25.\textsuperscript{228}

As with the earlier conflict-of-interest prohibition, the across-the-board ban appropriately addresses abuses that have been prevalent in the credit ratings process in recent years. Accordingly, these regulations do not unnecessarily or extensively restrict the freedom of NRSROs to effectively manage their business affairs. Instead, these changes simply mandate protective procedures that already should have been in effect.

C. Will the Changes Prevent Future Problems?

Overall, the SEC’s amendments establish meaningful improvements that raise the level of accountability of NRSROs. The new regulations, however, do not go far enough to safeguard against future harm. As discussed above, many of the changes, though good in theory, leave loopholes through which NRSROs can easily navigate. Additionally, the changes fail to address certain problems in the NRSROs’ procedures that could be effectively modified through regulation.

\begin{itemize}
\item \textsuperscript{225} Id.
\item \textsuperscript{226} See id. at 6467, 6483.
\item \textsuperscript{227} Id. at 6468, 6483 (to be codified at 17 C.F.R. § 240.17g-5(c)(7)).
\item \textsuperscript{228} See id.; see also Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36212, 36227 (proposed June 25, 2008) (Supplementary Information).
\end{itemize}
One significant deficiency in the amendments is that they fail to resolve the misleading effect resulting from the publication of a single credit rating. The solitary credit rating suggests to investors that a bond has always generated the same determination regarding its creditworthiness when, in actuality, the issuer has had multiple opportunities to restructure the tranches upon the advice of NRSRO analysts.\(^{229}\) Such an impression on investors is dangerous, because it is incorrectly simplistic in light of the fact that investors are not provided with the often conflicting results of an NRSRO’s prior analyses. The reliability of a credit rating is rightfully influenced by the uniformity or incongruity between the NRSRO’s initial determinations and the rating it actually publishes. Much like witness testimony in the trial context, the consistency or inconsistency of the NRSRO’s rating speaks to the level of credibility that should be placed on the ultimate rating.\(^{230}\)

For this reason, investors should have information about a security’s unpublished history in order to facilitate informed decisions by potential bond purchasers. If informed that a particular RMBS or mortgage-backed CDO received its ultimate rating after being given the chance (or, in some instances, multiple chances) to restructure the tranches, investors would have an appreciation of the factors that led to the security’s final rating. Such information would also place investors on notice that the bond’s underlying assets were not inherently strong and that the bond’s current rating was received largely as a result of payment structuring and not fortification of the assets themselves. Accordingly, NRSROs should be made to publish each of the ratings that a bond receives over time. The SEC could mandate such disclosures, whether public or confidential, under 17 C.F.R. § 240.17g-5; however, the recent amendments fail to establish such a requirement.

In addition, the amendments are notably limited to increasing the disclosure of information and preventing NRSROs from engaging in blatant conflicts of interest that should never have been condoned by the SEC from the outset. The glaring flaw in the SEC’s changes is the omission of any rule that would establish guidelines or precautionary measures for the ratings processes themselves. The failures in the SEC’s changes, however, do not lie solely with the SEC. After all, the Credit Rating Agency Reform Act places restrictions on the degree to which the SEC can regulate NRSROs. In fact, the Reform Act expressly provides that “neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical

\(^{229}\) See Unterman, supra note 1, at 61 n.26; see also supra notes 97-98, 135-37 and accompanying text.

\(^{230}\) Cf. Fed. R. Evid. 613 (permitting the use of prior inconsistent statements as a means of impeaching a witness’s credibility).
rating organization determines credit ratings.” 231 This confined latitude greatly restricts the SEC’s ability to supervise the conduct of NRSROs. The task, therefore, lies not only with the SEC to compel more substantive disclosures but also with Congress to confer greater authority on the SEC with regard to ratings regulations.

V. The NRSROs’ Insulation from Liability

While courtrooms have been flooded with suits against banks, underwriters, and mortgage firms as a result of the devastating subprime mortgage losses, lawsuits against NRSROs have been comparatively few.232 In fact, the cases that have been brought against the credit rating agencies have been viewed by many with curious skepticism.233 The reason for such hesitancy is that credit rating agencies have been strikingly well insulated from liability. For decades, courts have rejected investors’ suits against NRSROs by utilizing various legal theories, including First Amendment protection, lack of privity, and unreasonable reliance.234

A. First Amendment Protection

The Supreme Court established First Amendment protection for publishers in <em>New York Times Co. v. Sullivan</em>.235 The Court excused publishers from liability for defamation claims absent a showing of “actual malice” and reasoned that protection by means of such a standard for liability was necessary to encourage reporting on matters of public concern.236 The degree to which the Court’s First Amendment precedent affects investor lawsuits against credit rating agencies is a question of much debate.

1. Commercial Speech

While the Supreme Court has established broad protections for publications relating to matters of public concern, the Court has also repeatedly recognized

232. See David Segal, <em>Suddenly, the Ratings Agencies Don’t Look Untouchable</em>, N.Y. TIMES, May 21, 2010, at BU1 (reporting that to date only around thirty suits have been instituted against the rating agencies), available at http://www.nytimes.com/2010/05/23/business/23 rating.html?pagewanted=1.
233. See id.
236. See id. at 279-80. The Court defined “actual malice” as “knowledge that [a statement] was false or . . . reckless disregard of whether it was false or not.” Id. at 280.
that commercial speech requires less First Amendment protection than does traditional speech. Before 1976, the Supreme Court viewed commercial speech as wholly outside the purview of the First Amendment, and since that time, the Court has only recognized qualified protection for commercial communications. Because credit ratings assist the transfer of securities, if any degree of First Amendment protection is applicable, it is likely only the limited protection afforded to commercial speech.

a) Credit Ratings Are Commercial Speech

In *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, the Court characterized commercial speech as expression that “does 'no more than propose a commercial transaction.” Commercial speech has subsequently been described as “expression related solely to the economic interests of the speaker and its audience.” Though the Supreme Court has yet to establish with certainty which of these definitions should be applied, it seems clear that credit ratings fall within the scope of either. Credit ratings are designed for the single purpose of conveying a security’s credit risk. Thus, a rating is a purely financial expression that operates as a tool for facilitating a securities exchange.

Moreover, credit ratings are confined to expression through a symbol (e.g., AAA) and are thus incapable of speaking to anything beyond a bond’s commercial value. In other words, because it is restricted to a single symbol, a credit rating per se would not be published for a broad social or political purpose, which could arguably take it outside of the commercial speech context. Finally, the fact that NRSROs are paid to assign the ratings in order for the issuer to effectuate a sale demonstrates that a credit rating both

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237. See Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 758 n.5 (1985) (“In the area of protected speech, the most prominent example of reduced protection for certain kinds of speech concerns commercial speech.”); Ohralik v. Ohio State Bar Ass’n, 436 U.S. 447, 456 (1978) (“[U.S. Supreme Court decisions] have afforded commercial speech a limited measure of protection, commensurate with its subordinate position in the scale of First Amendment values.”).


242. Cf. Bd. of Trs. of the State Univ. of N.Y. v. Fox, 492 U.S. 469, 474-75 (1989) (holding that promotional speeches at Tupperware parties were commercial speech even though the speeches discussed other topics like “how to be financially responsible and how to run an efficient home”).
proposes a commercial transaction and speaks to the economic interests of the agency and the potential investor.

