

**SOX IT TO ‘EM: USING SARBANES-OXLEY AS A MODEL FOR
REGULATING CONFLICTS OF INTEREST IN THE CREDIT
RATING INDUSTRY**

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I. INTRODUCTION

The wave of corporate accounting scandals that unfolded at the turn of the millennium exposed major flaws in the U.S. corporate governance system. Executives at some of the nation’s largest companies committed egregious acts of corporate fraud and misrepresentation. And making matters worse, the scandalous acts were approved by the companies’ financial gatekeepers, their accountants. As regulators investigated these scandals, they discovered that conflicts of interest plaguing the accounting industry helped facilitate the abusive practices that occurred. In an effort to eliminate these conflicts and restore investor confidence in corporate financial statements, Congress passed an expansive regulation of the accounting industry, the Sarbanes-Oxley Act of 2002.

But accounting firms were not the only “gatekeepers” that neglected to protect the American public from the impending corporate implosions. The major credit rating agencies (CRAs or “rating agencies”) that were monitoring the failing companies remained silent despite insider knowledge that the companies were faltering. For example, although the major CRAs identified weakness in Enron’s financial statements months before the energy giant’s ultimate demise, the agencies waited until four days before the company declared bankruptcy to downgrade its credit

ratings. Although the rating agencies were publicly criticized for their ineffective performance, Congress did not attempt to address the problems confronting the credit rating industry when it drafted Sarbanes-Oxley.

In the years following the passage of Sarbanes-Oxley, the Securities and Exchange Commission (SEC or “Commission”) conducted an in-depth study of the credit rating industry. The Commission’s study revealed that conflicts of interest existed in the credit rating industry that were virtually identical to conflicts previously identified in the accounting industry. Yet despite this revelation, Congress took little action to correct these problems before the financial crisis struck in 2007.

This Note argues that a regulatory model similar to the one used for the accounting industry should be utilized to regulate conflicts of interest in the credit rating industry. Part II provides a brief background of the rating industry and discusses the reasons behind the rating agencies’ rise to prominence in the global finance market. Parts III and IV discuss the rating industry’s failure leading up to the financial crisis and the role that conflicts of interest may have played. Part V discusses how these conflicts were not addressed with post-Enron regulation (i.e., Sarbanes-Oxley) despite warning signs that the credit rating agencies were susceptible to the same conflicts of interest plaguing the accounting firms. Part VI argues that implementing controls similar to those imposed by Sarbanes-Oxley would have been, and still could be, a reasonable and effective method for regulating credit rating agency conflicts of interest. And finally, Part VII evaluates the most recently enacted regulations, noting that these efforts do not measure up to the Sarbanes-Oxley standard and thus will likely fail to remedy the credit rating industry’s problems.

II. CREDIT RATING AGENCIES AND THE GLOBAL FINANCIAL CRISIS

The 2007 collapse of the global financial system has been dubbed “the biggest crisis since the Great Depression.”¹ According to some scholars, the complex “financial weapons of mass destruction” at the core of the present crisis make it significantly worse.² In its wake, the financial system’s self-destruction left a multitude of casualties—far too many to number. Thus, academics, financial experts, and politicians worldwide are actively scrambling to identify and reprimand responsible parties. While there is an ample supply of blameworthy parties, much negative attention has focused on the credit rating agencies. For instance, the President’s

1. Joseph Stiglitz, *Guided By An Invisible Hand: The Bank Meltdown Marks a Turning Point in Our Thinking About How the World Works*, NEW STATESMAN, Oct. 20, 2008, at 18.

2. *Id.* (quoting Warren Buffet’s statement in Berkshire Hathaway’s 2002 annual report regarding derivative contracts).

Working Group on Financial Markets included “flaws in credit rating agencies’ assessments” on its short list of principal underlying causes of “turmoil in financial markets.”³

Rating agencies are firms that provide assessments about the creditworthiness of an entity or the financial obligations issued by an entity.⁴ In essence, CRAs are charged with evaluating the likelihood that a company or transaction will be able to meet its financial commitments.⁵ After evaluating an entity or product and reaching a judgment, a CRA assigns a letter grade, thus signaling to the public the agency’s opinion about the safety of investing in the particular company or financial product. The standard scale is AAA, AA, A, BBB, BB, and so forth.⁶ The top of this scale, AAA or “Triple-A,” denotes “the lowest expectation of credit risk” and is the closest to being considered “risk-free.”⁷ Generally, financial instruments or entities receiving a BBB or above rating are considered relatively safe or “investment grade.”⁸ Those falling below this mark are considered “speculative,’ ‘high-yield,’ or ‘junk.’”⁹

Investors became increasingly reliant on agency ratings during the period leading up to the crisis. One explanation for the increased reliance is that credit ratings are frequently incorporated into financial regulation.¹⁰

3. Press Release, President’s Working Group on Financial Markets, Policy Statement to Improve Future State of Financial Markets (Mar. 13, 2008), available at <http://www.treasury.gov/press-center/press-releases/Pages/hp871.aspx>.

4. *Credit Rating Agencies—NRSROs*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/nrsro.htm> (last modified May 12, 2011).

5. FITCH RATINGS, INSIDE THE RATINGS: WHAT CREDIT RATINGS MEAN 5 (2007), available at <http://research.fitchratings.com/dtp/pdf3-07/ytmr0608.pdf>.

