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Publication Date

2005-04-25

REGULATING THE RATING AGENCIES

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*“If you want to see a grown man cry ask him about Thailand’s 7.75% issue of 2007, rated A/A3 back in May [of 1997].”*¹

I. INTRODUCTION

Until four days before Enron declared bankruptcy, its debt was still rated “investment grade” by the major credit rating agencies, suitable as a safe investment for a conservative investor. Rating agencies purport to be experts in appraising the quality of debt. Clearly, four days before Enron declared bankruptcy, its debt was actually “junk.” The furor over Enron, WorldCom, and other recent debacles has led to calls for regulatory change in a number of industries. The rating agency regulatory regime is being revisited as part of this effort.² This Article seeks to evaluate what changes to the rating agency regulatory regime are appropriate.

The major rating agencies—Moody’s Investor Services, Standard and Poor’s, and Fitch—rate debt instruments and companies. A debt instrument’s rating principally reflects whether the instrument is likely to be repaid on a timely basis, and, increasingly, the amount that might be recovered should the instrument default. The rating agencies’ terminology, and in particular, the designation for the highest rating category, AAA, has entered into everyday parlance; high quality items of all sorts are not infrequently referred to as AAA rated.

* Associate Professor and Norman and Edna Freehling Scholar, Chicago-Kent College of Law. Thanks to Jeff Bauman, Bernie Black, Margaret Blair, Scott Faga, Mike Frankel, Tamar Frankel, Jeff Gordon, Robert Haft, Kate Litvak, Don Langevoort, Frank Partnoy, Clarissa Potter, Steve Salop, Supriya Sarnikar, Warren Schwartz, Mike Seidman, Christopher Yoo, and the participants at the Canadian Law and Economics Association Conference, the AALS Business Associations Section, the Levy Workshop at George Mason University School of Law, the Olin Workshop and a Faculty Workshop at Georgetown University Law Center, and a faculty workshop at Chicago-Kent College of Law, where I presented this paper, and also to the participants at the University of Connecticut Law School Symposium *Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron*, where I presented a related paper on Enron. Thanks also to Ameeta Patel, GULC Class of ‘03 and McDonough School of Business Class of ‘03, and Micah Thorner for excellent research assistance. I also wish to acknowledge generous financial support from the Georgetown-Sloan Project on Business Institutions.

1. *Rating Agencies Caught With Their Pants Down*, EUROMONEY, Jan. 15, 1998, at 51.

2. *Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws*, Securities Act Release Nos. 8236, 47972, 68 Fed. Reg. 35258 (June 12, 2003), <http://www.sec.gov/rules/concept/33-8236.htm> (last visited April 5, 2004) [hereinafter SEC Concept Release].

The four highest rating categories, from AAA to BBB-, are termed “investment grade.” Below-investment-grade categories start at BB+ and continue down to D. The regulatory regime requires or encourages various entities—broker-dealers, banks, money-market funds, insurance companies, trust companies, pension funds, and many others—to purchase financial instruments rated investment grade. But the favorable regulatory treatment is available only if the agency issuing the rating is designated by the SEC as a Nationally Recognized Statistical Rating Organization (NRSRO).³ Until very recently, there were only three NRSROs—Moody’s, Standard & Poor’s, and Fitch—with Moody’s and Standard & Poor’s dominating the market. On February 24, 2003, the SEC approved a fourth NRSRO, Dominion Bond Rating Service Limited.⁴ Favorable treatment for securities highly rated by NRSROs is the principal feature of the regulatory regime; the NRSROs themselves are not subject to substantive monitoring.

While the impetus for regulatory change is the Enron debacle, the SEC characterizes the process more broadly as a continuation of a preexisting project to review the regulatory regime applicable to rating agencies.⁵ Consideration is being given to issues such as whether rating agencies should be subject to substantive monitoring by the SEC and whether and how the NRSRO designation process should be changed.⁶ Dispensing with NRSRO designation altogether is also being considered.⁷

While the regime could be improved, it is certainly not in dire need of repair. Rating agencies certainly didn’t do a spectacular job with Enron, but there is considerable evidence that in the normal course, they do a good, if not stellar, job. The rating agencies also have apparently learned some lessons from Enron and its aftermath. The main problems regulatory change could address are those resulting from market concentration in the rating agency industry. The price of ratings may not be as low, and the quality of ratings may not be as high, as would be the case if the industry were more competitive. But the rating agencies are not completely

3. *Id.*; UNITED STATES SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 6–9 (Jan. 24, 2003), <http://www.sec.gov/news/studies/credratingreport0103.pdf> (last visited April 5, 2004) [hereinafter SEC REPORT].

4. Dominion Bond Rating Serv. Ltd., SEC No-Action Letter (Feb. 24, 2003), <http://www.sec.gov/divisions/marketreg/mr-noaction/dominionbond022403-out.pdf> (last visited April 5, 2004).

5. SEC Concept Release, *supra* note 2.

6. *Id.*

7. *Id.*

unconstrained as to price or quality. Potential competition serves as a constraint, as does the specter of increased regulatory scrutiny. Potential competitors themselves are another matter: they are probably the most clearly hurt by the present regime, as they face considerable barriers to entry.

Given the impetus for regulatory reform, we should take the opportunity to make a workable system better. Regulatory reform should do what it can to encourage a less concentrated market structure. To that end, the SEC should permit provisional, location-specific, and industry-specific NRSRO designations, and revisit in several years the decision to continue being in the business of certifying rating agencies.

Notwithstanding any efforts the SEC makes, significant market concentration may remain. Markets presently value rank-ordering of all debt offerings on one single metric, and may continue to do so. It is possible that only large firms with a (preferably longstanding) reputation for credibility and expertise can feasibly provide such a service. With size and age conferring significant advantages, it's not easy for a new rating agency to be established or gain a significant presence in the market. Recognizing that the market may still remain quite concentrated, regulatory reform should also encourage rating agencies to be more responsive to the needs of market participants. One promising suggestion contemplates creation of a public forum in which market participants would comment on rating agencies' performance.⁸

Less promising are suggestions to begin regulatory oversight of rating agency business operations, and to increase the ability of investors and others to sue rating agencies, insofar as these aim to improve "lax"—that is, shoddy—rating agency performance.⁹ These types of mechanisms tend to be far more effective at addressing conflicts of interest and gross negligence than laxity. And it's not just that the benefits of these mechanisms are low; the costs may also be high, especially the costs of frivolous litigation.

Conflicts of interest may become a significant problem, especially if the market becomes much less concentrated. Among the solutions that

8. *The Current Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*, Hearing Before the U.S. Sec. and Exch. Comm'n (Nov. 15 and Nov. 21, 2002) [hereinafter *The Current Role*] (statement of Amy Lancellotta, Senior Counsel, Investment Company Institute), <http://www.sec.gov/news/extra/credrate/investcoinstit.htm> (last visited April 5, 2004) and (testimony of Cynthia Strauss, Director of Taxable Bond Research, Fidelity Investments Money Management, Inc.), at <http://www.sec.gov/news/extra/credrate/credrate111502.txt> (last visited April 5, 2004). See also SEC Concept Release, *supra* note 2, Question 31.

9. SEC Concept Release, *supra* note 2, Questions 28–30; 32–35.

should be considered is an annual certification by rating agencies that they are operating in accordance with procedures to guard against conflicts.

This Article proceeds as follows. Part II provides background information about rating agencies and gives a brief history and description of the rating agency regulatory regime and the changes being considered. The part also considers the extent to which the rating agencies compete against each other. Part III appraises rating agency performance. How good a job do rating agencies do? Does issuer willingness to pay for ratings, and market willingness to accept lower interest rates on rated securities, reflect value that rating agencies provide? If so, what is the source of that value? Do ratings merely provide favorable regulatory treatment, or do they also provide information? Part III discusses some answers to these questions. Part IV discusses the case for reform of the regulatory regime applicable to rating agencies and appraises reform proposals. Part V concludes.

II. HISTORY AND BACKGROUND OF RATING AGENCIES AND THE REGULATORY REGIME

A. *History of the Rating Agencies*¹⁰

In 1909, John Moody formed the first rating agency, the predecessor to the present-day Moody's Investor Service.¹¹ Starting in the early 1900s, industries began to need more capital than they could raise through "relational" means; rating agency ratings helped investors who did not know the people involved in a business venture to appraise the costs and benefits of investing in the venture.¹² The predecessor of Standard &

10. My discussion of the history of rating agencies owes considerably to Richard Sylla, *An Historical Primer on the Business of Credit Ratings* [hereinafter Sylla], in RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 19 (Richard M. Levich et al. eds., 2002) [hereinafter RATINGS], and Richard Cantor & Frank Packer, *The Credit Rating Industry*, 19 FED. RESERVE BANK OF NEW YORK Q. 1 (1994) [hereinafter Cantor & Packer, *Credit Rating Industry*]; my discussion of the regulatory history owes considerably to Richard Cantor & Frank Packer, *Multiple Ratings and Credit Standards: Differences of Opinion in the Credit Rating Industry* [hereinafter Cantor & Packer, *Multiple Ratings*], in 12 FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS 3-5 (1996); Frank Partnoy, *The Paradox of Credit Ratings* [hereinafter Partnoy, *Paradox*], in RATINGS, *supra*; and Lawrence White, *The Credit Rating Industry: An Industrial Organization Analysis* [hereinafter White], in RATINGS, *supra*. I also draw on Roy C. Smith & Ingo Walter, *Rating Agencies: Is There An Agency Issue?* [hereinafter Smith & Walter], in RATINGS, *supra*.

11. Sylla, *supra* note 10, at 24.

12. See Sylla, *supra* note 10, at 24 (discussing why the information-supplying role fell to the new rating agency rather than the investment banks that had been underwriting and distributing securities).

Poor's was formed in 1916 by the Poor company.¹³ The Poor company itself was founded by Henry Poor as a provider of information about the first types of bonds widely sold, railroad bonds.¹⁴ As Sylla recounts the history, Poor's "merged with Standard Statistics, another information and rating company, in 1941, to form Standard & Poor's. In the 1960s, the company was taken over by McGraw Hill, the publishing giant."¹⁵ Fitch, which began rating bonds in 1924,¹⁶ has a history a bit more convoluted than its two competitors. It is presently owned by a French conglomerate, FIMALAC, and is an amalgam of several smaller agencies: Fitch, IBCA, Duff & Phelps, and Thomson BankWatch, an agency specializing in rating banks.¹⁷

Throughout the 1900s, the importance of rating agencies ebbed and flowed. However, beginning in the 1970s, Penn Central and other major defaults led to an increasing focus by both issuers and investors on the safety of debt instruments; rating agency ratings became far more sought after.¹⁸ In 1996, Thomas Friedman, a well-known columnist for the New York Times, famously characterized Moody's as one of the two superpowers in the world, the other superpower being the United States.¹⁹

While most people would consider Friedman's statement an exaggeration,²⁰ that Moody's and Standard & Poor's are enormously powerful presences in the financial markets is not in question. It is almost impossible to do a public offering of bonds without getting a rating from one, and often both, agencies; even private offerings are not infrequently rated. As Senator Joseph Lieberman noted:

The credit raters hold the key to capital and liquidity, the lifeblood of corporate America and of our capitalist economy. The rating affects a company's ability to borrow money; it affects whether a pension fund or a money market fund can invest in a company's bonds; and it affects stock price.²¹

13. *Id.*

14. *Id.*

15. *Id.*

16. Cantor & Packer, *Multiple Ratings*, *supra* note 10, at 4.

17. White, *supra* note 10, at 46, 58; See FITCH RATINGS, FITCH CORPORATE: HISTORY, at <http://www.fitchratings.com/corporate/aboutFitch.cfm?detail=2> (last visited April 5, 2004).

18. See Cantor & Packer, *Credit Rating Industry*, *supra* note 10, at 4.

19. Interview with Thomas Friedman, *The MacNeil/Lehrer Newshour* (PBS television broadcast, Feb. 13, 1996).

20. See, e.g., Partnoy, *Paradox*, *supra* note 10, at 66 (characterizing Friedman's statements as "patently absurd").

21. *Rating the Raters: Enron and the Credit Rating Agencies: Hearing Before the Senate Comm. on Governmental Affairs*, 107th Cong. 116 (2002) [hereinafter Lieberman Hearings] (statement of

Indeed, not only are most bonds traded on the public markets rated by both Moody's and Standard & Poor's, most industrial companies themselves are also rated by both agencies.²² By one account, Moody's rates seventy-eight percent of the industrial companies in the United States; Standard & Poor's rates sixty-six percent.²³ More evidence at least of Moody's prominence is its market capitalization: shortly after being spun off from Dun and Bradstreet Corporation²⁴ its market capitalization grew to six billion dollars.²⁵

Rating agencies rate the quality of debt and companies. The best rating possible is AAA (or Aaa); an investor can rest almost completely assured that an instrument rated AAA will pay principal and interest as scheduled.²⁶ The next best is AAA-, the next best is AA+, and so on. Any rating between AAA and BBB- is investment grade; the rating agency thinks that the obligor has at least a good, if not an excellent, capacity to repay principal and interest on the instrument as and when due. Any debt instrument rated below BBB- is considered speculative grade or "junk."²⁷ In addition to giving initial ratings, the agencies also monitor their ratings on an ongoing basis, upgrading and downgrading as they deem appropriate

Joseph Lieberman, Chairman, Comm. on Gov. Affairs), <http://govt-aff.senate.gov/032002lieberman.htm> (last visited April 5, 2004) (quoted text reflects official version).

22. See *New Interests, New Conflicts*, THE ECONOMIST, Apr. 14, 2001, Finance and Economics, at 2001 WL 7318498 [hereinafter *New Interests, New Conflicts*]. A few other statistics are worth noting: Standard & Poor's rates 99.2% of the bonds and preferred stock publicly traded in the United States. See *Rating the Rating Agencies: The State of Transparency and Competition: Hearing Before the Capital Mkts. Subcomm. of the House Fin. Servs. Comm.*, 108th Cong. 219-30 (2003) [hereinafter *Capital Markets Hearings*] (comments of Vickie A. Tillman, Executive Vice President, Standard & Poor's Credit Mktg. Serv.), <http://financialservices.house.gov/media/pdf/108-18.pdf> (last visited April 5, 2004). Moody's rates over 90% of the public market in bonds rated Aaa to Baa. MOODY'S.COM, PRODUCTS & SERVICES brochure - Corporate Research, at http://www.moody.com/cust/prodserv/prodserv_detail.asp?p=11&c=1 (last visited April 6, 2004).

23. See *New Interests, New Conflicts*, *supra* note 22, at 1. As discussed in the text accompanying note 17, the present Fitch is an amalgamation of several smaller agencies, the largest of which were Fitch and Duff & Phelps. Pre-amalgamation, the two agencies rated, in the aggregate, twenty percent of the United States' industrial companies. See Melvin Westlake, *Rating Agencies: Three's Company*, THE BANKER, Dec. 1, 2003, at 150 [hereinafter *Rating Agencies*].

24. Dun and Bradstreet acquired Moody's in 1962 and spun it off in 2000. Moody's Investor Services is currently an independent, publicly traded company (NYSE:MCO).

25. Partnoy, *Paradox*, *supra* note 10, at 65.

26. A very small percentage of AAA rated instruments do default; the default rate over a 15 year period for instruments rated AAA by Standard & Poor's was 0.52%. *The Current Role*, *supra* note 8 (comments of Leo C. O'Neil, President of Standard & Poor's), at <http://www.sec.gov/news/extra/credrate/standardpoors.htm> (last visited April 5, 2004).

27. The probability of default on a junk bond is high. For bonds rated CCC by Standard & Poor's, the probability of default over a 15-year period was 54.38%. *Id.* The probability of default is significant even for BB-rated bonds (almost the least "junky" of junk bonds): approximately 19.52% defaulted over a 15-year period. *Id.*

(and putting ratings on “credit watch” when they think a change in ratings may soon be warranted).