The Court has established that the government may more closely regulate the content of commercial speech than traditional speech without offending the First Amendment. First, if the commercial speech is misleading or concerns unlawful activity, the First Amendment does not protect the speech to any extent.\(^{243}\) Second, even assuming truthful speech about lawful activity, the First Amendment protects commercial speech only to the extent that the value of unregulated expression outweighs the government’s interest in supervising the speech.\(^{244}\)

\(b\) Because Negligent Credit Ratings Are Misleading, They Are Outside the Scope of Commercial Speech Protection

Although the First Amendment can curtail the government’s ability to regulate speech, the Court has explained that the government retains the authority to “insur[e] that the stream of commercial information flow[s] cleanly as well as freely.”\(^{245}\) Indeed, the Court has repeatedly affirmed that the First Amendment’s protection of commercial speech is premised on the notion that speech such as advertisements serves the public by conveying useful information.\(^{246}\) Based on this rationale, the Court has determined that when commercial speech does not provide accurate information, the usefulness of the expression is lost.\(^{247}\) Consequently, inaccurate and misleading commercial speech exists outside the scope of the First Amendment. The Court has stated that “there can be no constitutional objection to the suppression of commercial messages that do not accurately inform the public about lawful activity. The government may ban forms of communication more likely to deceive the public than to inform it . . . .”\(^{248}\)

The ratings that perpetuated the current credit crisis did not adequately inform the public. In fact, the public’s reliance on the ratings caused massive monetary losses, producing considerable harm to investors as well as to the U.S. financial market as a whole.\(^{249}\) Further, if not for the fact that the credit

\(^{243}\) Central Hudson, 447 U.S. at 563-64.
\(^{244}\) See id. at 566 (applying a four-part balancing test that considers whether the speech is protected by the First Amendment, whether the government interest is substantial, whether the regulation directly advances asserted government interest, and whether the regulation is well-suited to that interest).
\(^{245}\) Va. State Bd. of Pharmacy, 425 U.S. at 772.
\(^{246}\) See, e.g., Central Hudson, 447 U.S. at 561-62.
\(^{247}\) Id. at 563.
\(^{248}\) Id.
\(^{249}\) See Siew, supra note 50.
ratings misled market investors, there would be no viable private action before the courts, since the investors would have suffered no harm. Indeed, the credit ratings that would be at issue in any private action have proven themselves to be misleading because they caused the public to purchase unsound mortgage-backed securities by misrepresenting these bonds as investment grade.\footnote{250} Because the ratings that facilitated the credit crisis negligently misrepresented the riskiness of the bonds, the NRSROs cannot be shielded from liability on the basis of self-proclaimed First Amendment immunity.

c) Insulating NRSROs from Liability Does Not Further the First Amendment’s Objectives

(1) The Interest in Enforcing the Actual Malice Standard Is Slight

Even if a court were to find that the injurious ratings provided some degree of useful information, the interest in protecting such speech by requiring a showing of actual malice is slight. The Court’s determination that commercial speech deserves limited First Amendment protection is largely based on the recognition of two important distinctions from other types of speech: first, that the information communicated in commercial speech is easier to verify; and second, that commercial speech is less likely to be deterred by potential legal liability because of the financial benefits of the speech.\footnote{251} Upon applying these considerations to the issuance of credit ratings, it becomes clear that the objectives of the First Amendment are not furthered by requiring plaintiffs to satisfy the actual malice standard in suits against NRSROs.

The information relied on by NRSROs is objectively verifiable; therefore, NRSROs should not be entitled to the protections afforded journalists under the First Amendment actual malice standard.\footnote{252} The information used by NRSROs when determining a credit rating almost exclusively comes in the...
form of documents that depict the bond’s financial composition. Thus, the very manner by which the information is relayed differs substantially from the manner in which many news reporters receive their information. Often, news articles describe current events, and the information about the events derives from contemporaneous, first-hand observations and bystander accounts, which can be highly subjective. Because of this unavoidably subjective aspect of traditional reporting, the Court has granted reporters a degree of latitude with respect to mistake and falsity—namely, the actual malice standard. But these concerns that have generated First Amendment protection for traditional publications do not exist for bond ratings. The objective and durable nature of the information provided to NRSROs allows a credit rating to attain a level of accuracy that most other forms of reporting simply cannot attain.

The profitability of issuing credit ratings is also vastly greater than the typical revenues generated by publishers, which decreases the likelihood that the credit rating agencies will be deterred from making a communication for fear of legal liability. Part of the original rationale behind instituting a First Amendment defense for members of the press was to counteract a concern “that a ‘rule compelling the critic of official conduct to guarantee the truth of all his factual assertions’ would deter protected speech.” Yet because of the large proceeds that can be garnered from credit ratings, NRSROs are not susceptible to the possibility of deterrence based on a concern about legal costs. NRSROs receive approximately $250,000 per bond rating and can issue between twenty and twenty-five ratings per month. This far exceeds the sort of revenues that would discourage expression for fear that the expression might result in liability. The enormous profitability of issuing the ratings,

253. See id. at 7.
254. See New York Times Co. v. Sullivan, 376 U.S. 254, 279 (1964) (explaining that without a higher liability standard, journalists and critics “may be deterred from voicing their criticism, even though it is believed to be true and even though it is in fact true, because of doubt whether it can be proved in court or fear of the expense of having to do so”); id. at 271-72 (“[A]n erroneous statement is inevitable in free debate, and . . . it must be protected if the freedoms of expression are to have the ‘breathing space’ that they ‘need . . . to survive’ . . .” (quoting NAACP v. Button, 371 U.S. 415, 433 (1963))); see also supra note 236.
257. See Frank Partnoy, How and Why Credit Ratings Agencies Are Not Like Other Gatekeepers, in FINANCIAL GATEKEEPERS 59, 84 (Yasuyuki Fuchita & Robert E. Litan eds., 2006) (explaining that “Moody’s financial statements show that it actually is engaged in a business that is entirely different from publishing, one that is much more profitable”).
in and of itself, encourages NRSROs to continue their practices regardless of the existence of First Amendment protection.

Admittedly, the fact that NRSROs are paid by third-party sources to produce their credit ratings is not, by itself, dispositive on the issue of First Amendment protection. The Court in *New York Times v. Sullivan* explained that otherwise protected statements “do not forfeit [First Amendment] protection because they were published in the form of a paid advertisement.” 258 This determination was reached, however, only because the editorial at issue, a criticism of major civil rights violations, clearly would have fallen within the realm of protected speech had the article not been a paid editorial. 259 The Court reasoned that although the publication was an “editorial advertisement,” it “communicated information, expressed opinion, recited grievances, protested claimed abuses, and sought financial support on behalf of a movement whose existence and objectives are matters of the highest public interest and concern.” 260

Credit ratings, on the other hand, do not communicate such an expansive political message, but rather operate merely to facilitate the transfer of bonds. 261 So, while the Court has established that a published article on the highly political matter of civil rights did not lose protection simply because it was a paid publication, the Court has not held that entirely commercial publications that result from third-party payments are also worthy of First Amendment protection. For this reason, the Court’s disregard of the fees collected in *New York Times* does not render a consideration of the fees generated through credit ratings irrelevant on the question of First Amendment protection. 262 The revenues associated with the act of issuing credit ratings are, in fact, relevant to an evaluation of whether the speech will potentially be deterred absent heightened protection from liability. 263

In *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, the Supreme Court held that the First Amendment’s actual malice standard should not be applied in a defamation case against a credit reporting agency—an agency that assesses an individual’s credit score. 264 Though the ultimate holding turned

258. 376 U.S. at 266.
259. Id.
260. Id.
261. See Schwarcz, supra note 16, at 297, 300; see also supra text accompanying note 20.
262. See Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 759 (1985) (explaining that “the role of the Constitution in regulating state libel law is far more limited when the concerns that activated New York Times and Gertz are absent”).
264. See 472 U.S. at 751, 763.
primarily on the determination that an unpublished credit report does not implicate a matter of public concern, the Court also stressed that commercially driven communication “is solely motivated by the desire for profit, which . . . is a force less likely to be deterred than others.” The Court further observed that the profit motive reduces “any incremental ‘chilling’ effect” that governmental restriction might impose. 