6. Matthew Richardson & Lawrence J. White, *The Rating Agencies: Is Regulation the Answer?*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 101 (Viral V. Acharya & Matthew Richardson eds., 2009) (discussing the rating scale used by Standard & Poor’s and other agencies). Moody’s Investor Service, another major rating agency, uses a slightly modified scale: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, and C. See MOODY’S INVESTORS SERV., RATING SYMBOLS AND DEFINITIONS 4 (2010), available at http://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

7. FITCH RATINGS, *supra* note 5, at 5. According to Fitch, in 2007 only 1% of its corporate or financial institution obligors were classified as AAA. In contrast, AAA ratings were much more prevalent among structured financial products which can be divided into layers, thus allocating more risk to those parties willing to assume it. *Id.*

8. John Patrick Hunt, *Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 116 (2009).

9. *Id.*

10. See STAFF TO THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 101–02 (2002), available at news.findlaw.com/wsj/docs/enron/senenron100702rpt.pdf (finding that since 1975, eight federal statutes, forty-seven federal regulations, and more than one hundred state laws and regulations refer or rely on credit ratings). For a compilation of rating dependent regulation in the United States, see Frank Partnoy, *The Siskel & Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L. REV. 619, 686–701 (1999). Partnoy argues that “ratings are valuable, not because they are accurate and credible, but because they are the key to reducing costs associated with regulation.” *Id.*

For example, the Federal Deposit Insurance Corporation (FDIC) “prevents insured banks from investing in speculative-grade securities [and] enforces risk-based capital requirements that use credit ratings to assess risk-weights.”¹¹ A second explanation for the increased reliance on agency ratings is that many investment groups, such as the California Public Employees’ Retirement Fund, have established guidelines which only allow investment in securities stamped “investment grade” by a rating agency.¹²

But perhaps the most significant explanation for the heightened influence of credit ratings was the increased complexity of the financial products being traded. The Basel Committee on Banking Supervision noted that investors “entered the . . . market despite lacking the capacity to independently evaluate the risks of [the] complex . . . products” being exchanged.¹³ The financial products were indeed complex. According to one commentator, “in the case of [these] complex and opaque debt securities . . . , ‘do-it-yourself’ credit analysis, even by relatively sophisticated institutional investors, is no more feasible than ‘do-it-yourself’ brain surgery.”¹⁴ Even Alan Greenspan, the former chairman of the Federal Reserve, admitted in a CNBC documentary that he was unable to “make sense of the complex derivative products created out of mortgages.”¹⁵

The infamous products Greenspan was referring to are mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs). MBSs are created when governmental or private entities purchase mortgage loans from banks or other loan originators, assemble the loans into pools,

at 681. Thus, regulator imposed demand has eliminated rating agencies’ incentive to avoid conflicts of interest or protect the accuracy of their ratings. *Id.* at 682.

11. Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit* 15 (Wharton Fin. Insts. Ctr., Working Paper No. 07-43, 2008), available at <http://fic.wharton.upenn.edu/fic/papers/07/p0743.htm>.

12. CAL. PUB. EMPLOYEES’ RET. SYS., STATEMENT OF INVESTMENT POLICY FOR CREDIT ENHANCEMENT PROGRAM 3 (2008), available at <http://www.calpers.ca.gov/eip-docs/investments/policies/invo-risk-mang/credit-enhancement.pdf>. Cf. Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis* 14 (Harvard Law & Econ., Discussion Paper No. 612, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1096582 (“In certain instances, institutional bond buyers are subject to legal limitations that permit them only to buy investment-grade or AAA-rated debt.”).

13. BASEL COMM. ON BANKING SUPERVISION, THE JOINT FORUM, CREDIT RISK TRANSFER: DEVELOPMENTS FROM 2005 TO 2007, at 13 (2008) [hereinafter BASEL FORUM ON CREDIT RISK DEVELOPMENTS], available at <http://www.bis.org/publ/joint21.pdf?noframes=1>.

14. John C. Coffee, Jr., *Ratings Reform: The Good, The Bad, and The Ugly* 5 (Ctr. For Law and Econ. Studies, Columbia Univ. Sch. of Law, Working Paper No. 359, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1650802.

15. Cyrus Sanati, *Greenspan Says He Was Mystified by Subprime Market*, N.Y. TIMES DEALBOOK (Feb. 12, 2009, 7:50 AM), <http://dealbook.nytimes.com/2009/02/12/greenspan-says-he-was-mystified-by-subprime-market>.

and sell the pooled mortgages to private investors.¹⁶ An investor purchasing an MBS will then have a claim on the principal and interest payments made by the underlying mortgagors.¹⁷ A CDO, which is similar in many respects to an MBS, can take this “pooling” process a step further.¹⁸ CDOs resemble mutual funds, except rather than a portfolio of stocks, CDOs may be backed by various types of investment products, including collections of MBSs.¹⁹ After the various products are collected and packaged, a newly created CDO can be sliced into layers called “tranches,” with each tranche carrying varied levels of risk.²⁰ An individual investor will then purchase shares of the CDO tranche that satisfies his or her individual risk profile.²¹ As in the case of MBSs, CDO managers collect principal and interest payments from the underlying borrowers and distribute the payments to the private investors.²²

MBSs and CDOs contain thousands of mortgages originated by lenders throughout the country.²³ With such a high level of geographic diversity, investors, unlike the original lenders, are not privy to the information that might indicate whether underlying borrowers are susceptible to default.²⁴ For this reason, investors wishing to enter the mortgage market turned to rating agencies for assurance that the products would deliver on their promises.²⁵ Without a rating, mortgage products had no hope of being sold. One scholar went so far as to say that an MBS “didn’t exist until it was . . . anointed with a rating.”²⁶ In the end, ignorance about the true nature of these products facilitated widespread complacency among market

16. See *Mortgage-Backed Securities*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/mortgagesecurities.htm> (last modified July 23, 2010).

