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Credit Rating Agency Review Board: The Challenges and Implications of Implementing the Franken-Wicker Amendment to Dodd-Frank

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"It is clear that the past conduct [of Credit Rating Agencies] cannot be repeated."[1] – Luis A. Aguilar, SEC Commissioner

CREDIT RATING AGENCY REVIEW BOARD: THE CHALLENGES AND IMPLICATIONS OF IMPLEMENTING THE FRANKEN-WICKER AMENDMENT TO DODD-FRANK

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* Associate, Latham & Watkins, LLP, J.D. 2014 Northwestern University School of Law, I would like to thank foremost my wife, Jessica Oulton, for her unwavering support and dedication to our family. I would also like to thank Professor Kathleen Litvak for helping me think through the various issues raised when government tries to regulate financial markets. Finally, I would like to thank Richie Gregory and the editors at JBEL.

[1] Luis A. Aguilar, Comm'r, Sec. and Exch. Comm'n, Addressing Conflicts of Interest in the Credit Ratings Industry, (May 14, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171515642#.VCczdCtdWug.

ABSTRACT

The purpose of this paper is to analyze, critically review, and determine whether a hypothetical credit rating agency board, as suggested in the Franken–Wicker Amendment to the Dodd–Frank Act, is a viable option for combating the conflict of interest problem between credit rating agencies and issuers. Research methodology includes a careful review of various ways to structure the board and the potential unintended consequences of doing so. The Author uses original research hand-collected from video of the Credit Ratings Roundtable conducted in Washington D.C. on May 14, 2013. The Credit Ratings Roundtable brought together experts from the credit rating industry and government to discuss the viability of a credit rating agency board. After

reviewing the research, the paper concludes, while the credit rating agency board will be difficult to implement and may have various negative unintended consequences, it is currently the best option available to break the conflict of interest.

I. INTRODUCTION

On September 15, 2008, Lehman Brothers, one of the United States' largest and most respected investment banks filed for Chapter 11 bankruptcy protection.[2] The Lehman bankruptcy was the largest in the United States in terms of total debt by more than $500 billion dollars.[3] Shortly after the collapse, the financial markets entered a period of rapid decline.[4] While the causes of the great recession are varied, the ultimate result was the worst financial crisis in the United States since the Great Depression. Nearly six years later, the United States' economy has still not fully recovered, and many are still suffering from its devastating effects.[5]

One catalyst often pointed to, as a cause of the financial crisis, was the massive deterioration of the real estate market beginning in 2007.[6] Due to an array of factors, including prolonged low interest rates, aggressive sales tactics of mortgage originators, and the bundling of complex mortgage-backed securities, the United States experienced an incredible real estate bubble during the early 2000s. Many believe one reason for the crisis was credit rating agencies (CRAs), which rate debt instruments in an attempt to judge the ability of repayment, massively overrated securities backed by residential mortgages.[7]

CRAs have had an important role in the financial markets since the early Twentieth Century and help deal with the issue of asymmetric information in financial markets.[8] Currently, three CRAs: Moody's, Standard & Poor's, and Fitch, collectively, the "Big Three," rate the vast majority of security and debt

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2 Sam Mamudi, *Lehman Folds with Record $613 Billion Debt*, MARKETWATCH (Sept. 15, 2008, 10:11 AM), http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt.

3 *Id.*

4 *See Crash Course*, ECONOMIST (Sept. 7, 2013), http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article.

5 *Id.*

6 *See* James B. Bexley, et al., *The Financial Crisis and Its Issues*, 3 RES. BUS. & ECON. J.1, 3 (2011) (noting "the pain" experienced during the crisis became apparent as underlying real estate values plummeted).

7 *See* Gary Gorton, *The Subprime Panic*, 15 EUR. FIN. MGMT. 10, 32 (2009).

8 Marwan Elkhoury, *Credit Rating Agencies and Their Potential Impact on Developing Countries*, 186 UNITED NATIONS CONF. ON TRADE AND DEV. 1, 2–3, (2008), *available at* http://www.unctad.org/en/Docs/osgdp20081_en.pdf.

issuances—rating 95% of all issuances.[9] One particular issue identified after the crisis was the perverse conflict of interest created by a system that allows the issuers of securities to choose the CRA that will ultimately provide a rating analysis for the security.[10] Because issuers seek the highest rating possible for an issue, which allows them to market to more investors, CRAs were seen as being incentivized to provide the best rating, rather than an accurate rating.[11] Investors, in particular financial institutions, pensions, and other institutional investors, were forced by regulators to use CRA ratings when building investment portfolios.[12] Therefore, many investors had little choice but to invest in securities rated investment grade by the CRAs, regardless of their own risk-based credit analysis.[13]

Senators Al Franken (D-Minn) and Roger Wicker (R-Mass) proposed one possible solution to the conflict of interest problem, which has received a lot of attention. The Franken–Wicker Amendment to Dodd–Frank, proposes a Credit Rating Agency Board (Board) under the Securities and Exchange Commission (SEC). The Board's purpose is to break the conflict of interest by assigning a CRA to an issuer rather than allowing the issuer to choose a CRA.[14] While the amendment initially passed the Senate by a wide majority, outcry from the credit rating industry resulted in the amendment's removal from Dodd–Frank.

After Congress removed the amendment from the bill, the SEC undertook a study to determine the viability of creating the Board.[15] Following the study's release, Senators Franken and Wicker hosted the Credit Ratings Roundtable in Washington D.C. on May 14, 2013. Senators Franken and Wicker brought the CRAs together with government entities to discuss the possibility of creating the Board. Portions of the Credit Ratings Roundtable are found throughout this paper and, to date, have never been written about.

This article analyzes a hypothetical Board using the language in the

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[9] Christopher Alessi, Roya Wolverson & Mohammed Aly Sergie, *The Credit Rating Controversy*, COUNCIL ON FOREIGN REL., http://www.cfr.org/financial-crises/credit-rating-controversy/p22328 (last updated Oct. 22, 2013).

[10] *See, e.g.*, Rupert Neate, *Ratings agencies suffer 'conflict of interest', says former Moody's boss*, GUARDIAN (Aug. 22, 2011), http://www.theguardian.com/business/2011/aug/22/ratings-agencies-conflict-of-interest.

[11] *Id.*

[12] Emily M. Ekins & Mark A. Calabria, *Policy Analysis: Regulation, Market Structure, and Role of the Credit Rating Agencies*, 704 CATO INST. POL'Y ANALYSIS 1, 12–27 (2012), *available at* http://www.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf.

[13] *Id.*

[14] Press Release, Al Franken U.S. Senator for Minn., Sens. Franken, Wicker Push SEC to Implement Credit Ratings Industry Reform (July 24, 2013), *available at* http://www.franken.senate.gov/?p=press_release&id=2514.

[15] *See* Michael Hirsh, *Al Franken Gets Serious*, NEWSWEEK, July 5, 2010, http://www.newsweek.com/al-franken-gets-serious-74561.

Franken–Wicker Amendment as a baseline. The goal of the article is to review the hypothetical Board from the perspective of how it may function and perform in the credit rating markets and determine whether the Board is a viable alternative to the status quo. The hypothetical Board creates many complexities, new problems, and conflicts of interest; however, the Board is likely more desirable than the status quo. The Board is not the only possible solution to the problems inherent in the credit ratings industry, but it received a significant amount of attention during the discussions in Congress following the crisis and, therefore, is the subject of this article.

Part I gives a brief account of the role of CRAs in the financial markets, the role of CRAs in the financial crisis, the issuer-pays model, and the proposed reforms to the credit rating industry.[16] Part II analyzes the structure of the Board as outlined under the Franken–Wicker Amendment and the possibility of creating an assignment system.[17] After reviewing several possibilities, Part II raises some unforeseen problems the system may create.[18] Part III concludes by arguing while the Board will create additional bureaucracy and complexity, it is better than doing nothing at all and is the only proposal that directly breaks the conflict of interests.[19]

A. The Role of Credit Rating Agencies in Financial Markets and The Lead-Up to the Franken-Wicker Amendment

Accurate information is the lifeblood of an efficiently functioning and healthy financial market. CRAs were born in the early 19th Century to fill an information void and provide desperately needed information on the health of railroad companies.[20] This information was needed because some investors in railroads were suffering severe losses.[21] Though financial markets have grown in complexity since the early days of credit rating, the CRAs continue to operate as gatekeepers in the financial markets.[22] CRAs gather financial information from the issuers of debt instruments, then analyze, interpret, and disseminate information on the likelihood of repayment. These assessments are relative measures of creditworthiness. CRAs have historically avoided making

[16] *See infra* Part I.A–D and accompanying notes 21–82.

[17] *See infra* Part II.A–B and accompanying notes 83–131.

[18] *See infra* Part II.C and accompanying notes 132–203.

[19] *See infra* Part III and accompanying notes 204–207.

[20] *See* HERWIG LANGOHR & PATRICIA LANGOHR, THE RATINGS AGENCIES AND THEIR CREDIT RATINGS: WHAT THEY ARE, HOW THEY WORK, AND WHY THEY ARE RELEVANT 1 (Wiley 2010).

[21] *Id.*

[22] *See* Steven L. Schwarz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 2 (2002).

guarantees of creditworthiness and, thus, have avoided liability on free speech grounds when ratings prove to be inaccurate.[23]

The CRAs perform three main functions.[24] First, CRAs are designed to measure credit risk.[25] Second, CRAs provide a means of comparison between different securities issues.[26] Finally, CRAs provide the markets with a common standard to judge credit risk.[27] CRAs derive their value from the well-recognized fact markets contain asymmetric information. The borrower is eager to receive the loan and, therefore, is incentivized to provide information to the lender that is favorable for the borrower. The lender, on the other hand, would prefer to get all of the information—good and bad—about the borrower so the lender can make the appropriate risk calculations. In short, the borrower is much more likely to know whether it can repay, but the lender is rightly skeptical.