When rating agencies first came into existence, they rated only particular debt issues.²⁸ Now they also rate many different types of financial instruments, including those issued in “structured finance” transactions, highly complex debt transactions warranting their own category. Structured finance transactions are typically ratings-driven: most transactions are structured precisely to achieve a particular (high) rating.²⁹ Indeed, a structured finance transaction will almost never go forward unless some of the securities sold in the transaction achieve a high investment grade rating.³⁰ But some traditional debt transactions may proceed with lower, non-investment grade ratings. In some instances, the lower ratings will be unsolicited. But a firm might want to get such a

28. See Sylla, *supra* note 10, at 24. In fact, the first bonds rated were railroad bonds. *Id.* See also SEC REPORT, *supra* note 3, at 98.

29. STANDARD AND POOR’S, U.S. LEGAL CRITERIA FOR STRUCTURED FINANCE TRANSACTIONS, LEGAL CRITERIA OVERVIEW: GENERAL OVERVIEW (Apr. 1, 2002), at <http://www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp%2FPage%2FSiteSearchResultsPg&l=EN&r=1&b=10&search=site&vqt=legal+criteria+overview> (last visited April 6, 2004); see also Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 664–70 (1999) [hereinafter Partnoy, *Two Thumbs Down*]. Some commentators, including Partnoy, have criticized ratings-driven transactions on grounds that the transaction “ought” in some sense to drive the rating and not the other way around. See, e.g., Partnoy, *Two Thumbs Down*, *supra*, at 664–70. But the criticism is less valid than might initially appear to be the case. If the rating agencies are mistakenly favoring or encouraging a type of transaction—that is, they are treating the transaction more favorably than its fundamentals warrant—the criticism ought to be not that the transaction is ratings-driven but that its treatment is incorrect. If, by contrast, the rating agencies have identified a set of features that make a transaction easy and appropriate to rate as high quality, the endeavor does not seem so problematic. Investors look for transactions whose quality they can verify easily; the rating agencies work with the transaction structurers to create transactions as to which the rating agencies can cost-effectively give the investors the information they want. In traditional transactions, the rating agencies rate “what’s there.” In structured finance transactions, the rating agencies are able to work with the parties to create “what’s there”—to create an instrument with desirable attributes. Note that my remarks here are not applicable to abusive variants of structured finance transactions that were used in Enron.

Another ratings-driven practice is more problematic: when a company creates an instrument designed to be treated as equity by the rating agencies, but which has many of the characteristics of debt. Again, the problem is not that the practice is driven by the rating but that the rating agencies may be “getting it wrong.” Rating agencies, like many other entities, have to draw a line between debt and equity. This line is notoriously difficult to draw. In an exceedingly familiar dynamic, great energy is devoted to developing an instrument “just on the right side of the line.” Nobody has a great solution to this problem, but some lines—and perhaps the particular debt/equity line drawn by the rating agencies—are more easily gamed than others. Here, perhaps, more competition among rating agencies will lead to better results as more sophistication and nuance, and less of a mechanical approach, are brought to bear on the determination of a company’s debt and equity levels.

30. Structured finance transactions involve issuances of different classes of securities, some of which are more senior than the others. The most senior classes are investment grade, while the most junior classes may be below-investment-grade or unrated.

rating if it were higher than what the market might otherwise have thought. Recall that the rating agencies rate issuers (the companies issuing the debt) as well as debt issues. The issuer of a debt instrument might be rated BB; if the instrument contained sufficient structural protections, it might achieve a higher rating, BB+ or perhaps even higher.³¹

B. Who Pays the Rating Agencies and How Much Money Do They Make?

When rating agencies first came into existence, they earned their revenue from subscriber fees.³² As photocopying and other technology developed and became progressively cheaper, it became impossible to keep one subscriber from giving or selling information to others; thus, the major rating agencies switched business models, relying less on subscriber fees and obtaining the bulk of their revenue from the companies they rated.³³ Moody's estimates that fees paid by issuers for ratings comprise ninety percent of its revenues.³⁴

Some commentators have argued that the major rating agencies' business models have inherent conflicts of interest.³⁵ When firms pay for their own ratings, rating agencies might be tempted to give inflated ratings. Firms could threaten to take their business elsewhere if they don't get the desired rating, or they can offer to pay more in exchange for a higher rating. But many, if not most, commentators think that rating agencies' concern for their reputations will override their susceptibility to influence of this type. If markets think a firm can get a high rating just by paying for it, ratings won't be valued. Firms then won't pay much, if

31. "The practice of differentiating issues in relation to the issuer's fundamental creditworthiness is known as notching. Issues are notched up or down from the corporate rating level. Notching guidelines . . . take into account the degree of risk/confidence with respect to recovery." STANDARD AND POOR'S, CORPORATE RATINGS CRITERIA 57 (November 13, 2003) [hereinafter, CRITERIA], at <http://www2.standardandpoors.com/spf/pdf/fixedincome/CorpCrit2004.pdf> (last visited April 5, 2004) (page number is to adobe file page).

32. SEC REPORT, *supra* note 3, at 41; Cantor & Packer, *Credit Rating Industry*, *supra* note 10, at 4.

33. *Id.* The smaller agencies, however, do not depend on issuer fees to the same extent. For instance, the agency specialized in rating insurance companies, A.M. Best, gets about sixty percent of its revenues from publications, data, and subscriptions, and LACE Financial obtains ninety percent of its fees from subscribers. See *The Current Role*, *supra* note 8 (testimony of Larry Mayewski, Executive Vice President and Chief Rating Officer, The A.M. Best Company), <http://www.sec.gov/news/extra/credrate/credrate112102.txt> (last visited April 5, 2004) and (statement of Barron Putnam, President and Financial Economist, LACE Financial Corporation), <http://www.sec.gov/news/extra/credrate/lacefinancial.htm> (last visited April 5, 2004).

34. See MOODY'S CORP. SERVICES, 2002 ANNUAL REPORT 16 (2003).

35. See generally Smith & Walter, *supra* note 10; Cantor & Packer, *Credit Rating Industry*, *supra* note 10, at 4.

anything, to get ratings; rating agencies will become far less profitable and may even fail.³⁶ I largely agree with the argument that firms have generally not been able to pressure rating agencies into giving them higher ratings. That being said, as I discuss in Part IV, *infra*, there remains at least the potential for an Arthur Andersen-style conflict, insofar as rating agencies are increasingly offering ancillary services.³⁷ Indeed, if rating agency provision of ancillary services becomes more common, or if, either on account of regulatory reform or for some other reason, there come to be many more rating agencies, conflicts of interest may become a much more important issue.

Rating agency ratings on debt securities are usually solicited by the issuer of the debt. Sometimes, though, the rating agency rates debt without being solicited to do so. In such cases the issuer typically does not pay for the rating.³⁸

Standard and Poor's "as a matter of policy . . . assigns and publishes ratings for all public corporate debt issues over \$50 million—with or without a request from the issuer."³⁹ Fitch gives unsolicited ratings on a case-by-case basis; it began doing so to counter the perception that it was in the business only of giving inflated ratings to a company after Moody's

36. See, e.g., 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> (last visited April 5, 2004) (providing empirical evidence that "rating changes do not appear to be importantly influenced by rating agency conflicts of interest but, rather, suggest that rating agencies are motivated primarily by reputation-related incentives."). See also Cantor & Packer, *Credit Rating Industry*, *supra* note 10, at 4.

37. The provision of ancillary services might give rating agencies an incentive to compromise their ratings just as it apparently gave accounting firms the incentive to compromise their audits. Firms can exploit this incentive by threatening to give the rating agencies less ancillary business unless they get the desired ratings. On the role of such 'low-visibility sanctions' in the accounting context, see John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 CORN. L. REV. 269, 292 (2004) [hereinafter Coffee]; Jeffrey Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1237-38 (2002) [hereinafter Gordon]. See also note 37, *infra*, and accompanying text, and notes 180-184, *supra*, and accompanying text.

38. There have, however, been several newsworthy instances in which recipients of unsolicited ratings received bills and were "strongly encouraged" by agencies to remit payment. See, e.g., Penelope Lemov, *The Ruckus Over Ratings*, GOVERNING MAGAZINE, July 1996, at 26 [hereinafter Lemov].

39. CRITERIA, *supra* note 31, at 15. The publication defines public transactions as "those that are registered with the SEC, those with future registration rights, and other 144A deals that have broad distribution." *Id.* Dominion sometimes gives unsolicited ratings as well; its rationale is akin to Standard & Poor's rationale. See *The Current Role*, *supra* note 8 (testimony of Greg Root, Executive Vice President of Dominion), <http://www.sec.gov/news/extra/credrate/credrate111502.txt> (last visited April 5, 2004).

or Standard & Poor's refused to give an issuer the rating it desired.⁴⁰ Moody's had historically given unsolicited ratings; however, in response to strong criticism, it has apparently largely abandoned the practice, giving such ratings now only for high-yield junk bonds.⁴¹ The issue of unsolicited ratings is being revisited as part of the present regulatory change initiative.⁴²

Moody's and Standard & Poor's are quite profitable, as far as can be determined.⁴³ Standard & Poor's is a division of McGraw-Hill, and profit figures are not released separately.⁴⁴ But Moody's' profit margins have been as high as fifty percent,⁴⁵ leading one analyst to characterize Moody's as "the best franchise [he's] ever covered in [his] 20 years on Wall Street."⁴⁶ The same analyst estimated that S & P "has margins of a lower, but still enviable, 30 percent."⁴⁷ Fitch, like Standard & Poor's, is wholly owned by a private company,⁴⁸ its profits are therefore similarly

40. In a letter to issuers in October 1995, Fitch explained that it was planning to issue unsolicited ratings in order to "[c]hange the misperception that our ratings are higher than those of our competitors, which has resulted from our previous policy of only rating upon request of the issuer." *Fitch To Publish Unsolicited Corporate Ratings*, ASSET SALES REP., Oct. 30, 1995, at 1, available at 1995 WL 6919605. Indeed, empirical evidence had also suggested that Fitch ratings were higher than those issued either by Standard & Poor's or Moody's. See Cantor & Packer, *Multiple Ratings*, *supra* note 10, at 27 (summarizing research that suggested on average, Fitch assigned higher ratings than did Moody's or Standard & Poor's).

41. See *The Current Role*, *supra* note 8 (testimony of Ray McDaniel, President of Moody's Investor Serv.), <http://www.sec.gov/news/extra/credrate/credrate112102.txt> (last visited April 5, 2004); see also *id.* (testimony of Stephen Joynt, President and Chief Executive Officer, Fitch, Inc.); STAFF OF THE COMM. ON GOVERNMENTAL AFFAIRS, FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, S. PRT. NO. 107-75, at 21-22 (COMM.PRINT OCT.7,2002), at <http://govt-aff.senate.gov/100702watchdogsreport.pdf> (last visited April 5, 2004) [hereinafter ENRON COMMITTEE PRINT] (page numbers reflect official committee print).

42. SEC Concept Release, *supra* note 2.

43. "[T]here is at least circumstantial evidence that the ratings business is a very good business to be in. Since Standard & Poor's is part of a broad-gauge publisher whose divisional earnings are not publicly available, and since Fitch is privately held, only the publicly held Moody's Corporation shows any relatively "clean" evidence of profitability. For the year 2000, following the firm's launch in the market, shares showed a total return of almost 52% in a flat or declining market, trading in February 2001 at a P/E of 21.57 with a return on assets exceeding over 40%." Smith & Walter, *supra* note 10, at 305.

44. See THE MCGRAW-HILL COMPANIES, 2003 INVESTOR HANDBOOK, at http://media.corporate-ir.net/media_files/nys/mhp/reports/factbook03.pdf (last visited April 5, 2004).

45. Leslie Wayne, *Credit Raters Get Scrutiny and Possibly a Competitor*, N.Y. TIMES, Apr. 23, 2002, at C10 (quoting Bear Stearns analyst Kevin R. Gruneich).

46. *Id.*

47. *Id.* I discuss this matter in *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145 (2003) [hereinafter Hill, *Rating Agencies Behaving Badly*]. See also Lynn Hume, *Regulation: Don't Give Up NRSROs, Groups' Lawyers Tell SEC*, THE BOND BUYER, Nov. 22, 2002, at 24.

48. See FITCH RATINGS, FITCH CORPORATE: OVERVIEW, at <http://www.fitchratings.com/>

impossible to determine. There is some reason, though, to suppose that it is less profitable than the other two. Its market share is far smaller, its market position is apparently far weaker, and its fees have been estimated by some market participants to be appreciably less than those of Moody's and Standard & Poor's.⁴⁹

C. *The Regulatory Regime*

Starting in 1931, and continuing through the 1990s, regulations have been enacted that encourage or require many different types of institutional investors, such as banks, trust companies, pension funds, insurance companies, and money market funds, to prefer investment grade debt over debt that is less highly rated or unrated.⁵⁰ Certain types of investors are required to invest all or some proportion of their funds in investment-grade debt.⁵¹ Others are subject to lower capital reserve requirements if their portfolios consist of more investment-grade debt.⁵² Debt rated investment grade generally has more marketability, liquidity, and a lower interest rate than otherwise identical debt that is not so rated.

Issuers of securities rated investment grade may be able to use simplified securities offering documents.⁵³ And there are other statutes or regulations that confer benefits for issuance or purchase of investment grade securities, at both the Federal and state level.⁵⁴

Starting in 1975, the regulations favoring rated securities specified that the ratings at issue be obtained from a "nationally recognized statistical rating agency," designated as such by the SEC.⁵⁵ The NRSRO requirement

corporate/aboutFitch.cfm?detail=1 (last visited April 5, 2004); see also Smith & Walter, *supra* note 10, at 300-01.

49. My source for this information is conversations with various market participants.

50. Lieberman Hearings, *supra* note 21, at 131-36 (prepared statement of Isaac C. Hunt, Jr., Commissioner of the Securities and Exchange Commission [hereinafter Hunt Prepared Statement]), <http://govt-aff.senate.gov/032002hunt.htm> (last visited April 5, 2004). See generally Partnoy, *Paradox*, *supra* note 10, at 68-77; Cantor & Packer, *Credit Rating Industry*, *supra* note 10, at 5-8.

51. *Id.* Note that a few of the pertinent statutes deny favored regulatory treatment to instruments that are at the lowest quality end of the investment grade range. A statute might provide that the treatment is only available for instruments in, for instance, one of the three highest investment grades (that is, no lower than A-). See Cantor & Packer, *Credit Rating Industry*, *supra* note 10 at 6.

52. *Id.* Lieberman Hearings, *supra* note 21, at 131-37 (Hunt Prepared Statement); *Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934*, Exchange Act Release No. 39457, 62 Fed. Reg. 67940-01 (Dec. 17, 1997), <http://www.sec.gov/rules/proposed/34-39457.txt> (last visited April 5, 2004).

53. See Form S-3 of the Securities Act of 1933, Instructions I. B. 2 and 5.

54. *Id.* Partnoy, *Paradox*, *supra* note 10, at 75; SEC Concept Release, *supra* note 2, at n.3 and accompanying text.