17. *Id.*

18. Creation of a CDO is similar to that of MBS. See OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM’N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 9 (2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>. A sponsor creates a trust to hold the CDO’s assets and issue securities. *Id.* Usually a CDO is comprised of 200 or so debt securities in a pool. *Id.* This pool may include MBS along with many other types of debt securities. *Id.*

19. MARK ADELSON, NOMURA FIXED INCOME RESEARCH, CDOs IN PLAIN ENGLISH: A SUMMER INTERN’S LETTER HOME 1 (2004), available at http://www.vinodkothari.com/Nomura_cdo_plainenglish.pdf. CDOs can take various shapes and forms and are certainly not limited to MBS backing. *Id.* at 1–6.

20. *Id.* at 2.

21. *Id.*

22. OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, *supra* note 18, at 9.

23. *The Subprime Mortgage Crisis Explained*, STOCK MARKET INVESTORS, <http://www.stock-market-investors.com/stock-investment-risk/the-subprime-mortgage-crisis-explained.html> (last visited Jan. 1, 2012).

24. Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1121 (2009).

25. *Id.* at 1121–22.

26. DAVID FABER, AND THEN THE ROOF CAVED IN: HOW WALL STREET’S GREED AND STUPIDITY BROUGHT CAPITALISM TO ITS KNEES 87 (2009).

participants, and investors became “comfortable substituting a credit rating for their own due diligence.”²⁷ In essence, CRAs became the de facto “gatekeepers” of the securitized mortgage market.²⁸

III. CREDIT RATING AGENCY FAILURES AND CRITICISM

As it turned out, investor reliance on rating agency assessments was ill-advised. In the period leading up to the crisis, it is unquestionable that CRAs “grossly underestimated” the fundamental risks of the structured securities they were rating—particularly MBSs and CDOs.²⁹ The rating agencies, which were at one time “viewed as the answer to the uninformed [investor’s] prayer,” in fact “knew little or nothing about the underlying assets backing the securitised structures they were rating.”³⁰ According to Willem Buiter, the agencies “were not merely conflicted—they were completely out of their depth.”³¹

By late 2008, it was discovered that the agencies had “bestowed AAA ratings on hundreds of billions of dollars’ worth of dubious assets” that were in truth nothing more than “toxic waste.”³² Remarkably, 93% of the subprime MBSs issued in 2006 were subsequently downgraded to junk status.³³ By the time Congress held hearings to address its concerns, the three major rating agencies had already issued massive-scale downgrades: Standard & Poor’s (S&P) had downgraded more than two-thirds of its investment grade securities,³⁴ Moody’s Investors Service (Moody’s) had cut ratings on more than 5,000 of its MBSs,³⁵ and Fitch Ratings (Fitch) had issued downgrades to 158 of the 431 CDOs it had rated with securitized mortgage exposure.³⁶ The huge discrepancy between the true value of these products and the value expressed by the agencies’ ratings make it clear why the agencies have received such sharp criticism.

There are several explanations for the rating agencies’ poor performance. One explanation focuses on errors in the rating

27. BASEL FORUM ON CREDIT RISK DEVELOPMENTS, *supra* note 13, at 14.

28. Dennis, *supra* note 24, at 1122.

29. BASEL FORUM ON CREDIT RISK DEVELOPMENTS, *supra* note 13, at 14.

30. Willem H. Buiter, Professor of European Political Econ., London Sch. Of Econ. & Political Sci., Lecture on Lessons From the Global Financial Crisis for Regulators and Supervisors (June 13, 2009), available at http://eprints.lse.ac.uk/29048/1/Lessons_from_the_global_financial_crisis.pdf.

31. *Id.*

32. Paul Krugman, *Berating the Raters*, N.Y. TIMES, Apr. 26, 2010, at A23.

33. *Id.*

34. Gretchen Morgenson, *House Panel Scrutinizes Rating Firms*, N.Y. TIMES, Oct. 23, 2008, at B1.

35. *Id.*

36. Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57,967, 73 Fed. Reg. 36,212, 36,218 (proposed June 25, 2008).

methodologies employed. An evaluation of these methodologies reveals a fundamental flaw in the rating model, which reached conclusions using insufficient historical data encompassing too short a period of time.³⁷ CRA methodologies considered mortgage default rates between 1992 and 2000, a period in which significant residential property value appreciation prevented home owners from defaulting on their mortgages.³⁸ In effect, this data caused rating models to be based on the assumption that home prices would never fall.³⁹ The agencies further believed that even if home prices stalled or declined in one area of the country, the geographic diversification of mortgages pooled into each MBS would protect the securities from such isolated downturns. Indeed, “conventional wisdom” at the time was that a nationwide home price decline would be “unprecedented.”⁴⁰ In 2004, an FDIC senior economist supported this view when she found that while there was “potential” for home price decline in individual markets, history suggested it was “highly *unlikely* that home prices [would] fall precipitously across the entire country.”⁴¹ In retrospect, the fundamental errors in these assumptions are clear.

While there were evident errors in the rating methodologies employed, many critics have focused their attention on broader issues implicating the entire rating industry. Scholars have identified several perceived problems with the credit rating industry including limited competition in the credit rating market, lack of transparency in rating methodologies, and conflicts of interests between rating agencies and the companies they are rating.⁴² This Note focuses on the conflicts of interest, of which there are two primary concerns: (1) the “issuer-pays” conflict and (2) the “ancillary services” conflict.