While it is probable that a nationally published credit rating would be deemed to incorporate matters of public concern, the rationale in Dun & Bradstreet suggests that the actual malice standard should not be applied to NRSROs at least in part because of the verifiable and profitable nature of the speech. Accordingly, the interests that typically justify providing First Amendment protection to commercial speech are not compelling in the context of NRSROs.

(2) The Government’s Interest in Accountability Is Substantial

The government’s interest in securing the integrity of the securities market justifies denying NRSROs the protection of the actual malice standard. In Central Hudson Gas & Electric Corp. v. Public Service Commission of New York, the Court established that if the government’s interest is substantial, and if the form of a regulation advances the interest without unnecessarily restricting the speech, the First Amendment cannot foreclose the regulation of commercial speech. Upon examination of the context at hand, it becomes apparent that the government has a profound interest in ensuring the accuracy of credit ratings.

As explained below, the current bond market operates from an almost-exclusive reliance on credit ratings. Without credit ratings, investors face tremendous obstacles in assessing the value of a given bond. If, as a result of continued NRSRO negligence, investors lose faith in the ratings system, bond trading—a cornerstone of America’s current financial market—could cease to be a viable investment option. Thus, the strength of the national economy relies heavily on the integrity of the credit ratings system. The government’s interest in stimulating accurate credit ratings is therefore paramount, as evidenced by the SEC’s extensive investigation and subsequent regulatory amendments regarding NRSROs’ procedures.

265. See id. at 761-63.
266. Id. at 762.
267. Id. at 763.
269. See discussion infra Part VI.
270. See generally Husisian, supra note 57, at 414-25.
Allowing NRSROs to be held to the traditional standards of liability for the claims asserted against them—primarily negligence, negligent misrepresentation, and fraud—advances the government’s interest in maintaining an effective financial market. Conversely, if NRSROs receive the heightened protection of the actual malice standard, the interest in securing a stable economy becomes vulnerable. Because the jurisprudence of commercial speech has incorporated a weighing of the government’s interest against the speaker’s interest,\(^\text{272}\) it would be contrary to the Court’s interpretation of the First Amendment to allow NRSROs to take shelter under the actual malice standard rather than holding them to a negligence standard for the issuance of ratings. Additionally, because Congress has dictated that the SEC shall not supervise the methodologies of NRSROs,\(^\text{273}\) courts would be remiss to further insulate NRSROs by applying such an elevated legal standard. To do so would shield NRSROs from accountability and would fail to effectively enforce reasonable standards of care on the agencies. Accordingly, a court’s imposition of the actual malice standard in an investor’s negligence suit would not only frustrate the objectives of the First Amendment, but it would also jeopardize the stability of the country’s economy.

Balancing the conflicting interests associated with First Amendment protection for credit rating agencies demonstrates that the government’s interest is fortified by the public’s interest. Usually, the government’s regulatory interest is unrelated to the accuracy of the information conveyed by the speech and is instead tied to separate concerns—for example, the conservation of energy.\(^\text{274}\) Consequently, the government’s interest typically opposes the audience’s interest in receiving the information. Within the context of credit rating suits, however, the government’s interest is harmonious with the audience’s interest, as both the government and the audience are striving to encourage quality credit ratings.

What accounts for the difference in interest from one context to the other is the fact that the Central Hudson inquiry was developed to consider the

\(^{272}\) See Central Hudson, 447 U.S. at 566; see also supra note 244 and accompanying text.

\(^{273}\) Credit Rating Agency Reform Act of 2006, 15 U.S.C. § 78o-7(c)(2) (2006); see also supra text accompanying note 155.

\(^{274}\) See Central Hudson, 447 U.S. at 560. In Central Hudson, the Supreme Court struck down a New York regulation that completely banned promotional advertising by public utilities. See id. at 558-59, 571-72. Central Hudson established the test for determining the constitutionality of content-neutral state regulations affecting commercial speech. See id. at 566; see also supra note 244.
appropriateness of active government regulation of commercial speech, usually in the form of a prior restraint.\textsuperscript{275} By contrast, the court’s role as adjudicator on behalf of the government involves a passive form of regulation, which takes place only when citizens take action. The fact that the government and the public share the interest of promoting prudent rating practices should clearly demonstrate that the NRSROs exist outside the scope of First Amendment protection in the context of investors’ negligence suits. The apparent impropriety of applying First Amendment protection to private NRSRO suits becomes even more pronounced upon consideration of the credit rating agencies’ limited reportive role.

2. Credit Rating Agencies as Financial Reporters or Financial Advisors

The current First Amendment framework provides powerful protection for journalists, chiefly protection from negligence liability through the actual malice standard.\textsuperscript{276} As discussed above, this protective standard for liability was developed on the basis of certain assumptions about reporters, the reporting process, and the type of information being communicated to the public.\textsuperscript{277} Accordingly, when expression does not involve these assumptions, the appropriateness of affording the protection predicated on these assumptions should be closely scrutinized.

The Second Circuit has examined the appropriateness of the actual malice standard in an opinion that contrasted the activities of an NRSRO with those of a traditional journalist. In \textit{In re Fitch, Inc.}, the court determined that an NRSRO does not constitute a news reporter for the purposes of utilizing the “New York Press Shield Law,” which protects journalists from being compelled to disclose certain proprietary information during a third party’s discovery process.\textsuperscript{278} The court distinguished between the role of credit rating agencies and other journalists based on two compelling characteristics: first, credit rating agencies typically issue credit ratings only when they are hired and paid by an issuer; and second, the role of a credit rating agency is far more active than that of an onlooking reporter.\textsuperscript{279}

\textsuperscript{275} \textit{See Central Hudson}, 447 U.S. at 566.

\textsuperscript{276} \textit{See New York Times Co. v. Sullivan}, 376 U.S. 254, 279 (1964). While the Court has not reserved this special protection \textit{exclusively} for journalists, the rationale and effect of the \textit{New York Times} decision demonstrates that journalists will be the class most protected by its holding. \textit{See supra} note 254 and accompanying text. Furthermore, the First Amendment specifically protects “freedom of the press” in addition to the more generalized freedom of speech. \textit{See U.S. CONST. amend. I}.

\textsuperscript{277} \textit{See New York Times}, 376 U.S. at 271-72, 276, 279; \textit{see also supra} note 254 and accompanying text.

\textsuperscript{278} \textit{See 330 F.3d} 104, 108, 110 (2d Cir. 2003).