55. The NRSRO designation was introduced in connection with Rule 15c-3, the rule setting forth

was adopted in response to credit crises in the early 1970s.⁵⁶ The result, according to Frank Partnoy, was to “freeze” the then existing rating agencies and “severely limit the possibilities for new entrants.”⁵⁷ Since the NRSRO requirement went into effect in 1975, the SEC has designated only eight agencies as NRSROs, with the eighth agency obtaining the designation in February 2003; over the years, several entities merged into either Fitch or Moody’s, resulting in the present state of affairs in which only four rating agencies have the designation.⁵⁸

The extent to which the SEC is responsible for the small number of NRSROs is open to debate. Certainly, the procedure to become an NRSRO is opaque. There are no statutes or regulations establishing either the substantive or procedural requirements for an entity to become an NRSRO. The SEC responds that the substantive requirements, while not adopted in a regulation, have been published in a proposed rule and are well known.⁵⁹ The SEC is inclined to attribute the paucity of NRSROs to natural market forces.⁶⁰ The Egan-Jones rating agency has provided what

the deduction from net worth (“haircut”) a broker dealer must make for certain securities to assess his compliance with the net capital rule. Lieberman Hearings, *supra* note 21, at 132 (Hunt Prepared Statement) (“The Commission determined that it was appropriate to apply a lower haircut to securities held by a broker-dealer that were rated investment grade by a credit rating agency of national repute because those securities typically were more liquid and less volatile in price than those securities that were not so highly rated.”). But the NRSRO designation has been carried over to the remainder of the statutes requiring or encouraging investment in highly rated securities. Hunt notes that “over time, as the reliance on credit rating agency ratings increased, so too did the use of the NRSRO concept.” *Id.*

56. Partnoy, *Paradox*, *supra* note 10, at 74.

57. *Id.*

58. Capital Markets Hearings, *supra* note 22 (Testimony of Annette L. Nazareth, Director, U.S. Securities and Exchange Commission Division of Market Regulation), <http://financialservices.house.gov/media/pdf/108-18.pdf> (last visited April 5, 2004)

59. They note too that statutes in other jurisdictions for analogous designations have requirements similar to the SEC’s requirements. See *The Current Role*, *supra* note 8; BANK FOR INTERNATIONAL SETTLEMENTS, CREDIT RATINGS AND COMPLEMENTARY SOURCES OF CREDIT QUALITY INFORMATION 43–44 (2000) [hereinafter CREDIT RATINGS INFORMATION].

60. The following is dialogue between Representative David Scott (D-GA), and Annette Nazareth (director of the division of market regulation for the SEC), excerpted from a hearing held on April 2, 2003 on rating agencies before the Capital Markets Subcommittee of the House Financial Services Committee:

REP. SCOTT: Well, why have there not been any new rating agencies designed [sic] in the last 10 years? Do you see that as a problem?

MS. NAZARETH: I guess I have to put it in the context of how many have applied as well. Again, we think there are some natural barriers to entry here. There have not been that many applications. As you may know, at one point we were up to seven and because of consolidation in the industry, those seven who had been designated went down to three. And I would say in the last ten years we probably had about four or five additional rating agencies who had applied who did not receive the designation. We have currently three or four that are pending.

Capital Markets Hearings, *supra* note 22, at 20, <http://financialservices.house.gov/media/pdf/108->

may be the most visceral anti-SEC comments in this debate. A principal of the agency said that an SEC official told him: “We won’t tell you the criteria [for obtaining NRSRO designation], otherwise you might qualify.”⁶¹

The value of being an NRSRO has risen over time; increasing numbers of regulatory schemes have incorporated requirements for investment grade ratings by NRSROs. Furthermore, as Partnoy notes, besides formal regulation, there is also “formal and informal reliance by particular regulatory agencies who—in their day-to-day business—issue letters, orders, releases, and rules that depend on NRSRO ratings.”⁶² The demand for ratings by an NRSRO is thereby increased. Exacerbating the effect, many institutional investors are encouraged by institutional norms, embedded in guidelines, forms, and practices, to buy securities rated investment grade by one or more NRSROs. While the main beneficiaries of these guidelines, forms, and practices are Moody’s and S&P, the broader effect is to increase the demand for and the value of NRSRO ratings generally.

As noted above, notwithstanding its use in various statutes and regulations, the term NRSRO has not been officially defined, nor have criteria for NRSRO designation been formally adopted.⁶³ The SEC staff considers a number of criteria, the most important of which is that the agency be “nationally recognized” for the reliability of its ratings.⁶⁴ Hence the often remarked upon Catch-22: an agency has to be nationally recognized to be an NRSRO but has to be an NRSRO to become nationally recognized. The staff also looks at the following factors:

- (1) [T]he organizational structure of the rating organization;
- (2) the rating organization’s financial resources . . . ;
- (3) the size and experience and training of the rating organization’s staff . . . ;
- (4) the rating organization’s independence from the companies it rates;
- (5) the rating organization’s rating procedures . . . ; and
- (6) whether

18.pdf (last visited April 5, 2004). The term “natural” understood broadly might be considered to encompass some of the features I characterize as historical and institutional.

61. *Exclusion Zone: Regulators Promise a Belated Review of the Ratings Oligopoly*, THE ECONOMIST, Feb. 8, 2003, at 65 [hereinafter *Regulators Promise a Belated Review*]. One applicant for NRSRO status, LACE Financial, reported that it was contacted twice in eight years about the application. The first time, in 1992, was to acknowledge its receipt. The second time, in 2000, was to reject the application. See Jenny Wiggins, *A Chance to Step Into the Light*, FIN. TIMES, Dec. 9, 2001, at IT 10 [hereinafter Wiggins].

62. Partnoy, *Paradox*, *supra* note 10, at 75.

63. See Lieberman Hearings, *supra* note 21 (Hunt Prepared Statement), <http://govt-aff.senate.gov/032002hunt.htm> (last visited April 5, 2004).

64. *Id.*

the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed.⁶⁵

In 1997, the SEC proposed codifying these criteria, as well as a process for a rating agency to appeal the denial of the NRSRO designation. The SEC did not act on the proposal.⁶⁶

The current regulatory regime applicable to rating agencies principally serves to give favorable treatment to securities highly rated by an NRSRO. The regime doesn't scrutinize rating agency performance with a view toward imposing penalties for bad performance. Neither, it seems, do courts. Litigation against rating agencies has not been successful; Partnoy notes that "the only common element [in cases against rating agencies] is that the rating agencies win."⁶⁷ In one of the few cases to get beyond the preliminary stages, *Quinn v. McGraw-Hill*, the Seventh Circuit found against an individual attempting to sue Standard & Poor's for negligent misrepresentation and breach of contract for an investment that was initially A rated, then downgraded to CCC, and defaulted soon afterwards.⁶⁸ The Seventh Circuit characterized reliance on a Standard & Poor's rating as "unreasonable"⁶⁹—perhaps not the ideal characterization from the rating agency's perspective but far preferable to a finding of liability. Relatedly, ratings have been deemed "opinions" and therefore protected speech under the First Amendment.⁷⁰ There is also an exemption

65. *Id.* It's worth noting, too, that all of these criteria, except the national recognition one, relate to inputs in the process and not outputs. Some critics, including, most recently Professor Lawrence White, in his testimony before the House Subcommittee on Capital Markets, *supra* note 22, <http://financialservices.house.gov/media/pdf/108-18.pdf>, have argued that any certification should depend on outputs (that is, performance). While the principle behind the pro-output position is unassailable, any concrete proposal must avoid the present Catch-22 situation. So long as NRSRO designation exists, a new applicant will likely be limited in its ability to generate output sufficient to judge its capabilities.

66. See Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 39,457, 66 SEC Docket 254 (Dec. 17, 1997). See also Lieberman Hearings, *supra* note 21, at 135–36 (Hunt Prepared Statement), <http://govt-aff.senate.gov/032002hunt.htm> (last visited April 5, 2004). Preceding the 1997 proposal was a 1994 concept release, *Nationally Recognized Statistical Rating Organizations*, Securities Act Release Nos. 7085, 34616, 59 Fed. Reg. 46314-01 (Sept. 7, 1994), <http://www.sec.gov/rules/concept/34-34616.pdf> (last visited April 5, 2004).

67. Partnoy, *Paradox*, *supra* note 10, at 79.

68. *Quinn v. McGraw-Hill*, 168 F.3d 331 (7th Cir. 1999).

69. *Id.* at 336.

70. See *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.*, 988 F. Supp. 1341, 1348 (D. Colo. 1997), *aff'd*, 175 F.3d 848 (10th Cir. 1999) (holding that Moody's' unsolicited rating of the plaintiff's bond issue was merely an opinion, and protected expression under the First Amendment). See also Partnoy, *Paradox*, *supra* note 10, at 79.

from liability under Section 11 of the Securities Act of 1933.⁷¹ Rating agencies apparently don't have much to fear from litigation.

71. The exemption is just for NRSROs, the agencies whose ratings are most likely to be used in a Securities Act registration statement and hence would be most likely to face Section 11 liability.

[T]he 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.

Rule 436(g)(1) of the Securities Act of 1933, 17 C.F.R. § 230.436(g)(1) (2003).

D. Recent Regulatory Initiatives

The outcry in the wake of the Enron debacle has accelerated rating agency regulatory reform efforts. At various times in 2002 and 2003, there have been hearings in Congress and at the SEC. On January 24, 2003, the SEC issued a "Report on the Role and Function of Credit Rating Agencies in the Operation of Securities Markets."⁷² The report contemplated the publication of a Concept Release in 60 days and proposed rules a reasonable time thereafter.⁷³ The SEC's Concept Release was actually issued on June 4, 2003, and invited comments by July 28, 2003.⁷⁴

One hearing on the rating agencies was held before the Subcommittee on Capital Markets of the House Financial Services Committee on April 2, 2003.⁷⁵ As a result of the hearing, Richard Baker, the Chairman of the subcommittee, wrote a letter to the new SEC Chairman, William Donaldson asking for answers to a number of questions by June 4, 2003.⁷⁶ The questions included the following: "[I]sn't it true that NRSROs are not subject to the checks that either competition or the threat of legal accountability [referring to the exemption from liability granted under Rule 436(g) of the Securities Act of 1933] would provide?"; "[H]ow might the Commission eliminate the barriers to entry that it has created and foster a competitive environment for this industry?"; and "Why has the Commission not heeded the recommendation from the Department of Justice? [that requiring that a rating agency be (nationally) recognized created a nearly insurmountable barrier to entry]?"⁷⁷ It seems that the Committee was quite influenced by some of the testimony given, particularly that of a prominent academic, Lawrence White, of NYU's Stern School of Business, who argued that the SEC should not be in the business of certifying rating agencies.⁷⁸

The tone of the Baker letter to Donaldson, as well as the outcry over Enron, might seem to suggest that radical changes are imminent. However,

72. SEC REPORT, *supra* note 3.

73. *Id.*

74. SEC Concept Release, *supra* note 2, at 1.

75. Capital Markets Hearings, *supra* note 22, <http://financialservices.house.gov/media/pdf/108-18.pdf> (last visited April 5, 2004).

76. Letter from Representative Richard H. Baker, Chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, to William Donaldson, Chairman, SEC (Apr. 10, 2003), <http://financialservices.house.gov/media/pdf/04-10-03cra.pdf> [hereinafter Baker Letter] (last visited April 5, 2004).

77. Capital Markets Hearings, *supra* note 22, at 3, 5, 8-9, <http://financialservices.house.gov/media/pdf/108-18.pdf> (last visited April 5, 2004).

78. *Id.* at 5; *see generally id.*

the history of rating agency regulation suggests otherwise.⁷⁹ Indeed, while the language of the release suggests that radical change is “on the table” it also reveals a lack of consensus on the direction and goal of change.⁸⁰ The release begins by requesting comment on the possibility of abandoning the NRSRO designation altogether.⁸¹ It next requests comments on a proposal that is as pro-regulation as the abandonment of NRSRO status is anti-regulation: keeping the designation and perhaps imposing more hands-on oversight of NRSRO designated agencies.⁸² In the latter vein, the release also requests comments as to whether the NRSRO designation should be conditioned on an NRSRO abstaining from or limiting various practices that have been argued to be problematic, including “encouraging” payment for unsolicited ratings.⁸³ Also mentioned in the release is a proposal to solicit public comment on an annual or other regular basis as to rating agency performance.⁸⁴ The release also asks how potential conflicts of interest involving rating agencies might be best addressed.⁸⁵ The release asks a total of 56 questions, encompassing every conceivable issue relating to rating agencies.⁸⁶

79. Even the declaration of bankruptcy by Orange County, at a time when its short-term debt was rated by Moody’s and S & P as being of the highest quality (December 6, 1994), did not yield any reforms, notwithstanding cries of a volume and magnitude comparable to those elicited by Enron. See Ted Jackson, *Too Late to Help; Some Say Bond Rating Firms Don’t Act Until After the Damage is Done*, CHI. TRIB., June 26, 1995, at C1.

80. See SEC Concept Release, *supra* note 2. See also Alec Klein, *A New Look at Rating Firms; SEC Considers Cracking Down or Backing Off*, WASH. POST, June 7, 2003, at E2. Klein noted:

[P]utting together the report, which was expected in March, turned out to be more complicated than expected. The five-member commission had been battling around the concept release for weeks, wrestling over the nuances of language, according to sources familiar with the matter. The commission divided over ideological lines, the sources said, with the three Republicans arguing to emphasize less regulation and the two Democrats calling for more.

81. *Id.* at 4.

82. *Id.* at 7.

83. SEC Concept Release, *supra* note 2, at 14.

84. *Id.*

85. *Id.* at 8.

86. *Id.*

E. The Rating Agency Industry

1. Market Structure Generally

Even before the regulations providing for NRSRO designation came into existence, there were never a large number of non-specialist rating agencies. As White says, “a striking fact about the structure of the industry is the persistent fewness of incumbents. There have never been more than five general purpose bond rating firms.”⁸⁷ Indeed, in recent times, and until early 2003, there were only 3 NRSROs: Standard & Poor’s, Moody’s, and Fitch Investor Services. As discussed above, Fitch is an amalgam of smaller rating agencies merged in order to become a more formidable competitor to Standard & Poor’s and Moody’s.⁸⁸ Thus far, however, its market share is still a great deal smaller: Moody’s and Standard & Poor’s have a combined market share in excess of 80%, while Fitch’s market share is approximately 14%.⁸⁹ Aside from Fitch, there are a number of other rating agencies, both general purpose and specialized, but, as the above numbers suggest, they are quite small relative to Moody’s and Standard & Poor’s.

2. Dominance of Moody’s and Standard & Poor’s

The numbers set forth in the preceding sub-Part understate the market position of Moody’s and Standard & Poor’s. Issuers typically attempt to obtain both Moody’s and Standard & Poor’s ratings, and very occasionally use Fitch as a third rating. Fitch may, for instance, be used for a third rating if Moody’s and Standard and Poor’s disagree.⁹⁰ It is rare that Fitch

87. See White, *supra* note 10, at 41. However, there have been specialist firms. A notable example is Thomson BankWatch, acquired by Fitch, which specialized in rating banks and financial institutions. The maximum number of NRSROs, including specialist firms, has thus far been 7. See *The Current Role*, *supra* note 8. It will be interesting to see the effect of globalization on the rating agency industry. Moody’s and Standard & Poor’s are also the dominant players globally, although their dominance is not completely overlapping: Standard & Poor’s is more prominent in Latin America and Moody’s is more prominent in Asia. There are small rating agencies throughout the world that specialize geographically and by industry sector. See CREDIT RATINGS INFORMATION, *supra* note 59, at 34–37. The proposed Basel Accords (the international capital-adequacy standards for banks) would continue to embed rating agency ratings as part of the capital-adequacy determination. Interestingly, the Basel drafters are also grappling with the issue of rating agency “certification,” the analogue to the U.S. NRSRO designation. THE BASEL COMMITTEE ON BANKING SUPERVISION, A NEW CAPITAL ADEQUACY FRAMEWORK (1999).

88. See *Rating Agencies*, *supra* note 23.

89. See Wiggins, *supra* note 61, at IT 10.

90. See White, *supra* note 10, at 47, 48.

is used as a second rating, and even rarer that it is used as the only rating.⁹¹ There is, in effect, a two-rating norm, where the two ratings are those of Moody's and Standard & Poor's.

Once established, this norm easily persists. Consider a typical purchaser of rated bonds, such as a money management firm with clients on whose behalf it is investing. The individuals making the day-to-day investment decisions have guidelines, practices and "form" documents, all providing for purchase of debt instruments rated by Standard & Poor's and Moody's, from which they don't have reason to deviate. The firm that created the guidelines, practices and forms also has no strong reason to change them. Moreover, the incentive structures of the individuals within the firm tend to discourage efforts at form-changing.⁹² Such incentive structures may reflect the firm's desire to keep transaction costs low.