The issuer-pays conflict relates to the method by which rating agencies are compensated for their services. The vast majority of an individual rating agency’s revenue comes directly from the issuers of the products it is being paid to evaluate.⁴³ The concern here is that a rating agency will

37. See Dennis, *supra* note 24, at 1123–26.

38. *Id.* at 1125.

39. See Charles W. Calomiris, *The Debasement of Ratings: What’s Wrong and How We Can Fix It 5* (2009) (working paper) (on file with Columbia Business School).

40. ARNOLD KLING, *UNCHECKED AND UNBALANCED: HOW THE DISCREPANCY BETWEEN KNOWLEDGE AND POWER CAUSED THE FINANCIAL CRISIS AND THREATENS DEMOCRACY* 29 (Peter Berkowitz & Tod Lindberg eds., 2010).

41. Cynthia Angell, *Housing Bubble Concerns and the Outlook for Mortgage Credit Quality*, FDIC OUTLOOK, Spring 2004, at 3, 6, available at <http://www.fdic.gov/bank/analytical/regional/ro20041q/na/t1q2004.pdf>.

42. See Hunt, *supra* note 8.

43. See TECHNICAL COMM. OF THE INT’L ORG. OF SEC. COMM’NS, *THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS* 15 (2008) [hereinafter IOSCO Report], available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf>.

downplay the credit risk posed by an issuer in order to retain the issuer's business in the future.⁴⁴ The ancillary services problem relates to the fact that agencies are sometimes involved in structuring the products they are rating.⁴⁵ This occurs when rating agencies advise clients on how to structure a product to secure a desired rating. The concern here is that agencies engaging in pre-rating dialogue with issuers are unable to neutrally rate the products because they have become "creators of the instruments themselves."⁴⁶

IV. THE AGENCIES' UNSUPPORTED CLAIMS OF INNOCENCE

Naturally, rating agencies have strongly refuted the notion that conflicts of interest hamper the effectiveness of their ratings.⁴⁷ In a letter to investigating reporters at CNBC, Moody's claimed it "properly manages the potential for conflicts of interest and has added new safeguards that further address those conflicts."⁴⁸ But there is strong evidence contradicting the agencies' assertions of innocence. Before the House Committee on Oversight and Government Reform, Frank Raiter, former head of mortgage ratings at S&P, characterized his company's failures by simply stating: "Profits were running the show."⁴⁹ Raiter testified that S&P prioritized pleasing its customers above rating accuracy. According to Raiter, S&P refused to apply a more detailed rating methodology for mortgage backed CDOs because "improving the model would not [increase] . . . revenues."⁵⁰ And S&P was not the only CRA operating at closer than arms length. A former Moody's staffer described the climate at the turn of the

44. *Id.*

45. *See, e.g.*, Joshua D. Krebs, *The Rating Agencies: Where We Have Been and Where Do We Go From Here?*, 3 J. BUS. ENTREPRENEURSHIP & L. 133, 140-41 (2009).

46. *Id.* at 141.

47. *See* Richard Tomlinson & David Evans, *CDO Boom Masks Subprime Losses, Abetted by S&P, Moody's, Fitch*, BLOOMBERG, May 31, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajs7BqG4_X8I. Yuri Yoshizawa, group managing director for structured finance at Moody's, told Bloomberg that the "credit rating company's close relationship with CDO issuers doesn't compromise objectivity." *Id.* Similarly, Gloria Aviotti, Fitch's global head of structured finance, stated that "although her company talks with financial firms as they create CDOs, Fitch doesn't structure CDOs." *Id.*

48. *House of Cards* (CNBC television broadcast Feb. 12, 2009), at 44:14, available at <http://www.cnbc.com/id/15840232?video=1145392808&play=1>; *see also* Sam Jones, *How Moody's Faltered*, FIN. TIMES, Oct. 17, 2008, <http://www.ft.com/intl/cms/s/0/65892340-9b1a-11dd-a653-000077b07658.html#axzz1icOIQZf3> (Moody's claiming "'commercial considerations are never a factor in the rating assigned to an issuer or transaction. Our ratings and research are our only products, and our reputation is our only capital.'").

49. Morgenson, *supra* note 34.

50. *Id.* at 85. Some commentators have argued that issuers influenced rating agencies to use subjective measures to override their rating methodologies. *See* Coffee, *supra* note 14, at 13 ("[E]vidence shows not that the CRAs' valuation models were wrong, but that they were systematically overridden in a manner that increased the size of AAA tranches.").

millennium by stating, “There was suddenly a concentration on profits [T]here was a big personality shift in the company—lots of cozying up to clients went on.”⁵¹

There is also significant evidence that CRA provision of ancillary business services exceeded appropriate boundaries. Rating agencies had developed a “consulting type” relationship with their investment bank clients.⁵² As investment banks structured MBS deals, they searched for ways to ensure that a certain percentage of the security was classified as triple-A; the CRAs would tell them how to make that goal a reality.⁵³ Brian Clarkson, Moody’s former chief operating officer, explained the rating process to one investment magazine as one where “[y]ou start with a rating and build a deal around [that] rating.”⁵⁴ Ann Rutlege, a former Moody’s analyst, explained the process further by stating, “There are so many ways to turn something that’s crap into triple-A If you just follow the rules without following the spirit of the rules, it’s not difficult to do.”⁵⁵

The ability to consult with the CRAs before issuing a security was greatly appreciated on the institutional front—particularly by the investment banks controlling the majority of the deal flow.⁵⁶ With CRAs willing to give consultative advice on the front end, issuers could “shop[] around’ for the highest ratings on their lucrative . . . deals, including by playing one rating agency against another when informally consulting them on structures to achieve high ratings.”⁵⁷ One CRA’s participation in structuring deals came to light in a 2003 civil action.⁵⁸ The Second Circuit found that Fitch “played an active role in helping [its client] . . . structure [a] transaction.”⁵⁹ In the court’s opinion, the evidence “indicate[d] a fairly active role on the part of [a] Fitch employee in commenting on proposed

51. Jones, *supra* note 48.

52. FABER, *supra* note 26, at 90.

53. *Id.*

54. Jesse Eisinger, *Overated*, PORTFOLIO.COM (Aug. 13, 2007), <http://www.portfolio.com/news-markets/national-news/portfolio/2007/08/13/Moody-Ratings-Fiasco/index1.html#ixzz111NsC6YD>.

