

How and Why Credit Rating Agencies Are Not Like Other Gatekeepers

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I. Introduction

This conference addresses perhaps the most important policy question related to the recent wave of corporate scandals: what should be the role of private financial market gatekeepers?¹ In this paper, I assess potential answers to this question with respect to the least understood² gatekeeper: the credit rating agency.

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¹ The pre-2002 literature on gatekeepers was extensive. See, e.g., Frank Partnoy, *Barbarians at the Gatekeepers*, 79 Wash. U. L. Q. 491 (2001) (assessing proposal that gatekeepers be subject to a modified strict liability regime); John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 Bus. Law. 1195, 1210-13, 1232-33 (1999) (discussing the role of underwriters, accountants, lawyers, and directors as “gatekeepers” and “reputational intermediaries”); see also Stephen Choi, *Market Lessons for Gatekeepers*, 92 Nw. U. L. Rev. 916, 934-49 (1998); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org. 53 (1986); Ronald J. Gilson & Ranier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 613-21 (1984) (discussing the role of investment bankers as gatekeepers); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 Yale L.J. 857, 895-96 (1984); Michael P. Dooley, *The Effects or Civil Liability on Investment Banking and the New Issues Market*, 58 Va. L. Rev. 776, 794-95 (1972). The literature on gatekeepers has experienced something of a renaissance in response to the collapse of Enron and WorldCom. For a more recent discussion, see John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. Rev. 301 (2004); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U.L. Rev. 365 (2004); John C. Coffee, Jr., *Partnoy’s Complaint: A Response*, 84 B.U.L. Rev. 377 (2004); see also Peter B. Oh, *Gatekeeping*, 29 Iowa J. Corp. L. 735 (2004); Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. Rev. 413 (2004). There also is an extensive literature on lawyers as gatekeepers. See Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. Cal. L. Rev. 1019, 1049-72 (1993); John C. Coffee, Jr., *Regulating the Lawyer: Past Efforts and Future Possibilities: The Attorney as Gatekeeper: An Agenda for the SEC*, 103 Colum. L. Rev. 1293 (2003). Fred Zacharias, *Lawyers as Gatekeepers*, 41 San Diego L. Rev. 1387 (2004).

² See, e.g., Justin Pettit, Craig Fitt, Serguei Orlov & Ashwin Kalsekar, *The New World of Credit Ratings*, UBS Investment Banking Research, Sept. 2004 (“Credit ratings are rarely even mentioned in business schools and remain one of the most understudied aspects of modern corporate finance.”).

Credit rating agencies clearly belong within the broad classification of financial market gatekeepers.³ They play a verification function in the fixed income markets by designating alphabetical ratings of debt. They have a substantial stock of resources to pledge as reputational capital in the event they are found to have performed poorly.⁴ They act as agents, not principals, and are paid only a fraction of the proceeds of debt issues.⁵

However, credit rating agencies differ from other gatekeepers in several important ways. Although credit rating agencies have performed at least as poorly as other gatekeepers during the past five years, their market values have skyrocketed. Since 2002, as securities firms have restructured their approach to rating shares in response to a wave of private litigation and government prosecution (and to the general decline in the reputation of the ratings of securities analysts), the credit rating process has remained largely intact and credit ratings have become more prominent, important, and valuable.

In addition, credit rating agencies continue to face conflicts of interest that are potentially more serious than those of other gatekeepers: they continue to be paid directly by issuers, they give unsolicited ratings that at least potentially pressure issuers to pay them fees, and they market ancillary consulting services related to ratings. Credit rating agencies increasingly focus on structured finance and new complex debt products, particularly credit derivatives, which now generate a substantial share of credit rating agency revenues and profits. With respect to these new instruments, the agencies have become more like “gateopeners” than gatekeepers; in particular, their rating methodologies for Collateralized Debt Obligations (CDOs) have created and sustained that multi-trillion dollar market.⁶

³ See Coffee, *Gatekeeper Failure and Reform*, at 308.

⁴ As noted in Part II.A., there are serious questions about whether fluctuations in the rating agencies’ reputations affect their stock of capital. For example, during the past five years, as the market capitalization of most financial market gatekeepers has fallen, the market capitalization of the major rating agencies has increased. Not coincidentally, during the same time, rating agencies have not been subject to civil or criminal liability for malfeasance.

⁵ Rating agency fees are in the range of 3 to 4 basis points of the face amount for rating a typical corporate bond issue, and substantially more for complex issues. See Part II.A.

⁶ I discuss credit derivatives in greater detail in Part II.C.

Why are credit rating agencies so different from other gatekeepers? Part of the reason is that the most successful credit rating agencies have benefited from an oligopoly market structure that is reinforced by regulations that depend exclusively on credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs).⁷ These regulatory benefits – which I call “regulatory licenses” – generate economic rents for NRSROs that persist even when they perform poorly and otherwise would lose reputational capital. Until recently, there were only three NRSROs: Moody’s, Standard & Poor’s, and Fitch.⁸

Another reason credit rating agencies differ from other gatekeepers is that they have been largely immune from civil and criminal liability for malfeasance. Some securities law rules specifically exempt credit rating agencies from liability. More importantly, several lower-court judges have accepted – wrongly, in my opinion – the rating agencies’ arguments that ratings are opinions protected by the First Amendment.

Various proposals have been put forth to reform credit rating agencies, particularly NRSROs. Some initiatives have been directed at increasing competition among agencies by opening the process of designating NRSROs.⁹ A few commentators have proposed eliminating the NRSRO designation entirely.¹⁰ Recently introduced legislation would require credit rating agencies to register with the Securities and Exchange Commission, in the same way investment advisers and broker-dealers must register; this legislation would require reporting and record-keeping, but would not impose onerous substantive requirements.¹¹ Since 1999, I have advanced a proposal to

⁷ The Securities and Exchange Commission controls the NRSRO designation process, although numerous regulations outside the securities area depend on NRSRO status. For an excellent description of the structure of the credit rating business, see Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, at 41-64, in *The Role of Credit Reporting Systems in the International Economy* (Kluwer Academic Publishers 2002, Richard M. Levitch, Giovanni Majnoni, and Carmen Reinhart, eds.).

⁸ The SEC recently approved two additional NRSROs, so that currently, Moody’s, S&P, Fitch, DBRS and A.M. Best Company, Inc. are designated as NRSROs.

⁹ See SEC Staff Outline of Key Issues for a Legislative Framework (2005).

¹⁰ See Alex J. Pollock, *End the Government Sponsored Cartel in Credit Ratings*, AEI Institute for Public Policy Research, Jan. 2005.

¹¹ See H.R. 2990, *The Credit Rating Agency Duopoly Relief Act* (2005).

substitute market-based measures – such as credit spreads – for credit ratings in the numerous regulations that depend on NRSRO ratings.¹²

Credit ratings continue to present an unusual paradox: rating changes are important, yet possess little informational value.¹³ Credit ratings do not help parties manage risk, yet parties increasingly rely on ratings. Credit rating agencies are not widely respected among sophisticated market participants, yet their franchise is increasingly valuable. The agencies argue that they are merely financial journalists publishing opinions, yet ratings are far more valuable than the opinions of even the most prominent and respected financial publishers.

In this paper, I will argue that optimal policy with respect to credit rating agencies should account for the ways in which agencies differ from other gatekeepers. In Part II, I describe how agencies are different from other gatekeepers. In Part III, I explain some of the reasons why these differences have persisted, and in some cases widened. In Part IV, I assess various policy proposals, and argue that an ideal policy should both reduce the value of regulatory licenses and increase the threat of rating agency liability. Simply put, the best proposals would help resolve the paradox of credit ratings by creating incentives for credit rating agencies to generate greater informational value while reducing the impact of ratings on markets.

II. How Credit Rating Agencies Are Not Like Other Gatekeepers

The differences between credit rating agencies and other gatekeepers are stark. Credit rating agencies are more profitable than other gatekeepers, they face different and potentially more serious conflicts of interest, and they are uniquely active in structured finance, particularly CDOs. I assess each difference in turn.

¹² See Frank Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies*, 77 *Washington University Law Quarterly* 619 (1999)

¹³ See Frank Partnoy, *The Paradox of Credit Ratings*, *The Paradox of Credit Ratings*, at 65-84, in *The Role of Credit Reporting Systems in the International Economy* (Kluwer Academic Publishers 2002, Richard M. Levitch, Giovanni Majnoni, and Carmen Reinhart, eds.); see also Steven L. Schwarcz, *The Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 *U. Ill. L. Rev.* 14 (2002). Although initial credit ratings provide some guidance to purchasers at the time of issuance, it is not clear that they provide any information beyond that already reflected in the “price talk” associated with a fixed income instrument (i.e., before it is issued).

A. Profitability

I consider the profitability of credit rating agencies from two perspectives. First, I briefly examine the history of these agencies, and conclude that the business of rating bonds generally was not highly profitable until very recently. Second, I look more closely at the extraordinary increase in the profitability of credit rating agencies during the past five years. The performance of credit rating agencies is precisely the opposite of that of other gatekeepers, which were consistently profitable during the twentieth century, but have experienced difficulties during the past five years.

To put the profitability of modern credit rating agencies in context, it is worth remembering that before the 1970s, the agencies' business model was radically different than it is today. Before the 1970s, when the Securities and Exchange Commission created the NRSRO designation and various regulations began to depend on NRSRO ratings, credit rating agencies made money by charging subscription fees to investors, not ratings fees to issuers. In contrast, today roughly 90 percent of credit rating agencies' revenues are from issuer fees.¹⁴

The modern credit rating industry grew out of various American firms that began classifying bonds, primarily railroad bonds, during the late nineteenth century. By 1890, Poor's Publishing Company, predecessor of today's S&P, was publishing Poor's Manual, an analysis of bonds.¹⁵ During the following two decades, numerous analysts issued railroad industry reports with elaborate statistics and details about operating and financial data for individual companies.¹⁶

John Moody collected these details and believed that investors would pay for a service that synthesized the mass of information into an easily digestible format.¹⁷ He

¹⁴ See Moody's Form 10-K, at 18-22.

¹⁵ See, e.g., *In re Bartol*, 38 A. 527 (Pa. 1897) (approving of reference to Poor's Manual of 1890).

¹⁶ In 1906 and 1907, two prominent reports were published concerning the railroad industry – “The Earning Power of Railroads” by Floyd Mundy and “American Railways as Investment” by Carl Snyder – and John Moody relied heavily on both reports. See Partnoy, Siskel and Ebert, at n.79.

¹⁷ According to Moody, “While no one in this country had attempted such a thing as investment ratings by means of symbols, yet even in those days bonds were classified into groups according to quality and salability, especially by large investment institutions, such as insurance companies.

published his first rating scheme for bonds in 1909, in a book entitled *Analysis of Railroad Investments*, but there wasn't much demand for his ratings until the market boom of the 1920s. By 1924, the market for bond ratings was more competitive than it is today: Poor's, Standard Statistics Company, Inc., Fitch Publishing Company, and others published ratings, in addition to John Moody's rating company.¹⁸ These early rating agencies made money by charging investors subscription fees; they did not charge issuers.

Following the 1929 crash, the credit rating industry began a general decline.¹⁹ Investors were no longer very interested in purchasing ratings, particularly given the agencies' poor track record of anticipating the sharp drop in bond values beginning in late 1929. One infamous case involved a default by the Chicago, Rock Island & Pacific on bonds that all of the major agencies had given their highest ratings.²⁰ Investors recognized that the ratings were not of especially great value and in any event were based largely on publicly available information.

The rating business remained stagnant for decades. According to a study of 207 corporate bond rating changes from 1950 to 1972, credit rating changes generated information of little or no value; instead, such changes merely reflected information already incorporated into stock market prices (indeed rating changes lagged that information by as much as eighteen months).²¹ Concern about the failure of the rating

Moreover there had existed for a considerable time, I think, a bond rating system in Vienna and also, I believe, in Berlin. These foreign systems had been developed by symbols and the Austrian Manual of Statistics, which carried these symbols, was quite well known in Europe, although not at all in this country." Gilbert Harold, *Bond Ratings as an Investment Guide: An Appraisal of Their Effectiveness* 6 (1938) (quoting from John Moody, in a letter to Harold dated August 21, 1934).

¹⁸ Partnoy, Siskel and Ebert, at 639.

¹⁹ There is some evidence that regulations from the 1930s that depended on credit ratings encouraged the use of ratings and led to some resurgence in the industry. However, those profits were short lived, and by the end of World War II, credit rating agencies were not especially profitable.