Moreover, insofar as the guidelines, practices, and forms establish process-based standards that use a well-accepted measure of safety for investment decisions, the firm may also be seeking to streamline lawsuits by disappointed clients on whose behalf it made losing investments. Indeed, courts have remarked with favor on an investor's due diligence process that includes use of ratings by Moody's and Standard & Poor's.⁹³ Finally, many money management firms are judged by how well they

91. See Cantor and Packer, *Multiple Ratings*, *supra* note 10; Jewell & Livingston, *infra* note 117. See also note 114, *infra*.

92. See Claire A. Hill, *Theory Informs Business Practice: Why Contracts Are Written In "Legalese"*, 77 CHI.-KENT L. REV. 59, 70-74 (2002), where I explore these incentives. Furthermore, the ease with which computers permit changes to forms may paradoxically entrench the two rating norm. Because the practice of "marking up" a form may now be done 'automatically,' there may be less opportunity for specific provisions to be questioned and changed than was the case where drafters went through forms "manually," considering at each juncture what to change and what to keep.

93. In *George T. Glennie v. Abitibi-Price Corp.*, 912 F. Supp. 993, (W.D. Mich. 1996), the court stated:

[E]ven though the ratings of Standard & Poor's and Moody's are not *per se* determinative of prudence, they are significant factors in deciding whether an investment is prudent. That is, the ratings are important information that a fiduciary should consider in deciding whether a particular GIC [guaranteed investment contract, a type of investment vehicle] should be purchased for plan participants. This would be especially true of low ratings; a fiduciary of a plan would almost certainly violate the fiduciary duty if the fiduciary caused the plan to purchase a GIC in an insurance company with ratings below "investment grade." Consistently high ratings from the ratings agencies are also important. In the instant case, even though there were two downgrades of MBL [the life insurance company from which the GIC was purchased] in the months preceding February 14, 1991, and even though these downgrades and other reports pointed out MBL's exposure to non-performing mortgages and real estate, the downgrades and reports are balanced with favorable comments about MBL. Even considering the exposure, the ratings remained "investment grade." Further, as previously noted, even after the 1990 downgrades, MBL fit into the Plan's ratings guidelines.

Id. at 1002. See also Partnoy, *Paradox*, *supra* note 10, at 78-80 (citing a line of cases countenancing use, if not reliance, on rating agency ratings).

perform relative to particular indices; the indices are composed of debt chosen by reference to Moody's and Standard & Poor's ratings. As much as they might like to exceed the indices, money management firms (and the individual money managers) cannot reliably do so. They are far better off trying to do no worse. The best strategy to do no worse is to mimic the relevant index.⁹⁴ And even parties who are simply seeking to hold funds temporarily rather than attempting to earn a return, such as parties holding funds in escrow, are subject to, and help to perpetuate, the norm: guidelines, practices, or documentation (or, probably, all three) governing funds held in escrow arrangements may provide that the funds are to be invested in securities that are highly rated by Moody's and Standard & Poor's.

Just as the buyer of debt securities has no incentive to violate the two-rating norm, neither does the buyer of the rating—the issuer of the debt securities and its CEO. Rating agencies' fees, while perhaps supra-competitive, pale in comparison to the size of most rated debt offerings. A CEO may be second-guessed if he does not get two ratings and the offering is disappointing; a downside for not abiding by the norm is far more likely than any upside from flouting it. Probably most importantly, the second rating may very well pay for itself in the form of more advantageous financing rates.

Should the two-rating norm show some sign of eroding, Moody's and Standard & Poor's can reinforce it by threatening to issue ratings the issuer has not solicited, using only the information publicly available. The implicit threat is always that without an issuer's active participation in (and payment for) the rating, the issuer will not be given an opportunity to rebut any negative inferences that might be made from the public information.⁹⁵

94. The incentive applies both for firms and for the individual money managers within the firms. If a group of managers perform at the same level, even the same low level, there is no performance-based reason to fire any one manager. If, however, the manager attempts to outperform other funds by maintaining a risk level above the norm, he may perform worse than those funds, which would distinguish him from the herd, and expose him to being fired. See Judith Chevalier and G. Ellison, *Career Concerns of Mutual Fund Managers*, 114 Q. J. ECON. 389 (1999). See also Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation For "Dirty Pooling" and Some Other Types Of Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 176–77 (1997).

95. To be sure, rating agencies are limited in their ability to use unsolicited ratings strategically. First, there is potentially a reputational cost, although the cost is almost certainly less at the lower end of the quality spectrum, where unsolicited ratings may be concentrated, than at the higher end, since lower quality assessments are notoriously difficult to make. Furthermore, markets may correct for a rating they determine is too low, giving the issuer the more favorable financial terms they think the issuance deserves. When markets know a rating is unsolicited (and there is some dispute as to whether unsolicited ratings are always clearly designated as such), they may even apply some sort of rebuttable

How might such a norm have come about? Perhaps one firm thought to use two ratings to signal that it had nothing to hide. Others followed suit, and before long a norm had developed. This conclusion follows most readily if markets think a second rater is well situated to detect something the first rater may have missed. Nevertheless, even if the markets believed that the second rating provided almost no information other than the company's willingness to expose itself to additional scrutiny, the norm might very well have arisen. That the two ratings specified by the norm are Moody's and Standard & Poor's is not surprising, given the agencies' long history, size, and prominence.⁹⁶

3. *Competition Among Rating Agencies*

As noted in sub-Part C, *supra*, many commentators believe that the regulatory regime applicable to rating agencies discourages competition. A recent article in *The Economist* stated, “[I]f there is a lack of competition, the SEC is largely to blame.”⁹⁷ However, a good argument can be made that the market may not be able to accommodate many general-purpose agencies. Pre-NRSRO history provides some support for this argument. Moreover, consider the information the rating agencies are providing: a comparison of a great many bond issues (or companies) along one quality metric. Lawrence White compares ratings with the Scholastic Achievement Test (SAT) used by colleges in their admissions processes.⁹⁸ The greater the number of bond issues or companies, the more useful the comparison is, and the more difficult it is for any company other than a very large one, preferably with an established reputation, to make.

Whatever the cause of the entry barriers, standard economic theory

presumption that the rating is too low. But if the instrument is given a below-investment grade rating, even undeservedly, the resultant lack of marketability and liquidity will still affect its value.

96. However one believes the norm to have developed, it is unclear why the equilibrium would settle where it has, at two ratings, one from Moody's and one from Standard & Poor's. A plausible explanation is that the two ratings offer issuers the best net pricing from markets—that is, the most advantageous interest rates net of fees paid in connection with the offering—because markets, not believing that the third rating provides much information, don't give a discount at least equal to the price of the third agency's fees.

97. *Regulators Promise a Belated Review*, *supra* note 61, at 65.

98. Capital Markets Hearings, *supra* note 22, at 150 (testimony of Lawrence White citing his article on regulation of rating agencies), <http://financialservices.house.gov/media/pdf/108-18.pdf> (last visited April 5, 2004). The SAT analogy might be seen to support the “natural monopoly” position taken by the SEC; White, however, thinks more competition can and should be introduced into the rating agency industry. White seems more inclined to assign responsibility to the SEC for Moody's and Standard & Poor's market position; as I discuss in the text, in my view, the SEC and features of the market—natural, historical, and institutional—share responsibility.

would suggest that their existence, especially in an industry with very few players, would lead to less vigorous competition than would be the case if there were fewer entry barriers and more players. Certainly, Moody's and Standard & Poor's don't need to compete with each other for business in their traditional markets; given the fact that issuers typically get both Moody's and Standard & Poor's ratings, neither can realistically supplant the other. Their high profit margins may suggest that they don't compete much on price either.

But Moody's and Standard & Poor's do seem to compete in new markets where the norm of obtaining two ratings has not yet arisen or become entrenched, notably including some non-U.S. markets.⁹⁹ In such markets, one rating agency could actually capture business at the expense of another. Alternatively, if there were to be two ratings, a local agency might be the second agency used. These new markets don't yet have sufficient history for extensive data to exist on rating agency performance. It will be interesting to compare rating agency performance in these more contested markets with performance in the United States.¹⁰⁰

Fitch, by contrast, competes quite aggressively. One strategy has been to carve out a niche for itself in structured financing; its market share in structured financing is far higher than its market share for traditional bond issuances.¹⁰¹ Another strategy may be to compete on price and some related non-price terms. Anecdotal evidence exists that Fitch is cheaper, and easier to deal with during the ratings process, than are Moody's and Standard & Poor's.

But another strategy may have been to give more favorable ratings. Indeed, empirical evidence exists that Fitch's ratings are more favorable in many instances.¹⁰² Anecdotal accounts also suggest that the market perception, too, is that Fitch gives higher ratings. The obvious shortcomings of competing in this manner may suggest a non-regulatory reason why entry into the credit-rating industry has thus far been difficult--

99. See CREDIT RATINGS INFORMATION, *supra* note 59, at 33–43; see also *supra* note 87.

100. Interestingly, in (at least) one part of the structured finance market, private label mortgage securities, there apparently has been some real competition between Moody's and Standard & Poor's. The competition took the form of a reduction in required credit enhancement levels (and an apparently strategic use of unsolicited ratings). Fitch (and Duff and Phelps) also played a role; Fitch in particular was apparently able for a time to become the second agency used, paired with Moody's, when it entered the market requiring credit enhancement levels appreciably lower than those required by Standard & Poor's. See generally Cantor & Packer, *Credit Rating Industry*, *supra* note 10, at 20–21. It seems likely that buyers of these securities are particularly sophisticated; they therefore may have less need for the imprimatur provided by obtaining both a Moody's and a Standard & Poor's rating.

101. Cantor & Packer, *Credit Rating Industry*, *supra* note 10, at 19–20.

102. *Id.* at 16. Cantor & Packer, *Multiple Credit Ratings*, *supra* note 10, at 27.

and why entry might remain difficult even if regulatory barriers were reduced or eliminated.

Moody's and Standard and Poor's don't compete on their willingness to give high ratings. Empirical work shows that when Moody's and Standard & Poor's rate an issue differently, neither consistently rates higher than the other.¹⁰³ Markets, too, perceive the two agencies as conservative, and comparably so, in their ratings practices. Indeed, there is some empirical evidence that the two have become more conservative over the years.¹⁰⁴

III. APPRAISING RATING AGENCY PERFORMANCE

A. *Disputing the Regulatory License View*

How well do rating agencies perform? Ratings are supposed to provide information about the quality of a rated security. That issuers are willing to pay for ratings, and that investors are willing to accept lower interest rates for rated securities, might indicate that rating agencies do a good job providing valuable information. But some scholars are quite critical of rating agencies. Indeed, one scholar, Frank Partnoy, has taken an extreme position: ratings principally serve to provide favorable regulatory treatment, and have virtually no informational content.¹⁰⁵ “[T]he rating agencies have thrived, profited and become exceedingly powerful by selling regulatory licenses, the right to be in compliance with various rules and regulations,”¹⁰⁶ he argues. Referring to the *Quinn* case discussed in the preceding Part, he says: “[T]he irony is clear; at the same time virtually every financial regulator in the United States is relying substantively on credit ratings, a few smart judges in Chicago are saying such reliance *by an investor* is unreasonable.”¹⁰⁷

Evidence for Partnoy's position includes the following:

103. See generally Cantor & Packer, *Multiple Credit Ratings*, *supra* note 10 (suggesting that Standard & Poor's and Moody's ratings are comparably conservative, with Duff & Phelps and Fitch being less conservative). See also CREDIT RATINGS INFORMATION, *supra* note 59, at 174–75. Interestingly, Cantor & Packer, *Credit Rating Industry*, *supra* note 10, at 14–15, also mention some smaller rating agencies whose ratings were (as of the time the article appeared, 1994), lower than Moody's and Standard & Poor's. One is McCarthy, Crisanti, and Maffei, since merged with Duff & Phelps (and later, Fitch); the other is Dominion Bond Rating Service, a Canadian agency which was approved by the SEC as an NRSRO in February of 2003.

104. See Marshall Blume et al., *The Declining Credit Quality of U.S. Corporate Debt: Myth or Reality?* 53 J. FIN. 1389 (1998).

105. Partnoy, *Paradox*, *supra* note 10.

106. *Id.* at 80.

107. *Id.*

(a) A significant portion of investors are subject to the regulations at issue, regulations that require or encourage purchase of debt instruments rated investment grade by an NRSRO.¹⁰⁸ Therefore, instruments that aren't rated investment grade by an NRSRO have far fewer potential buyers than instruments that are so rated.

(b) Most purchasers of rated debt instruments are sophisticated institutional investors who do their own investigation into the instruments.¹⁰⁹

(c) Some survey data suggests that investors and issuers consider the informational value of ratings to be quite low.¹¹⁰

(d) Ample anecdotal evidence suggests that rating agencies are considered to be particularly uninformative when they downgrade or upgrade a debt issue:¹¹¹ they downgrade once market participants have become aware that a downgrade is warranted, as happened in Enron, the Asian Flu,¹¹² and other notorious debacles.¹¹³

In my view, Partnoy overstates the case. While favorable regulatory treatment is clearly an important part of the value of obtaining ratings, ratings must be doing more.¹¹⁴ Recall that firms routinely purchase two

108. See *supra* text accompanying notes 50–56.

109. See ENRON COMMITTEE PRINT, *supra* note 41, at 53–55 (page numbers reflect official committee print).

110. In a recent study, 63% of institutional investors surveyed said that they rely more on their internal credit ratings analyses than the analyses of the credit rating agencies. See H. Kent Baker & Sattar A. Mansi, *Assessing Credit Rating Agencies by Bond Issuers and Investors*, 29 J. BUS. FIN. & ACCT. 1367 (2002). Another study revealed that 43% of investors surveyed believed that ratings were not issued on a timely basis by the rating agencies, and twenty percent of issuers and thirteen percent of investors surveyed believed that rating agencies often or usually misstated risk. See David M. Ellis, *Different Sides of the Same Story: Investors' and Issuers' Views of Rating Agencies*, 7 J. FIXED INCOME 35, 41–44 (1998). In yet another survey, 40% of financial professionals surveyed believed that changes in their company's ratings were not timely, and 29% of practitioners who work with companies with rated debt believed that their companies' ratings were inaccurate. See ASSOCIATION FOR FINANCIAL PROFESSIONALS, RATING AGENCIES SURVEY: ACCURACY, TIMELINESS, AND REGULATION 2 (Nov. 2002), at http://www.afponline.org/Information_Center/ratings_survey.pdf (last visited April 5, 2004).

111. See *supra* note 110.

112. The "Asian Flu" is a nickname given the serious economic recessions suffered by a number of Asian countries in 1997, commencing with the fall of the Thai baht.

113. See, e.g., Peter Thal Larsen & Jenny Wiggins, *Bond Investors Berate Agencies*, THE FINANCIAL TIMES, Jan. 14, 2002, at C&FI 22; Jennifer Morris, *Investors Turn Cool on the Rating Game*, EUROMONEY, Jan. 1, 2002, at 38; Tim Reason, *Not Trigger Happy*, CFO MAG. Feb. 21, 2002, <http://www.cfo.com/Article?article=6640> (last visited April 5, 2004) [hereinafter Tim Reason].