The CRA, when performing its job efficiently, steps into this informational void and acts as an agent for the investor. A CRA's value lies in its expertise analyzing information not available to the typical investor. Rather than requiring individual investors to trust the information given to them by the potential borrower, investors are able to rely on the expertise of the CRAs when determining the creditworthiness of a borrower. The CRAs issue ratings that are easy for the common investor to understand and are given on a grading scale similar to educational institutions. For example, Standard and Poor's has a credit rating scale that starts at "AAA" for issues deemed to be the least risky to "D" for issues already in default.[28] When the CRAs can accurately predict the credit quality of a lender, the value of the credit analysis is positively correlated to the complexity of the financial product and the available information about the firm or economy. In other words, as the complexity of the information increases because the information is hard to prove, easy to manipulate, or just generally is difficult to understand, the more valuable an accurate rating from a CRA.

Furthermore, relying on CRAs is more useful for individual investors who may have limited resources to spend on credit analysis. The larger players in debt markets such as pension funds, financial institutions, and mutual funds are

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[23] Theresa Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 MINN. L. REV. 140, 142 (2009).

[24] LANGOHR & LANGOHR *supra* note 21, at 89–91; Stephen Harper, *Credit Rating Agencies Deserve Credit for the 2007-2008 Financial Crisis: An Analysis of CRA Liability Following Enactment of the Dodd-Frank Act*, 68 WASH. LEE L. REV. 1925, 1931 (2011).

[25] Harper, *supra* note 25, at 1931.

[26] *Id.*

[27] *Id.*

[28] *Credit Ratings Definitions and FAQ's*, STANDARD AND POOR'S, http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us (last visited on Feb. 24, 2014).

more likely to have the resources to perform their own detailed credit analysis. However, for decades the government mandated through regulations these large institutional investors invest in debt securities highly rated by the CRAs.[29] Therefore, even the most sophisticated investors were required to rely on ratings from the CRAs, regardless of their own analysis of a particular issuer's credit.[30]

B. The Role of Credit Rating Agencies During the Financial Crisis

The financial crisis of 2007–2008 resulted in hundreds of billions of dollars in investor losses, a massive $700 billion bailout of Wall Street banks, and the collapse of some of Wall Street's most storied institutions.[31] Much of the crisis was the direct result of the packaging and selling of securitized residential mortgage products. The CRAs had a significant role in this process. Because of the massive profits available to issuers who could securitize mortgages, CRAs served an important gatekeeping role.[32] A favorable rating from a CRA was critical to issuers because it gave them a regulatory license to sell to large institutional investors who were required to invest only in securities rated investment grade.[33]

Moreover, the CRAs were much more involved with issuers over mortgage-related financial products.[34] CRAs consulted extensively with issuers and discussed with them ways to earn higher ratings for their products.[35] The result was issuers began to conform their practices to fit the CRAs' model for investment grade ratings.[36] This, in turn, allowed the issuer to sell to larger groups of investors, ultimately leading to higher profits. As a result of this arrangement, CRAs earned approximately three times the fee revenue for rating mortgage securities than they did for traditional corporate and government bonds.[37]

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[29] *See e.g.* Rolf H. Weber & Aline Darbellay, *The Regulatory Use of Credit Ratings in Bank Capital Requirement Regulations*, 10 J. BANKING REG. 1, 4 (2008) (noting the requirement that banks use CRA ratings when determining capital requirements began in the 1930s).

[30] *See id.*

[31] Phillip Swagel, *The Cost of the Financial Crisis: The Impact of the September 2008 Economic Collapse*, PEW ECON. POL'Y GROUP, at 1, 4 (2009).

[32] *See* Josh Wolfson & Corinne Crawford, *Lessons from the Current Financial Crisis: Should Credit Rating Agencies be Re-Structured?*, 8 J. BUS. & ECON. RES., 85, 86–87 (2010).

[33] *See id.*

[34] Lawrence J. White, *Markets: The Credit Rating Agencies*, 24 J. ECON. PERSP. 211, 220 (2010).

[35] *Id.*

[36] *See id.*

[37] Elliot B. Smith, *Bringing Down Wall Street as Rating Let Loose Subprime Scourge*, BLOOMBERG (Sept. 24, 2008), http://www.bloomberg.com/apps/news?sid=ah839IWTLP9s&pid=newsarchive.

If the CRAs were providing accurate ratings and fulfilling their role of bridging the asymmetric information gap, one could say the ends justified the means. However, the CRAs' judgment on the creditworthiness of many mortgage securities was grossly inaccurate. Prior to the financial crisis, CRAs rated thousands of mortgage securities.[38] The vast majority of these securities received an AAA rating, the highest possible rating for a security.[39] Even though an AAA rated security historically has a 1% default rate, 90% of the securities rated between 2006–2007 were later downgraded to below investment grade.[40]

The resulting downgrades wreaked havoc on financial markets as investors tried to sell off securities as their value plummeted.[41] As values declined, large financial institutions were forced to write down over $500 billion in debt on their books.[42] These write-downs, in part, led to the collapse or selling off of some of Wall Street's most storied institutions including Lehman Brothers, Merrill Lynch, and Bear Sterns.[43] As confidence in financial institutions' ability to pay back loans faltered, the credit market began to seize up.[44] Unable to get access to credit to pay for daily operations, many businesses failed, which further contributed to the financial crisis.[45]

In response to the financial crisis, Congress passed the Wall Street Reform and Consumer Protection Act also known as "Dodd–Frank." The Act describes its purpose as to "Create a Sound Economic Foundation to Grow Jobs, Protect Consumers, Rein in Wall Street and Big Bonuses, End Bailouts and Too Big to Fail, Prevent Another Financial Crisis."[46] As part of the slew of reforms included in the Act, the drafters included provisions to reform the credit rating agency industry.

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38 Luis A. Aguilar, Comm'r, Sec. and Exch. Comm'n, Remarks at the Credit Ratings Roundtable (May 14, 2013), https://www.sec.gov/spotlight/credit-ratings-roundtable.shtml.

39 *Id.*

40 *Id.*

41 *See* Rachelle Younglai & Sarah N. Lynch, *Credit Raters Triggered Financial Crisis: Panel*, REUTERS (Apr. 13, 2011, 7:38 PM), http://www.reuters.com/article/2011/04/13/us-financial-regulation-report-ratingage-idUSTRE73C8GX20110413.

42 Smith *supra* note 38.

43 *Id.*

44 Kirk Shinkle, *America's Credit Catastrophe*, U.S. NEWS AND WORLD REP. (Oct. 3, 2008, 5:31 PM), http://money.usnews.com/money/business-economy/articles/2008/10/03/americas-credit-catastrophe.

45 *Id.*

46 Press Release, Dodd Frank Wall Street Reform and Consumer Protection Act (Jun. 29, 2010), *available at* http://democrats.financialservices.house.gov/press/PRArticle.aspx?NewsID=1306.

C. Proposed Reforms to Credit Rating Agencies

The government sought to reform credit rating agencies by including in Dodd–Frank provisions meant to address the CRAs' historic failure in properly rating mortgage securities.[47] The goals of Dodd–Frank are important to the hypothetical Board because they provide the baseline from which all formation and performance decisions are measured. A successful Board must meet the broad policy goals of Dodd–Frank while at the same time being cognizant of the blowback any structural decisions create. Therefore, the Board must be careful not to solve one problem and, in the process, create other unforeseen consequences that undermine the purposes of Dodd–Frank.

The reforms have two primary goals. First, Dodd–Frank seeks to ultimately reduce investor reliance on CRAs and incentivize institutions to rely on their own independent credit risk analysis.[48] Investors simply put too much stock in what the rating agencies said about securities. This reliance, in some ways, was artificial because the government began institutionalizing CRAs into the financial system as early as the 1930s.[49] The second goal of Dodd–Frank, with regard to CRA regulation, was to improve the quality of credit ratings conducted by the CRAs.[50] Decreasing reliance is not enough because many investors will likely continue to use CRA ratings.

To achieve the goals of reducing reliance on CRAs, Dodd–Frank began the unraveling of decades of regulations making reference to CRAs. The culmination of this process resulted in the removal of references to CRAs in a series of SEC and OCC regulations.[51] This included an amendment to the definition of "investment grade."[52]

Prior to the enactment of the regulation under Dodd–Frank, banks were

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[47] *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 931, 124 Stat. 1376, 1872 (2010).

[48] Ben Protess, *S.E.C. Seeks to Reduce Reliance on Credit Ratings*, N.Y. TIMES, Feb. 9, 2011, http://dealbook.nytimes.com/2011/02/09/s-e-c-aims-to-reduce-reliance-on-ratings/.

[49] *See* GILBERT HAROLD, BOND RATINGS AS AN INVESTMENT GUIDE: AN APPRAISAL OF THEIR EFFECTIVENESS 160–72 (1938); Frank Partnoy, *Historical Perspectives on the Financial Crisis: Ivar Kreuger, The Credit-Rating Agencies, and Two Theories About the Function, and Dysfunction of Markets*, 26 YALE J. ON REG. 433, 439 (2009).

[50] *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, *supra* note 48, § 931.

[51] Press Release, Sec. and Exch. Comm'n, SEC Removes References to NRSRO Ratings in Certain Rules and Forms (Dec. 27, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540564425#.VCdhJytdXLR; Press Release, Julie L. Williams, First Senior Deputy Controller and Chief Counsel, Office of the Comptroller of the Currency, Alternatives to the Use of External Credit Ratings in the Regulations of the OCC (Jun. 26, 2012), *available at* http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-18.html [hereinafter Office of the Comptroller].