\textsuperscript{279} \textit{See id.} at 109-10.
Because the decision to publish a credit rating is dependent on whether an issuer has hired the NRSRO to conduct the analysis, the court found that credit rating agencies do not act in a reportive role.\textsuperscript{280} The court emphasized that traditional news media, even financial media, issue reports based simply on whether an event seems “newsworthy.”\textsuperscript{281} In contrast, the court determined that Fitch only issued reports when issuers specifically paid it to do so.\textsuperscript{282} The court described issuers as “clients” of Fitch, which suggests that a credit rating agency’s role may be more closely likened to that of a financial advisor than that of a financial reporter.\textsuperscript{283}

Further, in an effort to lend additional support to the conclusion that Fitch fit the role of an advisor, the court directed attention to the fact that the credit rating agency’s active participation in the issuer’s financial decisions was uncharacteristic of a typical journalist.\textsuperscript{284} This determination followed the court’s review of discovery documents filed under seal, which consisted primarily of email correspondence between Fitch and the issuer.\textsuperscript{285} The court found correspondence that revealed a Fitch analyst discussing certain modeling assumptions that determine what components of a bond generate what ratings results.\textsuperscript{286} Further evidence revealed a Fitch analyst giving specific advice as to how the “deal structure” could be improved.\textsuperscript{287} The court reasoned that such “correspondence indicate[d] a fairly active role on the part of the Fitch employee in commenting on proposed transactions and offering suggestions about how to model the transactions to reach the desired ratings.”\textsuperscript{288} Based on this assessment, the court held that the evidence “counsel[ed] strongly against” recognizing Fitch as a news reporter for purposes of invoking the journalist privilege.\textsuperscript{289}

The distinctions made by the Second Circuit are highly informative to the First Amendment inquiry, because they articulate why NRSROs are undeserving of the protections designated for traditional news reporters. As \textit{In re Fitch} demonstrates, credit ratings are not sufficiently analogous to reportive publications to necessitate that the agencies that promulgate the

\textsuperscript{280} See id.; see also id. at 106 (explaining that “Fitch’s information-disseminating activity does not seem to be based on a judgment about newsworthiness, but rather on client needs”).
\textsuperscript{281} Id. at 109.
\textsuperscript{282} Id.
\textsuperscript{283} See id. (“Fitch only ‘covers’ its own clients. We believe this practice weighs against treating Fitch like a journalist.”).
\textsuperscript{284} Id. at 110-11.
\textsuperscript{285} Id. at 110.
\textsuperscript{286} Id. at 111.
\textsuperscript{287} Id.
\textsuperscript{288} Id. at 110-11.
\textsuperscript{289} Id. at 111.
ratings receive the same protections that were particularly carved out to safeguard journalists who report on matters of public concern. NRSROs simply do not issue credit ratings in order to inform “decision-making by the electorate.” Instead, NRSROs issue credit ratings because they have been commissioned to do so by bond issuers.

Unlike the articles considered in New York Times and its progeny, bond ratings are the result of a specific contract between the issuer and the NRSRO, the execution of which effectuates the selling and subsequent purchase of a bond. Consequently, a credit rating is not published primarily for the purposes of reporting the news, but is instead issued for the purpose of effectuating financial transactions. It is for this reason that the activity of issuing credit ratings seems to escape the aim of New York Times and its progeny, thus falling outside the scope within which the actual malice standard is appropriate.

3. The First Amendment’s Role in Nondefamation Claims

The incongruence of New York Times with NRSRO private suits is further illustrated by the fact that the theories asserted by investors generally do not involve defamation claims. Although the U.S. District Court for the Southern District of Texas recently determined in In re Enron Corp. Securities, Derivative & ERISA Litigation that the First Amendment protects NRSROs from liability for negligent misrepresentation absent a showing of actual malice, this opinion misapplied First Amendment jurisprudence. In support of its holding, the court cited cases from the Tenth and Seventh Circuits that provided First Amendment protection to credit rating agencies. Both of these cases, however, dealt with defamation claims, not claims for negligent misrepresentation. Thus, the district court not only failed to address the lesser protection afforded to commercial speech but also failed to assess the potential impropriety of utilizing the actual malice standard in an action for negligence.

Significantly, the Supreme Court has never held that the standard of actual malice applies to a negligent misrepresentation cause of action. This is likely because a claim for defamation is qualitatively different from a claim for negligent misrepresentation, which does not require a showing of culpability.

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293. See id. at 810, 818.
or knowledge of falsity.  The Supreme Court cases involving applications of the actual malice standard have almost exclusively involved defamation theories, with the exception of notable cases featuring intentional infliction of emotional distress, invasion of privacy, and the right of publicity. In fact, the instances in which the Court has applied the First Amendment actual malice standard have been confined to the area of intentional torts and torts involving personal dignitary interests. The limited scope of the actual malice standard suggests that its application in a negligence-based suit would be categorically inappropriate. Indeed, unlike intentional torts and claims involving dignitary interests, a claim of negligence or negligent misrepresentation is premised on the defendant’s breach of a duty of care; it follows, then, that a less stringent standard for liability should apply to such claims if the defendant owed the plaintiff a duty at the time of the alleged breach.

Considering the lower degree of protection afforded to commercial speech, the rating agencies’ limited repressive role, and the Supreme Court’s silence as to whether the actual malice standard should be extended to negligence suits, the argument for First Amendment protection in suits against NRSROs is attenuated and unconvincing. For this reason, courts should reject the NRSROs’ invocation of the First Amendment with regard to the inaccurate RMBS ratings and should hold NRSROs to the standards applied to other market participants. Unfortunately, even if courts do remove the actual malice standard, other hurdles exists for investors seeking compensation from NRSROs.

B. Lack of Privity Between NRSROs and Investors

As In re Enron illustrates, investors’ suits against NRSROs can raise allegations of negligent misrepresentation. One element of the negligent

295. See 37 AM. JUR. 2D Fraud and Deceit § 128 (2001) (listing the elements of a claim for negligent misrepresentation).
296. See Hustler Magazine v. Falwell, 485 U.S. 46, 48, 56 (1988) (holding that a public figure offended by a magazine’s parody could not succeed on an intentional infliction of emotion distress claim absent a showing of actual malice).
299. See KATHLEEN M. SULLIVAN & GERALD GUNTHER, FIRST AMENDMENT LAW 77-84 (3d ed. 2007).
300. See 37 AM. JUR. 2D Fraud and Deceit § 128.
misrepresentation claim requires the plaintiff to demonstrate a sufficient connection to the transaction for which the defendant allegedly presented inaccurate information.\textsuperscript{302} This requisite relationship between the plaintiff and the transaction is known as privity.\textsuperscript{303}

In \textit{First Equity Corp. of Florida v. Standard & Poor’s Corp.}, the Second Circuit held that investors do not have sufficient privity to bring negligent misrepresentation claims against NRSROs.\textsuperscript{304} The plaintiff in \textit{First Equity} asserted that S & P, in its publication, \textit{Corporation Records}, erroneously stated that Pan American World Airways securities would be convertible, during a specified period, into common shares at the value of principal plus accrued interest.\textsuperscript{305} In reality, however, the securities were only eligible for conversion at the value of the principal, not including accrued interest.\textsuperscript{306}

The court held that recovery was barred on the grounds that the plaintiff lacked privity to bring a claim against S & P.\textsuperscript{307} The court relied heavily on a New York case from 1921, \textit{Jaillet v. Cashman}, which held that a common investor could not sue the issuer of a false stock-ticker report.\textsuperscript{308} The rationale offered by the Second Circuit was that “as a matter of practical expediency,”\textsuperscript{309} courts should protect the publishers of false information from exposure “to claims by the entire public.”\textsuperscript{310}

The policy concerns espoused by the court, however, fail to appropriately account for the privity of an NRSRO subscriber. Just fours years before the \textit{First Equity} decision, in an action brought by lenders asserting negligence and fraud against their borrowers’ accounting firm, the New York Court of Appeals established three requirements for a finding of professional liability to third parties with whom there is no express contractual privity.\textsuperscript{311} First, the information provider “must have been aware that the financial reports were to be used for a particular purpose or purposes.”\textsuperscript{312} Second, the information provider must have had knowledge of a party’s or parties’ intent to rely on the
information. Third, “there must have been some conduct on the part of the [professionals] linking them to that party or parties, which evinces the [professionals’] understanding of that party or parties’ reliance.”