55. FABER, *supra* note 26, at 101.

56. JONATHAN KATZ ET AL., WORLD BANK GROUP, CREDIT RATING AGENCIES: NO EASY REGULATORY SOLUTIONS 3 (2009), available at <http://rru.worldbank.org/documents/CrisisResponse/Note8.pdf>.

57. *Id.* at 4; see also FIN. ECONOMISTS ROUNDTABLE, STATEMENT ON REFORMING THE ROLE OF THE STATISTICAL RATINGS ORGANIZATIONS IN THE SECURITIZATION PROCESS 5 (2008), available at <http://fic.wharton.upenn.edu/fic/Policy%20page/FER12%201%2008rev.pdf> (finding that “[i]ssuers and underwriters actively shopped for ratings and were unwilling to pay for ratings they deemed too low”).

58. *In re Fitch, Inc.*, 330 F.3d 104 (2d Cir. 2003).

59. *Id.* at 110.

transactions and offering suggestions about how to model the transactions to reach the desired ratings.”⁶⁰

V. WE HAVE BEEN HERE BEFORE – EARLIER FAILURES OF THE CREDIT RATING INDUSTRY

The recent criticisms of the rating agencies are not unique to the present financial crisis. Despite identifying weakness in Enron’s financial statements in May of 2001, it was not until nearly six months later, a mere four days before the company declared bankruptcy, that S&P, Moody’s, and Fitch finally downgraded the energy giant’s ratings.⁶¹ The lengthy delay in downgrading Enron’s ratings was met with anger and frustration by investors, politicians, and the general public, causing a cry for reforming the industry to be heralded.⁶² The cry, however, was not loud enough. In the end, “the accountants, not the rating agencies, came to shoulder much of the blame for Enron’s collapse and the economic downturn it wrought.”⁶³

Congress ultimately determined that conflicts of interest and other problems plaguing the accounting industry had facilitated Enron’s fraudulent behavior. Accounting firms were operating under a client-pays business model, where the companies being audited paid for the accounting services being rendered. Congress was concerned with this model because it believed accounting firms were incentivized to return favorable audit reports in order to secure future business. Congress also disapproved of accounting firms marketing and selling ancillary non-audit services to their audit clients. Congress believed selling ancillary services jeopardized auditor independence because accounting firms might fear that issuing unfavorable audit reports would place revenues from non-audit services at risk.

To curb these issues, Congress passed the Sarbanes-Oxley Act of 2002 (SOX).⁶⁴ Title II of SOX attempted to address congressional concerns about conflicts of interest by imposing numerous controls and restrictions on the accounting industry. For example, SOX prohibited accounting firms

60. *Id.* at 110–11. Fitch was not a party to the underlying lawsuit but was required by the lower court to turn over internal documents. *See American Savings Bank, FSB v. UBS PaineWebber, Inc.*, No. M8-85, 2002 WL 31833223 (S.D.N.Y. Dec. 16, 2002).

61. *See* Edward Wyatt, *Enron’s Many Strands: Warning Signs; Credit Agencies Waited Months to Voice Doubt About Enron*, N.Y. TIMES, Feb. 8, 2002, at C1 (discussing how alleged conflicts of interest may have played a role in the delayed downgrade).

62. *See Rating the Raters: Enron and the Credit Rating Agencies: Hearing Before the S. Comm. on Governmental Affairs*, 107th Cong. 3 (2002) (opening statement of Chairman Lieberman).

63. Jones, *supra* note 48.

64. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

from providing ancillary non-audit services,⁶⁵ required audit partners to periodically rotate off clients,⁶⁶ and closed the “revolving door” between firms and clients by forbidding engagements with a company whose key management previously worked with the accounting firm.⁶⁷

Interestingly, SOX did not include similar regulations directed at the credit rating industry despite that the credit rating industry was susceptible to virtually identical conflicts of interest. But while the brunt of SOX’s punch landed solely on the accounting industry, the rating industry’s problems were not completely ignored. However, instead of instituting regulations, SOX instructed the SEC to conduct an investigation into the role and function of CRAs in securities markets.⁶⁸ In response to that directive, the SEC held investigative hearings and subsequently issued a report identifying several concerns with the credit rating industry.⁶⁹ The Commission’s three primary concerns were parallel to the criticisms now being voiced: (i) the limited competition among rating agencies,⁷⁰ (ii) the lack of transparency in the rating process,⁷¹ and (iii) underlying conflicts of interest threatening the integrity of agency ratings.⁷²

More than five years after the Enron scandal became public and three years after the SEC’s report, Congress passed the Credit Rating Agency Reform Act (CRA Reform Act) as a first attempt to address the three issues identified by the SEC.⁷³ The CRA Reform Act addressed the limited competition in the industry by removing many of the barriers to entry that had kept competition away.⁷⁴ In 1975, the SEC began informally recognizing certain rating agencies as *nationally recognized statistical rating organizations* (NRSROs) in an effort to identify which agencies’

65. *Id.* § 201 (codified at 15 U.S.C. § 78j-1 (2006)) (banning ancillary services such as book-keeping, designing financial information systems, providing actuarial services, performing internal audits, assuming management or human resources functions, and providing broker, investment, and legal services).