[52] Office of the Comptroller *supra* note 52.

allowed to exclusively rely on the ratings of CRAs in determining the investment quality of a security. After the promulgation of the rules, banks are allowed to use external CRAs as one factor in determining investment quality.[53] However, the inquiry no longer ends there.[54] To fully comply with the regulation, financial institutions "should supplement any consideration of external ratings with due diligence processes and additional analyses that are appropriate for the institution's risk profile and for the size and complexity of the instrument."[55] Essentially, lawmakers wanted to encourage institutions to perform independent credit analysis and gave them the breathing room to do so by eliminating the requirement to rely exclusively on CRA ratings.

The Dodd–Frank's second purpose was to improve the quality of credit ratings. In this regard, Dodd–Frank took several approaches including greater internal controls,[56] more expansive and accessible disclosure of ratings,[57] increased liability for CRAs,[58] a whistleblowing duty,[59] and greater independence in corporate governance.[60] One of the most discussed issues are CRAs' expanded procedures dealing with the conflict of interest problem.[61] Addressing the conflict of interest is the primary objective of the Franken–Wicker Amendment;[62] however, the performance of the Board must be judged on how it interacts with the goal of reducing investor dependence on credit ratings.

D. The Conflict of Interest and Issuer Pays Model

The issuer pays model, where the issuer of a debt instrument seeks out and pays the CRA to provide a rating, was not always the standard in the industry. In the early days, the CRAs provided ratings to issuers free of charge. CRAs received their revenues from the sale of credit rating publications to investors.[63]

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[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.* § 932(a)(2)(B)(3).
[57] *Id.* § 932.
[58] *Id.* §§ 932(a)(1)–(3), 933, 939G.
[59] *Id.* § 934.
[60] *Id.* § 932(a)(8).
[61] *Id.* § 932.
[62] Press Release, Al Franken, U.S. Senator for Minn., Sens. Franken, Wicker Push SEC to Implement Credit Rating Industry Reform (Jul. 24, 2013), *available at* https://www.franken.senate.gov/?p=press_release&id=2514.
[63] Richard Cantor & Frank Packer, *The Credit Rating Industry*, 5 J. FIXED INCOME 10, 14 (1995), *available at* http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n2article1.pdf.

This was known as the user pays model. The transition away from the user pays model was brought about in large part because of Penn Central Transportation Company's $82 million commercial paper default in 1970.[64] Prior to that event, investors typically assumed any company with a household name was likely a good credit risk.[65] The Penn Central default caused investors to question the quality of commercial paper even for large, well-known firms.[66] Unwilling to take this risk, investors withheld their funds causing a liquidity crisis in the commercial paper markets.[67]

The lack of investor funds caused many companies who relied on the commercial paper markets to fail.[68] To counteract the lack of confidence, the companies began to actively seek credit ratings on their debt issuances from CRAs.[69] As demand for ratings from issuers increased, CRAs saw an opportunity to charge the issuers directly for credit ratings on debt.[70] By the early 1970s, the Big Three were all charging issuers directly for credit ratings.[71] This shift in business model also coincided with the SEC introducing the Nationally Recognized Statistical Rating Organization (NRSRO) designation, which was incorporated into many regulations.[72] The standardization of CRAs and their ratings into regulations institutionalized CRAs, making their ratings more valuable to issuers.[73] This perpetuated the issuer pays model many believe created the conflict of interest the Franken–Wicker Amendment seeks to remove.

The issuer pays business model creates an inherent conflict of interest. Prior to the 1970s, the CRAs received the majority of their revenues from subscription fees.[74] Today, CRAs receive between 90 to 95% of their revenues

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[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] *Id.*

[68] *See* Marcin Kacperczyk & Phillipp Schnable, *When Safe Proved Risky: Commercial Paper During the Financial Crisis of 2007-2009*, 24 J. ECON. PERSP. 29, 43 (2010), *available at* http://www.nber.org/papers/w15538.pdf (noting investors interpreted the Lehman Brothers bankruptcy as a signal commercial paper issued by financial institutions was riskier than originally thought).

[69] Cantor & Packer, *supra* note 64, at 14.

[70] *Id.*

[71] *Id.*

[72] Emily M. Ekins & Mark A. Calabria, *Policy Analysis: Regulation, Market Structure, and Role of the Credit Rating Agencies*, CATO INSTITUTE POL'Y ANALYSIS No. 704, 1 (Aug. 2012), *available at* http://www.cato.org/sites/cato.org/files/pubs/pdf/PA704.pdf.

[73] *Id.*

[74] Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 620 n.3 (1999).

directly from the issuers whose securities they are rating.[75] Some scholars see the adoption of the issuer pays model as creating a situation where the CRA is incentivized to provide the rating its customer desires.[76] Rather than trying to provide the most accurate ratings, the CRA may be looking forward to the next deal.[77] If the CRA were to provide a rating not favorable to the issuer, whether more accurate or not, the issuer would be less likely to hire the CRA for future deals. With the CRA dependent on the issuers for the vast majority of their revenues, the CRA would be more hesitant to provide a rating unfavorable to the issuer.

The argument CRAs are incentivized to provide desired ratings is well taken but possibly overblown. If all the CRA wanted to do was please issuers, then every rated deal would receive an AAA or its equivalent rating. However, not every deal receives the highest rating. It follows: there must be some market constraints on CRAs to provide accurate ratings. That said, the CRAs' incentive to look toward the next deal and provide investment grade ratings exists and is likely a partial cause of inflated credit ratings.

In a properly operating credit ratings market, perception of reputation among investors should incentivize CRAs to produce accurate credit ratings.[78] However, the SEC's designation of NRSROs unintentionally created an oligopolistic market for credit ratings.[79] The lack of competition allowed for greater credit rating market complacency and, coupled with inflated market demand caused by government regulatory pressures, forced institutional investors to value CRA ratings.[80] Thus, investors continued to rely on CRAs despite the decreasing informational value of their ratings.[81]

II. THE FRANKEN–WICKER AMENDMENT POSES ONE POSSIBLE SOLUTION TO THE CONFLICT OF INTERESTS PROBLEM

One proposed regulatory solution to the issuer pays model is known as the Franken–Wicker Amendment. This amendment, originally passed in the Senate as part of the Dodd–Frank Act, sought to create a credit rating agency review

[75] *Id.* at 652.

[76] *See* Nelson Camanho, et al., *Credit Rating and Competition*, (Social Science Research Network Working Series), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573035 (citing empirical studies showing the conflict of interest resulted in inflated credit ratings).

[77] *See id.*

[78] *See* Emily M. Ekins & Mark A. Calabria, Cato Institute, Policy Analysis: Regulation, Market Structure and Role of the Credit Rating Agencies 2 (2012).

[79] *See id.*

[80] *See id.*

[81] *See id.*

board within the SEC.[82] The Board would be responsible for assigning an issuer to a credit rating agency for each issue, rather than letting the issuer choose the rater.[83] With the incentive to look toward the next deal removed, the CRA will be more likely to provide an accurate rating, regardless of the desires of the issuer.

The Franken-Wicker Amendment largely leaves the design of the Board up to the SEC,[84] though the amendment does provide several guidelines. For example, the amendment prescribes the Board should be made up of an odd number of members.[85] The amendment requires the members of the Board include at least one representative each from the CRAs,[86] the securities issuers,[87] and an "independent" member.[88] In addition, the amendment specified, regardless of the total number of board members, investors must represent a majority of the board.[89] While the amendment received a fair amount of attention, no scholarship exists on how the Board might be implemented or designed. Furthermore, no scholarship exists that examines what implications a Board may have on the credit rating and financial markets.

The amendment received broad support in Congress and passed the Senate by a 64-35 margin.[90] With the relatively large Senate majority supporting the amendment, it would have been easy to believe the amendment would likely pass the House. However, the amendment did not make the final version of the bill.[91] Ironically, in conference committee, Congressman Barney Frank removed the amendment from Dodd–Frank.[92] Rather than pass the amendment, Congressman Frank thought there were too many questions as to what the consequences of creating the Board would be.[93] The Senators reached a compromise and decided to strip the amendment from Dodd–Frank but

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82 Restoring American Financial Stability Act of 2010, S. Amend. 3991 to S. Amend. 3739 to S. 3217 at S3653 (3)(C)(4), 111th Congress (2d. Sess. 2010) [hereinafter Restoring American Financial Stability Act], *available at* https://www.congress.gov/amendment/111th-congress/senateamendment/3991/text (an amendment to an amendment of Senate bill 3217).

83 *Id.*

84 *Id.* at (2)(A)(i)–(iii).

85 *Id.* at (2)(C)(i).

86 *Id.* at (2)(C)(ii)(III).

87 *Id.* at (2)(C)(ii)(II).

88 *Id.* at (2)(C)(ii)(IV).

89 *Id.* at (2)(C)(ii)(I).

90 U.S. Senate Roll Call Votes 111th Congress – 2nd Session (2010), U.S. SENATE, http://www.senate.gov/legislative/LIS/roll_call_lists/vote_menu_111_2.htm.

91 David M. Herszenhorn, *House-Senate Talks Drop New Credit-Rating Rules*, N.Y. TIMES, Jun. 16, 2010, at B5, *available at* http://www.nytimes.com/2010/06/16/business/16regulate.html?_r=0.