Under this noncontractual-privity standard, a subscriber to a financial publication would likely qualify to bring a negligence claim against the publisher. Yet this analysis was not even acknowledged by the court, which instead relied on outdated case law. By refusing to implement the appropriate standard for determining noncontractual privity, the Second Circuit convoluted its analysis and brought in First Amendment concerns under the guise of a privity evaluation. This is evidenced by the court’s conclusion that a subscriber of a securities information publication may only recover if the elements of fraud are established. In effect, the fraud requirement is the functional equivalent of the actual malice standard, which indicates the court’s misguided application of the law. Moreover, the court never pointed to clear precedent to explain why S & P’s status as a publisher changed the relevant inquiry.

For these reasons, the court’s determination is unpersuasive and fails to establish meaningful precedent on the issue. Surprisingly, this disappointing decision is not the last demonstration of legal arguments that have wrongly, yet successfully, been asserted against investors in NRSRO suits. In fact, at least one circuit has maintained that investor suits against NRSROs are untenable because investors are unjustified in their reliance on credit ratings.

313. Id.
314. Id.
315. As recognized by the Second Circuit in In re Fitch, Inc., 330 F.3d 104 (2d Cir. 2003), credit rating agencies differ significantly from other reporters who give financial and consumer recommendations because credit rating agencies are hired by issuers, paid by issuers, rely almost exclusively on information provided by the issuer, and in many instances take on the active role of advising the issuer about how to restructure their bond. See id. at 110-11. Moreover, unlike more typical financial publications that might give buying and selling recommendations, credit rating agencies derive the majority of their revenues from issuers’ payments rather than from advertisements and readers’ subscription fees. See Hill, supra note 82, at 50; see also supra text accompanying note 133.
316. See First Equity Corp. of Fla. v. Standard & Poor’s Corp., 869 F.2d 175, 178-80 (2d Cir. 1989); see also supra notes 307-10 and accompanying text.
317. See First Equity, 869 F.2d at 178-80.
318. See id. at 179-80.
319. See id. at 180.
C. Reliance on Ratings as Unreasonable

While certain courts and commentators have argued that an investor’s reliance on a rating is unreasonable, the significance of credit ratings to the financial market is nearly unparalleled. An illustration of the market’s extensive reliance on credit ratings can be found by considering the effects that a credit rating change had on RJR-Nabisco. In 1990, Moody’s lowered its rating on RJR-Nabisco, causing its bonds to lose 20% of their value in the two days following the ratings downgrade. RJR-Nabisco’s near-immediate loss totaled several hundred million dollars.

Yet the Seventh Circuit has maintained that an investor’s reliance on a bond’s credit rating is unreasonable. In *Quinn v. McGraw-Hill Cos.*, the court confronted a situation involving two banks that had invested $1.29 million in certain collateralized mortgage obligations. The plaintiff, the majority shareholder of the banks, was only authorized to purchase bonds that received an A rating or higher. Accordingly, the plaintiff alleged that he relied on S&P’s A rating when he purchased the bonds. Less than three years after the investment, “S & P abruptly downgraded the [bonds’] rating from ‘A’ to ‘CCC,’—an eleven point plunge.” Shortly thereafter, the bonds defaulted.

The plaintiff brought suit against S & P for breach of contract and negligent misrepresentation. The Seventh Circuit upheld the district court’s dismissal of the breach of contract claim, in which the plaintiff contended that he was a third-party beneficiary, because the contract between the bond issuer and S & P did not include “either express language identifying purchasers like Quinn by name or its functional equivalent.” Likewise, the Seventh Circuit upheld the district court’s dismissal of the negligent misrepresentation claim. The circuit court emphasized that the day after the bonds were purchased, the plaintiff received a memo from the bonds’ issuer warning that the bonds were “non-recourse obligations solely of the Issuer and [were] not insured or

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321. See, e.g., id.; see also Partnoy, *supra* note 257, at 80.
323. Id.
324. 168 F.3d at 332-33.
325. Id. The plaintiff paid each bank for its losses on the bonds out of personal funds, and the banks assigned him the right to sue. Id. at 333.
326. Id. at 333.
327. Id.
328. Id.
329. Id.
330. Id. at 334.
331. Id. at 334, 336.
guaranteed.” The memo further stated that the S & P ratings were “not a recommendation to buy, sell, or hold any such Bonds and [might] be subject to revision or withdrawal at any time.”

Despite the boilerplate nature of these direct statements, the court maintained that the statements “should have alerted Quinn to the fact that he was responsible for doing his own homework about the risks he was assuming.” Thus, the court held that even at the motion-to-dismiss stage, “any reliance [the plaintiff] may have placed on th[e] rating to reassure himself about the underlying soundness of the bonds was not reasonable.”

The Seventh Circuit’s conclusion, premised on boilerplate warnings and the plaintiff’s status as an “experienced banker,” suffers from a significant error. The opinion failed to consider that the purchaser often does not have the opportunity or means of “doing his own homework.” Because of the complex and confidential nature of the information that determines a bond’s rating, potential investors do not have the opportunity to assess the intimate details of a bond’s creditworthiness. After all, the determination of a bond’s worth ultimately turns on an evaluation of the ability of the mortgagors of the underlying assets to repay their loans, an inquiry that requires an examination of such borrowers’ credit histories and FICO scores, the locations of the mortgaged properties, and the terms of the mortgage agreements. To make such materials available to all potential purchasers of bonds would be to publicize highly confidential information.

Further, the sophisticated analysis required for evaluating a bond is highly complicated and would be impractical for individual investors to perform. Indeed, it is precisely because of the sophistication and confidentiality of the credit ratings analysis that rating agencies were created and continue to thrive. The Seventh Circuit’s failure to appreciate the symbiotic role of

332. Id. at 333.
333. Id. at 333, 336.
334. Id. at 336. The district court disposed of both claims by granting the defendant’s motion to dismiss for failure to state a claim. Id. at 333; see also Fed. R. Civ. P. 12(b)(6).
335. Quinn, 168 F.3d at 336.
336. Id.
337. See id.
338. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36212, 36214-19 (proposed June 25, 2008) (Supplementary Information); see also discussion supra Part III.A. As discussed above, the disclosure of data supporting a bond’s rating is one of the newly adopted regulatory amendments designed to make the ratings process more transparent, though the amendments restrict access to such data to other NRSROs. See discussion supra Part IV.A.1.
339. See SEC SUMMARY REPORT, supra note 61, at 7.
340. See Hill, supra note 82, at 55.
NRSROs in the financial market led it to wrongly hold that the plaintiff’s reliance was unreasonable, thereby preventing the negligent misrepresentation claim from proceeding to trial.

D. Progress in Suits Against NRSROs: In re National Century Financial Enterprises, Inc. Investment Litigation

Recently, at least one court has recognized that NRSROs can be held liable for the injuries caused by negligent and inaccurate ratings. On July 22, 2008, U.S. District Court for the Southern District of Ohio, in the consolidated case of In re National Century Financial Enterprises, Inc. Investment Litigation, ruled on motions to dismiss for failure to state a claim.\textsuperscript{341} Plaintiff Lloyds TSB Bank PLC (Lloyds) filed suit against Moody’s for allegedly inducing the purchase of millions of dollars of substandard securities notes.\textsuperscript{342} Simultaneously, Plaintiff New York Pension Funds (New York Funds) filed suit against Fitch on the same grounds.\textsuperscript{343} The complaints alleged that National Century Financial Enterprises, Inc. (National Century) had hired Moody’s and Fitch to rate the creditworthiness of its notes and that the agencies did so negligently.\textsuperscript{344} Both Lloyds, a limited public company, and New York Funds, a collection of pension funds that managed various employees’ and retirees’ assets, were only authorized to purchase AAA-rated securities, theoretically the most secure investments available.\textsuperscript{345} The plaintiffs’ investments in the National Century notes were, therefore, largely based on the AAA rating and the confidence that the rating engendered.