66. *Id.* § 203 (codified at 15 U.S.C. § 78j-1) (requiring lead and coordinating audit partners and reviewing audit partners to rotate off clients at least every five years).

67. *Id.* § 206 (codified at 15 U.S.C. § 78j-1) (prohibiting accounting firms from performing any audit services for a client if the CEO, Controller, CFO, or any other high ranking employee of that client was employed by the accounting firm and was involved in any capacity in that client’s audit for one year prior to the date of the beginning of the audit).

68. *Id.* § 702(b).

69. U.S. SEC. & EXCH. COMM’N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF SECURITIES MARKETS: AS REQUIRED BY SECTION 702(B) OF THE SARBANES-OXLEY ACT OF 2002 (2003) [hereinafter SEC REPORT ON CRAS], available at <http://www.sec.gov/news/studies/credratingreport0103.pdf>.

70. *Id.* at 36–40.

71. *Id.* at 32–36.

72. *Id.* at 40–43.

73. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified at 15 U.S.C. § 78o-7 (2006)).

74. *See id.*

ratings could satisfy regulatory requirements.⁷⁵ Prior to the CRA Reform Act, this designation arose essentially from market acceptance rather than regulatory standards.⁷⁶ Congress believed that a clear method for recognition would “open[] a clear path of entry for new competitors,”⁷⁷ and thus included within the CRA Reform Act uniform registration requirements for NRSROs.⁷⁸

Congress then used these newly established registration requirements to address the lack of transparency in the industry. To facilitate credit rating transparency, Congress required CRAs registering as NRSROs to disclose their rating procedures and methodologies in their applications to the SEC.⁷⁹ However, while disclosure was mandatory, the SEC was not permitted to regulate the “substance of credit ratings or the procedures and methodologies” used to generate credit ratings.⁸⁰ Thus, some have argued this restriction rendered the attempted reform “toothless” and ineffective.⁸¹

Finally, the CRA Reform Act attempted to resolve potential conflicts of interest plaguing the credit rating industry. Arguably, this effort to quell conflicts of interest was the most inept aspect of the legislation. Rather than placing tangible restrictions on permissible activities, Congress merely required rating agencies to “maintain[] and enforce written policies and procedures . . . to . . . manage any conflicts of interest”⁸²—an extremely light burden compared with the restrictions SOX placed on accounting firms.⁸³

The CRA Reform Act’s weak attempt at addressing rating agency conflicts of interest is particularly intriguing considering the degree of similarity between the credit rating industry’s conflicts of interest and those found in the pre-SOX accounting industry. The 2003 SEC report directly identified the two primary conflicts of interest frequently complained about: the issuer-pays model and the increasing development of ancillary business activities.⁸⁴ The Commission expressed concern that the issuer-

75. KATZ ET AL., *supra* note 56, at 4.

76. *Id.*

77. *Id.* at 2.

78. See 15 U.S.C. § 78o-7(a) (2006). This aspect of the CRA Reform Act has been somewhat effective at opening the industry to more competition. Although S&P, Moody’s, and Fitch are still the dominant players in the industry, the number of NRSROs has doubled since the CRA Reform Act was passed. See Richardson & White, *supra* note 6, at 103–04.

79. 15 U.S.C. § 78o-7(a)(1)(B)(ii).

80. 15 U.S.C. § 78o-7(c)(2).

81. Krebs, *supra* note 45, at 143.

82. 15 U.S.C. § 78o-7(h)(1).

83. Compare 15 U.S.C. § 78o-7(h)(1) (requiring CRAs to maintain policies to avoid conflicts of interest), with Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, and *supra* notes 64–67 and accompanying text (restricting accounting firms from conducting engagements with certain clients and requiring audit partner rotation).

84. SEC REPORT ON CRAS, *supra* note 69, at 40–43.

pays model could tempt CRAs to “rate issuers more liberally, and temper their diligence in probing for negative information.”⁸⁵ With respect to ancillary business activities, the report stated concern that “rating decisions might be impacted by whether or not an issuer purchases additional services offered by the credit rating agency.”⁸⁶ The Commission specifically noted this conflict was arguably “analogous to that of accounting firms offering consulting services.”⁸⁷ Yet, despite the SEC’s strong comparison of the rating agency conflicts of interest with the conflicts faced by pre-SOX accounting firms, Congress refused to impose controls on the rating agencies to eliminate these concerns.

VI. APPLYING SOX-LIKE REGULATION TO CREDIT RATING AGENCIES

There are many readily identifiable similarities between the accounting and credit rating industries. Foremost, firms in both industries serve as “gatekeepers” for the marketplace. In passing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the sweeping reform handed down in response to the financial crisis, Congress found that rating agencies “play a critical ‘gatekeeper’ role in the debt market that is functionally similar to that of . . . auditors, who review the financial statements of firms.”⁸⁸ Further, as one might expect, as gatekeepers, both of these industries are premised on independence.⁸⁹

Importantly, the similarities between accounting firms and CRAs are not limited to their roles as gatekeepers. As the SEC noted in its SOX-mandated report, and as indicated by the evidence discussed above, the credit rating industry is also vulnerable to the same conflicts of interest found in the pre-SOX accounting industry.⁹⁰ Both accounting firms and

85. *Id.* at 41.