92 *Id.*

93 *Id.*

commission the SEC to perform a study on what the Board might look like and what the effects of the Board might be.[94]

A. Other Possible Solutions to the Conflict of Interest Do Not Adequately Address the Problem

The Franken–Wicker Amendment is not the only option available to deal with the conflict of interest. It is likely some industry participants will argue the Board creates too many unintended consequences and will pervert financial markets. At the Credit Ratings Roundtable, Reginald Imamura, Chairman of the Board for the Structured Finance Industry Group, argued for another solution.[95] Mr. Imamura believes better regulatory oversight coupled with enforcement of 17 C.F.R. § 240.17(g)(5) would be more effective.[96]

Regulation 240.17(g)(5) prohibits CRAs with a conflict of interest with an issuer from offering a rating unless the conflict is disclosed and the CRA "has established and is maintaining and enforcing" written policies and procedures to manage the conflict.[97] While this proposal has the benefit of not complicating the system with additional bureaucracy and expense associated with the Board, it still puts the onus on the CRAs to manage the conflict of interest. In essence, the effect of this proposal would be to continue the status quo as it does not introduce additional competition, and Mr. Imamura does not discuss how the proposal results in more accurate ratings. Indeed, at least one scholar argues the regulation simply does not go far enough.[98]

Another proposal discussed by Martin Hughes, Chief Executive Officer of Redwood Trust Inc., is to retain the status quo but mandate no CRA can rate two deals in a row from the same issuer.[99] The proposal has an appealing sound because it would eliminate the need for a bureaucratic board. However, the proposal does not deal effectively with the conflict of interest. If the issuers are still allowed to choose CRAs to rate deals, the CRAs will still be incentivized to provide desired ratings rather than accurate ones. All the proposal does is shift the incentive from the next deal to the deal after the next deal.

A more recently proposed solution, by scholar Robert Rhee, suggests a

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94 *Id.*

95 *Credit Ratings Roundtable*, Sec. and Exch. Comm'n, First Session at 1:05 (May 14, 2013), http://www.sec.gov/news/otherwebcasts/2013/credit-ratings-roundtable-051413.shtml.

96 *Id.*

97 17 C.F.R. § 240.17(g)(5) (2012).

98 Lawrence White, *Professor Larry White Comments on SEC Rule 17g-5 Program at the SEC Credit Ratings Roundtable*, NYU STERN SCH. BUS. (May 14, 2013), http://www.stern.nyu.edu/experience-stern/faculty-research/white-creditratings-roundtable.

99 *Credit Ratings Roundtable*, *supra* note 96, at 2:18–20.

small portion of revenues earned by the Big Three should be confiscated and put into a separate fund.[100] The government could then use this fund to pay for a "pay-for-performance" bonus each of the agencies would compete for on a periodic basis.[101] Rhee believes such a system would significantly reduce the conflict of interest problem, increase competition, and subsequently increase the quality of the ratings.[102]

The bonus proposal is interesting because it requires little regulation and would only marginally upset the current system. The flaw in the proposal is it does not account for a rogue rating agency who refuses to compete for the bonus. If we assume CRAs are in fact competing for business on the basis of providing desired ratings, it stands to reason a rater who does not vie for the bonus could focus on gaining market share by providing desired ratings to issuers. Presumably, this practice would be quite lucrative as issuers would choose the rating agencies that did not seek to win the bonus. Either the redistribution of revenues would have to be so high as to make it impossible not to play, or only the least profitable rating agencies would compete for the bonus. Thus, Rhee's proposal may in fact increase the incentives for the Big Three to provide desirable ratings over accurate ones to make up for the lost revenues. The remainder of this section looks at the proposed Board as written in the Franken–Wicker Amendment and analyzes what affect the Board would have in the markets.

B. The Structure of the Credit Rating Agency Review Board as Articulated in the Amendment Helps Break the Conflict of Interest but Has Many Unintended Consequences

The Franken–Wicker Amendment instructs "[t]he Board shall initially be composed of an odd number of members selected from the industry."[103] Specifically, the amendment calls for a Board made up of "not less than a majority" of members from the "investor industry who do not represent issuers."[104] The amendment further instructs the remaining members should be composed as follows: not less than one member should represent issuers,[105] not less than one member should represent the CRAs,[106] and not less than one

[100] Robert J. Rhee, *On Duopoly and Compensation Games in the Credit Rating Industry*, 108 NW. U. L. REV. 85, 89 (2014).

[101] *Id.* at 114.

[102] *Id.* at 111.

[103] *See* Restoring American Financial Stability Act of 2010, *supra* note 83, at (2)(C)(i).

[104] *Id.* at (2)(C)(ii)(I).

[105] *Id.* at (2)(C)(II).

[106] *Id.* at (2)(C)(III).

member should be "independent."[107] While the amendment clearly presents some guidance on how the Board should be structured, it does not articulate why the Board should be structured this way. Furthermore, the amendment fails to articulate the consequences of a Board structured this way and, therefore, gives the SEC a great deal of latitude in designing the Board. A more in depth analysis is needed to determine the incentives created by structuring the Board as instructed in the amendment.

1. The Amendment Uses the Make-Up of the Board to Shift the Power Balance from the Issuers to the Inventors but Fails to Account for Unintended Consequences

The first provision requiring the Board to be made up of an odd number of members for the creation of the Board seems fair enough. It makes perfect sense for the Board to consist of an odd number of members so a tie vote for a given decision is not possible. Though, it is worth articulating there is no provision discussing what happens if one of the members is not allowed to vote for some reason.[108] For example, it may be because of, ironically, a conflict of interests between a Board member and a decision, the member may need to abstain. This may particularly be true because the amendment calls for members to be "from the industry."[109] To address such an event it may be necessary to include alternate members for each category in the event of a tie.

The amendment gives the power to address these issues to the SEC provided its ultimate decision is not "in contravention with the intent" of the amendment.[110] Given the broad language of the statute, the SEC could take any number of courses. One option would be to delegate the authority to make these decisions back to the Board. The benefit of this course of action is the Board itself likely has more information about the idiosyncrasies and, therefore, would be more likely to craft an efficient solution. On the other hand, putting the Board in charge of these decisions may create the perception of cronyism and undermine the legitimacy of the Board.

The second issue to address is the amendment's charge requiring the majority of the Board to be made up of the "investor industry."[111] The conflict of interest, as seen by many, including the sponsors of the amendment, is the move from the investor pays model to the issuer pays model created an inherent

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[107] *Id.* at (2)(C)(IV).
[108] *See* Restoring American Financial Stability Act of 2010, *supra* note 83, at (2)(C)(i).
[109] *Id.* at (2)(C)(ii)(I).
[110] *Id.* at (2)(E).
[111] *Id.* at (2)(C)(ii)(I).

conflict of interest.[112] Under the investor pays model, the CRA acts as agent for the investor seeking out credit information from issuers. After retrieving this information, the CRA analyzes and disseminates an opinion as to the creditworthiness of the debtor to the investor. However, under the issuer pays model, this relationship is perverted.

Rather than incentivizing the CRA to provide accurate ratings to investors, the model incentivizes CRAs to provide favorable ratings to the issuer. A favorable rating from a CRA all but guarantees the issuer's securities will be sold. The reason is a favorable rating essentially grants the issuer a "regulatory license"[113] to sell to institutional investors. The concept of granting regulatory licenses derives from 1936 when the OCC and the Federal Reserve mandated banks could not hold securities rated below investment grade by at least two CRAs.[114] The effect of this ruling was more than half of the nearly two thousand publicly traded bonds issued failed the regulators' new test and could no longer be held by banks.[115] Some scholars have argued this move by the regulators shifted the CRAs' incentive of providing accurate ratings to providing regulatory licenses.[116] Issuers now needed to seek investment grade ratings from the CRAs to have the regulatory license to sell to financial institutions. This is important because financial institutions make up a large share of the bond markets.

The amendment attempts to shift the balance of power back to the investors by giving them a majority on the new Board.[117] This seemingly benign and logical directive can have incredible consequences and, therefore, must be approached carefully. The first issue is what does the amendment mean by "investor"? There are a multitude of different investors who rely on CRA credit analysis and neither the amendment nor Dodd–Frank provides any guidance regarding how to interpret this important term.[118]

When the average person hears the word "investor," the person likely thinks of a worker saving for retirement. In one sense, this is accurate because

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[112] Press Release, Al Franken U.S. Senator for Minn., Sen. Franken's Statement Calling for Action on Reforming the Credit Rating Agency (Jul. 25, 2013), *available at* https://www.franken.senate.gov/?p=news&id=2516.

[113] *See* Partnoy, *supra* note 50, at 439.

[114] *See* Gilbert Harold, Bond Ratings as an Investment Guide: An Appraisal of Their Effectiveness 160–72 (1938); Partnoy, *supra* note 50, at 439.

[115] Ivar Kreuger, The Credit-Rating Agencies, and Two Theories About the Function, and Dysfunction of Markets, 26 YALE J. ON REG. 433, 440 (2009).

[116] FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 9–35 (Times Books, 2003).

[117] *See* Restoring American Financial Stability Act of 2010, *supra* note 83, at S3653 (2)(C)(ii)(I).

[118] *See* 12 U.S.C. § 5301 (2012).

most individual investors invest in mutual funds.[119] Mutual funds, like other institutional investors, pool large amounts of investor funds and then use those funds to invest in securities.[120] The basic idea is a small individual investor, who cannot otherwise diversify his or her assets because of a lack of funding, can pool assets with many other investors. As a whole, the holders of the mutual fund shares are able to purchase a diversified portfolio of assets that are professionally managed by the fund manager.[121] Mutual funds make up a large portion of the institutional investor class holding $26.8 trillion in assets as of 2012.[122] Other institutional investors include insurance companies, pension funds, private equity funds, and hedge funds. These investors wield vast power in the financial markets because they not only retain the best talent and have vast amounts of funds at their disposal, but this talent affords them a reputation for deep investment knowledge.