²⁰ See Partnoy, Siskel and Ebert, at 643.

²¹ See George E. Pinches & J. Clay Singleton, *The Adjustment of Stock Prices to Bond Rating Changes*, 33 *J. Fin.* 29, 39 (1978).

agencies to generate accurate and reliable information led to public arguments for regulation of the credit rating industry.²²

Yet the agencies were not regulated, in part because regulators perceived that they did not play a prominent role in the financial system. During the early 1970s, the SEC decided that instead of regulating the credit rating industry, it would begin relying on the ratings of a handful of major credit rating agencies in making certain regulatory determinations, beginning with the calculation of net capital requirements for broker-dealers.²³ In adopting these net capital rules, the SEC created the NRSRO concept, although it neither defined the term nor indicated which agencies qualified as NRSROs. During the following years, the SEC suggested through a series of no-action letters that the major established credit rating agencies qualified for NRSRO designation, but that other smaller agencies did not.

Over time, the SEC – and then other administrative agencies, as well as Congress – established additional legal rules that depended on NRSRO ratings.²⁴ This shift in regulatory approach corresponded to a change in the economics of the credit rating industry. In particular, credit rating agencies abandoned their long-held practice of charging investors for subscriptions, and instead began charging issuers for ratings based on the size of the issue. As additional regulations came to depend more on NRSRO ratings, those ratings became more important, and more valuable. Notwithstanding these changes, during the 1980s, the business of rating bonds grew only modestly. In 1980, there had been just thirty professionals working in the S&P Industrials group; by 1986, there were still only forty.²⁵

The major rating agencies dramatically increased the number of bonds they rated during the 1990s. By 1997, Moody's was rating 20,000 public and private issuers in the

²² L. Macdonald Wakeman, *The Real Function of Bond Rating Agencies*, 1 *Chase Fin. Q.* 19 (1981). Wakeman found that by the 1970s, bond ratings simply mirrored the market's assessment of a bond's risk and generated little information not already reflected in the market price of the bonds. See also W. Braddock Hickman, *NBER, Corporate Bond Quality and Investor Experience* (1958) (assessing default rates of investment and non-investment grade bonds through 1943).

²³ SEC Rule 15c3-1 set forth certain broker-dealer "haircut" requirements, and required a different haircut for securities based on credit ratings assigned by NRSROs.

²⁴ See Partnoy, *Paradox of Credit Ratings*, at 74-78.

²⁵ Partnoy, Siskel and Ebert, at 649.

U.S., and about 1,200 non-U.S. issuers, including both corporations and sovereign states; S&P rated slightly fewer in each category. Moody's rated \$5 trillion worth of securities; S&P rated \$2 trillion. Both companies' operating margins were thought to be in the range of thirty percent (Moody's had not yet gone public, and McGraw-Hill, S&P's parent, did not publish much information about S&P's profitability).²⁶ The agencies' power and profitability at this time were reflected in a quip by commentator Thomas Friedman that there were only two superpowers in the world – the United States and Moody's – and that sometimes it wasn't clear which one was more powerful.²⁷

It is remarkable that the recent meteoric ascent of credit rating agency revenues and profits began only several years after Friedman's quote. Consider Chart 1, which depicts the increase in the revenues and net income of Moody's during its life as a public company since 2000.

Chart 1 – Moody's Income Statement Data, 2000-04 (\$MMs)

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Revenue	1,438	1,247	1,023	797	602
Expenses	652	584	485	398	314
Operating Income	786	663	538	399	288
Net Income	425	364	289	212	159

As of early September 2005, Moody's market capitalization was more than \$15 billion, roughly the same as Bear Stearns Companies Inc., a major investment bank. Yet Bear Stearns had 11,000 employees and \$7 billion of revenue, whereas Moody's had 2,500 employees and \$1.6 billion of revenue. Moody's operating margins have consistently been more than 50 percent since 2000, even higher than they were during the 1990s. Moody's share price trades at a significantly higher multiple than the typical

²⁶ Partnoy, Siskel and Ebert, at 650. Moody's was owned by The Dun & Bradstreet Corporation prior to its spinoff in September 2000.

²⁷ The NewsHour with Jim Lehrer: Interview with Thomas L. Friedman (PBS television broadcast, Feb. 13, 1996).

publicly traded gatekeeper, such as an investment bank. Moody's diluted EPS for 2004 was just \$2.79 per share, and its stock price in 2005 was in the range of \$50 to \$60 per share. In contrast, investment bank P/E ratios have been closer to 10. Perhaps most remarkable is that Moody's \$15 billion market capitalization is supported by assets of just \$1.4 billion.

Moody's success is even more striking because of the simplicity of its business, the vast majority of which is fee income from ratings. For example, Moody's has not used derivatives and has not had any off-balance sheet arrangements with unconsolidated entities or financial partnerships. Nor does Moody's take on substantial interest rate or credit risk.

Although similar data is not available for S&P Ratings Services, whose stock is not publicly traded, it appears to be similarly profitable. As of September 2005, S&P and Moody's had credit ratings outstanding on roughly the same number and amount of debt instruments. S&P had credit rating opinions outstanding on approximately \$30 trillion of debt, including 745,000 securities issued by roughly 42,000 obligors in more than 100 countries.²⁸ Moody's numbers were roughly the same.²⁹ And, as noted above, S&P and Moody's charge similar fees.

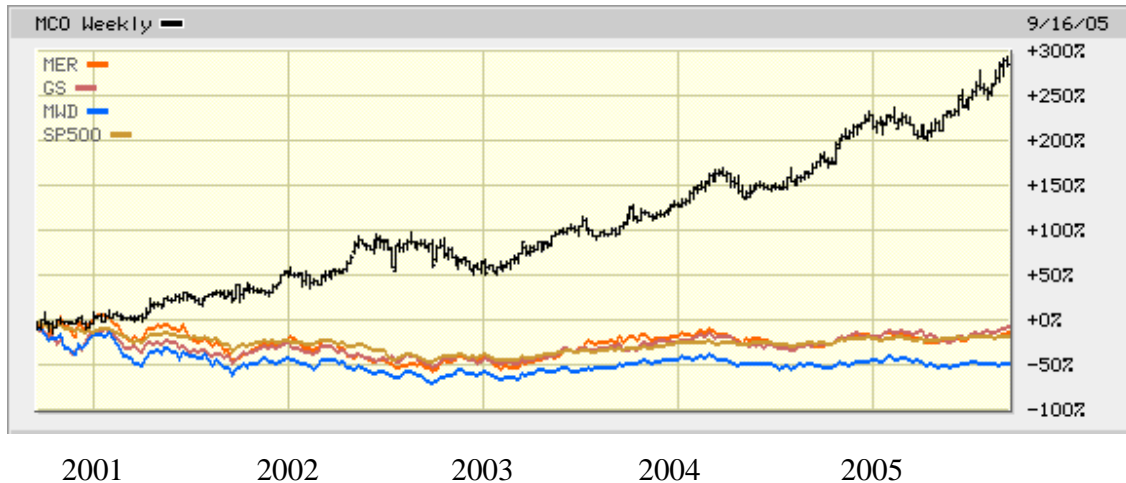
In financial terms, the credit rating agencies have been moving in the opposite direction of other gatekeepers. While the value of Moody's shares has increased by more than 300 percent during the past five years, most banks' shares have declined in value. Accounting firm profits also have declined, at least until the Sarbanes-Oxley Act of 2002 generated new opportunities.³⁰ Arthur Anderson is gone, and KPMG barely survived. Most gatekeepers have experienced high volatility during the past five years. But Moody's shares have steadily increased during this period, as depicted in Chart 2.

²⁸ See Testimony of Rita M. Bolger, Managing Director and General Counsel for Standard & Poor's, Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee, June 29, 2005, Ex. A, at 1.

²⁹ Moody's 2004 Form 10-K, at 3.

³⁰ Law firm profits also have increased in the aftermath of Sarbanes-Oxley.

Chart 2 – Moody’s Share Price vs. S&P 500 vs. Major Investment Banks



A portion of the relative increase in the value of credit rating agencies reflects the legal settlements and future expected liability of other gatekeepers, particularly banks and accounting firms. While other gatekeepers have paid billions of dollars in legal settlements during since 2002, the credit rating agencies have paid virtually nothing. The primary reason for this difference is that the rating agencies have successfully defended against litigation by claiming their business is financial publishing so that their ratings are “opinions” protected by First Amendment privileges. That liability issue is addressed in Part III.B.

Although Moody’s might say it is in the financial publishing business, market participants do not believe it. Moody’s is substantially smaller than the other major financial publishers and generates less revenue, but has a much higher market capitalization. Consider the following financial data from Moody’s, along with that of two major financial publishers, Dow Jones and Reuters.³¹

³¹ The comparison is similar for other publicly traded companies in the publishing industry.

Chart 3 – Moody’s vs. Major Financial Publishers

	<u>Mkt</u>			<u>Oper</u>	<u>Oper</u>		
	<u>Cap</u>	<u>Revenue</u>	<u>Employees</u>	<u>Cash</u>	<u>Marg</u>	<u>Pr/Rev</u>	<u>Pr/Empl</u>
Dow Jones	\$3.3bn	\$1.7bn	7,143	\$224MM	9%	1.9	\$461,991
Reuters	\$9.3bn	\$5.3bn	15,475	\$413MM	11%	1.8	\$600,969
Moody’s	\$15.2bn	\$1.6bn	2,500	\$632MM	54%	9.5	\$6,080,000

As of September 2005, Dow Jones had revenues that were slightly higher than the revenues of Moody’s and Dow Jones had nearly three times as many employees, yet Moody’s shares were worth nearly five times as much. Reuters, a much larger firm than Moody’s by most measures, has a much small market capitalization. The reasons are obvious: Moody’s has much higher operating margins. Investors will pay five times more for a dollar of Moody’s revenue than for a dollar of the revenues of Dow Jones or Reuters. Each Moody’s employee is associated with ten times more market value than each Dow Jones or Reuters employee. By virtually any financial measure, Moody’s has a much more valuable franchise than other financial publishing firms, and is much too profitable to be considered a financial publisher. If Moody’s were in the same business as financial publishing firms, one would expect these ratios to be close.

In sum, credit rating agencies have been more profitable than other gatekeepers. Unlike the “opinions” of other gatekeepers, the ratings of NRSROs are increasingly important and valuable.³² This is true notwithstanding the abysmal recent performance of credit rating agencies.³³

³² Both anecdotal evidence and academic studies suggest that rating changes are increasingly important events. See U.S. Securities and Exchange Commission, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, January 2003, at 5 <http://www.sec.gov/news/studies/credratingreport0103.pdf> (noting that “the importance of these opinions to investors and other market participants, and the influence of these opinions on the securities markets, have increased significantly”).

³³ Although the credit rating agencies argue that rating changes are correlated with actual defaults, that claim is a low goal that virtually anyone could achieve simply by reading a newspaper. The market value and regulatory importance of ratings suggests that agencies are at least trying to do something more than merely publish ratings that are correlated after-the-fact with default

B. Conflicts of Interest

All of the major gatekeepers have been accused of serious conflicts of interest. However, the conflicts at credit rating agencies are different, and potentially more serious than those at other gatekeepers, not only because agencies are paid directly by the issuers they rate, but also because the vast majority of rating agencies' revenues are from those fees. In addition, those credit rating agencies with market power, specifically S&P and Moody's, have been developing ancillary businesses, including consulting, that other non-credit rating agency gatekeepers are now restricted in developing.

The SEC recently conducted formal examinations of the three major NRSROs, and reported serious concerns about conflicts of interest. The first and most obvious conflict arises from the fact that issuers pay NRSROs for their ratings. This conflict has existed since the 1970s, when the SEC began implementing NRSRO-dependent rules and rating agencies switched from charging investors to charging issuers for ratings. However, the SEC has pointed to an increase in potential conflicts in recent years.

As noted above, approximately 90 percent of rating agency revenues are from issuers who pay for ratings.³⁴ Rating agencies fees vary based on the size and complexity of the issue.³⁵ For corporate debt, the fees are in the range of three to four basis points of the size of the issue, with minimum amounts in the range of \$30,000 to \$50,000 and

experience. Indeed, it was the agencies' poor performance in assessing companies before the recent wave of corporate defaults that led Congress to study and then critique the industry. For example, consider the following statement from Senator Joseph Lieberman, whose Senate committee held the first hearings on Enron: "The credit-rating agencies were dismally lax in their coverage of Enron. They didn't ask probing questions and generally accepted at face value whatever Enron's officials chose to tell them. And while they claim to rely primarily on public filings with the SEC, analysts from Standard and Poor's not only did not read Enron's proxy statement, they didn't even know what information it might contain." Senate Committee on Governmental Affairs, Press Release, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs (Oct. 7, 2002).