114. There is one significant exception to this statement: a structured finance deal structured for a particular investor who is studying the deal closely. The investor may not need any information about the deal, and may not even be subject to guidelines that require him to buy highly rated instruments; he may just be buying the favorable regulatory treatment. In such cases, just one rating may be obtained, and perhaps a Fitch rating rather than a Moody's or S & P rating.

ratings, and indeed, routinely purchase those ratings from the agencies that may very well charge the most, Moody's and Standard & Poor's. While some of the regulations at issue require two ratings,¹¹⁵ most require only one.¹¹⁶ And that one rating (or one of two ratings, if two are required) could come from Fitch; such a rating probably costs appreciably less to obtain than does a rating from Standard & Poor's or Moody's. If companies were mainly buying the regulatory treatment—that is, the ability to sell their debt instruments to investors required or encouraged to buy NRSRO-rated investment-grade debt—they would not pay much more than was necessary to obtain that treatment. Moreover, Partnoy is hard pressed to explain empirical evidence that markets react differently to debt with two ratings than with one, and that they react more favorably to debt with Moody's and Standard & Poor's ratings than to debt with a rating by Fitch and one other agency and more favorably to debt with a rating only by Moody's or Standard & Poor's than one by Fitch.¹¹⁷

More evidence that favorable regulatory treatment is not the main reason why issuers get ratings is that issuers seek ratings even when they expect the ratings to be below investment grade. One example, discussed in Part II.B, *supra*, is when an issuer with a low rating issues debt with structural protections that raise the debt's rating above the issuer's own rating, but still below investment grade. Recall that the favorable regulatory treatment is only accorded to instruments rated investment grade. If the regulatory treatment were the main benefit ratings offered,

115. For instance, broker-dealers can keep lower capital reserves for commercial paper, nonconvertible debt securities, and nonconvertible preferred stock in which they hold proprietary positions if the instruments are rated investment grade by at least two NRSROs. 17 C.F.R. § 15c3-1(c)(2)(vi)(E) (2003) (commercial paper); 17 C.F.R. § 15c3-1(c)(2)(vi)(F) (2003) (nonconvertible debt securities); and 17 C.F.R. § 15c3-1(c)(2)(vi)(H) (2003) (preferred stock).

116. A buyer might still want the second rating to increase the security's liquidity, so he can sell to a buyer who did need the second rating. But these types of securities are not very actively traded.

117. One finding is that where Moody's and Standard & Poor's both give the same rating, investors accept less of a return than they do where there is only one rating, or a rating by either Moody's or Standard & Poor's accompanied by a second rating from Fitch. Where the two ratings differ, which occurs for about seventeen percent of all debt issues with two ratings, there have been different findings as to how the market price is affected. Some studies find that the market prices the issue at the average rating; others find that the market prices issues above investment grade at the lower rating and issues below investment grade at somewhere between the average rating and the lower rating. See Cantor & Packer, *Multiple Ratings*, *supra* note 10; Jeff Jewell & Miles Livingston, *Split Ratings, Bond Yields, and Underwriter Spreads*, 21 J. FIN. RES. 185, 185–204 (1998) [hereinafter Jewell & Livingston]. Evidence exists that there's more of a discount for split ratings in the investment-grade range than in the non-investment-grade range. One argument made to explain these findings is that investment-grade investors are more conservative than non-investment-grade investors. See John R. M. Hand et al., *The Effect of Bond Rating Agency Announcements on Bond and Stock Prices*, 47 J. FIN. 733 (2003).

obtaining a below-investment grade rating would be almost a complete waste of money. The ability to sell bonds to investors subject to the NRSRO-favoring regulatory regime thus can't be all—or, I would argue, even most—of the value of ratings. Rather, markets also value ratings for the information the ratings provide. Indeed, consistent with the view that ratings are providing valuable information, voluminous empirical evidence suggests that in the normal course, rating agencies do fairly well in gauging the relative quality of the financial instruments and firms they rate. The higher rated an instrument, the less likely it is to default and the longer it is likely to take to default.¹¹⁸

Rating agencies do particularly well when it comes to initial ratings. Where they seem to do worse, and where they have been most vociferously criticized, is in their ongoing ratings¹¹⁹—their upgradings and downgradings. Consider Enron, WorldCom, the Asian Flu, and the many other examples where, it seems, downgrades came much too late. But in the agencies' defense, upgrading and downgrading ratings is a great deal harder than rendering an initial rating.

Ratings downgrades represent a thorny analytic problem. Wholly correct downgrading is a theoretical and practical impossibility. The very fact of the downgrade has an effect; even if no information about the present financial situation of the company is being conveyed, investors will react. They may be required to sell some portion of their holdings for regulatory reasons. The company may have "ratings triggers" in some of its financing documents, which permit its investors (including its bank lenders) to take action against the company if its debt's rating falls below a certain level. The types of actions might include acceleration of the debt, calling a default, or increasing the debt's interest rate.

Whether or not there are ratings triggers, a downgrade will probably cause all the company's sources of financing to closely scrutinize all of the

118. See Hill, *Rating Agencies Behaving Badly*, *supra* note 47, at n.49 and accompanying text. The evidence that rating agencies are good at assessing absolute quality is far less clear; the percentage of defaults in each category has fluctuated, with standards for achieving a particular rating having increased over time. See Blume, *supra* note 104; see Cantor & Packer, *Credit Rating Industry*, *supra* note 10. See also STANDARD & POOR'S 2003 ANNUAL CORPORATE DEFAULT STUDY (Jan. 27, 2004), at <http://www2.standardandpoors.com/spf/pdf/products/Ratings%20Performance%202003.pdf> (last visited April 5, 2004). Rating agencies may also be worse at rating at the lower end of the quality spectrum. Certainly, for a time this was true, and Michael Milken's fortune and fame while at Drexel Lambert, premised on the undervaluation by rating agencies and markets of "junk" bonds, were the result.

119. Some agencies revisit ratings on a set schedule, saying the rating is good only for a pre-specified period of time. Another approach is that ratings stay in effect unless and until they are modified.

company's financial obligations; they may begin to look for "outs" in their financing documents, and may very well find them. Each downgrade causes deterioration, which may warrant a further downgrade, which may cause further deterioration, and so on. Standard & Poor's argued that this is precisely what happened with Enron.¹²⁰ Preventing a rating downgrade from starting a downward financial spiral isn't easy. Discouraging rating triggers might be a start, and attempts are being made along these lines.¹²¹ Lenders are being encouraged, in public pronouncements and by rating agencies, not to include such triggers in their agreements.¹²² Nonetheless, given the importance of ratings, even in the absence of a ratings trigger a downgrade will almost necessarily worsen the company's financial situation, even if the only information it conveys is the fact that it has occurred. In other words, a downgrade doesn't just convey information—the fact that a downgrade has occurred *is* information.

Furthermore, while deterioration occurs along a continuum, ratings changes are necessarily discrete—the rating is either in one category or in another. A small difference in quality can make a big difference, especially if what has occurred is a decline from investment grade to below investment grade.

If ratings cannot be purely and mechanically descriptive, the door is open to consider matters other than "getting it right." What sorts of matters might appropriately be considered? Consider a far-flung analogy: the suicide in 2003 of French chef Bernard Loiseau. Some attributed his suicide to the "downgrading" of his restaurant by the prestigious Gault-Millau guide from "19" to "17."¹²³ Should Gault-Millau have taken into account before the downgrading what it thought Loiseau would do?

120. Solomon B. Sampson, *Commentary: Playing Out the Credit Cliff Dynamic*, Dec. 12, 2001, at <http://www2.standardandpoors.com/spf/pdf/fixedincome/cliff.pdf> (last visited April 5, 2004); see also ENRON COMMITTEE PRINT, *supra* note 41, at 88–89 (page numbers reflect official committee print).

121. In 2001, Moody's acknowledged the serious negative consequences of triggers and announced that it would incorporate those consequences in its ratings and research. See MOODY'S INVESTOR SERVICES, MOODY'S ANALYSIS OF U.S. CORPORATE RATING TRIGGERS HEIGHTENS NEED FOR INCREASED DISCLOSURE (July 2002), at http://www.moody.com/moodys/cust/research/venus/Publication/Special%20Comment/noncategorized_number/75412.pdf (last visited April 5, 2004). In a subsequent statement, Standard & Poor's agreed with Moody's' assessment of the dangers of triggers and suggested that issuers might consider removing them from debt covenants. Tim Reason, *supra* note 113. The possibility of eliminating or minimizing the use of triggers raises a number of issues. Besides the thorny question of how it would be done—what force would be brought to bear, and by whom—there is also the question of what to do about swaps. Rating triggers, in the form of contractual provisions unwinding a swap if a counterparty's ratings decline, are an integral and, it might seem, necessary component of swaps.

122. *Id.* See also Hill, *Rating Agencies Behaving Badly*, *supra* note 47, at nn.43–48 and accompanying text.

123. See Brian Miller, *Cooking Up A Storm*, N.Y. TIMES, Mar. 15, 2003, at A17 [hereinafter

On November 8, 2001, Moody's was asked not to downgrade Enron's debt below investment grade because Enron would go bankrupt and markets would be disrupted.¹²⁴ Moody's' response was that it would downgrade if it thought the debt warranted downgrading—that the results of a downgrade shouldn't and wouldn't figure into Moody's decision. In theory, Moody's answer seems correct: its job is to “get the rating right” rather than to consider its consequences. But Moody's can't feasibly try to “get it right” at every moment in time. It will necessarily have to decide whether a state of affairs will persist, worsen, or improve. If Moody's had concluded that Enron's debt was, on November 8, 2001, below investment grade but there was a reasonable chance it could return to investment grade, should Moody's have downgraded? A Moody's downgrade below investment grade would virtually have precluded any climb back up to investment grade.

Indeed, how should a rating agency decide precisely when the downgrading threshold has been met? Should slower or quicker downgrades be favored? Being slow to downgrade can suggest that the rating agency is getting it wrong and has not yet appreciated the severity of the problem. But the rating agency may also think the deterioration is only short term, and that if it doesn't downgrade, the issuer will return to financial health. Issuers will typically favor slower downgrades, but investor preferences are less homogenous. Those subject to constraints that require them to sell lower rated instruments may not wish to be “forced” to sell when many others are also selling. Indeed, after being criticized for downgrading too slowly in Enron and the other debacles, the rating agencies greatly accelerated their pace of downgrading; the agencies

Miller].

124. Moody's felt that Enron's fortunes were deteriorating and that a proposed merger with Dynegy, which was Enron's only real hope, was unlikely to occur because the transaction documents too readily permitted Dynegy not to consummate the transaction. Tremendous pressure was applied to the rating agencies not to downgrade below investment grade; the agencies seem, according to a congressional report, to have resisted the pressure, and refrained from downgrading below investment grade only when the terms of the Dynegy merger were changed to make Dynegy's obligation to merge with Enron less conditional. ENRON COMMITTEE PRINT, *supra* note 41, at 16–17 (testimony of John Diaz, Managing Director, Moody's Investors Service (page numbers reflect official committee print)). Indeed, it was alleged that Robert Rubin, then the vice chairman of Citigroup, made calls to the undersecretary of the Treasury and to Moody's Investor Services in an (unsuccessful) attempt to assist Enron only days before the company filed for bankruptcy. *See id.* All this being said, a cynic's perspective might be to the contrary. The congressional hearing was, in part, prompted by accusations of undue influence involving governmental officials. The resulting vindication of the former government officials may reflect in part the committee members' eagerness to limit the interpretation of the rules applicable to former government officials in their subsequent dealings with the public sector.

were then criticized for downgrading too quickly.¹²⁵ One can't please everyone, and it's not completely clear whom the rating agencies ought to try to please. Just "getting it right" doesn't seem to be an option: a rating agency can't ignore how markets will react to the ratings change itself, and not just to the information that the rating change is intended to reflect.

Ongoing monitoring presents other difficulties. Ongoing monitoring won't benefit from the economies of information acquisition available in the initial rating process, when investment banks, law firms and others involved in the transaction are also engaged in overlapping and related activities. Furthermore, companies won't have the same incentives regarding provision of information on an ongoing basis as they do for the initial rating. During the initial rating process, the company tries to assure the rating agencies that they are getting "the complete picture" by providing both bad information and good. Thereafter, the company has no incentive to voluntarily bring bad information to the rating agencies' attention. The rating agencies know this, but they can't feasibly investigate the company on an ongoing basis as thoroughly as they did during the initial rating process: the costs of such an investigation would be astronomical. Upgrading and downgrading will therefore be less accurate than initial ratings. Rating agencies will try to correct for the fact that they may not be hearing bad news promptly, but they can't credibly be continually threatening to downgrade, demanding assurances that there isn't undisclosed bad news.

All this being said, even if one concedes the difficulties involved in downgrading, the rating agencies' performance in Enron was clearly deficient. As Senator Joseph Lieberman noted:

[T]he 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.¹²⁶

125. David Ivanovich, *Energy Traders Struggle to Meet Post-Enron Credit Rules*, HOUSTON CHRON., June 1, 2002, at A1.

126. Senate Committee on Governmental Affairs, Press Release, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs (Oct. 7, 2002) (statement of Chairman Joe Lieberman), at http://www.senate.gov/~gov_affairs/100702press.htm (last visited April 5, 2004) [hereinafter Watchdog Press Statement]. While much of the commentary on rating agencies, including this Article, focuses principally on Moody's and Standard & Poor's, Lieberman criticizes Fitch as well. Its

Still, appraising rating agency performance is exceedingly difficult. Partnoy can't be right: rating agencies must be doing something other than giving favored regulatory treatment. But what else *are* they doing? I argue above that they are doing precisely what they claim they are doing: providing information.¹²⁷ I cited empirical evidence that may provide some support for this claim.¹²⁸ But critics of the rating agencies haven't been appeased by this evidence.¹²⁹ They argue that even if the rating agencies are generally "getting it right," they aren't "getting" anything the market isn't getting first.¹³⁰ AAA-rated securities may very rarely default, but the markets would have known the securities were unlikely to default without the rating agency rating. When rating agencies downgrade an issue and the issue later defaults, the failure may very well have been caused by the downgrade. The rating agency did not reflect or predict a state of affairs, but rather, caused that state of affairs. And the same may be true prospectively. Because ratings have so much influence on the terms on which a company can get financing, they may be self-fulfilling. A company with debt rated AAA gets good financing terms on that debt and, perhaps, on other debt, which causes its financial condition to remain good, which causes its debt to remain of high quality and not default, and so on.

Proving this criticism wrong is difficult. But note, interestingly, that it tends to be made by people who think that rating agencies' staffs are comprised of people who are lacking in either ability, motivation, or both – the underlying assumption is clearly that less skilled or less motivated employees produce information of little or no value. One response, which I make below, is to discuss in detail the information rating agencies might be providing, and argue that they could provide much of that information even if their staffs' capabilities were as lacking as these critics hypothesize.

B. How Ratings Might Provide Information

1. Nature of the Information

What information might ratings provide? It might be information about

downgrades mirrored closely the downgrades of Moody's and Standard & Poor's. *Id.*

127. *See supra* notes 114–18 and accompanying text.

128. *Id.*

129. *See, e.g.,* Partnoy, *Paradox*, *supra* note 10.

130. *Id.* at 66.

“fundamentals,” *e.g.*, the cash flow supporting repayment on the rated instrument, possible claims against the issuer, other claims on the issuer’s funds, and so on. Some have argued that the rating agency rank and file gathering the information may not be as sophisticated, or, given their compensation schemes, as highly motivated, as the (mostly institutional) investors supposedly being informed by the ratings.¹³¹ Even if rating agency personnel aren’t as skilled or focused as most investors who buy bonds, there are many reasons to suppose rating agencies nevertheless could produce valuable information. One reason is time. An investor may not have the time to look at each possible investment candidate in depth. The major rating agencies are in the business of rating most companies and most debt issues. An investor may need a quick basis upon which to include or exclude possible investments before pursuing in-depth review of a few select candidates.

Another related reason is specialization. Rating agencies specialize in rank ordering each debt issue by relative quality. Investors may find such information—at least, the rating agency’s ranking, even if their own ranking might have differed—useful, but not worthwhile to generate for themselves. Yet another reason is access. Most issuers will make considerable quantities of time available to the major rating agencies; they are less likely to devote much time to particular investors, even those investing comparatively large amounts.¹³² Even if the information the rating agencies produce is not of the same caliber the investor would have produced, it can still be a valuable input.