In addition to fraud and negligence claims, Lloyds brought allegations against Moody’s for violation of section 10(b) of the Securities Exchange Act and its corresponding regulations.\textsuperscript{346} Similarly, New York Funds asserted claims against Fitch for “aiding and abetting fraud, negligent misrepresentation, negligence, and gross negligence.”\textsuperscript{347} Though dismissing the section 10(b) allegations and fraud allegations, the court held that the negligence-based claims were appropriately brought against the NRSROs.\textsuperscript{348}

\textsuperscript{341} 580 F. Supp. 2d. 630, 634, 656 (S.D. Ohio 2008); see also Fed. R. Civ. P. 12(b)(6).
\textsuperscript{342} In re National Century, 580 F. Supp. 2nd at 634.
\textsuperscript{343} Id.
\textsuperscript{344} Id. at 636. Indeed, New York Funds alleged that Fitch rated these notes as AAA in spite of the fact that an estimated 50% of the issuer’s receivables were fabricated. Id.
\textsuperscript{345} See id. at 634-36.
\textsuperscript{346} Id. at 635; see also 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5(b) (2008). Lloyds also asserted claims under both Ohio and New Jersey’s “blue sky” laws. See In re National Century, 580 F. Supp. 2d at 635.
\textsuperscript{347} In re National Century, 580 F. Supp. 2d at 636.
\textsuperscript{348} Id. at 656.
1. First Amendment Applicability

Citing cases such as In re Enron Corp. Securities, Derivative & ERISA Litigation\textsuperscript{349} and Compuware Corp. v. Moody’s Investors Services, Inc.,\textsuperscript{350} the NRSROs argued that First Amendment protection for the ratings prevented liability from being placed on the NRSROs.\textsuperscript{351} The NRSROs urged that because ratings are a matter of public concern, liability cannot be established absent a showing of actual malice.\textsuperscript{352} For purposes of the dismissal motion, however, the district court accepted that the ratings at issue were not a matter of public concern because they were only communicated in the notes’ offering materials, which were provided solely to select institutional investors who had the ability to invest tens of millions of dollars on the bonds.\textsuperscript{353} Because the ratings at issue were not disseminated to the general investing public, but were instead provided only to a specialized class of investors, the NRSROs’ claim for First Amendment protection did not justify dismissal.\textsuperscript{354}

2. Securities Exchange Act and Fraud Claims Brought Against Moody’s

Among its causes of action, Lloyds alleged securities violations against Moody’s.\textsuperscript{355} To establish a valid claim under section 10(b) of the Securities Exchange Act and its corresponding regulatory provision,\textsuperscript{356} Lloyds had to prove that the purchase of the notes was the result of “(1) a misstatement or omission, (2) of a material fact, (3) made with scienter, (4) justifiably relied on by plaintiffs, and (5) proximately causing them injury.”\textsuperscript{357} Although the court found that Lloyds sufficiently demonstrated that Moody’s had misstated a material fact,\textsuperscript{358} the court ultimately dismissed the section 10(b) claim because of the plaintiff’s failure to adequately establish an inference of scienter— that is, “a mental state embracing intent to deceive, manipulate, or defraud.”\textsuperscript{359} To survive a 12(b)(6) motion to dismiss, the inference of scienter must surpass a level of mere reasonableness or permissibility and must instead be “cogent and

\textsuperscript{349} 511 F. Supp. 2d. 742 (S.D. Tex. 2005)
\textsuperscript{350} 499 F.3d 520 (6th Cir. 2007).
\textsuperscript{351} In re National Century, 580 F. Supp. 2d. at 639.
\textsuperscript{352} Id.
\textsuperscript{353} Id. at 640.
\textsuperscript{354} See id.
\textsuperscript{355} Id. at 635.
\textsuperscript{357} In re National Century, 580 F. Supp. 2d at 637 (quoting Helwig v. Vencor, Inc., 251 F.3d 540, 554 (6th Cir. 2001) (en banc)).
\textsuperscript{358} See id. at 639.
\textsuperscript{359} Id. at 643.
\textsuperscript{360} Id. at 640 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976)).
compelling."\textsuperscript{361} According to the court, Lloyds’s claims against Moody’s did not meet this requirement because the complaint failed to identify specific information known to Moody’s that would have caused the NRSRO to question the legitimacy of National Century’s credit enhancements.\textsuperscript{362}

Moreover, though Lloyds alleged that the fraudulent practices were so widespread that Moody’s could not have avoided having knowledge, the court rejected this assertion as an insufficient basis for scienter.\textsuperscript{363} The court stated that while allegations concerning a fraud’s broad magnitude can be sufficient for inferring that certain company insiders were aware of the fraudulent practices, nothing in the complaint demonstrated that Moody’s was in such an intimate position.\textsuperscript{364} As a result, the court dismissed the Securities Exchange Act section 10(b) claims.\textsuperscript{365}

The court dismissed Lloyds’s claim for fraud on similar grounds.\textsuperscript{366} A showing of fraud requires the plaintiff to establish six elements: (1) the defendant represented or concealed a fact, (2) that was material to the transaction, (3) with knowing falsity or with such reckless disregard that knowledge is inferable, (4) with the intent to mislead another in reliance, (5) the plaintiff’s reliance was justifiable, and (6) the resulting injury was a proximate result of the reliance.\textsuperscript{367} The court noted that while the complaint generally stated that Moody’s had acted “recklessly or with gross negligence” in its assignment of the AAA ratings, the complaint did not offer sufficient factual allegations to support that assertion.\textsuperscript{368} Because Lloyds did not allege specific information encountered by Moody’s during its ratings analysis that should have informed the agency that the AAA ratings were not representative of the creditworthiness of the notes, the court dismissed the fraud claim.\textsuperscript{369}

3. Negligent Misrepresentation

Lloyds and New York Funds also brought claims against the defendants for negligent misrepresentation. To prove negligent misrepresentation, a plaintiff must establish, among other things, that in the course of a business transaction, the defendant supplied false information to parties of the transaction as a result

\textsuperscript{361} Id. at 641 (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007)).
\textsuperscript{362} Id. at 642-43.
\textsuperscript{363} Id.
\textsuperscript{364} Id. at 642.
\textsuperscript{365} Id. at 644.
\textsuperscript{366} Id. at 645-46.
\textsuperscript{367} Id. at 645 (citing Russ v. TRW, Inc., 570 N.E.2d 1076, 1083-84 (Ohio 1991)).
\textsuperscript{368} Id.
\textsuperscript{369} Id. at 645-46.
of the defendant’s failure to exercise reasonable care in gathering or conveying the information.

Though the NRSROs argued that no privity or fiduciary duty extended to the plaintiffs because the plaintiffs were neither parties to nor intended beneficiaries of the underlying transaction, the court rejected this argument. Admittedly, the plaintiffs were not parties to the contract between the NRSROs and the bond issuer. The court emphasized, however, that the agencies rated the bonds with the knowledge that those ratings would be included in the offering materials that were provided to the plaintiffs. Thus, because the plaintiffs were in fact members of a limited class who would foreseeably depend on the ratings, the court found that the plaintiffs had sufficiently alleged the existence of privity to survive the defendants’ motions to dismiss.