³⁴ Because rating agencies rate thousands of bond issues, they do not depend on any particular issuer, so the concern about conflicts is more systemic than individualized. For example, S&P has stated that no single issuer or issuer group represents more than about two percent of the total annual revenue of its rating business. See SEC Report, at 41. In this way, credit rating agencies are unlike auditors, who might depend on one company for a more substantial share of revenue.

³⁵ Standard & Poor's Ratings Services, U.S. Ratings Fees Disclosure, Apr. 20, 2005, available at <http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/Page/CreditRatingsRatingsPoliciesPg&r=1&l=EN&b=2&s=148>.

maximum amounts in the range of \$300,000.³⁶ For structured finance issues, fees range up to 10 basis points, and fees for complex transactions are substantially higher, up to \$2.4 million.³⁷

The rating agencies recognize that conflicts arise from having issuers pay for ratings, but they say that historically they have been able to manage those conflicts. For example, S&P has adopted procedures designed to ensure that no individual is able to link credit rating opinions to fees.³⁸

Of course, credit rating agencies and other gatekeepers face some of the same actual and potential conflicts. For example, credit rating agency board members serve in various capacities for companies the credit rating agencies rate. For example, WorldCom shared a director with Moody's and received favorable ratings even after its bonds were trading at non-investment grade credit spreads.³⁹ Unlike other financial intermediaries, credit rating agencies have not been pressured to eliminate such conflicts.

To illustrate the differences between credit rating agencies and other gatekeepers with respect to conflicts, I will focus on two areas of conflict – ancillary services and unsolicited ratings – where credit rating agencies have not been subject to as much regulatory intervention as have other gatekeepers.⁴⁰ First, with respect to ancillary

³⁶ High volume issuers and multi-year ratings receive discounts. For a general description of credit rating agency fees, see Daniel M. Covitz & Paul Harrison, *Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate*, Federal Reserve Board Finance and Economics Discussion Series 2003-68, at <http://www.federalreserve.gov/pubs/feds/2003/200368/200368pap.pdf>. In addition, the agencies charge monitoring fees, cancellation fees, and initial confidential rating fees, which can be in the range of \$20,000 to \$50,000.

³⁷ Buried in its copyright terms on its website, Moody's makes the following disclosure: "MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to \$2,400,000." Moody's Terms of Copyright, <http://www.moodys.com/moodys/cust/AboutMoody/AboutMoody.aspx?topic=copyright>.

³⁸ See Standard & Poor's Ratings Services Code of Practices and Procedures, Sept. 2004.

³⁹ Clifford L. Alexander, Jr., former chairman of Moody's, served on the board of WorldCom/MCI for 19 years, as well as the board of Wyeth, another company Moody's rated. Alec Klein, *Wash. Post*, Nov. 22, 2004, at A09.

⁴⁰ CDOs, discussed in Part II.C., also present unique conflicts of interest. For example, Fitch has alleged that S&P and Moody's have engaged in anticompetitive practices in the structured finance

services, credit rating agencies market pre-rating assessments and corporate consulting.⁴¹ For an additional fee, issuers present hypothetical scenarios to the rating agencies to understand how a particular transaction – such as a merger, asset sale, or stock repurchase – might impact their ratings. Although the rating agencies argue that fees from ancillary services are not substantial, there is evidence that they are increasing.⁴²

In addition, Moody's, S&P, and Fitch each offer risk management consulting services. According to the SEC, the products and services offered include “public and private firm credit scoring models, internal ratings systems services, and empirical data on default incidence, loss severity, default correlations, and rating transitions.”⁴³ The SEC found that these marketing activities exacerbated the conflicts of interest at the agencies.

These ancillary services resemble consulting services offered by accounting firms. Just as an issuer might feel pressured by its auditor to use the auditor's consulting services, they might similarly feel pressure to use a credit rating agency's consulting services. Issuers might worry that if they did not purchase these other services from the agency, that decision would negatively impact their rating. Conversely, issuers might believe that if they did purchase ancillary services, their rating would improve. In addition, with respect to rating assessment services, once the agency has indicated what rating it would give an issuer after a corporate transaction, the agency would be subject to pressure to give that rating. For example, if an agency were paid a fee to advise an issuer

market by “notching” – lowering their ratings on, or refusing to rate, structured finance securities unless a substantial portion of the assets in the pool also were rated by them. See Press Release, Fitch Ratings, Survey Shows Majority of Structured Finance Executives Oppose Notching as Practiced by Moody's and S&P, Mar. 27, 2002; see also Standard & Poor's Structure Finance, S&P Global Cash Flow and Synthetic CDO Criteria, Mar. 21, 2002, at 24 (“For inclusion in synthetic CDOs, reference entities are rendered eligible if they have a public, private, or implied issuer credit rating (ICR) by Standard & Poor's.”).

⁴¹ In September 2005, S&P announced that it was abandoning its practice of providing corporate governance ratings, an ancillary service that was in potential conflict with its practice of providing credit ratings.

⁴² See McGraw-Hill Companies 2001 Form 10-K (“[S&P's] revenue from rating evaluation services ... increased substantially during 2000.”).

⁴³ See SEC Report, at 42.

that a stock repurchase would not affect its rating, it would be more difficult for the agency to change that issuer's rating after it completed the repurchase.

Again, the rating agencies claim they are able to manage these conflicts. They have implemented policies and procedures to separate their consulting and ratings functions. However, evidence gathered by the SEC suggests that these policies are not effective, and that rating agency analysts both perform ancillary assessments and are involved in marketing consulting services.⁴⁴

Obviously, the primary difference between credit rating agencies and other gatekeepers with respect to conflicts related to ancillary services is that regulators have not restricted credit rating agency consulting. In contrast, accounting firms and corporate boards face new rules regarding conflicts of interest. Research analysts at investment banks must comply with restrictions on their activities and compensation. Yet no such rules govern credit rating agencies.

A second area of conflict arises from unsolicited ratings the agencies give to some issuers. Unsolicited credit ratings have been highly controversial, and are the subject of ongoing litigation and scrutiny, but no new regulation.

Moody's has estimated in the past that one percent of its ratings have been unsolicited; S&P and Fitch have not publicly stated how frequently they issue unsolicited ratings, although they admit to engaging in the practice.⁴⁵ Although it is not clear precisely how frequently credit rating agencies issue unsolicited ratings, it is clear that they do it. The vast majority of ratings are solicited by issuers, but it seems reasonable to assume based on available data and empirical evidence that roughly one percent of corporate credit ratings are unsolicited. It is not clear what the percentage might be with respect to structured finance ratings.

During the past decade, the Department of Justice has opened investigations into the practice of giving unsolicited ratings, but has not yet brought a prosecution. On July 29, 2005, Moody's disclosed that it had received subpoenas from New York Attorney

⁴⁴ See SEC Report, at 43.

⁴⁵ Alec Klein, *Credit Raters' Power Leads to Abuses, Some Borrowers Say*, *Washington Post*, Nov. 24, 2004, at A01. The extent to which Moody's continues to issue unsolicited ratings remains unclear. See *Compuware v. Moody's Investors Services, Inc.*, 324 F. Supp.2d 860 (E.D. Mich. 2004).

General Eliot Spitzer seeking information about its practice of issuing unsolicited ratings. It seems likely that regulators will continue to scrutinize unsolicited ratings.

The controversy surrounding the practice of unsolicited ratings began in 1993, when the Jefferson County School District in Colorado decided to issue new bonds to take advantage of lower interest rates.⁴⁶ Although it had hired Moody's for previous bond issues, it decided to hire S&P and Fitch instead of Moody's for these particular bonds.⁴⁷ On October 20, 1993, the school district priced the bonds, and they initially were selling well. However, two hours after the pricing, Moody's issued a "negative outlook" on the bonds.⁴⁸ Several buyers immediately canceled their orders, and the school district was forced to reprice the bonds and pay a higher rate. It sued Moody's, alleging that this "negative outlook" contained falsehoods and had increased the cost of issuing the bonds by \$769,000.

Moody's defended against the lawsuit by arguing that its evaluation of the school district's bonds was a constitutionally protected "opinion." The court agreed, and its dismissal of the claims was upheld on appeal.⁴⁹ For now, I want to set aside the First Amendment implications of this case (and others), which I address below in Part III.B, and focus on the implications of unsolicited ratings.

The decision in the Jefferson County case suggested to credit rating agencies that the courts would protect them from litigation if they issued unsolicited ratings. Notwithstanding the investigation by the Department of Justice, anecdotal evidence suggests that the agencies have continued to issue unsolicited ratings.⁵⁰

⁴⁶ See *Jefferson County School District No. R-1 v. Moody's Investor's Services, Inc.*, 175 F.3d 848 (10th Cir. 1999).

⁴⁷ See Leslie Eaton, *Judge Dismisses Lawsuit Against Moody's Service*, *The New York Times*, May 10, 1996, at D2.

⁴⁸ Moody's said, "The outlook on the district's general obligation debt is negative, reflecting the district's ongoing financial pressures due in part to the state's past underfunding of the school finance act as well as legal uncertainties and fiscal constraints" See *Jefferson County*, 175 F.3d at 850.

⁴⁹ Moody's was separately fined \$195,000 in 2001 for obstructing justice by destroying documents in the investigation. See Alec Klein, *Credit Raters' Power Leads to Abuses, Some Borrowers Say*, *Wash. Post*, Nov. 24, 2004, at A01.

⁵⁰ For example, Michigan Municipal Bond Authority officials said they received a Moody's bill for an unsolicited rating after they chose Fitch to rate some bonds they issued in spring 1995.

With respect to unsolicited ratings, the credit rating agencies are unique among gatekeepers. In particular, the conflicts involving securities analysts are the reverse of those associated with credit ratings: the allegation is that analysts give unduly favorable ratings to persuade issuers to pay additional fees for other services, not that they give unduly unfavorable ratings to persuade issuers to pay for the ratings. In other words, the securities analyst conflicts are “pull” conflicts in which the analyst dangles the prospect of favorable ratings to obtain future fees, whereas the rating agency conflicts are “push” conflicts in which the agency threatens the issuer with unfavorable ratings to obtain current fees.

With respect to other gatekeepers, such as auditors, the notion of unsolicited ratings makes little sense. An accounting firm would not likely give an audit opinion to a non-client; indeed it likely would find it cost prohibitive to do so. It is interesting that credit rating agencies believe they are capable of publishing accurate unsolicited ratings even if they have no access to management or inside information, and are making a judgment based simply on publicly available information.⁵¹

Finally, one twist to the practice of unsolicited ratings is that credit rating agencies might feel obligated to issue them to preserve a First Amendment defense. If the agencies only rate bonds when they receive payment from issuers, their ratings appear less like protected speech. But if the agencies are publishing “opinions” about issuers who are not paying fees, they appear to be acting more like journalists. As noted above, the evidence indicates that financial market participants do not believe credit ratings are merely the opinions of journalists. If they did, shares of Moody’s would be worth \$3

They returned the bill unpaid. See *Watching the Watchers: Justice Department Launches Probe of Moody’s Ratings*, *Tulsa World*, Mar. 28, 1996, at E1. In one publicized case, Moody’s began publishing credit ratings of the bonds of Hannover Re, a large German reinsurer, after it told Moody’s it didn’t see the value in a Moody’s rating (it already was paying S&P and Fitch ratings fees). As Hannover Re continued to refuse to pay Moody’s for a rating, Moody’s continued to downgrade its debt. When Moody’s finally cut Hannover Re’s rating to below investment grade in 2003, the company’s share value declined by \$175 million. See Alec Klein, *Spitzer Examining Debt Ratings by Moody’s*, July 30, 2005, at D01.

⁵¹ There is an argument that unsolicited ratings are a sign of market failure in the credit rating business, because they indicate that some agencies, particularly Moody’s, believe they can extract fees from issuers by threatening to publish unduly unfavorable ratings. Such a strategy would only work if issuers did not believe there were sufficient competition to obtain a more accurate rating.

billion, not \$15 billion. But if credit rating agencies never issued unsolicited ratings, they would appear to be even less like financial publishers, and therefore even less likely to be protected by free speech principles.