Ratings also provide information in the form of a signal as to the debt issuer’s own views about the issue for which it is obtaining a rating. Recall the two-rating norm: an issuer typically gets ratings from both Moody’s and Standard & Poor’s. In abiding by the two-ratings norm, an issuer signals that it has nothing to hide. If an issuer obtains no ratings, one rating (especially from Fitch), or a rating from Moody’s and one from

131. *Id.* at 72 (“Rating agency analysts track the credit quality of up to 35 companies each, and are paid significantly less than similarly placed professionals on Wall Street. Both S&P and Moody’s have high levels of staff turnover, modest salary levels and limited upward mobility; moreover, investment banks poach the best rating agency employees. These factors limit the ability to rating agencies to generate valuable information.”) (internal citation omitted).

132. Differential access may work as a barrier to entry for newer or smaller rating agencies. Various solutions are possible, some of which might require regulatory intervention and some of which should not. The time limitations of issuers might spur the newer or smaller agencies to develop particularly efficient means of obtaining the most information with the least access. But there may nevertheless continue to be an advantage to the access obtainable by the established agencies. Solutions requiring issuers to offer more access, or requiring rating agencies to share information with other rating agencies, are of course quite problematic.

Fitch, the issuer could be signaling that it has something to hide, something it thinks the major rating agency or agencies whose rating(s) weren't sought might ferret out.

Ratings also provide information about themselves. As I discuss in the preceding Part, a rating *is* information about what the issuer's borrowing costs will be and the liquidity and marketability of the instruments being rated. Especially with regard to ratings close to the investment grade/non-investment grade boundary, the information may also indicate what the rating agencies themselves may later do (*i.e.*, downgrade), or what investors will do in response to the rating agencies' actions (*i.e.*, sell in response to downgrade). As discussed in the preceding Section, this self-fulfilling feature of ratings is particularly prominent in rating agencies' ongoing monitoring activities: when an issue is downgraded, the issuer will almost certainly experience higher borrowing costs, which may trigger a further deterioration of the issuer's financial condition and the issue's credit quality.

Rating agencies need not be exceedingly skilled to provide this information. Indeed, for some of the information, they need not be skilled at all, insofar as the information reflects a prediction of their future intentions to change a rating in a manner that affects its liquidity. If this latter type of information were the only information rating agencies provided, my criticism of Partnoy would be unwarranted; providing information about future regulatory treatment is not materially different from only providing the treatment itself. But the picture I paint is one in which the rating agencies have some skill, if only because the mechanisms I describe would not work nearly as well unless the markets believe that rating agencies have some skill. There is no good reason to suppose that markets' beliefs in this regard would be mistaken. Certainly, a company signaling that it doesn't have anything to hide by subjecting itself to rating agency scrutiny will be sending a stronger signal to the extent rating agencies are perceived to be able to catch whatever the company might be trying to hide.

2. Independence

The foregoing described the sort of information that ratings might be providing. It argued that the information, particularly as to initial ratings, is of "good enough" quality, even if anecdotal accounts of limitations in the capabilities or motivation of rating agency rank and file are true. But to be valuable, rating agency information cannot just reflect that the rating agencies know what they're talking about; it also has to reflect that their

authority is not compromised by self-interest. Expertise isn't worth anything in this context without independence. Both are necessary; neither is sufficient.

Markets apparently do believe—correctly, I think—that rating agencies are independent, notwithstanding that rating agencies are paid by the issuers. Rating agencies could not function without a reputation for independence.¹³³ Indeed, their reputations for independence may mean more than their reputations for expertise (so long as they are perceived to have some baseline level of expertise). As one rating agency veteran quoted by *The Economist* said, “We may be incompetent, but we’re not dishonest.”¹³⁴ Rating agencies can credibly say that they won’t readily risk their reputations.¹³⁵

One might respond: but didn’t accounting firms also have and need reputations for independence? As is well known, accounting firms severely compromised their independence. But there is a key difference between rating agencies and accounting firms. Because of the two-rating norm, Moody’s and Standard & Poor’s are able to withstand the pressure issuers might exert to obtain higher ratings. The issuers’ threats to go elsewhere simply are not credible.¹³⁶ Moreover, rating services are quite profitable, and rating agencies haven’t focused on ancillary services nearly to the extent that the accounting firms did. Accounting firms’ focus on ancillary services, and the enormous profitability of those services relative to standard auditing services, were other reasons why accounting firms were susceptible to pressure from their clients: a client could simply threaten to cut back on the accounting firm’s provision of lucrative non-auditing services should the accounting firm not be willing to agree to the

133. Note that an alternative means for the rating agencies to give their ratings credibility—a financial stake either in the debt issue they are rating or the issuer, whether by guarantee or investment—is not feasible. Unless they get such a stake in all their issues, they should not get a stake in any; otherwise, the conflict would be enormous, as they would be motivated to treat very differently issues in which they had a stake. Presumably, buying any kind of sizeable stake in all their issues would be financially infeasible. Even buying the size stake that might be affordable wouldn’t work: because rating agencies retain an obligation to update their ratings, they would have a serious conflict because they would benefit themselves by delaying a downgrade and accelerating an upgrade.

134. *Exclusion Zone—Do Rating Agencies Distort Financial Markets?*, *THE ECONOMIST*, Feb. 8, 2003, at 65 [hereinafter *Exclusion Zone*].

135. For a general discussion of rating agencies’ concern with their reputations, see Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 14 (2002).

136. But there is reason to be concerned for the future., as rating agencies are increasingly offering ancillary services. The provision of ancillary services by accounting firms was an important reason why accounting firm independence became compromised. See note 37, *supra*, and the discussion of this point in Part IV, *infra*.

client's preferred accounting treatment.

The rating agencies' incentives to preserve their reputations and keep potentially dissatisfied regulators at bay prevail. The two-rating norm has costs—certainly to potential new entrants into the rating agency market, and perhaps to issuers and investors as well—but it also has this important benefit. Fitch, too, is constrained, at least somewhat, from acceding to issuer pressure to rate higher as it works to rebut the perception that its ratings are more favorable than Moody's and Standard & Poor's. With Moody's or Standard & Poor's rating the vast majority of issues, there will typically be a point of comparison by which a Fitch rating could appear "too high." The present rating agencies sometimes argue against expanding the number of rating agencies on grounds that issuers may begin to shop for favorable ratings, just as they shopped for favorable accounting treatment. Given the results of shopping for favorable accounting treatment—Enron leaps to mind—it is hard to characterize the present rating agencies' pronouncements in this regard as completely self-serving.

There may be other reasons why rating agencies' independence would be less likely to be compromised than accountants' independence. In the moderate term, it may be harder for rating agencies to hide deliberately inaccurate ratings than it was for accountants to conceal that they were approving questionable accounting treatment. The accuracy of ratings can be measured *ex post*; rating agencies and others maintain detailed statistics as to the performance of rated issues. By contrast, accountants' deficiencies in performance may not come to light. The information would be hard to compile; indeed, the assessment of what constituted bad performance wouldn't necessarily be easy or even a matter of consensus. *Ex post* assessments are, of course, just *ex post* assessments: a rating agency might have some plausible explanation as to why a group of AAA rated securities had defaulted at higher rates and more quickly than did some BB rated securities; conversely, the rating agency might look as though it performed well but might just have been lucky. Complicating matters, even seeming good performance by rating agencies may reflect the influence ratings have over a company's future trajectory. But it is far more likely that performance statistics for rating agencies reflect, at least in significant part, that the agencies are *ex ante* "getting it right." While ratings can influence the future trajectory of a debt issue, they can't completely dictate it— even AAA rated securities have defaulted. And luck can only explain away so much. Rating agencies accordingly will presume that their reputations may be damaged if they issue ratings they

think are inaccurate at the outset, especially if there are many such ratings and the inaccuracy is large.

Furthermore, rating agency compensation structures may do a better job than have accounting firm compensation structures of encouraging independence: rating agency compensation structures are apparently not based on *ex ante* “rainmaking.”¹³⁷ By contrast, accounting firm compensation structures, which rewarded rainmaking and client retention, created problematic incentives for accountants to prefer their own interests and those of their clients over the interests of markets and, ultimately, the accounting firms’ long-term reputational interests.

Finally, to the extent a rating agency might be tempted to respond to issuer pressure to issue too high a rating, the possibility that another agency could render a lower unsolicited rating may serve as a disincentive. But this latter point suggests that there may still be room for deliberately inaccurate ratings. Indeed, rating agencies have been accused of giving unsolicited ratings that deliberately are too low for strategic reasons—to ensure that issuers purchase (solicited) ratings in the future. Perhaps “too low,” unsolicited ratings can be given without big reputational cost; indeed, appraising quality at the lower end of the quality spectrum is known to be particularly difficult.¹³⁸ Still, even if there is some room for deliberately inaccurate ratings, it would seem that there isn’t much room.

The foregoing has addressed why markets might value the information provided by ratings. It addressed why rating agencies wouldn’t succumb to pressure to inflate an issue’s rating. The pressure was directed at rating an issue better than its (relative) quality would dictate. But mightn’t rating agencies be pressured to rate *all* issues too highly—that is, rate all or more instruments investment grade—as an end-run around regulators? Recall that only investment-grade securities get favorable regulatory treatment. Why wouldn’t rating agencies go along with across-the-board inflation? Investors would get more flexibility in their investment decisions, and

137. Capital Markets Hearings, *supra* note 22, at 219–30 (comments of Vickie A. Tillman, Executive Vice President, Standard & Poor’s Credit Mktg. Servs.) <http://financialservices.house.gov/media/pdf/108-18.pdf> (“No portion of an analyst’s compensation is directly dependent on . . . the amount of fees paid by that specific company to Standard & Poor’s.”). But this is not to say that rating agency compensation structures can’t be improved. Comments are being requested on this subject, as well as on the subject of what the SEC’s role should be as to rating agency compensation, in the June 12, 2003 SEC Concept Release. See *supra* note 2.

138. As to unsolicited ratings, see Soku Byoun & Yoon S. Shin, *Unsolicited Credit Ratings: Theory and Empirical Evidence* (Oct. 2002), available at http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID354125_code021212500.pdf?abstractid=354125 (last visited April 5, 2004); Winnie H. Poon, *Are Unsolicited Credit Ratings Biased Downward?*, 27 J. BANK. & FIN. 593 (2003). See also note 95, *supra*.

rating agencies might be able to get larger fees to reflect that the issued securities would be more marketable and more liquid. So long as the rank ordering is correct, markets shouldn't care. Clearly, the issuers wouldn't complain that they were rated too highly. Rating agencies' reputational hit should in most cases be small; apparently, a good reputation can be maintained if the highest-rated instruments very rarely default and the rank ordering of instruments is correct. There is apparently less of a reputational stake in absolute levels of quality remaining constant. Indeed, absolute levels of quality have not stayed constant; ratings generally have become more conservative.¹³⁹

The answer may be that while the minimum quality threshold for investment grade may seem (and to some extent be) arbitrary, at a certain point quality becomes much more difficult to determine with precision, and defaults are not unlikely.¹⁴⁰ If "investment grade" instruments defaulted at a much higher rate than they do now, the risk of negative consequences to the rating agencies—regulatory scrutiny or investor lawsuits—might increase to levels far exceeding the benefits of colluding with investors. That investors might have wanted the flexibility to invest in more questionable instruments and do an end-run around regulators *ex ante* in no way precludes them from bringing a lawsuit against the rating agency *ex post*—presumably, too, there is no way for investors credibly to precommit not to bring such suits. Even if the lawsuits would not prevail, defending against them might be quite expensive.

C. Other Reasons Why Ratings Are Purchased

The foregoing has considered why markets value ratings. But ratings aren't just purchased because they are valued by markets; there are other reasons. The direct purchasers of ratings are issuers; investors, who are demanding less of a return from a rated instrument, are also indirectly purchasing ratings. As discussed in Part II.E, *supra*, the corporate managers making the decision to obtain a rating, the individuals making investment decisions for money management firms, and money management firms making such decisions for their clients, all have their own incentives, in the case of the corporate manager, to purchase ratings, and in the case of an individual acting on behalf of a money management firm and the firm, to purchase rated securities. Some of those incentives may reflect agency costs: a corporate manager tries to avoid being second-

139. See *supra* notes 104 and 118.

140. *Id.*; See also Hill, *Rating Agencies Behaving Badly*, *supra* note 47, at n.49.

guessed over the conduct of an offering, an individual making investment decisions tries to keep his job at the expense of potentially obtaining better results for his firm, and the individual and the firm pay for “cover” from clients or courts in case an investment declines.

D. Explaining Rating Agency Performance

As discussed above, Enron was clearly no triumph for the rating agencies. In my article *Rating Agencies Behaving Badly: The Case of Enron*,¹⁴¹ I detail the chronology at issue. In mid-October of 2001, after deterioration in Enron’s financial condition started to become known, the rating agencies began reviewing Enron and periodically downgraded it thereafter.¹⁴² Still, as late as November 28, 2001, four days before Enron declared bankruptcy, the rating agencies rated Enron’s debt BBB-, the lowest investment-grade rating, but investment grade nonetheless. Enron is just one among a number of spectacular accounts of rating agencies’ lackluster performance in anticipating major debacles. Others include WorldCom, Global Crossing, the “Asian Flu”, Executive Life, Orange County, and Washington Power (“Whoops”¹⁴³), and a few other lesser-known debacles such as the recent National Century Financial Enterprises transaction.¹⁴⁴

A good argument can be made that all these cases were extraordinary. There was either serious chicanery or, in the case of the Asian Flu,¹⁴⁵ an international financial crisis. It may not be so clear that failing to catch extraordinary fraud or international crises shows that rating agencies are doing a bad job. What rating agencies such as Moody’s and Standard & Poor’s do is rank virtually all debt issues (and the companies issuing the debt) by quality. While they do in-depth research on companies, they do not purport to go beyond what company officials tell them. What the agencies are saying is, “If what the company officers tell us is true, the

141. *Id.*

142. *Id.* at 1148–50.

143. Capital Markets Hearings, *supra* note 22, at 4, <http://financialservices.house.gov/media/pdf/108-18.pdf> (last visited April 5, 2004); Dan Ackman, *The WorldCom We Hardly Knew*, FORBES.COM, June 26, 2002, at <http://www.forbes.com/2002/06/26/0626topnews.html> (last visited April 5, 2004); *Rating Agencies Fail Early Warning Test*, THE RECORD, Dec. 9, 1994, at C1; Chip Brown, *After Default, The Questions of Blame and Duty Linger*, WASH. POST, Dec. 5, 1984, at A1; Hill, *Rating Agencies Behaving Badly*, *supra* note 47, at n.50.

144. See generally Seth Lubove, *Why Wasn’t NCFE’s Collapse Predicted Sooner?*, FORBES.COM, Nov. 21, 2002, at http://www.forbes.com/2002/11/21/cz_sl_1121ncfe.html (last visited April 5, 2004).

145. See *supra* note 112.

company (or the debt) is of X quality.” Going beyond company statements and documents might sensibly be another specialty, focusing more intensively on fewer companies.

But, it might be argued, the red flags should have been visible even to somebody not going beyond company statements and documents. While ferreting out well-concealed fraud might be a different task than ranking by quality, noticing a red flag planted prominently in the entryway to the company’s headquarters while interviewing the CEO would surely be within the rating agencies’ ambit. Missing the red flag would suggest that the normal ranking by quality wasn’t being done properly either. This argument is difficult to dismiss, at least retrospectively. That being said, as more facts about Enron and the other debacles become known, it is clear that for every red flag, there were small, less transparent ones that would have been very difficult to detect. Greater vigilance should have helped, but would it have timely detected the extent of the debacle? Finally, if there had been more vigilance on the part of the rating agencies and others, would there simply have been more concealment by the Enron executives?

The rating agencies’ performance in Enron generated considerable criticism. Joseph Lieberman, Chairman of the Senate Governmental Affairs Committee, a Committee that produced a report on Enron,¹⁴⁶ characterized it as “dismally lax.”¹⁴⁷ But, as I argued above, the laxity may not have been quite so dismal, and, more importantly, may not manifest itself in such problematic ways in less exceptional circumstances.¹⁴⁸ Moreover, the public airing of the “dismal laxity” charge and the conduct that prompted it should serve as a wake-up call to rating agencies, prompting them to put in place mechanisms to prevent recurrences. Still, it seems reasonable to see laxity, and perhaps sometimes, “dismal laxity,” as a potential problem, especially among agencies in a highly concentrated industry with significant barriers to entry.