The varied nature of the "investor industry" brings up a key issue in the design of the Board. The Franken–Wicker amendment is silent on which investors will be represented on the Board. A representative from all of the "investor industry" constituencies may be impractical. However, the Board will decide issues that affect the entire class. Some of these decisions will undoubtedly affect some investors negatively and others positively and to different degrees. Having at least one member representing each type of institutional investor may cause the Board to be inefficient. The members may fight over various proposals slowing down the business of the Board and potentially preventing issuers from getting their products into the markets in a timely fashion.

However, not having each member represented may disadvantage the unrepresented. The result may be appointment to the Board will become a coveted position within the industry. This may encourage cronyism, or at worst corruption, in an attempt for the institutional investor class to ensure a seat at the Board. For example, it is likely a position on the Board would be a way to secure future employment with one of the member constituencies. Because a position with a private firm may be financially lucrative, appointment to the Board would be desirable. The competition for appointment to the Board may

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[119] 2014 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry, INVESTMENT COMPANY INST., [hereinafter 2014 Investment Company Fact Book], available at http://www.icifactbook.org/fb_ch2.html#us (last visited Feb. 17, 2014) (noting, in 2013, "an estimated 96 million individual investors owned mutual funds and held 90% of total mutual fund assets directly or through retirement plans at year-end.") .

[120] Mutual Fund, SEC. AND EXCH. COMM'N, available at http://www.sec.gov/investor/tools/mfcc/mutual-fund-help.htm.

[121] *See id.*

[122] *See 2014 Investment Company Fact Book*, *supra* note 120.

lead to the selling of seats by those capable of selecting membership.

Furthermore, the "investor industry" membership constituency will likely need to include a member who represents individual investors. If for no other reason than for appearances, given the political climate and general negative image of Wall Street following the recent crisis, the public may find it hard to legitimize a Board made up of Wall Street's biggest investors. The appointment of a member to represent the general public may be a good idea for public perception, though the value of such a member on the function and performance of the Board may be minimal.

2. The Use of a Rotating Board with Term Limits Can Help Mitigate Some Problems Raised by the Exclusion of Some Investor Constituencies but may Result in a Less Efficient Board

The amendment gives the SEC the authority to "establish fair procedures for the nomination and election of future members."[123] This gives the SEC the flexibility to adjust the process for electing a new board and provides opportunity to correct some of the problems inherent in designing the Board. A possible, though imperfect, solution to this problem would be to create a rotating board with each member subject to term limits. The SEC could focus on the overall make-up of the Board rather than on the individual members in an attempt at a more "fair" Board. Under this system, members of the Board would serve for a short term staggered at specific time intervals.

At the conclusion of each member's term, a new Board member would be appointed from a different class of investors. As previously noted, it would be preferable for the individual investor class to have a constant presence on the Board to help quash the appearance of investor elitism. While during any given term there would still be incentives for each investor to favor his or her investor constituency, the idea is over time this should even out as other investors rotate onto the Board.

It should be noted this is also a flawed, imperfect solution. While a rotating Board with term limits may seem fair, it would be inefficient. One particular concern is experience. With a new group of Board members rotating in every few years, the experience of the outgoing Board will generally be lost. The new members will have to be brought up to speed on what is in front of the Board at the time they arrive. There could be unresolved pressing issues that were before the outgoing Board. As it is likely the markets will be reacting to any news from the Board, the disruption of an incoming Board in the middle of

[123] *See* Restoring American Financial Stability Act of 2010, *supra* note 83, at (2)(C)(iv)(I).

an important decision could create inefficiencies in the market. The rotating Board could become too bureaucratic and unwieldy with inexperienced—with respect to the Board—Board members slowing down progress every few years. Even in the case where you allow previous Board members to rotate back in, it is likely the issues before the Board will have substantially changed. This will further impede the efficiency of the Board's operations.

The same criticisms discussed above apply to the remaining composition of the Board as mandated by the amendment. The amendment calls for at least one Board member to represent the issuers,[124] one to represent CRAs[125] and one "independent" member.[126] There are a variety of issuers including Goldman Sachs, Chase, and the other large Wall Street banks. As we have seen, in addition to the Big Three, there are also smaller companies.[127] Having a member who is or was an executive from any particular issuer or rating agency presents its own conflict of interest problem. The perception will be the member is biased toward his or her former or current employer. Thus, the SEC will need to devise some strategy to ensure corruption, cronyism, and inefficiencies are minimized when composing the Board.

A particular area of concern that must be discussed is what the amendment means when it calls for at least one "independent" member. The Black's Law Dictionary definition of "independent" is: "not subject to the control or influence of another."[128] Presumably, it would be difficult, if not impossible, to meet this standard if choosing from within the industry. The term implies the perception of independence as much as it does actual independence from influence. It is difficult to imagine a former industry insider as "independent" from the influence of the industry whether that industry is investor, issuer, or CRA. Furthermore, having a politician on the Board is also counterintuitive to the concept of independence. In particular, the financial industry gives large sums of money for political campaigns.[129]

One possible solution to the influence of money on the politician is to prohibit a politician, perhaps a Congressional Senator or Representative, who serves on the Board from accepting campaign contributions from the financial industry. However, it will be difficult, if not impossible, to find a politician who

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124 *Id.* at (2)(C)(II).

125 *Id.* at (2)(C)(III).

126 *Id.* at (2)(C)(IV).

127 *See* Alessi, Wolverson & Sergie, *supra* note 10.

128 BLACK'S LAW DICTIONARY 376 (4th pocket ed. 2011).

129 *See* Jenifer Liberto, *Wall Street Pays Big to Influence Washington*, CNN MONEY (Jan. 31, 2012, 2:19 PM), http://money.cnn.com/2012/01/31/news/economy/wall_street_influence/ (noting in 2011 and 2012 Wall Street spent over $300 million to influence legislators with a particular focus on regulators under Dodd-Frank).

has not received significant amounts of money from this industry in the past. In fact, the financial industry is the largest donor for fifty-seven of one hundred senators and one hundred fifty-nine of four hundred thirty-six House members.[130] This fact limits the field of political candidates for the position significantly. Moreover, it is likely the most qualified politicians for this position would have some financial background. Logically, it seems likely a candidate with such a background would have already been courted by the financial industry.

Excluding industry insiders and politicians leaves the possibility of a private citizen who has business, organizational, or academic experience to fill this role. It is unclear how the SEC would go about selecting such an individual. It is important to note any selection would still face the already discussed hurdles of cronyism, corruption, experience, and public perception. It is highly unlikely the SEC could find a truly "independent" board member with the required skills to meaningfully participate on the Board. However, the fact an independent Board member will never be perfect should not dissuade the Board from doing the best it can to find an independent member.

C. The Assignment of a Credit Rating Agency to an Issuer

The ultimate goal of the CRA Board is to break the conflict of interest by assigning a CRA to an issuer rather than allowing the issuer to choose the CRA. The Franken–Wicker Amendment directs the Board to "evaluate a number of selection methods, including a lottery or rotating assignment system . . . to reduce the conflict of interest that exists under the issuer-pays model."[131] The method of the assignment system brings up several concerns including what institution has the expertise to design the system, how best to design a system that addresses the conflict of interest, how to design the system to minimize unintended consequences, and how to design a system that increases competition in the credit ratings markets.

1. The Board is the Ideal Institution to Design the Assignment System Because Board Members Have a Broad Knowledge Base and Have a Vested Interest in the Success of an Assignment System

The first consideration is whether the Board is the correct entity to choose the assignment method. Other possible choices would be the SEC or Congress.

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[130] Dave Gibson, *Who Owns Congress? A Campaign Cash Seating Chart*, MOTHER JONES (2010), http://www.motherjones.com/politics/2010/09/congress-corporate-sponsors.

[131] *See* Restoring American Financial Stability Act of 2010, *supra* note 83, at (5)(B)(i)(I).

Among these choices, the use of the Board to create an assignment system seems best. The primary concern when deciding who should design the assignment system is competence. While the SEC most likely has staff familiar with the various issues and positions of the constituents, it seems unlikely the SEC is more competent than the Board. Regarding Congress, it is unlikely the institution has the requisite financial knowledge or the resources to undertake the design of the assignment system. Therefore, the Board is likely the best choice for the design of a CRA assignment system that would break the conflict of interest inherent in the status quo.

First, the composition of the Board contains a much broader base of knowledge to draw on when designing the system. Because the Board will be compromised of investors, CRA representatives, issuer representatives, and an independent member, it is less likely relevant issues will be overlooked. The use of the Board and its proposed composition is particularly important given the main goal of breaking the conflict of interest. Recall the source of the conflict is the direct payment for rating services by issuers to the CRAs.[132] Because the amendment specifically requires a majority of the Board consist of representatives from investors, it is more likely any assignment system will favor investors over issuers.

Furthermore, neither the SEC nor Congress has a direct financial stake in the implementation of the assignment system. For the purposes of proper incentives, it makes more sense to leave the design of the assignment system to the actors who will be most affected. The most pressing concern is whether doing so will produce the unwanted result of favoring certain actors over others. However, because the amendment calls for a Board with a variety of constituents, the majority of which are investors, the Board is probably the best choice to design the process.

2. Increasing Competition in the Credit Ratings Industry Without Addressing the Conflict of Interest Will Not Lead to More Accurate Ratings

One concern is what impact the assignment system will have on incentivizing competition between CRAs. The regulators have long recognized creating more competition among the CRAs is one way to help control the conflict of interest.[133] If the rating agencies are forced to compete with each

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[132] *See supra* Part I.D and accompanying notes 64–82..