C. **Structured Finance**

Perhaps the starkest difference between credit rating agencies and other gatekeepers in recent years has been the increasingly substantial role the agencies play in rating new structured finance issues, particularly credit derivatives.⁵² Financial institutions first began using credit derivatives during the mid-1990s as a mechanism to transfer credit risk, primarily because it enabled them to hedge the risk associated with their lending operations and to reduce balance-sheet capital requirements.

The simplest form of credit derivative – the Credit Default Swap (CDS) – facilitates the transfer of credit risk, and does not directly implicate or involve credit rating agencies. In a CDS, one party agrees to pay money to another party if a specified “credit event” occurs, typically a default on a specified bond. One party is “buying” protection against default, and will be paid in the event of default. The other party is “selling” protection against default, and will pay in the event of default. In other words, protection buyers transfer credit risk to protection sellers, in exchange for a payment, or premium, either upfront or over time.⁵³ The CDS market has been controversial, in part because banks used CDSs to transfer hundreds of billions of dollars of credit risk to insurance companies, pension funds, and other institutions prior to the recent wave of corporate defaults. There is an active policy debate about the costs and benefits of CDSs, but it does not directly involve credit rating agencies.

⁵² Credit derivatives are private contracts in which parties agree to transfer the credit risk associated with one or more issuer. The credit derivatives market did not exist a decade ago, but suddenly has become a multi-trillion dollar market. See, e.g., JPMorgan Credit Derivatives and Quantitative Research, *Credit Derivatives: A Primer*, Jan. 2005, at 1 (citing estimate that at the end of 2004 the total notional size of outstanding credit derivatives was \$5 trillion).

⁵³ Note that a CDS also creates credit risk, because the parties are exposed not only to the underlying credit of the asset, but also to the credit of their CDS counterparty. CDSs are now traded on exchanges, as well as in private counterparty transactions. There has been pressure to move to exchange trading of CDSs in order to standardize various contract terms.

Credit rating agencies enter the picture with respect to a second form of credit derivative, known as a Collateralized Debt Obligation (CDO).⁵⁴ CDOs are structured, leveraged transactions backed by one or more classes of fixed income assets.⁵⁵ In the mid-1990s, CDOs typically were based on portfolios of high-yield corporate bonds. During the past several years, CDOs have been based on other assets, including asset backed securities, CDSs, and even other CDOs.⁵⁶

At the core of a typical CDO is a Special Purpose Entity (SPE) that issues securities to investors in several different classes, or tranches, most of which are rated by a credit rating agency. The SPE's proceeds are used to purchase a portfolio of fixed income assets. If some of the assets default, the most junior of the SPE's securities takes the first loss. Payments to each tranche are governed by a stipulated priority of payments.

There are two broad categories of CDOs that are relevant to this discussion: cash flow CDOs and synthetic CDOs. Cash flow CDOs involve the actual purchase of real fixed income assets whose cash flows are used to pay investors in the different tranches. Synthetic CDOs bundle the same kinds of credit risk exposure without real assets, by selling protection on the underlying assets using CDSs. Cash flow CDOs were motivated both by reduction in bank capital charges and potential arbitrage opportunities. Because synthetic CDOs essentially create new instruments, instead of using assets on bank balance sheets, they are motivated primarily by arbitrage, not regulation.⁵⁷

It is worth thinking about precisely how such "arbitrage" opportunities have arisen. According to S&P, "rating agencies played an important role in the development

⁵⁴ See generally Janet Tavakoli, *Collateralized Debt Obligations & Structured Finance* (2003).

⁵⁵ See Standard & Poor's *Structure Finance, S&P Global Cash Flow and Synthetic CDO Criteria*, Mar. 21, 2002, at 4.

⁵⁶ Recently, the CDO markets have experienced some difficulties. In April and May 2005, market participants were surprised when equity tranches of CDOs suddenly became much cheaper, while mezzanine tranches became more expensive. Likewise, CDOs obviously performed poorly after the increase in corporate defaults during 2002. In 2003, S&P and Moody's downgraded 150 cashflow CDO transactions, 108 more than in 2001. See Anthony Currie, *Cool Heads Rule in CDO Land*, *Euromoney*, Apr. 2003, at 114.

⁵⁷ See Standard & Poor's *Structure Finance, S&P Global Cash Flow and Synthetic CDO Criteria*, Mar. 21, 2002, at 5; see also Standard and Poor's *Structured Finance Ratings: Criteria for Rating Synthetic CDO Transactions*, Sept. 2003.

of the market since they were able to develop criteria to size default risk based on rates of the underlying obligors.”⁵⁸ In other words, the rating agencies have developed methodologies for rating CDOs that result in the combination of the tranches being worth more than the cost of the underlying assets. The difference between the price investors in aggregate pay for CDO tranches and the cost of the underlying assets must be substantial, because it covers the high fees the various participants charge for structuring and arranging a CDO, and for managing the underlying assets.

So how does such “arbitrage” arise? There are two views. The first is that actual value is created during the CDO process, either because the underlying assets are mispriced or because market segmentation otherwise prevents parties from buying the types of portfolios that CDOs create. It is difficult to test this view, but there are reasons to be skeptical. Investors who want to own diversified portfolios of fixed income assets are not prohibited from doing so. Moreover, if markets were segmented by risk, one would expect market pressure to lead corporations that issue bonds to create capital structures that would be most attractive to particular market segments. Corporate bonds are not like home mortgages, which typically cannot be purchased individually or even in diversified classes. Economists know that arbitrage opportunities rarely persist unless there is a dominant information asymmetry or regulatory explanation. The purchasers of CDO tranches typically are sophisticated and the regulatory rationales do not apply to synthetic CDOs. Moreover, the cost of this so-called “arbitrage” is enormous: if a trillion dollars of CDOs have been sold, financial intermediaries have earned billions of dollars in fees.

A second view is that because the methodologies used for rating CDOs are complex, arbitrary, and opaque, they create opportunities for parties to create a ratings “arbitrage” opportunity without adding any actual value. It is difficult to test this view, too, although there are reasons to find it persuasive. Essentially, the argument is that once the rating agencies fix a given set of formulas and variables for rating CDOs, financial market participants will be able to find a set of fixed income assets that, when run through the relevant models, generate a CDO whose tranches are more valuable than

⁵⁸ See Standard & Poor’s Structure Finance, S&P Global Cash Flow and Synthetic CDO Criteria, Mar. 21, 2002, at 5.

the underlying assets. Such a result might be due to errors in rating the assets themselves (i.e., the assets are cheap relative to their ratings), errors in calculating the relationship between those assets and the tranche payouts (i.e., the correlation and expected payout of the assets appear to be higher and therefore support higher ratings of tranches), or errors in rating the individual CDO tranches (i.e., the tranches receive a higher rating than they deserve, given the ratings of the underlying assets). These arguments are complex and subtle, and a complete analysis is well beyond the scope of this paper.⁵⁹

Nevertheless, it is possible to gain some insight by closely examining the CDO rating process. Consider S&P's methodology. S&P uses a proprietary model called CDO Evaluator, which simulates the loss distribution and time to default of the assets in the portfolio using Monte Carlo methods and determines if in any of the simulations a loss trigger is breached. During the late 1990s, both S&P and Moody's developed early versions of such models with the close cooperation of the investment banks that created CDOs. S&P released the first version of CDO Evaluator in November 2001, and has released several updated versions since then.

Once a client has signed an engagement letter, S&P and the client use CDO Evaluator to run Monte Carlo simulations to establish the default level of each proposed pool of assets at each rating level. The model uses default estimates based on the existing ratings of the assets. For example, for a tranche to be rated AAA, S&P might require that it be able to withstand a default rate of 30 percent of the asset pool for a particular period of time, assuming a level of defaults based on the ratings of those assets. The default rate for lower credit ratings would be correspondingly lower. The model also incorporates assumptions about how much of the face value might be recovered after a default.

From a mathematical perspective, pricing the tranches of a CDO is a reasonably straightforward task. First, one calculates the expected cash flows of the underlying assets over time. Then one determines how those cash flows would be paid out to each tranche over time. The equity, or most junior, tranche absorbs losses up to the first

⁵⁹ The rating agencies are sensitive to these arguments. As S&P has described the CDO process, "This is not alchemy or turning straw into gold, but rather the implementation of structured finance to create different investment risk profiles, based on the structuring of credit support." See Standard & Poor's Structure Finance, S&P Global Cash Flow and Synthetic CDO Criteria, Mar. 21, 2002, at 14.

“attachment point.” Then the most junior mezzanine tranche absorbs losses up to the next attachment point, and so on. The rating agencies then give a credit rating to each of the tranches (but usually not to the junior tranche) based on assumptions about certain key variables, including expected default rates, recovery rates, and correlation rates among assets.

Although this process employs sophisticated mathematical techniques, the conclusions can be somewhat dubious. For example, a rating agency might run 100,000 computer simulations to determine the number of times a breach would occur, that is, how often a particular tranche would lose value beyond a certain level. However, the variable in this assessment is the number of breaches out of the 100,000 runs, not the magnitude of the breach or any qualitative analysis of the breach. For example, for a typical five-year synthetic CDO, S&P might establish a confidence interval for the AAA level of 0.284%, meaning that the particular tranche would be “breached” in 284 runs out of 100,000.

However sophisticated the techniques, they are subject to the limitations of “garbage in, garbage out.” For example, S&P calculates a probability distribution of default rates for a portfolio, and then calculates a set of Scenario Default Rates (SDRs) in two steps.⁶⁰ First, for a given tranche to receive a particular rating, the probability of defaults in its portfolio exceeding the portfolio default rate cannot exceed the default rate for a corporate bond with that rating. Second, S&P multiplies the portfolio default rate by an adjustment factor depending on the tranche. This is basically an error factor that in S&P’s judgment should adjust for the fact that actual defaults might be higher or lower.

But recovery rates and recovering timing for assets vary depending on the nature of the asset, particularly its seniority. This is far from an exact science – recovery times vary by jurisdiction, legal framework, and debtor’s rights – and there rarely is historical evidence of default rates for particular assets (especially rated assets). Yet the assumed recovery inputs the rating agencies use necessarily must be precise ones.

⁶⁰ CDO Evaluator Applies to Correlation and Monte Carlo Simulation to Determine Portfolio Quality, Nov. 13, 2001.

The default probability estimates S&P uses are fixed, based on default probability estimates within a given rating category. S&P has published assumptions about default rates to be used in certain CDO calculations, as set forth in Chart 4 below.⁶¹

Chart 4 – S&P Default Rate Assumptions for CDOs

	<u>ABS (all)</u>	<u>Corp Year 4</u>	<u>Corp Year 7</u>	<u>Corp Year 10</u>
AAA	0.25%	0.19%	0.52%	0.99%
AA	0.50%	0.57%	1.20%	1.99%
A	1.00%	0.81%	1.81%	3.04%
BBB	2.00%	1.81%	3.94%	6.08%
BB	8.00%	9.49%	14.20%	17.47%
B	16.00%	21.45%	26.15%	28.45%

If a CDO manager is able to purchase assets within a particular rating category at market prices that implied a lower default rate than the one suggested in the above table, the manager could create an “arbitrage” profit by achieving a higher rating. To the extent purchasers of CDO tranches care primarily about ratings and yields, rather than the analysis of the actual default probability of the assets, the CDO would add value. It is important to note that the agencies rate bonds within a particular rating category, say AAA, even though market prices imply different probabilities of default. They permit CDO managers to assume that the rating agencies’ assumptions, not the market’s implicit assumptions, are the relevant ones when evaluating the tranches of CDOs. Put another way, credit rating agencies are providing the markets with an opportunity to arbitrage the credit rating agencies’ mistakes (or, more generously, the fact that rating categories cover a broad range of default probabilities, rather than a point estimate).

The problems with how CDO pricing models incorporate various measures of correlation among assets are even more troubling. Clearly, the ratings of CDO tranches should be sensitive to the correlation of the underlying assets. Yet even as late as 2002,

⁶¹ CDO Evaluator Applies to Correlation and Monte Carlo Simulation to Determine Portfolio Quality, Nov. 13, 2001.