146. ENRON COMMITTEE PRINT, *supra* note 41.

147. Watchdog Press Statement, *supra* note 126. The temptation of both legislators and the public is to appraise the rating agencies by what they missed and what damage was done, rather than what they held themselves out as being able to detect, and what their specialization ought to have enabled them to detect. Indeed, I would argue that some of the Enron-inspired calls for reform—particularly the call for reform of the rating agency regulatory regime—are overly influenced by the size of losses investors suffered, something that should have no logical relationship to the inquiry at issue. Surely, the size of the “bet” made on something occurring or not occurring should not be a measure of what rating agencies ought to do. Somebody could make a huge financial bet that an AA+ rated instrument would never be downgraded to AA (or that it would be so downgraded); that an investor lost huge amounts betting that the world would not change should not be the rating agencies’ problem.

148. If, however, Enron proves not to be an exceptional case, rating agencies will need to become better at detecting such cases.

Traditional economic theory would find laxity—some deficiency in quality reflecting inattention—puzzling. Why wouldn't rating agencies deliver the best product possible? Presumably, the better the product, the more money people will be willing to pay for it. Rather than shirking on quality, the monopolist (or oligopolist) can simply raise the price. One possibility is that rating agencies are not able to raise prices any further. But it seems likely that the rating agencies still have room to raise prices. Certainly, there are no regulatory restrictions on rating agency fees.¹⁴⁹ That being said, even if there is room to raise prices somewhat, the rating agencies are not unconstrained. At a certain point, regulators might very well step in. Furthermore, recall that the main rating agencies at issue are Moody's and Standard & Poor's, and that there exist other NRSROs. At a certain point, issuers would go to Fitch.

Another possibility is that the rating agencies, having obtained privileged positions courtesy of the government, have adopted some of the pathologies of government bureaucracies. This account is consistent with the anecdotal accounts of many market participants. That being said, it still presents somewhat of an analytic puzzle. The rating agencies may resemble regulatory agencies in some respects, but they are not regulatory agencies. In the classic law and economics account, the regulatory agencies' incentives are to get what they can get more of—leisure and larger fiefdoms.¹⁵⁰ The possibilities for getting lots of extra money are limited. The same is not true of rating agencies.

Yet another possibility relates to how rating agencies adapted to the explosion of “rocket science” and “rocket scientists” in financial markets. In the 1970s and 1980s, financial sophistication began increasing exponentially.¹⁵¹ New financial instruments of staggering complexity were developed with the help of finance wizards using high-powered computers.¹⁵² Keeping pace would have required considerable resources. Investment banker salaries began to climb precipitously, and Wall Street law firms had to give their lawyers large raises to prevent them from being

149. House Financial Services Capital Markets Subcommittee Chairman Richard Baker (R, LA) makes this observation in his April 10, 2003 letter to SEC Chairman William Donaldson. See Baker Letter, *supra* note 76.

150. See GLEN O. ROBINSON, *AMERICAN BUREAUCRACY: PUBLIC CHOICE AND PUBLIC LAW* 87 (1991).

151. Kenneth A. Carlow et al., *A Survey of U.S. Corporate Financing Innovations: 1970-1997*, 12 *J. APPL. CORP. FIN.* 55 (1999).

152. Henry Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 *U. PA. L. REV.* 333, 338–39 (1989).

stolen by investment banks.¹⁵³ The skills required by rating agency personnel might seem closer to those required by investment bankers than are lawyers' skills; keeping pace might very well have required a larger investment from the rating agencies than even the law firms made, and in any event, certainly not a smaller one. But it seems plausible, and perhaps even likely, that a sufficient investment was not made. Certainly, rating agency compensation for the "rank and file" is considerably lower than rank and file investment banker compensation¹⁵⁴ (and, for that matter, compensation of the law firm lawyers doing rated deals). The result may be that the rating agencies' level of financial sophistication did not rise with the level of things about which they had to become sophisticated, and about which others had increasingly become sophisticated. One can envision agency-cost problems at the rating agencies, with individual managers not wanting to argue for large investments in personnel and infrastructure, and the trajectory continuing so that the sophistication gap became wider and wider. Ratings quality might have suffered from not keeping up with the "state of the art." The product would be good—indeed, good enough—but not as good as it could be.

IV. EVALUATING THE NEED FOR REFORM AND THE REFORM PROPOSALS

A. Introduction

As discussed in the previous Part, the overall picture of rating agency performance is mixed. Rating agencies get it spectacularly wrong in some instances; they generally get it right in most others. It's not clear how much they are getting that the markets aren't getting themselves, or that the agencies aren't in some sense causing. But the rating agencies do seem to be free of conflicts. To the extent the rating agencies are getting things wrong simply looking in the market's rear view mirror, or issuing self-fulfilling ratings, such shortcomings don't seem to be on account of problematic self-interest. As *The Economist* notes, "Even [the agencies'] failure to spot the impending bankruptcies of Enron, WorldCom and Global Crossing until seconds before their default has been blamed not on lack of integrity, but on lack of street wisdom."¹⁵⁵ We need to understand how the rating agencies came to lack street wisdom, at least as to the

153. Robert Hanley, *Money, Power Lure Lawyers to Investment Banks*, L.A. DAILY J., Jul. 17, 1987, at 1. I also recall this from my own experience as a Wall Street lawyer during the mid-1980s.

154. See *supra* note 131.

155. *Regulators Promise a Belated Review*, *supra* note 61, at 65.

Enron debacle and the other financial debacles, and what ought to be done to rectify the situation.

B. The Need for Reform: Who Is Being Hurt?

1. Effects on Investors and Markets

The Enron debacle highlights rating agencies' provision of lower quality information and their badly timed upgrades and downgrades. Investors and markets generally were hurt. Investors and markets generally are hurt if they give ratings more credence than is warranted; they also may be hurt by the volatility caused by precipitous upgrading and downgrading.

2. Effect on Issuers

Issuers, too, may be hurt. They may be paying too much—recall the profit margins obtained by Moody's and Standard & Poor's.¹⁵⁶ Issuers also may be paying too much as a result of pressure to buy too many ratings. The argument gains force to the extent that the two-rating norm owes its continued existence to the actions of Moody's and Standard & Poor's, particularly the practice of giving (or threatening to give) unsolicited ratings, rather than the informational value of the second rating. In my view, it's unlikely that the norm is in fact being actively maintained in this manner. But, even if issuers aren't being forced to buy ratings for fear that a rating agency might rate unsolicited, and likely more negatively,¹⁵⁷ they are in a sense being "forced" to buy two ratings by the two ratings norm. Depending on how one characterizes the norm—as an efficient way for

156. See *supra* notes 43–49 and accompanying text.

157. Many stories have been told about Moody's unsolicited ratings. In one such story, Moody's tried to bill a bond issuer that it had rated without having been solicited to do so. It sent a letter telling the issuer that it should "reflect on the propriety of failing to pay for the substantial benefits that the issuer reaps from our efforts." Smith & Walter, *supra* note 10, at 312. The Department of Justice investigated Moody's for anticompetitive practices in 1996. There was speculation at the time that the investigation was precipitated by a civil lawsuit brought by a school district in 1993. The district sued Moody's over the agency's assignment of an unsolicited rating on the district's outstanding debt. See *Jefferson County Sch. Dist. v. Moody's Investor's Servs., Inc.*, 988 F. Supp. 1341, 1343, 1348 (D. Colo. 1997), *aff'd*, 175 F.3d 848 (10th Cir. 1999) (dismissing the case even though Moody's' unsolicited rating was considerably lower than other ratings received by the district from other agencies). In another situation that the DOJ may have considered in launching its investigation, Moody's supposedly tried to solicit ratings business on a two million dollar bond issued by Chippewa County, Michigan in 1995. It was reported that, after choosing to use rating services other than Moody's, Chippewa officials received a letter from the Executive Vice President of Moody's "warning that the "absence of a Moody's rating . . . might imply that we believe that there exist deficiencies" in the financing arrangements. Moody's proceeded to demand payment for its research services in reviewing the bond. See Lemov, *supra* note 38, at 26. In February of 1999, the DOJ ended the investigation without finding anti-competitive practices at Moody's. See Kenneth N. Gilpin, *Justice Dept. Inquiry on Moody's is Over, with No Charges Filed*, N.Y. TIMES, Mar. 13, 1999, at C3.

issuers to give signals to markets or as sticky and path-dependent - one will have a different assessment as to whether obtaining the two ratings constitutes paying “too much.”

If the present state of affairs results in lesser effort being expended by the rating agencies and hence, lower quality information, the issuer may also be paying too much in that it has to get a (costly) second or third rating to make up for possible informational deficiencies in the first rating.

3. Effect on Potential Competitors

More obviously and more directly, the present state of affairs hurts would-be entrants to the rating agency industry. For reasons discussed at length in Part II.E.3, *supra*, new entrants have not had an easy time of it.

C. Evaluating the Reform Proposals

What is the goal of rating agency regulatory reform? The impetus for the attention being given to reform is Enron. But the goal should not be to prevent another Enron. Rather, the main goal should be to neutralize the effects the regulatory regime and the natural, historical, and institutional forces may have had and be having on entry into the rating agency business and on day-to-day rating agency performance. The rating agencies may lack some competitive edge because of the regulatory, historical, institutional, and natural barriers to entry into the rating agency business. Prices may not be as low as they would be in a more competitive market. And a few rating agencies are benefiting by being given, for free, the ability to sell valuable regulatory treatment.

But the problem should not be overestimated. The concentrated market structure in the rating agency industry and the barriers to entry clearly cause some deviations from the “ideal” of a fully competitive market. But it is worth noting that rating agencies, especially Moody’s and Standard & Poor’s, are not unconstrained. Regulators stand ready to regulate, and actual and potential competition (notably Fitch, and perhaps Dominion) does exist; Moody’s and Standard & Poor’s (and the other NRSROs) thus have incentives to keep quality above a certain minimum level and to keep prices below a certain maximum level. Still, there could be improvement. Prices might be lower, quality might be higher, and new entrants would not face so many hurdles if the market structure were less concentrated.

The government is part of the problem. Thus, it should be part of the solution by minimizing, if not eliminating, regulatory barriers to entry. However, eliminating regulatory barriers to entry immediately, as some

have suggested,¹⁵⁸ would be ill-advised. If NRSRO designation was eliminated in the near future and the government got out of the business of certifying rating agencies, new agencies should spring up. But, paradoxically, the dominance of Moody's and Standard & Poor's might very well also increase.¹⁵⁹ The dynamics I have discussed in this Article suggest the existence of a sticky institutional norm that nobody in a position to do so has an incentive to change. To the contrary, issuers buying ratings and investors buying rated securities have every incentive to stay with the "tried and true." The costs of the present state of affairs are not directly borne by any decision-maker in the process. Indeed, the actual purchaser of ratings, the corporate manager of the issuers, does not pay from his own personal funds, and may very well be punished if he does not buy the standard raters' ratings.

In the short and perhaps moderate term, the type of information the rating agencies provide may require a concentrated market structure. New entrants' difficulties getting into the general purpose rating agency market may ultimately be intractable. But even if that is the case, in the moderate to long term, there is no reason why the present select few (until very recently three, and now four NRSROs) should be granted the exclusive right to sell favorable regulatory treatment.

My proposal is gradually to increase the number of NRSROs and revisit the issue of eliminating the NRSRO designation in five years, or until such time as can reasonably be estimated to be needed for new firms to establish their reputations and perhaps carve out some niches. There should be a particular emphasis on approving NRSROs confined to particular geographic- or business-sector niches. Notwithstanding the economies and advantages of general purpose agencies, the smaller, more specialized agencies may be able to establish themselves more readily and

158. Capital Markets Hearings, *supra* note 22 (testimony of Dr. Lawrence J. White, Professor of Economics, Stern School of Business, New York University), <http://financialservices.house.gov/media/pdf/040203lw.pdf> (last visited April 5, 2004); Partnoy, *Paradox*, *supra* note 10, at 80–81.

159. It is interesting in this regard that Moody's supports eliminating NRSRO designation, Letter from Raymond W. McDaniel, President Moody's Investor Services, to Jonathan G. Katz, Secretary, SEC, 2–4 (July 28, 2003), at http://www.moodys.com/moodys/cust/research/venus/Publication/Special%20Report/noncategorized_number/78937.pdf (last visited April 5, 2004), while Fitch favors keeping the designation, Letter from Charles D. Brown, General Counsel, Fitch, Inc., to Jonathan G. Katz, Secretary, SEC, 1–2 (July 28, 2003), at http://www.fitchibca.com/shared/sec_statement.pdf (last visited April 5, 2004), and Standard & Poor's favors keeping the designation on grounds that withdrawing it "on a wholesale basis" would be disruptive to markets. Letter from Leo C. O'Neill, President, Standard & Poor's to Jonathan G. Katz, Secretary, SEC, 6 (July 28, 2003), at http://www2.standardandpoors.com/spf/pdf/media/SP_CONCEPT_RELEASE_JULY_28_2003.pdf (last visited April 5, 2004).

fundamentally change the nature of the market. Globalization offers cause for optimism in this regard. Once market participants in markets where the two-ratings norm is established become more familiar with markets where the two-rating norm isn't established, and the markets become more integrated with one another, the norm may erode. It should be noted that some would-be competitors to the major rating agencies don't like the idea of limited designations; they fear that they would be branded second-class.¹⁶⁰ This seems like a legitimate concern; however, on balance, it seems outweighed by the potential benefits of reducing market concentration.

When the NRSRO concept is revisited with a view towards eliminating the designation as it presently exists, other options for specifying the quality of various investors' portfolios should be considered. Rating agencies could continue in their quality certification role without having to be NRSROs; a pure market measure, such as credit spread, could be used;¹⁶¹ and/or regulators already overseeing safety and soundness for financial institutions could do case-by-case analyses when they do their financial institution examinations.

Another important issue, assuming the NRSRO designation is to be retained in the short to moderate term, is the criteria for NRSRO designation. That the procedure for NRSRO designation be made more transparent, and that the SEC be required to proceed along a pre-specified timetable, seem like easy and obvious fixes. The SEC disputes claims that eager entrants are not dealt with expeditiously and with encouragement;¹⁶² still, the SEC has pronounced itself willing to respond to the oft-made criticism that the process should become more transparent both procedurally and substantively.¹⁶³

Agreeing on an appropriate process should be comparatively uncontroversial. The appropriate substantive criteria for NRSRO status are more difficult to formulate. Certainly, the "national recognition" standard has been problematic, given that it entrenches existing agencies and

¹⁶⁰ See Jenny Wiggins, *A Chance to Step Into The Light*, FIN.TIMES, Dec. 9, 2002. ("Other options available to the SEC include providing smaller agencies with some form of limited recognition, acknowledging their expertise in select areas such as banking. This option, however, is not popular with the smaller agencies, which do not want to be considered 'second-class'.")

¹⁶¹ Partnoy supports the credit-spread alternative. See Partnoy, *Paradox*, *supra* note 10, at 80–81.

¹⁶² See generally Capital Markets Hearings, *supra* note 22, at 219–30 (testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission), <http://financialservices.house.gov/media/pdf/108-18.pdf> (last visited April 5, 2004).

¹⁶³ *Id.* See also SEC Concept Release, *supra* note 2.

discriminates against newer ones. If replacing the standard is rejected, provisional designations should be allowed. Critics have noted that the present standards are based largely on “inputs” such as how the agency does its job; they propose that “outputs”—how good the agency is at its job—are more appropriately considered.¹⁶⁴ That proposal seems unobjectionable as well, so long as its application does not implicitly serve to entrench more established agencies.