[133] *See e.g.* Santos, T., & Wood, N.J., *Bush Signs Credit Rating Agency Reform Legislation*, 26(9) AFP EXCHANGE 1, 10–11 (2006) (noting the Credit Rating Agency Reform Act of 2006 sought to reform the process by which credit ratings are recognized and, therefore, will foster competition).

other, the firms are more likely to produce accurate ratings. However, under the current issuer pays system, researchers have cast some doubt on the likelihood increased competition alone would increase accuracy.[134] It may be increasing the number of CRA firms in the market increases competition. However, what they compete over is very important. Some research suggests when there is increased competition in the CRA markets, the firms compete not for accurate ratings but for repeat business from the issuers.[135] Thus, without breaking the conflict of interest inherent in the issuer pays model, increased competition may exacerbate the problem.

One empirical study by the Harvard Business School suggests increased competition alone is unlikely to improve the CRA system.[136] The study used the rise of Fitch as an example of increasing competition in the system.[137] Ultimately, the study found stronger competition led to three results.[138] First, as Fitch's market share increased, the bond ratings actually moved further toward the higher end of the ratings spectrum.[139] This evidence suggests the increased competition from Fitch caused CRAs to provide more favorable ratings to issuers in an attempt to secure more business. It should be noted, however, more empirical analysis is needed on the actual cause of the increase in favorable ratings, which may or may not be directly tied to increased competition.

Second, the ratings given were not actually correlated with the ultimate yield on the corporate bonds issued.[140] In other words, the information provided in the ratings appeared to not influence the yield offered in the bond offering. It could be the presence of Fitch simply had no effect on the accuracy of ratings or the ratings offered by Fitch were comparable to ratings by Moody's and Standard & Poor's. However, this data suggests the ultimate investors in corporate bonds did not believe the increased competition resulted in more accurate ratings.

Finally, firms whose bonds were ultimately downgraded saw unexpectedly severe drops in the price of their securities.[141] The researchers took this to mean, because ratings agencies tended to favor positive ratings, a drop in the

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134 *See* Martha Lagace, *Why Competition May Not Improve Credit Rating Agencies*, HARV. BUS. SCH. (Aug. 31, 2009), http://hbswk.hbs.edu/item/6260.html.

135 *Id.*

136 *Id.*

137 *Id.*

138 *Id.*

139 *Id.*

140 *Id.*

141 *Id.*

rating meant there must be a really significant problem with the company.[142] One conclusion from the study is increased competition actually further perpetuated the conflict of interest problem.[143] Credit ratings firms still competed on bottom line ratings, not accuracy, and, thus, the issuers had the upper hand.

Possibly the most important problem the Board can correct is shifting the paradigm from competing for business to competing for accurate ratings and innovation in the art of rating credit. As the Harvard Business Study points out, the increase in competition in the market when Fitch became prominent caused lower quality less accurate ratings.[144] The article does not say directly it is because the CRAs were competing for business. However, given the monetary incentives, oligopolistic market structure, and conflict of interest in the status quo, it is a reasonable conclusion. The Board, if it can break the conflict of interest, will go a long way to reforming the system by changing the baseline. Without breaking the conflict of interest, increased competition will merely exacerbate the problem as more CRAs compete for business from issuers.

The move to an assignment system will, even with all bureaucratic problems noted, break the conflict of interest problem with respect to issuers choosing CRAs to rate their products. It may seem counterintuitive, however, to argue a cold government assignment system would increase competition. After all, it seems the antithesis of competition for the Board to select winners who will earn substantial fees from rating securities.

However, the Board does have the ability to create a more competitive environment, particularly in an oligopolistic system. Oligopolies are typically defined as industries with high barriers to entry that limit competition in the market.[145] The credit ratings market is one where barriers to entry, such as brand name, experience advantage, and economies of scale, are prevalent.[146] Further complicating the issue was the SEC's creation of the NRSRO designation. Any credit rating firms not designated NRSROs are destined to be ignored by investors.[147] With investors ignoring non-NRSROs, issuers had little use for the firms, as an "investment grade" rating did not grant the issuer a

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[142] *Id.*

[143] *Id.*

[144] *Id.*

[145] *Oligopoly II: Entry Barriers*, POLICONOMICS, *available at* http://www.policonomics.com/lp-oligopoly2-entry-barrier/ (last visited Nov. 23, 2014) (noting oligopolies typically have high entry barriers preventing the entrance of new competitive firms).

[146] White, *supra* note 35, at 217.

[147] This is particularly so when institutional investors were required by regulation to invest in securities rated "investment grade" by NRSROs.

regulatory license to sell to institutional investors.[148]

The Board presents the SEC with the opportunity to correct the unintentional creation of an oligopoly within the credit ratings industry. The first step is to break the conflict of interest, to shift the paradigm from competing for business to competing for accurate ratings. The Board is the only proposal that unequivocally accomplishes this primary objective of Dodd–Frank. Once the conflict of interest is broken, the Board can level the playing field by creating a system that encourages and provides incentives for smaller CRAs to gain experience. By doing so, the Board creates an environment where it is more likely the Big Three will face real market competition.

3. The Assignment System May Create New Unintended Conflicts of Interest, but These Conflicts are More Desirable Than the Issuer-CRA Conflict

Another issue regarding the assignment of CRAs by the Board is the selection method. Douglas Peterson, President of Standard & Poor's Rating Service, believes there must be two components to an assignment system.[149] First, the initial assignments must be random to avoid the problem of moral hazard.[150] Mr. Peterson did not articulate why random assignments would prevent moral hazard. However, it is a reasonable assumption if a CRA knew it would be selected, there would be no need to focus on accurate ratings, rather than a desirable rating. The CRA could continue to take the risk of providing desirable ratings with less fear an inaccurate rating would prevent selection in the future. Thus, the cost of providing an accurate rating that may not be desirable for an issuer is left to "other" rating agencies.

Second, the Board must be careful not to create a series of metrics that tells the CRAs how to build their ratings models.[151] It would not be beneficial to the credit ratings system to have government actors instructing CRAs on how to perform credit ratings. The credit ratings business is far too complicated with multiple industries and economic variables to have a "one size fits all" government solution. Rather, the Board should only create metrics that judge the results of various ratings by CRAs on two or three important pieces of data, such as the level of default and the number of ratings that go from "investment grade" to "below investment grade."[152]

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[148] *See* White, *supra* note 35, at 217.
[149] *Credit Ratings Roundtable*, *supra* note 96, at 1:20.
[150] *Id.*
[151] *Id.*
[152] *Id.*

Reginald Imamura, Chairman of the Board for the Structured Finance Industry Group, voiced similar concerns with the assignment system.[153] For example, Mr. Imamura pointed out, while the assignment system may break the conflict of interest between the issuers and the CRAs, it may create a conflict of interest between the Board and the CRAs.[154] Though Mr. Imamura did not explain exactly what he meant by a conflict of interest between the Board and the CRAs, it seems likely he was referring to the CRAs' desire to please the Board, rather than provide accurate ratings.

If this is the case, Mr. Imamura raised an interesting idea. While it is currently unclear how the Board will be designed, it is relatively easy to see how a conflict may arise between the Board and the CRAs. In the same way the issuers decide which CRAs will rate securities under the current system, the Board and its policies will decide how CRAs are selected for lucrative ratings. Because it is likely an assignment system will be based on a computer algorithm that selects CRAs based on a series of criteria, it is likely clever CRAs will decipher the selection criteria and skew their ratings in an attempt to influence selection.

The incentive to influence the selection process by catering ratings to the algorithm may be an unintended consequence of the assignment system. The underlying question is whether the new assignment system is a better outcome than the current system. If the algorithm is based primarily on various performance measures of CRAs, it stands to reason this type of conflict is more desirable than one based on providing particular investment grade ratings. The new system would be particularly better because the old system seems to incentivize firms to ignore accuracy of ratings when there is a higher risk of default and honor ratings when there is a low risk of default.

Though empirical data is certainly needed, the new system will at least provide some incentive for firms to provide more accurate ratings. To do this, the Board must design an assignment system that rewards firms for more accurate ratings and punishes firms with inaccurate ratings. Firms who are better at making accurate default predictions will be rewarded by a higher likelihood of selection for future deals, while firms who are less accurate will have a lower probability of selection. The financial rewards of selection should be enough incentive to encourage accuracy and innovation. This should result in a more even distribution between high and low default ratings. It is also worth noting, while it is easy to pontificate on both sides of the argument, without instituting the assignment system, the counterfactual necessary for empirical research is difficult to replicate.

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[153] *Id.* at 1:05.
[154] *Id.*

4. The Board Can Create an Environment That Allows New CRAs to Enter the Market and Increase Competition

The problems faced by smaller CRAs in the current market were articulated by Jules Kroll at the Credit Ratings Round Table in Washington D.C. in May 2013.[155] Mr. Kroll, who is the CEO of Kroll Bond Ratings, a relatively small CRA, stated the "little guys" face significant obstacles to rating deals.[156] Discussing the difficulty of obtaining the expertise necessary to rate securities in different business sectors, Mr. Kroll noted each category can take anywhere from nine to twelve months to gain the required expertise.[157] The long time period needed to research a given industry can cost millions of dollars.[158]

Mr. Kroll's point regarding the costs of training staff and gaining expertise in particular areas can be partially dealt with by aggressive hiring practices. The labor force of financial experts does not exist in a vacuum. It is common in the financial industry for employees to move among several firms during their career. The primary issue Mr. Kroll addressed is not staff related, but rather opportunity related. Without the prestige and financial benefits associated with working for the Big Three, it would be difficult for the smaller agencies to attract top talent.