S&P's correlation inputs for corporate assets were simply 0.3 within a given industry and 0.0 between industry sectors. The correlation inputs for asset backed securities were similar. S&P recognized that these inputs were flawed, but used them nonetheless.⁶² The Bank for International Settlements also has expressed concerns about this kind of model risk, particularly with respect to correlation.⁶³

Perhaps surprisingly, it is the investment bank structuring the CDO, not the rating agency, that typically performs these complex calculations.⁶⁴ The process of rating CDOs becomes a mathematical game that smart bankers know they can win. A person who understands the details of the model can tweak the inputs, assumptions, and underlying assets to produce a CDO that appears to add value, even though in reality it does not.

The mathematical precision of the models is illusory, because numerous subjective factors enter the process as well. For example, the rating agency evaluates the CDO asset manager, who has discretion to engage in trading. CDOs typically are not fully funded when they are first rated; instead, the manager has a set of parameters governing which assets it is permitted to buy or sell. There also are difficult questions about the documentation of CDOs, as well as record and reporting requirements, which are not yet standardized.⁶⁵

⁶² See Standard & Poor's Structure Finance, S&P Global Cash Flow and Synthetic CDO Criteria, Mar. 21, 2002, at 46 ("As data becomes available, the correlation coefficients will be modified based on documented studies.").

⁶³ See Bank for International Settlements, *The Role of Ratings in Structured Finance*, Jan. 2005. Some credit rating agency officials have echoed those concerns. See *BIS Vindicates Agencies, But Warns on Ratings Limitations, Correlation Risk, Structured Finance International*, Jan. 1, 2005, at 56 (quoting the head of CDOs at S&P in London as saying, "I'm not sure correlation risk has been fully understood by anyone. We try to be very clear to the market about what our assumptions are and how our models work.").

⁶⁴ For example, S&P states that "[t]he transaction's sponsor or banker will generally perform the cash flow modeling and provide Standard & Poor's with the results and the model. The sponsor or the banker doing the cash flow modeling must also provide to Standard & Poor's an independent-accountant verification that the proprietary cash flow model is representative of the transaction structure, and that the dominant cash flow run results are as indicated by the party doing the modeling." See Standard & Poor's *Structured Finance, S&P Global Cash Flow and Synthetic CDO Criteria*, Mar. 21, 2002, at 17-18.

⁶⁵ Additional complications arise as to what are known as leveraged super senior notes, essentially tranches above the AAA-rated notes that take the last loss in a CDO transaction.

Even if these difficulties could be surmounted, consider the complexities associated with so-called “CDO Squared” transactions, whose assets consist of a reference portfolio of other CDOs and asset-backed securities (or, less commonly, “CDO Cubed” transactions, whose assets consist of a portfolio of CDO Squareds). Again, the models require assumptions about all of the variables stated above, but this time piled on to a second (or third) level, with respect to the underlying CDOs, in addition to the underlying assets of those CDOs. Moreover, although a typical CDO Squared transaction might involve 1,000 corporate names,⁶⁶ there are only about 400 issuers of liquid corporate bonds. That means certain names must appear more than once. According to S&P, each corporate name appears in such transactions, on average, 4.17 times.⁶⁷

Economists should ask why parties would do CDOs, given these complexities. If the problem is that bonds are mispriced, one would expect the CDS market to resolve that problem, or at minimum provide lower cost opportunities to arbitrage that mispricing than high-fee CDOs. If the problem is that bond purchasers and issuers are in different market segments, one would expect issuers to take advantage of potential arbitrage opportunities by adjusting their capital structure and/or leverage to attract neglected segments of the market. Yet there is little evidence CDOs are used to create new assets with underrepresented credit ratings; instead, the ratings of CDO tranches span the same range as those of corporate bonds.

⁶⁶ Drill-Down Approach for Synthetic CDO Squared Transactions, Standard & Poor’s, Dec. 10, 2003.

⁶⁷ Id.

If the mathematical models have serious limitations,⁶⁸ how could they support a \$5 trillion market? Some experts have suggested that CDO structurers manipulate models and the underlying portfolio in order to generate the most attractive ratings profile for a CDO. For example, parties included the bonds of General Motors and Ford in CDOs before they were downgraded because they were cheap relative to their (then high) ratings.⁶⁹ The primary reason the downgrades of those companies had an unexpectedly large market impact was that they were held by so many CDOs.⁷⁰

Thus, with respect to structured finance, credit rating agencies have been functioning more like “gateopeners” rather than gatekeepers. The agencies are engaged in a business, the rating of CDOs, which is radically different from the core business of other gatekeepers. No other gatekeeper has created a dysfunctional multi-trillion dollar market, built on its own errors and limitations.⁷¹

⁶⁸ Recent research in finance shows that asset pricing models of the variety used by credit rating agencies fail to explain real world data. See Nikola A. Tarashev, *An Empirical Evaluation of Structural Credit Spread Models*, BIS Working Papers No. 179 (July 2005). For example, observed market spreads typically are much higher than those predicted by structural models, especially at the high quality end of the rating spectrum. See Til Shuermann, *A Review of Recent Books on Credit Risk*, Federal Reserve Bank of New York (Sept. 2004) (citing numerous studies). These studies suggest that there are significant non-credit components to spreads on fixed-income instruments. Moreover, such models fail to take into account tail risk, and are based on historical measures, which often are not good predictors. One would think that the collapses of firms such as Long-Term Capital Management and Askin Capital Management would have been sufficient warning to entities attempting to engage in arbitrage based on such models. See also Mark Whitehouse, *How a Formula Ignited Market that Burned Some Big Investors*, *Wall St. J.*, Sept. 12, 2005, at A1.

⁶⁹ Likewise, more than three-fourths of the pre-2002 CDOs S&P rated in the United States contained WorldCom bonds, representing an average of more than one percent of the assets of synthetic CDOs. See Jenny Wiggins, *Growth of Structured Finance Sector Set to Slow*, *Financial Times*, July 1, 2002, p. 26. Representatives of Moody’s have stated that 58 of the synthetic CDOs it rated had exposure to WorldCom. See Rebecca Bream, *Moody’s Expects Pressure on CDOs*, *Financial Times*, July 10, 2002, p. 31.

⁷⁰ See Henny Sender, Carrick Mollenkamp & Michael Mackenzie, *Wall St. J.*, May 11, 2005 (quoting Janet Tavakoli, a prominent structured finance expert, as suggesting that “managers often game the portfolio”).

⁷¹ One open question is the fate of the synthetic CDO market outside the United States, where it appears that transactions are driven more by “arbitrage,” not regulatory capital motivations, particularly in Japan. See *From Crisis to Opportunity: The Evolution of CDOs in Japan*, *Structured Finance Int’l*, May 1, 2005, at S4; see also Charles Adams, Donald J. Mathieson & Garry Schinasi, *International Monetary Fund, International Capital Markets: Developments, Prospects, and Key Policy Issues 185-212* (1999), available at

III. Why Credit Rating Agencies Are Not Like Other Gatekeepers

Given the differences between credit rating agencies and other gatekeepers, the next question is: why? Are there substantive economic differences between the function of rating credit, such that one would expect credit rating agencies to differ from other gatekeepers in the way they do? Or are the differences due to other factors?

The first reason for the differences between credit rating agencies and other gatekeepers is the regulations that depend on NRSRO ratings. It is difficult to argue that the function of providing credit ratings is much different from an economic perspective than the functions of other gatekeepers. Of course, credit rating agencies provide certification services only with respect to debt, while securities analysts provide certification services only with respect to equity. However, there is little reason to think that distinction would generate the marked differences discussed in Part II. Indeed, financial institutions also generate credit ratings, although they are used primarily for internal purposes. However, non-NRSRO credit ratings are not particularly valuable, because they do not implicate any regulatory consequences. This argument is discussed in Part III.A.

A second reason for the differences is that credit rating agencies generally are not subject to civil liability for malfeasance. It is not surprising that the credit rating agencies would prefer to compare themselves, not to gatekeepers such as securities analysts and auditors, but to publishing companies. As an S&P official argued at a recent legislative hearing, “The very notion that a bona fide publisher – whether it be BusinessWeek, The Wall Street Journal, or S&P – can be required under the threat of penalty or other retribution to obtain a government license, adhere to government dictates about its policies and procedures, and/or submit to intrusive examinations before being permitted to disseminate its opinions is inconsistent with core First Amendment principles.”⁷² This argument is discussed in Part III.B.

<http://www.imf.org/external/pubs/ft/icm/1999/index.htm> (assessing the role of the major credit rating agencies in various countries).

⁷² Testimony of Rita M. Bolger, Managing Director and General Counsel for Standard & Poor’s, Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee, June 29, 2005, at 2.

A. Regulatory Licenses

I have argued elsewhere that the paradox of credit ratings – how they can be so valuable yet lack informational content – can be resolved by understanding the regulatory framework in which credit rating agencies operate.⁷³ I will not repeat the details of this argument here, except to note that this regulatory framework differs from that of other gatekeepers in important ways.

In particular, credit ratings are valuable, not because they contain valuable information, but because they grant issuers “regulatory licenses.” In simple terms, a good rating entitles the issuer (and the investors in a particular issue) to certain advantages related to regulation. The regulatory license view of credit ratings illuminates some of the unique aspects of the role of credit rating agencies. Once regulation is passed that incorporates ratings, rating agencies will begin to sell not only information but also the valuable property rights associated with compliance with that regulation.

Moreover, if regulation enables only a few raters to acquire and transfer regulatory licenses, or if it imposes costs on new raters that raise the barriers to entry, the rating agencies will acquire market power in the sale of regulatory licenses. Unlike rating agencies selling information in a competitive market, rating agencies selling regulatory licenses under oligopolistic (or even monopolistic) conditions will be able to earn abnormal profits.⁷⁴

The regulatory license view can be generalized beyond credit ratings, and applies to a certain extent to other gatekeepers. For example, securities regulations set forth in great detail the minimum qualifications for certified and public accountants and for accountants’ reports.⁷⁵ Federal regulations also require registered companies to file

⁷³ See Partnoy, Paradox of Credit Ratings, at 74-78.

⁷⁴ For an assessment of the oligopolistic nature of NRSROs, see Lawrence J. White, The Credit Rating Industry: An Industrial Organization Analysis, at 41-64, in *The Role of Credit Reporting Systems in the International Economy* (Kluwer Academic Publishers 2002, Richard M. Levitch, Giovanni Majnoni, and Carmen Reinhart, eds.).

⁷⁵ 17 C.F.R. 210 (1999). These qualifications depend on certification requirements specified by the relevant state licensing agency.

audited financial statements for the previous three fiscal years.⁷⁶ Other regulations cover the content and quality of accountant reports.⁷⁷ Section 404 of the Sarbanes-Oxley Act now requires certification of internal controls.⁷⁸

Since 1973 credit ratings have been incorporated into hundreds of rules, releases, and regulatory decisions, in various substantive areas, including securities, pension, banking, real estate, and insurance regulation.⁷⁹ As noted above, the cascade of regulation began when, following the credit crises of the early 1970s, the SEC adopted broker-dealer net capital requirements in Rule 15c3-1, the first securities rule that formally incorporated NRSRO ratings. I have noted elsewhere the extensive credit-rating dependent rules and regulations promulgated under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, various banking and insurance regulations and statutes, and other regulatory schemes.⁸⁰ More recently, international regulatory standards, including the Basel 2 capital accords, have depended on credit ratings.

Such extensive regulatory dependence on credit ratings is unique. For example, investors do not receive differential regulatory treatment when they purchase stocks with “buy” ratings from securities analysts. Investors might not buy securities of an issuer without the relevant opinion letters from an audit firm, but that audit firm’s opinion typically does not determine the level of the investors’ compliance with other regulation.

To the extent other gatekeepers are selling regulatory licenses, their role is problematic in ways that are similar to the above problems associated with credit ratings. Investment banking fairness opinions are unduly expensive, in part because they provide support for a due diligence defense for directors of a company who approve a merger or sale. The same is true of audit opinions, which similarly provide a legal defense. The

⁷⁶ See 17 C.F.R. 210.3-01-02.

⁷⁷ See 17 C.F.R. 210.2-02.

⁷⁸ Section 404 has generated enormous controversy, because of the high cost of implementation. It is not surprising that various gatekeepers have attempted to seek rents associated with Section 404, which essentially is a scheme requiring that companies obtain regulatory licenses associated with their own internal controls.

⁷⁹ See Partnoy, Siskel and Ebert, at 690-95.