86. *Id.* at 42. An example of this is Moody’s downgrade of Hannover Re, one of the world’s largest reinsurance corporations. In 1998 Moody’s approached Hannover to persuade the company to subscribe to its rating service. When Hannover rejected the offer, Moody’s published an unsolicited rating one notch below the company’s current rating issued by S&P. Over the next few years, Moody’s further downgraded Hannover’s credit rating on three occasions, the last of which initiated a 10% drop in the company’s stock. Hannover’s management claimed this was “pure blackmail,” alleging that Moody’s promised to increase the ratings if the company would subscribe to its services. See Patrick Van Roy, *Is There a Difference Between Solicited and Unsolicited Bank Ratings and If So, Why?* 7–8 (Nat’l Bank of Belgium, Working Paper No. 79, 2006), available at <http://www.nbb.be/doc/ts/publications/wp/wp79En.pdf>; see also Alec Klein, *Spitzer Examining Debt Ratings By Moody’s*, WASH. POST, July 30, 2005, at D1.

87. SEC REPORT ON CRAS, *supra* note 69, at 42.

88. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931(2), 124 Stat. 1376, 1872 (2010).

89. See C. Richard Baker, *The Varying Concept of Auditor Independence: Shifting with the Prevailing Environment*, CPA J. ONLINE, Aug. 2005, available at <http://www.nysscpa.org/cpajournal/2005/805/infocus/p22.htm>.

90. See *supra* notes 84–87 and accompanying text.

rating agencies operate under a client-pays system that creates an added incentive to reach conclusions favorable to the party paying the bill. Additionally, rating agencies market ancillary business services to their clients much in the same way pre-SOX auditors did. Indeed, the SEC found similarity between its concern that credit “issuers may be pressured into using [ancillary services] out of fear that their failure to do so could adversely impact their credit rating” and its concern with ancillary services in the pre-SOX audit context.⁹¹

Attempts to differentiate auditor conflicts of interest from those found in the credit rating industry are tenuous at best.⁹² One academic has argued that the issuer-pays model in the credit rating industry is not comparable to the accounting industry’s client-pay model because “as the numbers indicate, no single issuer holds enough financial leverage over any CRA to make inflating a credit rating worthwhile.”⁹³ However, upon deeper inspection it is clear this argument does not withstand scrutiny. The argument is based on the conclusion that “no single rating client is likely to contribute more than *two percent* of any CRA’s total revenue.”⁹⁴ On the one hand, such an argument is of little value because “this metric for independence . . . says nothing about the independence of the audit team [or credit analyst] that actually made the relevant decisions.”⁹⁵ However, assuming *arguendo* that the empirical reasoning is valid, the argument is still unpersuasive—particularly in light of the fact that Enron accounted for only *one percent* of its auditor’s total revenues.⁹⁶

Another major flaw in the above argument is that it fails to recognize the difference between rating agencies operating in the bond market and rating agencies operating in the structured finance market. As the International Organization for Securities Commissions (IOSCO) noted, the issuer-pays conflict is “more acute where structured finance transactions are being rated, [because] the volume of deals and corresponding rating

91. SEC REPORT ON CRAS, *supra* note 69, at 43. The report further stated, “in the case of ratings assessment services, there are concerns that, to the extent a rating agency has already ‘promised’ a certain rating to an issuer’s hypothetical scenario, pressure to match the actual rating to the promised rating is likely to be forceful, even if the ultimate analysis otherwise might not have supported the rating.” *Id.*

92. Nicole B. Neuman, A “Sarbanes-Oxley” for Credit Rating Agencies? A Comparison of the Roles Auditors’ and Credit Rating Agencies’ Conflicts of Interests Played in Recent Financial Crises, 12 U. PA. J. BUS. L. 921 (2010) (attempting to distinguish credit agencies from audit firms while arguing a measure similar to SOX would be ineffective).

93. *Id.* at 941.

94. *Id.* at 942 (emphasis added).

95. Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1176 (2003).

96. *Id.* at 1176 n.33 (finding that Enron accounted for less than 1% of Arthur Andersen’s total revenue).

business attributable to particular financial institutions” is much higher.⁹⁷ The truth is that major issuers of structured financial products are likely to hold a high degree of leverage over the CRAs they do business with. The claim that no rating client represents more than two percent of a CRA’s business assumes that each structured product being rated is an individual rating client.⁹⁸ While each product, i.e., each MBS or CDO, may be rated under a separate contract, these products cannot be accurately viewed in isolation. In the years preceding the financial crisis, there were a limited number of investment banks creating these structured finance deals.⁹⁹ As one scholar pointed out, the top six investment banks controlled over fifty percent of the structured finance market, and the top dozen accounted for over eighty percent.¹⁰⁰ Thus, these banks could forcefully “threaten to take a substantial volume of business elsewhere, if dissatisfied.”¹⁰¹ Viewed from this perspective, CRAs faced even more pressure to succumb to their clients’ wishes than pre-Enron auditors did.

Given the similar role and, more importantly, vulnerabilities of rating agencies and audit firms, it is sensible that these two industries should be regulated using parallel measures—at least with respect to addressing conflicts of interest. Recent studies have established that SOX’s regulation of the accounting industry produced positive effects both on audit quality and on investor confidence in audited financial statements.¹⁰² Using SOX as a rubric, regulators can enact similar measures with respect to the ratings industry, which will in turn produce comparable enhancements in credit rating quality and confidence in those ratings.