The court further found that the plaintiffs adequately alleged that the NRSROs failed to exercise reasonable care in determining whether there was a factually accurate basis for their ratings. Although the plaintiffs’ allegations fell short of the pleading standard for scienter, the court reasoned that if the NRSROs had exercised reasonable care in obtaining the financial information used to generate its rating, the multiple weaknesses inherent in the bonds plaintiffs purchased would have been reflected in the credit ratings.

Lastly, the court rejected the NRSROs’ argument that the plaintiffs were unjustified in their reliance on the credit ratings. The NRSROs asserted that they issued precautionary statements that described their ratings as opinions, which should have prevented the plaintiffs’ reliance. The court maintained, however, that even “opinions can be the basis of liability if the opinion is not factually well-grounded.” Additionally, the court stated that at the very least, the plaintiffs presented sufficient allegations that the issue of whether the reliance was reasonable should be left to the trier of fact.

370. Id. at 646.
371. See id. at 646-48, 652-53.
372. See id. at 648, 653.
373. Id.
374. See id.
375. See id.
376. See id. at 643; see also supra text accompanying notes 358-64.
378. Id. at 648-49, 653.
379. Id. at 648, 653.
380. Id. at 648 (citing, inter alia, Mayer v. Mylod, 988 F.2d 635, 638 (6th Cir. 1993)).
381. See id. at 648, 653.
4. The Effect of the National Century Opinion

By recognizing that liability for negligence can be imposed for opinions when those opinions do not reflect a sound factual basis, the court correctly determined that the plaintiffs should have the opportunity to hold each NRSRO accountable for its careless guidance. In so ruling, the court properly examined the defendants’ conduct at the time the ratings were determined rather than holding defendants to a hindsight-based standard of care. Moreover, the court reached its conclusion after making the important recognition that investors can have privity to assert claims against NRSROs and that investors’ reliance on ratings can be reasonable.

Though the court appropriately rejected the NRSROs’ First Amendment defense, the situation before the court involved the rare instance of an unpublished rating. For this reason, the court was able to avoid addressing the difficult issue of whether the First Amendment protects published ratings against negligence claims. Consequently, the opinion does not provide solace to the majority of investors seeking relief from the First Amendment liability hurdle.

The dismissal of the fraud and section 10(b) claims further demonstrates the difficulties facing investors who instigate private actions against NRSROs. Yet in spite of the heightened pleading requirements for fraud and section 10(b) claims, the law has provided a certain degree of latitude for claims against corporate insiders. As the opinion recognized, in the context of claims against company insiders, assertions that the misconduct was too widespread to go unnoticed by the defendants can be sufficient for surviving a motion to dismiss.

But the law has not afforded plaintiffs the same latitude in private actions against NRSROs for erroneous published ratings. It is partly for this reason that lawsuits against corporate officers have experienced considerably greater success. If not for some pleading concessions, it is almost impossible for a plaintiff to prevail against a motion to dismiss for failure to state a claim because section 10(b) and fraud claims require the plaintiff to demonstrate scienter before having the benefit of discovery evidence. Thus, until the law develops a practical pleading requirement for securities violations and fraud

382. See id. at 648.
383. See id. at 648-49, 653.
384. See discussion supra Part V.D.1.
386. See id. at 642; see also supra text accompanying note 364.
388. See discussion supra Part V.D.2.
claims against credit rating agencies, it is unlikely that a plaintiff will ever get past the motion-to-dismiss stage on such causes of action.

The *National Century* opinion is significant because it demonstrates much-needed progression away from shielding the credit rating agencies from liability. Just as Congress must authorize more regulation of NRSROs, so too must the judiciary continue to break down the makeshift barriers that prevent successful private actions against NRSROs. It will not be until the NRSROs are made answerable to some authority that the ratings practices will guard against the susceptibility of the NRSROs to issue ratings on bonds containing risks not fully appreciated.

**VI. The Importance of NRSRO Accountability**

While it has been argued that NRSROs will self-regulate because of their interest in maintaining a credible reputation, this notion has become somewhat outdated. At one time, some lawmakers and analysts believed that the agencies would implement appropriate rating standards to ensure a reliable reputation. Gregory Husisian summarized this notion by stating that “[t]he marketplace is too pervasive a task master, and monitoring costs are too low to permit a negligent rating agency to survive for long.” Under such a theory, the NRSROs’ desire for self-regulation is almost synonymous with self-preservation. Yet in light of the increased opportunity for rating agencies to generate substantial fees from bond issuers, the virtually automated reliance that investors place on ratings, and the relative lack of competition in the credit ratings market, NRSROs had every incentive to set prudence aside.

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390. *Id.* at 440.
391. Hill, *supra* note 82, at 50; see also *supra* text accompanying note 133.
393. See Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36212, 36213 & n.8 (proposed June 25, 2008) (Supplementary Information) (indicating that only nine entities had achieved NRSRO status as of 2008 and that the vast majority of ratings are issued by only three of those entities).
394. See SEC SUMMARY REPORT, *supra* note 61, at 26 (citing emails between NRSRO analysts explaining the relaxation of rating standards to maintain market share: “We are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing risk of losing deals.” (alteration omitted)).
A. Unprecedented Opportunities for Revenues

The RMBSs and CDOs not only created new forms of bonds for the agencies to rate, but they inundated the ratings industry with millions of new securities whose entire identities were dependent on their ratings. This significantly increased the revenues that the rating agencies collected from issuers who paid to have the bonds rated. In fact, the profits recognized by the three top NRSROs increased from approximately $3 billion in 2002 to more than $6 billion in 2007, largely due to increased demand for ratings on structured finance products. The implication, then, is that the incentive for self-regulation can be dismantled when a new, complex form of security infiltrates the investment market. Because NRSROs are motivated by revenue, their loyalties lie with the issuer, not the investor. Thus, NRSROs’ ratings determinations are susceptible to undue influence by issuers—who, after all, foot the bill. Moreover, NRSROs benefit from the innovation of new financial products because they provide more opportunities to generate issuer fees. Accordingly, NRSROs have every incentive to rate new products, despite the fact that the ratings analysts may not have developed a comprehensive understanding of how these products should be valued.

Some legal theorists are hesitant to apply a negligence standard to NRSROs because they fear that the hindsight tendencies of a negligence theory would produce unsound verdicts against rating agencies. Still, it is important to note that certain people in the financial industry not only saw the problems that would be created by the market’s fixation with derivatives but openly warned about such problems. In 2002, for example, Warren Buffet described structured-finance products as “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.” The fact that prominent financial experts identified and openly warned about the financial instruments that led to the current credit disaster, coupled with the concerns expressed by NRSRO analysts themselves, eviscerates the assertion that a finding of negligence against NRSROs would implicate a standard of care improperly prejudiced by the benefit of hindsight. Because the agencies are

395. See id. at 7.
396. See Credit and Credibility, supra note 256.
397. See, e.g., Husisian, supra note 57, at 442-44.
398. Recall that the term “derivatives” refers to financial products whose values are solely dependent on the value of other underlying assets—e.g., RMBSs and CDOs. See supra note 14.
400. See discussion supra Part III.C.
charged with the sole task of assessing the creditworthiness of bonds, NRSROs should have recognized the dangers themselves or heeded the warnings of others and taken the necessary steps to ensure the propriety of the ratings they issued on RMBSs and CDOs.

Absent an enactment from Congress granting the SEC more authority to regulate the ratings practices of NRSROs, individual lawsuits are the only means of incentivizing NRSROs to place more importance on the accuracy of their ratings than on the financial gain of rating to generate the maximum issuer fees. If the current financial crisis has proven anything, it has proven that corporations cannot be trusted to self-regulate when doing so goes against their short-term self-interest.