⁸⁰ See Partnoy, Paradox of Credit Ratings, at 74-78.

very high fees associated with compliance with Sarbanes-Oxley Section 404 do not reflect the intrinsic market value of an accounting firm's substantive controls review, but rather reflect the expense associated with being in compliance with that new law.⁸¹

The overriding message is that regulatory licenses are costly. They create oligopolistic pressure, and exacerbate rent-seeking among already concentrated industries. They might be necessary when a regulator is unwilling to or cannot make substantive decisions on its own and the market failure is sufficient serious to justify the cost. But as a general matter, regulators should be very careful not to create regulatory licenses, and once they are created they should take great care in policing them.

Unfortunately, regulators have taken no such care with respect to NRSRO ratings. Once the notion of NRSRO-based regulation became standardized, market participants began to frame decisions in terms of ratings much more frequently. To the extent financial market behavior is path-dependent, regulatory licenses have started parties down a suboptimal path, where dependence on ratings has generated behavioral influences. Once legal rules approve of reliance on credit ratings, it is only natural that individuals would come to rely heavily on such ratings as well.

B. Liability

The unique problems associated with credit rating agencies as gatekeepers stem from a second source: their lack of exposure to civil and criminal liability. Unlike other gatekeepers, rating agencies are explicitly immune from certain violations of securities law, including Section 11 of the Securities Act of 1933 and Regulation FD.⁸² Moreover, rating agencies have been unique among gatekeepers in their ability to argue that their

⁸¹ See Donald C. Langevoort, *Internal Controls after Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems,"* forthcoming *J. Corp. L.* (2005); William J. Carney, *The Costs of Being Public after Sarbanes-Oxley*, Emory L. & Econ. Res. Paper 05-4, Feb. 2005.

⁸² Rule 436(g)(1) of the Securities Act of 1933, 17 C.F.R. § 230.436(g)(1) provides for exemption of liability for NRSROs: "The security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization . . . shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act." NRSROs generally are shielded from liability under the securities laws for all conduct except fraud. See *Financial Oversight of Enron: The SEC and Private Sector Watchdogs*, Report of the Staff to the Senate Committee on Governmental Affairs, at 105, Oct. 8, 2002.

function is merely to provide “opinions” that are protected by the First Amendment. Because of these differences, rating agencies have not paid substantial judgments or settlements resulting from the recent wave of corporate fraud.

The credit rating agencies claim that their core business is financial publishing.⁸³ Specifically, NRSROs have long argued that their core activities are the journalistic pursuits of gathering information on matters of public concern, analyzing that information, forming opinions about it, and then broadly disseminating that information to the public. They have had some limited success in putting forth these arguments in litigation.

As noted above in Part II.A., Moody’s financial statements show that it actually is engaged in an entirely different business from publishing, one which is much more profitable. In addition, in its most recent proxy statement, Moody’s itself suggests that its business is not financial publishing. It notes that it “does not believe there are any publicly traded companies that represent strict peers.”⁸⁴ For purposes of assessing the compensation paid to senior executives, Moody’s looks instead to a “peer group” of “financial services companies with market capitalization comparable to the Company.”⁸⁵ Interestingly, Moody’s does not provide a list of the names of any of these companies, but leaves it to investors to guess at which financial services companies might provide relevant benchmarks for paying executives.

But even if one accepted the argument that credit rating agencies are financial publishers, that does not end the inquiry. It remains a question whether holding such a

⁸³ Consider the following statement by Moody’s: “As set forth more fully on the copyright, credit ratings are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, selling or holding.” See Moody’s Ratings Definitions, <http://www.moodys.com/moodys/cust/AboutMoody/AboutMoody.aspx?topic=rdef&subtopic=moodys%20credit%20ratings&title=Introduction.htm>, visited Sept. 2, 2005.

⁸⁴ Moody’s 2004 Proxy Statement, Mar. 23, 2005, at 24. For the purposes of assessing its share price performance, Moody’s compares itself to publishing companies, including Dow Jones and Reuters. As noted in Part II.A., Moody’s is not comparable to those two companies from a financial perspective.

⁸⁵ *Id.* at 22.

publisher or speaker liable for malfeasance would impact expression.⁸⁶ The securities laws are predicated on the assumption that corporate speech can be regulated. The Supreme Court has clearly indicated that “commercial speech” can be regulated to the extent it is false or misleading.⁸⁷ Moreover, the securities laws provide for liability for false and misleading statements even if those statements were not made with the kind of malicious intent that is required for other forms of speech.⁸⁸ If speech by an issuer can be regulated, it should follow that speech by an agent of the issuer, whom the issuer has paid to speak, also can be regulated, on a similar rationale.

The Supreme Court has never ruled directly on the issue of whether gatekeepers are entitled to First Amendment protection for their opinions, and it is not clear what position it would take. In one somewhat related case, Dun & Bradstreet v. Greenmoss Builders,⁸⁹ the Supreme Court held that statements made in an individual’s credit report are not a matter of public concern that would give a credit reporting agency (in this case, Dun & Bradstreet, the former parent of Moody’s) special privileges under the First Amendment. Although Dun and Bradstreet is not directly on point, the Court did note in that case that the market-driven nature of the speech made heightened First Amendment protection unnecessary. On the other hand, in a different case also not directly on point, Lowe v. SEC, the Supreme Court noted in dicta that “It is difficult to see why the expression of opinion about a marketable security should not also be protected.”⁹⁰

In the lower courts, both S&P and Moody’s have persuaded some judges to dismiss claims against them (Fitch has had less success), and to note that credit ratings were protected expressions of opinion.⁹¹ However, the courts have distinguished

⁸⁶ See County of Orange, 245 B.R. at 154 (“S&P’s status as a financial publisher does not necessarily entitle it to heightened protection under the First Amendment”).

⁸⁷ Central Hudson Gas & Electric Corp. v. Public Service Commission, 447 U.S. 557 (1980).

⁸⁸ See New York Times v. Sullivan, 376 U.S. 254 (1964).

⁸⁹ See Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749 (1985).

⁹⁰ Lowe v. SEC, 472 US. 181, 210 n. 58 (1985).

⁹¹ See, e.g., Jefferson County Sch. Dist. No. R-1 v. Moody’s Investor’s Servs., 175 F.3d 848, 856 (10th Cir. 1999) (dismissing claims for tortious interference, injurious falsehood, and anti-trust violations because Moody’s credit ratings are “protected [*177] expressions of opinion”); County of Orange v. McGraw-Hill Cos., 245 B.R. 151, 157 (C.D. Cal. 1999) (“The First Amendment protects S&P’s preparation and publication of its ratings.”).

situations where credit rating agencies were merely acting as journalists or information gatherers from situations where the agencies were playing a more significant role in the transaction.

The most recent case was part of the Enron litigation in federal district court in Texas. In one of the numerous actions in Newby v. Enron Corp., the consolidated litigation brought by various investors against numerous Enron-related entities, Connecticut Resources Recovery Authority (CRRA) sued to recover approximately \$200 million of public funds it lost on a complex transaction it did with Enron in December 2000.

The transaction effectively was a \$220 million loan from CRRA to Enron. Enron stopped making payments after it filed for bankruptcy protection on December 2, 2001, and CRRA sued S&P, Moody's, and Fitch, alleging that they were liable for negligent misrepresentation and violations of the Connecticut Unfair Trade Practices Act, because they failed to exercise reasonable care or competence in obtaining and communicating accurate information about Enron's creditworthiness.⁹² Specifically, at the time of the transaction between CRRA and Enron, all three agencies gave Enron's debt ratings in the investment grade category. CRRA claimed those ratings were undeserved.⁹³

The Newby court found opinion divided on the question of credit rating agency liability, and concluded that any First Amendment protection for credit ratings was "qualified," not absolute.⁹⁴ In other words, credit ratings clearly can be regulated, the same as other corporate speech that is not entitled to absolute First Amendment protection. The court further observed that there is a potential conflict of interest created by the compensation issuers pay to credit rating agencies.⁹⁵ However, the court ultimately dismissed the rating agencies from the case, in part because of the weak factual allegations made by CRRA.

⁹² Newby v. Enron Corp., 2005 U.S. Dist. LEXIS 4494, at *174 (S.D. Tex. Feb. 16, 2005).

⁹³ As of October 2000, S&P gave Enron a BBB+ rating with "unsecured outlook stable," Moody's gave Enron a Baa1 rating with "no watch," and Fitch gave Enron a BBB- rating.

⁹⁴ Newby, at *203.

⁹⁵ Newby, at *216.

Before the Enron litigation, various courts had reached a range of results in cases filed against the rating agencies. In the litigation surrounding the financial collapse of Orange County, the judge dismissed some, but not all, of the claims against S&P, and ruled that S&P's constitutionally protected speech "was not absolutely privileged."⁹⁶ In Commercial Financial Services v. Arthur Andersen,⁹⁷ a case involving ratings of asset backed securities, the court held that the First Amendment did not protect the credit rating agencies. The crucial distinction between the CFS case and the Orange County litigation was that CFS had asked Moody's to rate its bonds and had in fact paid Moody's for rating them. (In Jefferson County, the unsolicited ratings case discussed above, Moody's had not been asked to rate the bonds and was not paid.) The court noted that although a journalist's speech might be protected, if CFS had hired that journalist to write a company report about the bonds, a different standard would apply.

Other cases have suggested that the question of whether credit rating agencies are liable depends on particular circumstances, such as the sophistication of the investor and the complexity of the transaction. In Quinn v. McGraw-Hill, the Seventh Circuit suggested that it was unreasonable for an investor to rely on an "A" rating from S&P, but nonetheless permitted claims for negligent and fraudulent misrepresentation against S&P to go forward.⁹⁸ In American Savings Bank v. UBS PaineWebber, the court held that "the journalist privilege is a qualified one. Fitch is not primarily engaged in newsgathering generally, nor was it doing so when procuring the information sought by the subpoenas. The Court finds that Fitch is not entitled to the protections offered by the journalist privilege."⁹⁹). The transaction at issue in that case was a CDO.

⁹⁶ See In re: County of Orange, debtor, County of Orange v. McGraw Hill Cos. Inc., D.C. Calif., SA CV 96-765 GLT, Bankruptcy No: SA 94-22272 JR, 3/16/98); see also Orange County May Proceed With Claims Against Standard and Poor's, 30 BNA 444, Mar. 20, 1998. S&P settled the case with a payment of \$ 140,000 to Orange County.

⁹⁷ Commercial Financial Services, Inc. v. Arthur Andersen LLP, 94 P.3d 106, 109 (Okla. Civ. App. 2004) ("The Rating Agencies' ratings fall somewhere between those opinions which receive constitutional protection and those that do not.").

⁹⁸ See Quinn v. McGraw-Hill Companies, Inc., 168 F.3d 331, 336 (7th Cir. 1999).

⁹⁹ Am. Sav. Bank, FSB v. UBS PaineWebber, Inc., 2002 U.S. Dist. LEXIS 24102, at * 2-3 (S.D.N.Y. Dec. 16, 2002).

Rating agencies have had success challenging subpoenas and refusing to turn over documents, although the courts generally have given them only a qualified journalist's privilege, if any privilege at all. For example, in August 1992, Pan Am served a document subpoena on S&P seeking information about meetings between S&P and Delta as part of S&P's credit rating process. (Pan Am had alleged that it was forced to stop flying when Delta repudiated a commitment to fund Pan Am's reorganization.) S&P refused to produce the documents, claiming the journalist's privilege. A bankruptcy court held a hearing and ruled that S&P was not acting as a journalist when it gathered the relevant information.¹⁰⁰ Judge Blackshear noted that S&P's activities were market driven and that it received fees for its ratings activity. Judge Loretta Preska reversed the ruling and found that S&P was protected by the First Amendment, noting that other journalists, including television reporters, newspaper publishers, and booksellers all have received First Amendment protection even though their speech was profit-motivated.¹⁰¹

What is one to make of these disparate decisions? The most one can say is that to the extent a credit rating agency only plays the role of information gatherer, and is not involved in structuring the transaction it rated, courts have been more sympathetic to claims that credit rating agencies are entitled to qualified protection.¹⁰² However, the courts have been more skeptical of free speech claims where the rating agency has played a significant role in structuring the transaction it rated.¹⁰³ Obviously, this is an area that would benefit from some clarification.

Perhaps the reason credit rating agencies have been unique among gatekeepers in obtaining at least partial First Amendment protection for their certifications is that they

¹⁰⁰ *In re Pan Am Corp.*, 161 B.R. 577 (S.D.N.Y. 1993).