Mr. Kroll went on to discuss the barriers to competition. According to Mr. Kroll, there are two big obstacles to entering the credit rating business. First, the established CRAs do not welcome competition.[159] Instead, they frequently "take shots" at the smaller agencies to dissuade investors from trusting their ratings.[160] Second, but related, Mr. Kroll stated the biggest obstacle is the investment management guidelines for issuers.[161] Put simply, according to Mr. Kroll, certain institutions will not hire rating agencies that are not Moody's, Standard & Poor's, or Fitch.

Mr. Kroll's point is well taken with regard to investment management guidelines. Banks, bondholders, pension fund trustees, and other institution investors use investment management guidelines to make investment decisions.[162] As a result, credit ratings play an important role in portfolio governance because many investment management guidelines limit the quality

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155 *Id.* at 1:50–53.

156 *Id.*

157 *Id.*

158 *Id.*

159 *Id.* at 1:53–55.

160 *Id.*

161 *Id.*

162 Richard Cantor, et al., *The Use of Credit Ratings in Investment Management in the U.S. and Europe*, 17 J. FIXED INCOME 13, 14 (2007).

of assets money managers can invest in to those rated "investment grade" by CRAs.[163] However, rather than refer to credit quality generally, most investment management guidelines refer to investment ratings by the Big Three.[164] For example, in one survey of two hundred investors from Europe and the United States, 72% of fund managers' investment management guidelines referred to specific CRAs by name.[165] Of those who did so, almost all referred to Moody's and Standard & Poor's, and 70% referred to Fitch.[166] Only 9% referred to CRAs generally, and only 25% referred to NRSROs in general.[167]

The Board can provide several ways to deal with this issue. One possibility is, by assigning CRAs to issuers, the Board opens up the ratings market to the smaller CRAs who otherwise would not be selected by the issuer. Mr. Kroll alluded to this idea in his testimony. By arguing the current system results in significant barriers to entry, Mr. Kroll implied the Board could actually result in increased competition in the industry. It seems likely, because the Board's assignment system beaks the conflict of interest problem, the issues brought up in the Harvard Business School study may be rectified. Without the threat of exclusion of CRAs by issuers hanging over their head, the CRAs' incentives may shift, *ceteris paribus*, from competing for business to competing for accuracy. However, this will of course depend on how the Board devises the assignment system. It will be paramount the system rewards accurate ratings with a greater probability of selection for future deals.[168]

5. The Board Must Create an Assignment System That Allows the Smaller CRAs to Gain Experience so They Can Compete with the Big Three in the Credit Ratings Market

The SEC must be careful however in considering such a drastic solution to the conflicts of interest problem as an assignment system. While in theory the move to an assignment system could increase competition for accurate ratings, it also raises several practical issues that must be addressed. First, artificially increasing the market share of smaller CRAs is not done without possible consequences. While, Mr. Kroll implied issuers seek out the Big Three CRAs because of name recognition, those from within the large CRAs argue they

163 *Id.*
164 *Id.* at 20.
165 *Id.*
166 *Id.*
167 *Id.*
168 *Credit Ratings Roundtable*, *supra* note 96, at 1:20 (discussing any assignment system should reward CRAs that are more accurate and sanction CRAs that are less accurate by increasing and reducing the probability of future business, respectively).

simply have more expertise.[169]

It is hardly arguable analyzing and rating securities is a complicated business that has many variables. In addition to financial statement analysis, the CRAs must also be familiar with the business model. This familiarity necessarily includes knowing what the current concerns and opportunities are in a given industry, as well attempting to anticipate future issues or opportunities.[170] Insiders and analysts argue the Big Three simply have more experience in the various industries and, thus, are in a better position to rate the securities accurately and efficiently.[171]

In short, the Big Three argue the smaller firms do not have the necessary expertise to rate certain securities.[172] The lack of expertise will be a significant challenge for a credit rating board tasked with assigning a variety of CRAs to the thousands of securities that need ratings each year. Without some mechanism to provide less experienced CRAs the opportunity to expand into other industries, the Board may end up assigning the Big Three to the many security issues. Assigning the majority of the most complex securities to the Big Three seems to subvert the very purpose of increasing competition. If the Board is not careful, it may end up furthering the oligopoly and reducing further the influence of smaller CRAs. It is worth noting, even if this were the case, the conflict of interest would still be lessened because the issuers would still not select which CRAs rate their deals. The real concern is there would be no incentive for the Big Three to innovate and provide more accurate ratings that would benefit investors.

a. The Board Can Create an FDIC-Style Fund to Pay for Smaller CRAs to Gain Experience and Expertise

The need to provide smaller CRAs with the experience necessary to properly rate securities in the variety of industries necessary to encourage competition presents an interesting problem. It would seem not only unfair but also potentially inefficient and disastrous to allow CRAs with little experience to rate particular securities for issuers. After all, the issuers have significant investments in their packages of securities and, in large part, rely on CRAs for regulatory licenses.

Some commentators, including Arthur Bolden, discussed the possibility of creating a system that allows inexperienced CRAs to receive the training

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[169] *Id.* at 1:50–59.
[170] *Id.*
[171] *Id.*
[172] *Id.*

necessary to compete.[173] One possible solution is to create an FDIC-style insurance fund the proceeds of which could be used to pay for CRAs to participate in issuances they were otherwise unqualified to rate. The smaller CRAs would receive the same information as the issuer chosen to officially rate the deal; however, their ultimate rating would not be released to the public.[174] Ideally, this would result in a system where less experienced CRAs could receive the training necessary to rate future deals without harming the financial system directly.

Regardless of training, the fund could be used to provide a useful check regarding the accuracy of credit ratings and incentivize CRAs to provide more accurate ratings. One possibility, given the Board's regulatory discretion, is to set up a randomized supplemental rating system. The idea behind the system is to provide for at least one independent secondary rating for a randomized sample of issues. Indeed David Raboy, Chief Economic Consultant at Patton Boggs LLP, made a similar suggestion by stating at least two CRAs should be assigned to each issue.[175] Using funds derived from a tax on each rating agency, the Board would set up a system in which certain issues received a "secret" rating from another CRA.

The purpose of implementing such a system is to incentivize CRAs assigned to an issue to provide the most accurate ratings possible. Another possibility is the secret rating may encourage innovation on the part of the officially selected rater and the secret rater. In both cases, the Board could incentivize the firms to provide more accurate ratings by making increased accuracy a pretext to a greater likelihood for selection on future issues. The Board can make the assignment system account for accuracy by designing an algorithm that solves for experience and past performance.

b. The Board Must Mandate Issuers to Use Board Provided CRA Ratings, but This May Create Other Unintended Consequences

Another issue is the Franken–Wicker Amendment does not bar issuers from seeking ratings outside of the new Board. Indeed the amendment explicitly states "[n]othing in this section shall prohibit an issuer from requesting or receiving additional credit ratings."[176] This language undercuts the effectiveness of the Board. Because the process of removing the regulatory

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[173] *Id.*

[174] *Id.* at 1:32 (discussing the possibility of allowing less experienced CRAs rate issues in order to gain experience by Speaker David Reboy).

[175] *Id.*

[176] See Restoring American Financial Stability Act of 2010, supra note 83, at (9).

requirements for investors to use investment grade ratings by CRAs has begun, there is no reason for the issuers to not go outside of the Board. It would, therefore, be useful for the Board to implement a regulation requiring such investors to receive an investment grade rating from a CRA through the Board's assignment process.

Furthermore, requiring investors to receive investment grade ratings from CRAs through the Board's assignment system may interfere with the first goal of Dodd–Frank regarding CRAs—making investors less dependent on CRA ratings.[177] Along the same lines, a requirement to use ratings given through the assignment system may give investors the impression the government sanctions the ratings given through the assignment system. Opponents of the Board have articulated the unintended consequence of increasing investor reliance on CRAs as one reason to not implement the amendment.[178]

During the Credit Ratings Roundtable, Mr. Bolden introduced another complication: What happens if the CRA selected to rate the issue simply is not interested?[179] It may be, because of a lack of expertise and an unwillingness to invest to gain expertise, a particular CRA may not want to rate certain types of securities. The Board should consider whether to force CRAs to rate whichever securities are assigned to them as a condition of participating in the Board's selection process.

Another possibility is it may be useful to have CRAs that specialize in certain industries. Specialization would likely benefit the system because a CRA may over time become so good at rating certain industries it becomes the preferred CRA for the Board on those issues. If the Board consistently chooses the same CRA for certain issues, it would introduce anti-competitiveness back into the system and pervert the purpose of the Board.

However, Stephen Hall, securities analyst with Better Markets Inc., pointed out the situation where there are a limited number of CRAs in the system will not persist.[180] Put simply, because of the vast amounts of money that can be made rating securities, competition for ratings should fill voids in the ratings market.[181] If one firm is making a significant amount of money specializing in one area of the market, other firms will seek to compete in those markets. Over time the increased competition will result in multiple CRAs within the various industries.

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[177] *See* Ben Protess, *S.E.C. Seeks to Reduce Reliance on Credit Ratings*, N.Y. TIMES, Feb. 9, 2011, http://dealbook.nytimes.com/2011/02/09/s-e-c-aims-to-reduce-reliance-on-ratings/.

[178] *Credit Ratings Roundtable*, *supra* note 96, at 1:50.

[179] *Id.* at 1:29.

[180] *Id.* at 1:40–41.