Even with all these changes, entry into the rating agency industry by a new firm will not be easy. Becoming a small niche agency shouldn't be hard, but making inroads on the positions of Moody's and Standard & Poor's will be quite challenging. A new entrant is hard pressed to compete on price or low standards (or even ease of dealings). Fitch has reportedly tried all three, with only limited success; certainly, low standards would not help, because they run counter to what the market needs in a rater: a reputation for being tough. And competing by having standards tougher than those of Moody's and Standard and Poor's isn't an intuitively winning strategy either.

As discussed in Part II.E, *supra*, using Fitch or some new entrant rather than one or both of the major agencies will also run counter to the incentives of many of the individuals in the position of making the decision. Nobody at the issuer or the investor firms has the incentive to “take a chance” on a lesser known or an unknown rating agency. To the issuer, the higher prices charged by Moody's and Standard & Poor's seem (and indeed, are) small relative to the improvement in financing terms and insulation from being second-guessed on that aspect of the debt offering. CEOs of issuers, and the issuers themselves, will be better rewarded by more successful offerings than they are rewarded for economizing on the offering expenses.

To have the best chance of achieving a less concentrated market structure, the government may need to play a role, especially in the short term. For instance, the SEC might issue a release discussing the standards for becoming an NRSRO and noting – indeed, emphasizing-- that *all* NRSROs had met those standards. Those investors fearing litigation because they purchased securities rated by an NRSRO that wasn't Moody's or Standard and Poor's that later lost value or even defaulted might conclude that they could get (nearly?) as much “cover” with a new

164. Capital Markets Hearings, *supra* note 22 (testimony of Dr. Lawrence J. White), <http://financialservices.house.gov/media/pdf/040203lw.pdf> (last visited April 5, 2004) (The SEC's criteria “must be centered on *outputs*—the efficacy of firms in predicting bond defaults—rather than the inputs that were the focus of its 1997 proposals.”).

agency as with the old ones, and at a cheaper price. But the government's actions to decrease the dominance of the present NRSROs and in particular, Moody's and Standard & Poor's, will necessarily and appropriately be limited. For instance, requiring issuers to get more (or less) than two ratings would probably, and correctly, be considered unwarrantedly and excessively intrusive.

It has been proposed that the government should get involved in ongoing monitoring of rating agencies.¹⁶⁵ To the extent that the rating agency market is a natural oligopoly, government monitoring might seem appropriate. But on closer reflection, I think the idea should be abandoned, at least insofar as what's being considered is government inspections, extensive record-keeping requirements, and other "traditional" types of oversight.¹⁶⁶ Monitoring can fairly well be designed to catch egregious shirking or fraud. But monitoring with the end of making lax behavior less lax should be less successful. The result is likely to generate make-work, with no real improvement. Where rating agencies are failing is not in the increment that traditional monitoring of this type could capture.

One intriguing proposal related to ongoing monitoring bears further consideration. Two commentators, Fidelity and the Investment Company Institute, have suggested a process analogous to the one used for broadcast licenses.¹⁶⁷ Broadcast licenses are renewed periodically, and public comment is solicited as to whether the licenses should be renewed, and if so, on what terms. The proposal is that the NRSRO designation be subject to renewal using a comparable process.¹⁶⁸ The rationale apparently is that the process can to some extent substitute for the lack of vigorous competition in the rating agency industry.

The first question to consider is whether a threat not to renew NRSRO designation would be credible. The answer would seem to be no. Certainly, there has never been a non-renewal of a permanent broadcast license; there has been only one non-renewal of a temporary license.¹⁶⁹

165. SEC Concept Release, *supra* note 2.

166. *Id.*

167. *The Current Role*, *supra* note 8 (testimony of Amy Lancellota, Senior Counsel of the Investment Company Institute), <http://www.sec.gov/news/extra/credrate/investcoinstit.htm> (last visited April 5, 2004); *Id.* (testimony of Cynthia Strauss, Director of Taxable Bond Research, Fidelity Investments Money Management, Inc.), <http://www.sec.gov/news/extra/credrate/credrate111502.txt> (last visited April 5, 2004).

168. *Id.* See also Concept Release, *supra* note 2, at Question 31.

169. The FCC grants the vast majority of broadcast license renewals, despite the discretion allowed under the "public interest" standard that it uses to evaluate renewal applications. See Christopher S. Yoo, *The Rise and Demise of the Technology-Specific Approach to the First Amendment*, 91 GEO. L.J. 245, 258 (2003) [hereinafter Yoo].

And it seems likely that the pressures against non-renewal would be considerable, especially as to Moody's and Standard & Poor's. Markets would almost certainly react very strongly if one of these designations were threatened with non-renewal. Even with lesser pressures, it would seem, the FCC is reluctant not to renew a license.

But even if NRSRO designation non-renewal weren't a plausible outcome of public hearings, such hearings could nevertheless be valuable. The fear of being shamed would presumably constrain rating agencies.¹⁷⁰ For this idea to work properly, the members of the public entitled to comment must be carefully chosen; self-serving shamers would have strong incentives to use the process to advance their own interests, as some say has happened in the broadcast context.¹⁷¹

These objections aside, the public hearings idea may be worth further consideration. The SEC's Concept Release asks for comments on a more general version of the idea: "Question 31: Should the Commission solicit public comment on the performance of each NRSRO, including whether the NRSRO's ratings continue to be viewed as credible and reliable? If so, how frequently should public comment be solicited (*e.g.*, annually)?"¹⁷² Perhaps a bi-annual hearing timetable might be best, with a procedure for conveying informal comments to the agencies and to the SEC in the intervening time. The interval for the formal hearings should be short enough to produce the desired dialogue and accountability, but not so short that completion of a hearing is followed fairly quickly by the need to prepare for the next one.

Even if NRSRO designation was abandoned or the standards were considerably loosened, some process for public comment might still be desirable and feasible. Perhaps rating agencies would be required simply to register as such, rather than needing SEC approval, and registered agencies would be subject to a public comment process. The sanction could simply be the shaming from unfavorable comments made in a public forum.

Other suggestions for reform have included greater accountability for rating agencies in court.¹⁷³ Greater judicial scrutiny of rating agencies does

170. On shaming generally, see David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1834 (2001).

171. My source for this statement is a conversation with Christopher Yoo.

172. SEC Concept Release, *supra* note 2, at 10.

173. The proposed changes are principally to eliminate the Rule 436(g) exemption of rating agencies from Section 11 liability. *See supra* notes 71 and 77 and accompanying text. But greater liability could also mean judicial or legislative "overruling" of the Quinn decision, and a heightened duty, to both issuers and investors, on the part of rating agencies.

not seem to be to be indicated. It is too easy to second-guess a rating; greater scrutiny would seem to invite frivolous litigation of the “have ratings downgrade, will sue” variety.¹⁷⁴ Ratings are not insurance against changes in the world. Fraud should be actionable, but there is no evidence that rating agencies have acted fraudulently. Litigation does not seem to be needed to address the shortcomings Senator Lieberman’s hearings noted in connection with Enron. Indeed, since Enron went bankrupt, the rating agencies seem to have avoided the kind of “dismal laxity” of which Lieberman accused them.¹⁷⁵ On the contrary, some have even criticized rating agencies for being too attentive and downgrading too quickly.¹⁷⁶ In sum, litigation is ill-suited to capture the increment we want captured, the increment between rating agency performance in a market with high market concentration and high barriers to entry, but considerable constraint arising from the need to both maintain a good reputation and keep potential regulation at bay, and rating agency performance in a more open market. This increment would be better captured by encouraging increased competition and by allowing for a public comment process. It should be noted, though, that unless competition can be significantly increased, even the best of these solutions will likely improve only quality; these solutions should have a far harder time lowering price.

D. Reform Goals Compared: Rating Agencies Versus Other Enron Actors

The goals of rating agency reforms are quite different from the goals of other reforms prompted by Enron and the other debacles. Consider the conduct of some top executives of Enron and of the other companies that had spectacular implosions: using accounting tricks to conceal liabilities and record fictitious profits; gaming compensation measures to get stock options and bonuses; arranging to sell themselves company assets at bargain prices; obtaining concealed loans at below-market terms; using corporate funds for personal purposes; and giving assurances about the condition of the company to employees while selling large quantities of their own holdings of the company’s stock. Consider the conduct of accountants: certifying questionable financial statements for fear of losing lucrative clients or getting less of the clients’ lucrative non-auditing business. Consider also the conduct of stock analysts: publicly touting a

174. My point is strengthened by the arguments I make in Part III.B about the impossibility of downgrading “correctly.”

175. Watchdog Press Statement, *supra* note 126.

176. See Miller, *supra* note 123, at A17.

company's stock, contrary to the analyst's private belief that the stock was a "dog," in order to obtain the company's investment banking business.

There were prohibitions on many, if not all, of this conduct before Enron and the other debacles.¹⁷⁷ Enron simply revealed that the prohibitions had not been effective and that the incentives to engage in some of this conduct had increased. The debate on proposed solutions should proceed along a well-worn path, weighing and honing some combination of enhanced monitoring and reducing incentives to engage in this conduct, and perhaps considering the roles other actors can play: judges in taking a more activist stance on executive compensation; shareholder-activists in using the proxy process; and society in changing social norms.

Contrast these behaviors of executives, accountants, and stock analysts with the behavior of the rating agencies in Enron. The assessment of the Senate Committee studying the matter was that "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 officials chose to tell them."¹⁷⁸ The rating agencies didn't work hard enough, apparently. But even if they had worked harder, would they have worked well enough? Redirecting efforts from a bad end (for instance, in the case of Andrew Fastow, former CEO and CFO of Enron, self-enrichment) to a good end (in Fastow's case, enrichment of Enron's shareholders) is far more tractable than requiring people to do a better job.

What happened in Enron suggests "laxity" in performance reflecting the effects of regulatory, natural, historical, and institutional barriers to entry. But conflicts of interest were largely avoided, largely because of the market oligopoly those barriers helped create and perpetuate. Because of the two-rating norm, companies couldn't play one rating agency off against another, as they apparently did with accountants. As is now well known, accounting firms, also paid by the companies to which they provided financial services, succumbed to the pressure their clients exerted.¹⁷⁹ A client would tell its accounting firm to vouch for a particular accounting treatment or risk losing the client's auditing business, not to mention the far more lucrative consulting business that often accompanied auditing work.¹⁸⁰ Such a threat by a client was credible because only one

177. Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915 (2003).

178. Watchdog Press Statement, *supra* note 126.

179. See Coffee, *supra* note 37; Gordon, *supra* note 37.

180. *Id.*

accountant certification was needed for regulatory purposes,¹⁸¹ and there were several equally reputable firms (the “Big Eight,” now the “Big Four”) competing for each company’s business. And should the client be unwilling to bear the not-inconsiderable reputational and other costs of firing its accounting firm, the client could simply threaten to reduce the accounting firm’s other (quite lucrative) work for the client, imposing what Professors Coffee and Gordon characterize as a “low visibility” sanction.¹⁸²

Rating agencies haven’t been nearly as susceptible to the same pressures. The non-ratings work they have done has been less lucrative relative to rating work than non-auditing work has been relative to accounting work. (Indeed, some have characterized audit work as a ‘loss leader.’) Thus, the sanction of reducing non-ratings work might be comparably “low visibility” for a rating agency as for an accounting firm but it would be far less effective. Furthermore, because rating agency performance is easier to measure than accounting firm performance, the costs to the rating agency of succumbing to pressure should be considerably higher.¹⁸³ But conflicts of interest may become more of an issue for rating agencies as they increasingly develop and promote more lucrative non-ratings services.¹⁸⁴ Moreover, regulatory reforms might succeed in appreciably increasing the number of rating agencies; companies then might be able to play the rating agencies off one another, as they were able to do with their accounting firms. The SEC and the rating agencies have acknowledged the dangers; various responses are being considered, similar to the types of responses considered in the context of accounting firms, including the separation of personnel doing the different types of businesses within the rating agency and prohibitions

181. Perhaps only one certification was needed because the more intensive review required for each audit made the costs of subsequent audits high and the incremental benefits to investors low. And perhaps there came to be several accounting firms because, while a “national” reputation was needed, once a certain quantity threshold was passed, having additional companies on the client list added neither to the value of the audit nor to the reputation of the accounting firm. While an accounting firm had to be quite big to compete, as consolidation of the “Big Eight” to the “Big Five” (then to the “Big Four” after the fall of Andersen) proved, there was little incremental benefit to having the client list extend beyond “sizeable” to “comprehensive.” The value of the service requires expertise and appreciable size; since the inquiry is only partially focused on comparability, and the accounting standards themselves are written to allow for comparability, the comparison is not the accounting firm’s job.

182. See Coffee, *supra* note 37, at 292; Gordon, *supra* note 37, at 1238.

¹⁸³ *Id.*

¹⁸⁴ One new service is “ratings estimation,” in which the rating agency tells issuers what rating it would give for a contemplated transaction. Having made the estimate, the rating agency may then feel constrained to abide by it even after new facts emerge.

or limitations on rating agency ancillary businesses.

However else conflicts and the potential for conflicts are addressed, serious consideration should be given to having rating agencies provide a certification on a regular (probably annual) basis that they have adopted procedures to guard against and detect conflicts of interest (and specifying those procedures), and that all employees of the rating agency are familiar with the procedures and are subject to sanctions for violations. Should the certification prove false or even negligently made, the rating agency should be subject to a fine or other sanction.¹⁸⁵

V. CONCLUSION

The regulatory regime applicable to rating agencies is being revisited on account of Enron. Enron itself may not warrant regulatory change, but there is no reason not to take advantage of the opportunity to make a workable system better. To take full advantage, we need to conduct a thorough re-examination of the regime. The most basic questions need to be addressed: To what extent should regulators be involved in assuring the “safety and soundness” of various investors’ investment portfolios? Which investors? And using what means?

This Article weighs in on the debate. It makes some concrete suggestions as to how regulatory reform ought to proceed. Critically, it does so mindful of the institutional context in which the reforms would be carried out. Too often theorists don’t sufficiently consider transition issues, institutional detail, and institutional constraints. Energy is spent on devising the Nirvana solution and arguing for its strengths notwithstanding that adoption of the Nirvana solution may be very unlikely or even undesirable in the short-term. Meanwhile, unembedding long-embedded practices that agency problems within institutions as well as inertia reinforce is given short shrift.

My Article gives a rich institutional account of rating agencies upon which policymakers can draw to form and appraise an appropriate regulatory regime. Such an account is helpful on its own terms and as an antidote to the regulatory fervor that Enron has inspired. Clearly, something ought to be done to prevent future Enrons. But it is important not to act reflexively on a political impetus, making ill-considered regulatory changes just to be doing something. The flip side of a precipitous call for action is a hasty retreat when the furor dies down. And

185. Questions 37-40 of the SEC Concept Release, *supra* note 2, consider possible approaches to rating agency conflicts of interest.

this too is a peril. Previous crises have also spurred calls to action, but once the issue dropped from view nothing further was done.

The easiest proposal to defend on theoretical grounds is probably the elimination of the NRSRO designation and replacement with a more market-based solution.¹⁸⁶ But there are considerable perils of eliminating NRSRO designation too quickly. The Economist characterized the January 2003 SEC report on rating agencies as “dither[ing] over possible cures, and steer[ing] away altogether from by far the most sensible idea: to reverse the trend of the past 60 years, and start taking credit ratings out of financial regulation altogether.”¹⁸⁷ The instinct is the right one, and many commentators share it; however, if the process is not carefully managed, the effect may be the opposite of what was intended: to more firmly entrench Moody’s and Standard & Poor’s. The government surely helped create the rating agency oligopoly, both by its restrictions on entry, which limited supply of NRSRO ratings, and its use of NRSRO ratings in various regulatory schemes, which increased demand for those ratings. But the government doesn’t have the ability to readily destroy the oligopoly; use of NRSRO ratings and in particular, Moody’s and S&P’s ratings, has simply become too entrenched. Still, the government is in a good position to help deal with the oligopoly, even if only by ameliorating its effects.

186. *See supra* note 161 and accompanying text.

187. *Let Go of Nanny*, THE ECONOMIST, Feb. 8, 2003, at 1.