¹⁰¹ But this argument creates problems for rating agencies who argue both that their ratings are speech and who do not issue unsolicited ratings. Courts have based decisions in part on the fact that rating agencies rate all issuers, not merely those that pay them fees to do so. See *In re Pan Am Corp.*, 161 B.R. 577 (S.D.N.Y. 1993) ("The record is uncontradicted that S&P does not merely provide ratings to issuers who pay a fee."). To the extent the rating agencies only provide ratings to issuers who pay them for the ratings, their argument is weaker.

¹⁰² See *Compuware Corp. v. Moody's Investors Services, Inc.*, 324 F. Supp.2d 860 (E.D. Mich. 2004) (Moody's was entitled to protection as a journalist under New York's reporter's privilege statute).

¹⁰³ See *In re Fitch*, 330 F.2d 104, 111 (2d Cir. 2003) (finding such a relationship was "not typical of the relationship between a journalist and the activities upon which the journalist reports").

have more clearly disclaimed the value of their opinions. Unlike equity analysts, who provide “buy,” “hold,” or “sell” recommendations, credit rating agencies say that they are not providing investment advice.¹⁰⁴ In any event, credit rating agencies have used the privilege more effectively than any other gatekeeper, not only to avoid liability, but to avoid regulatory scrutiny.

Finally, it is interesting that the credit rating agencies seem to be worried that their First Amendment protections might be at risk. Moody’s has noted in its financial statements that it “faces litigation from time to time from parties claiming damages relating to ratings actions. In addition, as Moody’s international business expands, these types of claims may increase because foreign jurisdictions may not have legal protections or liability standards comparable to those in the U.S. (such as protections for the expression of credit opinions as is provided by the First Amendment).”¹⁰⁵ The SEC was hampered in its investigation of NRSROs by claims that the First Amendment shielded them from producing certain documents to the SEC, and the legislative report on credit ratings was skeptical of the First Amendment claims of credit rating agencies.¹⁰⁶ This difference between credit rating agencies and other gatekeepers might be short-lived, as judicial doctrine shifts and rating agency lobbying becomes less effective. In other words, the primary reason for this difference might be that no authoritative body has carefully considered the question of credit rating agency liability.

¹⁰⁴ Although equity analyst opinions are typically thoroughly disclaimed today, those disclaimers were weaker before 2001.

¹⁰⁵ Moody’s 2005 Form 10-K, at 31-32.

¹⁰⁶ The report noted: “The fact that the market seems to value the agencies’ ratings mostly as a certification (investment grade v. non-investment grade) or as a benchmark (the ratings triggers in agreements) and not as information, and the fact that the law, in hundreds of statutes and regulations, also uses their work that way, seems to indicate that their ratings are not the equivalent of editorials in *The New York Times*. The fact that the rating agencies have received First Amendment protection for their work should not preclude greater accountability.” *Financial Oversight of Enron: The SEC and Private Sector Watchdogs*, Report of the Staff to the Senate Committee on Governmental Affairs, at 124, Oct. 8, 2002.

IV. Proposals

It follows from the discussion in Part III that policy solutions should address the reasons why credit rating agencies are not like other gatekeepers. The ideal proposals would reduce the benefits associated with regulatory licenses and impose a real threat of liability on credit rating agencies for malfeasance.

A. Reduce the Benefits of Regulatory Licenses

There are various ways to reduce the benefits associated with regulatory licenses. The simplest would be to remove the NRSRO designation. One preliminary question is whether the markets could function properly without this designation. Prior to the 1970s, they operated reasonably well, so there are reasons to think the markets and regulators could adapt to a system without NRSROs. It might be a difficult transition, as regulators would be forced to make the kinds of decisions they previously had made with respect to substantive regulation of financial market participants. They would no longer be able to delegate important authority and responsibility to NRSROs. For example, the SEC would need to decide how to assess the net capital requirements of broker dealers. Regulators would need to determine which bonds were appropriate for money market funds. The Basel 2 accords suggest that some regulators might have the ability to perform such tasks. Although Basel 2 relies in part on credit ratings, it also contains alternative mechanisms for determining bank capital requirements without reference to credit ratings.

However, while it might be a good idea to eliminate the NRSRO designation, it seems politically unlikely. A more plausible possibility is to find a replacement for NRSROs. There are three alternatives to the current regime. First, regulators could open the market to new NRSROs. Second, regulators could replace NRSROs with a market-based measure such as credit spreads or credit default swaps – or even an equity-based measure of credit risk. Third, regulators could replace the concept of recognition in the NRSRO regime with the concept of “registration” more familiar in securities regulation more generally. Recently introduced legislation has taken this last approach. Any of these approaches likely would be superior to the current regime.

1. Open the Market to New NRSROs

In April 2005, the SEC proposed new rules defining the term NRSRO.¹⁰⁷ The SEC suggested that one regulatory solution might be simply to approve more NRSROs. Moody's has indicated it would support proposed new rules opening the market to competition from other agencies.¹⁰⁸

One weakness of this approach is that simply adding NRSROs will not eliminate regulatory licenses. To the extent there are natural monopoly pressures in the credit rating industry, those pressures would persist. It is worth remembering that twenty years ago there were many more NRSROs, but consolidation in the industry reduced that number to three. If the credit rating industry is a natural monopoly, even if the SEC approves new NRSROs, the market will consolidate, unless antitrust regulators or other pressures prevent it from doing so.

Moreover, opening the market to new NRSROs also raises the question of which credit rating agencies will qualify for designation. The criteria the SEC has suggested should be the basis for assessing new NRSROs are problematic, and are likely to cement the current oligopoly structure.¹⁰⁹ Nor is it clear that opening the market to competition would generate any new informational value. Even absent consolidation, there is an argument that opening the market to competition could make regulatory licenses more important, by creating incentives for rate shopping among issuers. The SEC appears willing to screen new NRSROs, but it could not possibly police the ratings of approved NRSROs to determine if the conflicts of interest mentioned above were leading rating agencies to issue inaccurate ratings. Nor has the SEC suggested it would or should

¹⁰⁷ Definition of Nationally Recognized Statistical Rating Organization, SEC Release Nos. 33-8570, 34-51572; IC-26834; File No. S7-04-05 (Apr. 19, 2005).

¹⁰⁸ See Jeanne M. Dering, Executive Vice President, Global Regulatory Affairs, Moody's Corporation, Letter to the Editor, *Financial Times*, July 15, 2005, at 12 ("Contrary to Professor Partnoy's implication, Moody's endorses market-based levels of competition in the provision of credit rating opinions.").

¹⁰⁹ Requiring that NRSRO ratings be "publicly available" or "generally accepted in the financial markets" would cement the oligopoly enjoyed by current NRSROs. See Letter from Frank Partnoy, University of San Diego School of Law, to Jonathan G. Katz, Secretary, Commission (June 9, 2005); see also Testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law, Hearings before the United States House of Representatives, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, "Legislative Solutions for the Rating Agency Duopoly" (June 29, 2005).

perform that function. Overall, opening the market to new NRSROs seems a weak, and perhaps counterproductive, choice, even if it would be superior to the current approach.

If regulators decided simply to open the market to competition, they might improve that approach by including among new NRSROs one or more credit rating agencies that rated debt issues using a market-based measure. For example, a credit rating agency might simply follow credit spreads or CDS prices and issue alphabetical ratings based on market prices. The algorithm for converting credit spreads or CDS prices could be straightforward and transparent, perhaps even automated, based on a rolling average of credit spreads, the market prices of credit default swaps (which are becoming increasingly standardized), or even one of the equity-based methodologies currently used by the rating agencies themselves. The next section assesses these alternatives.

2. Replace NRSROs with Market-Based Measures

If regulators are attracted to the market-based approach, they might consider avoiding the problems associated with the NRSRO concept entirely by removing the NRSRO designation and replacing it with a market-based measure of credit risk. The SEC has been considering this proposal during recent years, although it has not yet endorsed it. The great advantage to a market-based measure is that it incorporates all available information into a rating, including the ratings of other credit rating agencies. Moreover, a market-based rating could be designed to be very timely, or to be lagged, based on a rolling average of data.

Indeed, Moody's already has done much of the work to generate market-based ratings. Moody's publishes "Market Implied Ratings" – known as MIRs – which reflect the market price of credit for various issues over time. Moody's argues that its ratings are superior to MIRs, but it is unclear if the reason for the difference between a Moody's credit rating and a MIR is the inability of the market to price credit risk accurately, or the inability of Moody's to reflect the risks associated with a particular issue in its ratings in a timely manner. Moody's argues it is the former, but the latter seems more likely given the evidence set forth in Part II.

There have been three areas of criticism surrounding the proposal that credit spreads would be a viable substitute for credit ratings. (Some of the same criticisms might be made regarding a proposal to use CDS or equity prices.) First, some critics have alleged that credit spreads would be more volatile than ratings.¹¹⁰ It certainly is true that credit ratings are, and are intended to be, more stable than daily fluctuations in the market. However, it is easy to limit the volatility of credit spreads simply by using a weighted average over time. Indeed, from a volatility perspective credit spreads are superior to credit ratings, because they enable the regulator to make an explicit choice about volatility, instead of leaving that decision to a handful of credit rating agencies, who do not appear to be contemplating the consequences of volatility in ratings in any systemic way.

Instead, the current approach actually magnifies volatility, by creating and then unleashing a wave of selling pressure following downgrades.¹¹¹ Because the rating agencies approach downgrades in an ad hoc manner, they become trapped in a situation where if they choose to downgrade an issue below investment grade, they potentially will force the insolvency of the issuer. Market-based ratings might avoid such problems, because market participants would be able to anticipate a downgrade with greater certainty in advance; such an approach might reduce the negative consequences associated with the human behavioral component of rating downgrades.

Moreover, information available in the market would be reflected over time more gradually through the use of credit spreads, so that institutional investors would be able to plan when they might need to sell bonds for regulatory purposes. In contrast, credit rating changes are a discrete event that often come as a great surprise to investors (as was

¹¹⁰ See SEC Report, at 39; see also Claire Hill, *Regulating the Rating Agencies*, 82 *Wash. U. L. Q.* 43, 85-86 (2004) (suggesting a “pure market measure” should be used only after the additional NRSROs have been approved and the NRSRO designation reconsidered).

¹¹¹ Professor Jon Macey has argued that issuers “capture” credit rating agencies, not because of these conflicts, but because “issuers make it impossible for rating agencies to downgrade them.” Jonathan R. Macey, *The Future Disclosure System: A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Rules Versus Enabling Rules*, 81 *Wash. U. L. Q.* 329 (2003) (noting that a downgrade below investment grade is particularly important because it can shut off a company’s access to capital and calling such a downgrade “a corporate nuclear bomb”).

the case with Enron, for example – the single largest daily decline in Enron’s share price, in percentage terms, was the drop immediately following the downgrade below investment grade).

In any event, it is unclear why, if there is negative information reflected in the market for particular bonds, that information should not be reflected in regulation, too. As a policy matter, if NRSRO-based regulations make sense, they might as well be based on accurate ratings. If particular bonds are likely to be in default soon, so that various institutions will need to sell them when they are downgraded, why shouldn’t that process begin sooner rather than later? What advantage was gained by waiting for the credit rating agencies to downgrade Enron, abruptly throwing the company into bankruptcy?

The second objection is that credit spreads are backward looking.¹¹² This objection is, to be blunt, preposterous. Numerous academic studies have shown that credit ratings are backward looking, much more so than markets, and the agencies admit as much. The advantage of credit spreads is that the regulator can make a decision as to how backward looking a measure they will use. Moreover, the markets for bonds, as well as the markets for CDSs and equities, incorporate information about future expectations. To the extent any measure is likely to be forward looking, it is a market measure, not an NRSRO rating.

The third objection is potentially more problematic: that the use of credit spreads or some other market-based measure would be limited to liquid securities. At the outset, it would be worth using such a measure for liquid securities, or at least giving regulated entities that option, even if on a temporary or experimental basis. With the development of the CDS market, there are market measures for many otherwise illiquid bonds. Critics are correct that there would be limitations as to illiquid securities, although it would be a straightforward exercise to calculate reasonable market estimates of credit spreads even for illiquid bonds. Indeed, Moody’s does precisely this with its market-based

¹¹² See The Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, Hearings Before the U.S. Securities and Exchange Commission (Nov. 15, 2002) (Fernandez testimony), available at <http://www.sec.gov/spotlight/ratingagency.htm> (“Spreads are the reflection of the last trade in the marketplace, and that market may be wrong on any given day about the long-term fundamental value, the probability of default or ultimate recovery value of any security.”).

comparisons, and both Moody's and Fitch use equity-based measures where bonds are not sufficiently liquid.