[181] *Id.*

The existing Big Three are likely to put up a significant amount of resistance to a secret system. One objection that is immediately apparent is the secret system perverts competition in the free market. By collecting revenues from each CRA based on a percentage of total revenues, the Board would essentially be redistributing money from the more successful CRAs to the less successful ones.

Though empirical research is necessary, this may provide a disincentive for CRAs because portions of their profits are being taken away. However, given the lucrative business of credit ratings it seems likely these concerns may be overblown. Even if CRAs continue to be motivated to participate in the assignment system, it may be firms seek to rate credit for issuers outside of the system. While the Board will not sanction the ratings offered outside of the assignment system, investors may come to trust the ratings outside of the assignment system. A vibrant rating market outside of the Board's system would likely create legitimacy concerns and may result in a *de facto* issuer pays model.

D. Measuring Performance and the Benefits of Standardization in the Industry

If the Board is to provide a system that rewards accuracy and performance, it is necessary for the Board to define the parameters of performance. A particular area where the Board could offer the benefits of standardization is in the area of CRA performance evaluation. The current reporting system for CRAs is substantially inconsistent across the industry.[182] To properly compare the performance of CRAs across a variety of industries, the CRA reporting elements must be consistent.[183] There is currently no consistency requirement at the regulatory level for performance evaluation tools such as symbols, industry specifications, and definitions.[184] The result of the inconsistency is measuring performance of CRAs is very difficult.[185]

Lin Bai identified four areas of inconsistency across the CRAs. First, there is inconsistency at the broadest sector rating level.[186] For example, Standard & Poor's divides ratings into five sectors including "corporate

[182] Lin Bai, *The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?*, 7 N.Y.U. J.L. & BUS. 47, 63 (2010), *available at* http://scholarship.law.uc.edu/cgi/viewcontent.cgi?article=1008&context=fac_pubs.

[183] *Id.*

[184] *Id.*

[185] *Id.*

[186] *Id.*

issuers."[187] The corporate issuers sector is made up of industrial companies.[188] Compare this with a smaller CRA, such as Ratings & Investment Information, Inc. (R&I). R&I also has a corporate issuers category that includes financial institutions in addition to industrial corporations.[189] A&M Best further complicates the category by including mostly insurance companies in the corporate issuers category.[190] It becomes apparent very quickly an investor who wanted to compare CRAs in this category would first have to sift through the data to create consistent criteria. The investor would essentially have to sort through millions of rows of Microsoft Excel data before even attempting to run a statistical analysis.[191] Similar inconsistencies exist when comparing the debt issuers industry sector, when comparing across geographic regions, and among the ratings symbols used among firms.[192]

In this area the Board can provide for standardization across CRA reporting metrics. The results of the standardization would be two-fold. First, increased standardization across CRAs would provide investors with a more useful and efficient method to judge the performance of CRAs across industry sectors. The result is investors could more easily determine which CRAs are most accurate for each of the given standardized sectors.

Arthur Bolden, a financial analyst with fifteen years of experience in complex financial instruments, agrees.[193] While Mr. Bolden is not a proponent of the Board, he does think tying CRA performance to compensation is an appropriate endeavor.[194] The regulatory authority of the Board to provide for standardization is one method to better judge CRA performance. However, it is plausible to institute a standardization regime through other regulatory means without the creation of the CRA Board. For example, the SEC, as the chief regulator for CRAs could simply promulgate new rules requiring standardization within the industry.

The second benefit is a standardized process would provide the Board with a more efficient method of evaluating CRA performance. If the purpose of the Board is to incentivize firms to seek the most accurate ratings and, therefore,

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[187] *Id.* (citing Standard and Poor's rating history information, *available at* http://www.standardandpoors.com/prot/ratings/history-samples/en/us/).

[188] *Id.*

[189] *Id.* (citing Rating and Investment Information Inc., NRSRO (2008), *available at* http://www.r-i.co.jp/eng/regulatory-affair/nrsro.html).

[190] *Id.* (citing A.M. Best, (Form NRSRO) Exhibit 1, *available at* http://www.ambest.com/nrsro/formnrso.pdf).

[191] *Id.* at 64.

[192] *Id.* at 64–65.

[193] *Credit Ratings Roundtable*, *supra* note 96, at 1:27

[194] *Id.*

encourage creativity and innovation, there must be some way to evaluate the performance of the CRAs against each other. The Board must have a system in which it is able to reward CRAs who consistently outperform their peers by increasing the likelihood of being assigned to new issues. The result would be a complete revision of the "compete for business" versus "compete for accuracy" dichotomy. Increased business would come from accurate ratings—not from providing particular ratings.

However, one particular issue the Board will have to deal with regarding standardization is whose measure of standardization to use. One option is for the Board to choose one of the existing rating agency's methods of evaluating performance. However, doing so may create an advantage for that particular agency. If performance measurements are one method by which the Board will select who gets assigned to particular issues, forcing all but one CRA to adopt new methods will create a competitive disadvantage for those firms.

Furthermore, adopting one CRA's performance methods will provide an opening for opponents of the Board to attack the Board on bureaucratic efficiency grounds. While no empirical evidence exists, it seems likely the costs of adopting a new measurement process will be high. First, it will likely cost CRAs significant amounts of money to reorient their information collection and reporting methods. This will be particularly true for the smaller CRAs, which do not have the resources to undertake such a project. Second, it will likely take a significant amount of time for the CRAs to comply with the new requirements. In a financial system that issues thousands of debt instruments in need of a rating, this time lag could significantly slow down the process and create inefficiencies.

The second option for the Board is to create an entirely new system of performance measurement. While this system may seem more "fair" because it would apply to all CRAs, it too suffers from the same issues of cost and efficiency. Furthermore, it is unclear how such a performance system could be designed and who the designer would be. It stands to reason any designer will be subject to immense pressures from the industry to design a system to benefit a particular style of measurement. Therefore, regardless of the type of performance standardization the Board chooses, it will be subject to charges of corruption, inefficiency, and illegitimacy.

Another issue regarding performance measure has to do with the fact different investors have different measures. Sanjeev Handa, Managing Director at TIAA-CREF, pointed out this issue at the Credit Ratings Roundtable.[195] As an example, Mr. Handa stated a bond issued in 2007 at a certain credit spread

[195] *Id.* at 1:33.

might have been downgraded by a CRA in 2009.[196] As a result of the downgrade, different investors may have had difference reactions.[197] One investor may have immediately sold the bond as a result of the downgrade while another may have decided to wait out the crisis.[198] As the market improved, the bond's value may have increased above the 2007 level.[199] As a result, because of a different time horizon preference, one investor made money while the other lost money.[200]

The issue presented by this hypothetical is how to assess the performance of the CRA. Did the CRA get it wrong when it gave the bond a high rating in 2007? Did it get it right when it downgraded the bond in 2009? Or, did it get it wrong when it downgraded because the bond ultimately recovered? Security performance is dependent upon multiple variables not directly in the control or knowledge of the CRA.[201] Mr. Handa argued ratings should be just one measure of performance and there should be no bright line test—market conditions, performance of the economy, and risk tolerance also matter in judging performance.[202]

Mr. Handa's argument highlights the complexity of credit rating analysis. To measure performance, the Board must derive some baseline to start the analysis. One response to Mr. Handa is the hypothetical he proposed takes place in an economic environment where the majority of securities were failing. When the economy experiences a significant decline overall, it is easy to see how judging the decisions of CRAs is difficult because economic decline is hard to predict. It would be much more reasonable to state CRAs should be judged during more stable economic conditions because attributing cause and effect is much easier. However, Mr. Handa's point is well taken. Any performance system will have to address the baseline and account for fluctuations due to unforeseen economic circumstances before assessing CRA rating performance.

III. CONCLUSION

In the wake of the greatest financial crisis since the Great Depression, the public was rightly outraged. Many commentators and industry professionals blamed CRAs for their inability to accurately rate mortgage-backed securities in

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196 *Id.* at 1:33–37.
197 *Id.*
198 *Id.*
199 *Id.*
200 *Id.*
201 *Id.*
202 *Id.*

the lead up to the crisis.[203] As a result, Congress had a kneejerk reaction seeking to implement new legislation to prevent a future crisis.[204] One part of Congress's overall strategy was to regulate the CRA industry more heavily.[205]

The Franken–Wicker Amendment passed the Senate with strong bipartisan support.[206] The creation of a credit rating agency review board to assign issuers to CRAs has appeal. It is widely recognized the conflict of interest inherent in the issuer pays model has negative consequences for the accuracy of credit ratings.

However, the implementation of the Board and the assignment system will come at some cost. If the SEC is to implement such a system, it must first address the myriad of concerns ranging from lack of expertise to restricting competition within the credit rating markets. While an imperfect solution, it seems unlikely there is a perfect solution. No regulation is perfect, but no regulation needs to be perfect to be effective. Without reforms, the mistakes of the CRAs that contributed to the financial crisis are sure to be repeated.

The Board will undoubtedly create new problems ranging from the inefficiencies of bureaucracy to questions about the competence of CRAs assigned to issuers. However, the Board will break the conflict of interest by removing the CRAs' financial incentives to provide issuers with the ratings they desire. If properly designed, the Board can also increase competition among CRAs by providing opportunities to CRAs who do not get many opportunities to rate securities in the current system. The CRA industry will be forever changed by the implementation of the Board. It can, therefore, rightly be expected to receive a great deal of criticism and push back from Wall Street. It certainly may be the Board will ultimately fail. However, the system needs a significant overhaul, and, of the options being discussed, the Board is the most viable option.

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203 *See supra* Part I.B and accompanying notes 32–47.
204 *See supra* Part II and accompanying notes 83–95.
205 *See supra* Part II and accompanying notes 83–95
206 *See supra* Part II and accompanying notes 83–95.