Indeed, it is often the case that the profit of acting for immediate financial gain is higher than the profit of acting to enhance a credible reputation. Because credit ratings play such a unique and integral role in the securities market, investors have little choice but to continue their reliance on NRSROs, even after their reliability is called into question. Consequently, there is insufficient encouragement for NRSROs to strive for accuracy in their ratings when such strong financial incentives exist for issuing the largest number of favorable ratings. Under the current revenue structure, NRSRO analysts are encouraged to issue ratings in fast turnaround, resulting in cursory reviews that are subject to persuasion by outside factors such as the NRSRO’s relationship with the issuer and the desire to secure monetary gains. Because enforcement of strict ratings procedures does not necessarily benefit NRSROs, and because the government does not regulate the NRSROs’ methodologies, private lawsuits serve the important role of monitoring the practices of NRSROs.

B. Society’s Expectations

While S & P, Moody’s, and Fitch have all cited their own generalized disclaimers to support the contention that the prescribed ratings are merely opinions, their advertising and publication materials consistently assert reliability, accuracy, and in-depth analysis. Moody’s website, for example,
touts that its “commitment and expertise contributes to transparent and integrated financial markets.” The tone of these promises changes dramatically in Moody’s official code of conduct, where it plainly describes its credit ratings as “current opinions” that “do not constitute investment or financial advice, and . . . are not recommendations to purchase, sell, or hold particular securities.” Such language is essentially boilerplate in view of the actual nature of ratings in the bond market, and it is of little practical import since few investors take the time to locate and read the NRSRO’s code of conduct. As noted by one scholar, the fact remains that “[d]espite the rating agencies’ disclaimers, investors still rely on the ratings to a considerable extent.” Such reliance is perhaps best evidenced by the fact that institutional investors and fiduciary funds condition their investment options entirely on bond ratings.

The high expectations of the public are justified by an agency’s status as an NRSRO. Unlike other credit rating agencies, NRSROs hold the coveted position of being federally recognized securities raters. When the government grants an agency the status of NRSRO, it may appear to the public that the government endorses the reliability of the ratings published by the agency. While this quasi certification mark places a degree of responsibility on the government, which has chosen to endorse the organization, it also places a higher standard on NRSROs.

As a result of their status as nationally recognized credit rating organizations, NRSROs are understandably looked to by investors for reliable information about bonds, and issuers almost exclusively use NRSROs as the source of their bonds’ ratings. It is therefore clear that NRSROs benefit from the increased credibility associated with their federally recognized status. Consequently, it is only appropriate that the NRSROs should be held liable when they fail to live up to the very distinction that facilitates their success.

408. Huisian, supra note 57, at 424.
409. See supra notes 56-57 and accompanying text.
410. See Hill, supra note 82, at 53-55.
411. See Lynch, supra note 392, at 242-43.
C. Lack of Alternatives

The information used by NRSROs in examining a bond is generally not available to the public for purposes of individualized assessment.\textsuperscript{412} Moreover, even if such information were available, the evaluation of a bond is a detailed and highly information-based process,\textsuperscript{413} which a typical investor is ill-equipped to undertake.\textsuperscript{414} Without the ability to access the relevant acquisition agreements, loan portfolios, and the like, investors have no viable means of purchasing bonds without relying on a credit rating. Consequently, the chances that a common investor would understand the structure of bonds, even if the necessary information were available, are slim to none.

In addition, all NRSROs operate with the same types of deficiencies, leaving public investors with no place to turn for bond analyses. Each of the three major NRSROs has conflicts of interest, each uses similar ratings methodologies (in spite of their deficiencies), and each receives the bulk of its profits from issuer fees.\textsuperscript{415} Nonetheless, since the entire framework of the bond market has been structured around the ratings system, issuers and buyers alike are left with essentially no alternate means of conducting a bond exchange. Investors also do not have the option of receiving more comprehensive analyses elsewhere, given the relative consolidation of the bond rating industry.\textsuperscript{416} The NRSROs’ near monopoly places investors and the financial market in a quagmire characterized by a “take it or leave it” dependence on NRSROs.

VII. Conclusion

In a March 20, 2002, hearing before the Committee on Governmental Affairs, Senator Joseph Lieberman, chairman of the Committee, compared the function of credit rating agencies to that of the Food and Drug Administration (FDA). He maintained that the FDA does not let a drug go out on the market . . . until [it has] gone over all sorts of investigations to guarantee that [the drug] is safe, and then doctors prescribe the drug, people use it in reliance on that. To

\begin{itemize}
\item \textsuperscript{412} See Husisian, supra note 57, at 430-31; see also supra note 338 and accompanying text.
\item \textsuperscript{413} See SEC SUMMARY REPORT, supra note 61, at 7; see also discussion supra Part III.A-B.
\item \textsuperscript{414} See Husisian, supra note 57, at 418 (noting that the typical investor is “relatively unsophisticated in the techniques needed to evaluate the riskiness of [bond] issues”).
\item \textsuperscript{415} See discussion supra Part III.C-D.
\item \textsuperscript{416} See Hunt, supra note 62, at 131 (explaining that the three major credit rating agencies have been reported to control between 85% and 99% of the current market share); see also supra note 393.
\end{itemize}
some extent, we have asked [the credit rating agencies] to play . . .
a similar role with regard to corporations.\textsuperscript{417}

Much like pharmaceuticals developers require the FDA’s approval of drugs, corporations seeking to issue debt securities require credit ratings, and investors expect a certain amount of integrity in those ratings. A staff report prepared by the Committee of Governmental Affairs expounded upon Senator Lieberman’s premise by emphasizing that “unlike [the] FDA, which is accountable to Congress, the raters answer to no authority.”\textsuperscript{418} Though this comment does not suggest the nationalization of NRSROs, the current problems indicate that it is time for the pendulum to move away from the primarily hands-off supervision of securities ratings.

As this comment has demonstrated, NRSROs stand in the comfortable position of “reaping the benefits of the capital markets without risking any capital,”\textsuperscript{419} and they further enjoy a decreased risk of liability compared with other market participants. Even with the present circumstances, in which the subprime crisis was unquestionably perpetuated by the careless ratings of structured-finance products, it is uncertain whether NRSROs will assume responsibility or will instead maintain their status as “Teflon advisors.”\textsuperscript{420} The virtual insulation from accountability that NRSROs currently enjoy begs the question: does the law recognize a credit rating immunity? This comment suggests that unless the NRSROs are made to be accountable, either through regulation or litigation, the law is edging frightfully close to implicitly affirming just such a privilege.

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\textit{A. Brooke Murphy}
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\textsuperscript{417} \textit{Rating the Raters: Enron and the Credit Rating Agencies: Hearing Before the S. Comm. on Governmental Affairs}, 107th Cong. 30 (2002) (statement of Sen. Joseph Lieberman, Chairman, S. Comm. on Governmental Affairs).

\textsuperscript{418} \textit{Staff of S. Comm. on Governmental Affairs, 107th Cong., Financial Oversight of Enron: The SEC and Private-Sector Watchdogs} 98 (Comm. Print 2002).

\textsuperscript{419} \textit{Id.}

\textsuperscript{420} The term “Teflon advisors” is not used in the financial industry but is being utilized here to depict the resilience of the credit rating agencies. The term is also a loose reference to former President Ronald Reagan’s nickname the “Teflon President,” which was given for his tendency to emerge from problematic situations relatively unscathed.