Objectors argue that market participants would manipulate any market-based measure, using it to their advantage, either for arbitrage or to take advantage of legal rules that depended on market-based ratings. However, it is unclear whether market participants would have greater incentives to manipulate market-based measures than NRSROs have to manipulate ratings. Moreover, if one market participant attempted to manipulate an issue through large amounts of buying or selling, that activity would both create liquidity and signal a potential arbitrage opportunity to other market participants. Market participants would not benefit from the NRSRO oligopoly, and therefore would face competition from other firms who could profit from attempts at price manipulation. The bond, CDS, and equity markets are far more competitive than the current market for NRSRO ratings.

Perhaps most importantly, a market-based proposal would remove perverse incentives to engage in CDO transactions. If CDOs create value overall, parties would continue to do them under a market-based alternative to NRSROs. But if CDOs are merely a complex exercise in manipulating mathematical models based on inaccurate ratings, they should disappear, or at least decline in number and importance.

Interestingly, Fitch has made several statements in its recent research that suggest market-based measures might be a more viable option than anyone previously had thought.¹¹³ Both Fitch and KMV, a unit of Moody's, use equity prices to make calculations regarding debt ratings. A market-based measure based on equity prices –

¹¹³ Consider the following statements: "In the light of the empirical findings and the observations on methodological issues, we conclude that market-based methodologies are superior to solely ratings-driven methodologies in estimating asset correlations. Market based methods address all of the aforementioned shortcomings of the latter category, and any possible systematic overestimation bias can easily be addressed with a calibration exercise." FitchRatings Structured Finance, Quantitative Financial Research Special Reports: A Comparative Empirical Study of Asset Correlations, July 14, 2005, at 19, available at <http://www.fitchratings.com>. "Correlations can be measured using credit spreads from either the bond market or the credit default swap market. One clear advantage of this approach, as in the case of equity-based correlations, is that the information is readily available in the market place." FitchRatings Structured Finance, Quantitative Financial Research Special Reports: A Comparative Empirical Study of Asset Correlations, July 14, 2005, at 3 (citing limited universe of credit default swap market coverage and lack of historical data coverage, and potential for liquidity and data quality concerns).

which the NRSROs already use – would not have many of the drawbacks the critics have suggested might apply to a regime based on credit spreads or CDS prices. Certainly, equity markets are more liquid and less susceptible to manipulation. Policymakers who reject the credit spread and CDS alternatives might consider whether an equity-based bond credit rating measure would be an attractive market-based alternative.

3. Replace “Recognized” with “Registered”

A third proposal, reflected in legislation introduced by Representative Michael G. Fitzpatrick (Pennsylvania), is to replace the concept of recognition in the NRSRO regime with the concept of “registration” familiar in securities regulation more generally.¹¹⁴ As initially proposed, this legislation would fundamentally alter the role of the SEC with respect to credit rating agencies. Instead of granting NRSRO designations, the SEC would oversee the registration of new credit rating agencies. It also would be involved in inspection, examination, and enforcement.¹¹⁵

S&P in particular has challenged this legislation on First Amendment grounds, repeating many of the arguments the rating agencies have made in private litigation. On June 29, 2005, at a House Financial Services subcommittee hearing on the new credit rating agency legislation, Floyd Abrams, the well-known First Amendment lawyer was present – and was recognized by the members of Congress – even though he was not scheduled to be a panelist, and did not testify. Abrams’s presence sent a clear message to members of Congress that the rating agencies likely would challenge the proposed legislation as unconstitutional. At the hearing, counsel for S&P argued that the bill would violate the First Amendment, because rating agencies are “members of the financial press.”¹¹⁶ And indeed S&P recently sent a memorandum, authored by Mr. Abrams, to the subcommittee staff arguing that the proposed legislation is unconstitutional.¹¹⁷

¹¹⁴ H.R. 2990, The Credit Rating Agency Duopoly Relief Act (2005).

¹¹⁵ This legislation is in some tension with the SEC Staff Outline, in which the Commission would continue to approve NRSRO status.

¹¹⁶ See Alec Klein, *Credit Raters Speak Against Oversight*, June 30, 2005, at A08.

¹¹⁷ This memorandum insists, incredibly, that Congress has no more power to regulate credit ratings than the publication of editorials in financial newspapers and magazines. See A

The legislation has many positives, and perhaps most importantly it presents a unique opportunity to confront the First Amendment argument head on. The question of whether ratings are merely opinions protected by free speech doctrine is sufficiently important that it should be litigated properly, and decided by the federal appellate courts. Unfortunately, private litigation has not yet generated any decisive cases and it remains unclear what protections credit rating agencies should receive. Whatever the courts decide, it is important to have some clarity, and this legislation appears to be the only possible route to that end.¹¹⁸

The most attractive feature of the legislation is that it would confront the regulatory license issue. Because the principal barrier to entry for credit rating agencies no longer would be SEC approval, market forces would be able to operate on NRSROs. Of course, to the extent the rating business is a natural monopoly, the market structure arising from a registration regime might not be that different from the current structure under a designation regime. But to the extent the overall securities system of registration makes sense, even if it reinforces some oligopolistic pressure, it ought to work equally well for credit rating agencies.

A registration system would be more consistent with the letter and spirit of the securities laws. In other words, the Commission would take the same approach to NRSROs that it has taken in other areas, pursuant to and consistent with Congressional authority. The legislation would permit the 130-plus non-NRSRO agencies to compete with current NRSROs, and it would create incentives for new rating agencies to enter the market. Perhaps most importantly, it would encourage new rating agencies to use market based measures in assessing companies.

Constitutional Analysis of H.R. 2990, at 2, 14-17 (2005), available at <http://www.standardandpoors.com/>. It also wrongly suggests that the question of whether rating agencies are distinguishable from other financial market gatekeepers, such as accountants, is settled law, citing *In re Scott Paper Securities Litig.*, 145 F.R.D. 366 (E.D. Pa. 1992). However, First Amendment experts have noted, to the contrary, that free speech protection in the securities area is narrow. See, e.g., Frederick Schauer, *The Boundaries of the First Amendment: A Preliminary Exploration of Constitutional Salience*, 117 Harv. L. Rev. 1765 (2004) (citing cases narrowly interpreting free speech protections).

¹¹⁸ To the extent a court followed the relatively narrow set of cases in which credit rating agencies are viewed exclusively as mere publishers, the legislation likely would survive any First Amendment scrutiny. Indeed, it would be difficult for a court to strike down a registration regime without calling into question the basis for securities regulation more generally.

B. Create a Threat of Liability for Rating Malfeasance

The final policy proposal is simple: make credit rating agencies liable for malfeasance, and limit the extent to which the First Amendment is deemed to protect their “opinions.” This could be done in two ways. First, courts could reject the agencies’ argument that their ratings are constitutionally protected speech. Here, the trends seem to be promising, notwithstanding the recent ruling in the Enron litigation. Judges are recognizing that the First Amendment protection of rating agencies is not qualified, not absolute, and depends on context. At minimum, CDO ratings do not appear to be protected.

The courts or Congress might mark the distinction emerging in some cases between agencies playing an active role as contrasted to the passive role of simply publishing an opinion. Ironically, the argument for constitutional protection is strongest with respect to unsolicited ratings, for which the agency is not paid and is not actively involved in either the structuring of the issue or an investigation of the issuer. In contrast, the agencies’ role in the CDO market is far less likely to be protected speech. Agencies play an active role in structuring CDOs, and their “opinions” with respect to CDOs are less public.

Overall, this policy prescription is simple: treat credit rating agencies like other gatekeepers. Credit rating agencies have become unique in various ways during the past decade. That should not have happened. The simplest way to reverse course would be to amend Section 11 and Regulation FD to include NRSROs, and to make it clear – whether through legislation or judicial decision – that credit rating agencies “opinions” are no different from the “opinions” of other gatekeepers.

V. Conclusion

Professor Coffee has suggested a four-part typology of rules to govern gatekeeper behavior: (1) structural rules, (2) prophylactic rules, (3) “empowerment” rules, and (4) liability rules. Following this typology for credit rating agencies, structural rules could be

designed to eliminate regulatory licenses by substituting alternatives, including market-based measures, to the current regime of NRSRO designation. Liability enhancing rules could make credit rating agencies liable for the same kinds of malfeasance as other gatekeepers, either by imposing negligence-based liability or a modified form of strict liability.¹¹⁹ Prophylactic or empowerment rules seem less likely to improve the current situation.¹²⁰ Proposals for new codes of conduct¹²¹ or voluntary approaches¹²² seem especially poorly suited to address the problems discussed here.

¹¹⁹ Strict liability would have advantages over negligence liability, because it would give gatekeepers appropriate incentives to investigate issuers rather than prepare legal defenses, and it would force issuers, assuming gatekeepers passed on the costs, to bear the expected social cost of fraud. It also would avoid the thicket of ex post adjudication that creates the incentives for dysfunctional gatekeeper behavior in the first place. See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. Rev. 301 (2004); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U.L. Rev. 365 (2004); John C. Coffee, Jr., *Partnoy's Complaint: A Response*, 84 B.U.L. Rev. 377 (2004).

¹²⁰ Prophylactic rules might include prohibitions on self-dealing or other conflicts of interest. For example, regulation might preclude rating agencies from taking fees from issuers, or rating firms related to their board members. The rating agencies have voluntarily implemented such prophylactic rules. It is hard to imagine that the credit rating agencies would be in need of "empowerment" rules, which would seek to give them greater leverage over issuers. "Empowerment" rules are directed at the problem that for the gatekeeper to be an effective monitor on behalf of investors, it must be independent of the issuer's management. Sarbanes-Oxley recognized this problem and transferred all responsibility for the hiring, supervision, retention, and compensation of auditors to the audit committee, whose own independence it also enhanced. This article has suggested that the power of S&P and Moody's over issuers already is too great and should be limited.

¹²¹ For example, in September 2004, S&P adopted a "Code of Practices and Procedures." Unfortunately, self-regulation seems unlikely to solve the central problems associated with the differences between credit rating agencies and other gatekeepers. S&P's Code is largely self-serving. It begins with a disclaimer, stating that "by making this Code available to the public Ratings Services does not assume any responsibility or liability to any third party arising out of or relating to this Code." Standard & Poor's Ratings Services Code of Practices and Procedures, Sept. 24, 2004. Its first set of provisions includes addition disclaimers and remarks that essentially are intended to protect S&P from civil and criminal liability. In Section 1.1.1 of the Code, S&P states that "Ratings are current opinions regarding creditworthiness and not verifiable statements of fact." Section 1.1.2 states, "Ratings do not constitute investment or financial advice. Ratings are not recommendations to purchase, sell, or hold a particular security." Section 1.1.3 states, "Ratings Services relies on the issuer, its accountants, counsel, advisors and other experts for the accuracy, completeness and timeliness of the information submitted in connection with the rating and surveillance process." Section 1.1.4 states, "Ratings Services is not obligated to perform any due diligence or independent verification of information submitted to, or obtained by, Ratings Services in connection with the rating and surveillance process." Even the provisions directed at minimizing conflicts of interest are modest. Section 3.3.2 provides that analysts should not be involved in the negotiation of fees with issuers.

In sum, credit rating agencies will continue to present unique difficulties until regulators address the ways in which those agencies differ from other gatekeepers. Credit rating agencies are more profitable than other gatekeepers and at least as subject to conflicts of interest, particularly in the CDO market. They benefit from regulatory licenses and limitations on liability more than other gatekeepers. This article has suggested that reforms directed at credit rating agencies should reflect these differences between the agencies and other gatekeepers. Specifically, regulators should consider market-based alternatives to the NRSRO regime, as well as approaches that would make NRSROs liable for malfeasance, just like any other gatekeeper.

¹²² On December 23, 2004, the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) published a voluntary Code of Conduct Fundamentals for Credit Rating Agencies (“IOSCO Code”). The IOSCO Code is not binding on credit rating agencies, and does not carry the threat of sanction. It reflects two years of deliberation, and does little more than what the agencies already have done with respect to conflicts of interest. The Committee of European Securities Regulators (“CESR”) has produced a similarly toothless set of recommendations.