It is important to recognize that despite the positive effect SOX has had on investor confidence and audit quality, it was not a perfect regulatory measure. As with any congressional action, SOX has faced its share of justified criticism. Critics have argued that specific extraneous or over-burdensome requirements have produced unnecessary costs outweighing the legislation’s benefits.¹⁰³ In fact, ninety-four percent of executives

97. IOSCO Report, *supra* note 43, at 15.

98. Neuman, *supra* note 92, at 941 (“[A]ny given issuer can offer hundreds of different financial instruments. As a result, each NRSRO rates thousands of different financial instruments and has thousands of different credit rating clients.”).

99. See Coffee, *supra* note 14, at 8–9.

100. *Id.* at 9.

101. *Id.* at 8.

102. See Press Release, Ctr. for Audit Quality, Post-SOX Audit Quality Has Improved, Say Nation’s Audit Committee Members: Respondents Believe Most SOX-Related Changes Have Had Positive Impact (Mar. 18, 2008), available at http://www.thecaq.org/newsroom/release_03182008.htm.

103. See, e.g., Chris Evans, *Directors Call for Sarbanes-Oxley Repeal*, ACCOUNTANCY AGE (Feb. 23, 2006), <http://www.accountancyage.com/aa/news/1778091/directors-sarbanes-oxley-repeal> (Seventy-two percent of directors surveyed said SOX made them too cautious, and consequently they are “not taking the necessary risks to drive growth”).

interviewed in a 2007 survey expressed belief that SOX compliance costs overshadowed the regulation's benefits.¹⁰⁴ The SEC manifested some measure of agreement with this complaint when it adopted a more principles-based, rather than formulistic, interpretation of SOX requirements.¹⁰⁵

While suggestions that SOX overreached in some areas should caution regulators, for our purposes it is significant to note that the vast majority of criticism is limited to a small segment of the Act's provisions. Criticisms of SOX tend to be relegated to select provisions—namely § 404, the provision requiring corporate managers to create, maintain, and test processes that monitor internal controls over financial reporting.¹⁰⁶ In contrast, there has been negligible debate over the SOX provisions aimed at eliminating conflicts of interest and preserving auditor independence. The only substantive attack on SOX's conflict of interest provisions argues that these measures were enacted without strong empirical support.¹⁰⁷ However, this minority position has been sharply contradicted.¹⁰⁸ The general perception is that the SOX provisions aimed at eliminating conflicts of interest are supported by “substantial” evidence and that such regulation is “consistent with a very common sense body of logic.”¹⁰⁹ In the same manner, strong safeguards, similar to those established by SOX, are the intuitive solution to limit abuses that arise when rating agencies interact with clients at closer than arms length.

VII. RATING RECENT REGULATION

After the collapse of the financial market unearthed the true scope of the rating industries' failures, it became clear that the CRA Reform Act was an insufficient response to rating agency problems. As a result, Congress and the SEC both took up these issues for further consideration. On July 21, 2010, President Barack Obama signed the Dodd-Frank Act into

104. Tim Reason, *Feeling the Pain: Are the Benefits of Sarbanes-Oxley Worth the Cost?*, CFO MAGAZINE, May 1, 2005, available at <http://www.cfo.com/article.cfm/3909558?f=search>.

105. See Cheryl L. Wade, *Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?*, 39 LOY. U. CHI. L.J. 595, 607–10 (2008) (discussing the SEC's revised interpretation of SOX compliance as more principle-based as opposed to a check-the-box type of compliance).

106. *Id.* at 607 (discussing Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404, 116 Stat. 745, 789 (codified as amended at 15 U.S.C. § 7262)).

107. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1534–37 (2005) (arguing that nineteen of twenty-five studies conducted suggest that provision of non-audit services does not bear a relationship to audit quality).

108. See Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843, 1858 (“By looking through a slightly broader lens and accessing newer studies that were unavailable to Professor Romano, we hope to demonstrate that SOX rests on a much more solid empirical foundation than many have believed.”).

109. *Id.* at 1879–80.

law, a sweeping financial reform which contained a number of provisions aimed at addressing criticisms of the rating agencies.¹¹⁰ The SEC similarly has promulgated a series of regulations with respect to rating agencies, several of which are directly aimed at limiting conflicts of interest.¹¹¹ The following paragraphs evaluate the degree to which these efforts, as compared with similar measures codified in SOX, are likely to effectively address the two primary conflicts of interest addressed in this Note.

A. *SOXing the Issuer-Pays Conflict of Interest*

SOX attempted to temper the accounting firm client-pays conflict by imposing two primary restrictions. First, it closed the so-called “revolving door” between accounting firms and their clients by prohibiting accounting firms from performing audit services for a client if the CEO, Controller, CFO, or any other high ranking employee of that client was previously employed by the accounting firm and was involved in any capacity in that client’s audit.¹¹² Second, it required lead audit partners and reviewing audit partners to rotate off clients at least every five years.¹¹³

SEC regulations have taken a different approach when addressing the issuer-pays conflict with rating agencies. In June 2007, the Commission passed a rule prohibiting any agency from providing ratings for a client that generated more than ten percent of the agency’s prior year total net revenue.¹¹⁴ This regulation makes sense, as one can intuitively recognize that a rating agency would have difficulty issuing an impartial credit rating for a client holding such significant financial leverage. Yet, while clients issuing structured financial products can generate a high percentage of a CRA’s revenue, some scholars have argued the ten percent threshold is too high and will rarely, if ever, be met.¹¹⁵ Impartiality can certainly be threatened when a client generates less than ten percent of a CRA’s total net revenue. In 2007, Moody’s earned more than \$2.2 billion in gross

110. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 931–939H, 124 Stat. 1376, 1872–90 (2010).

111. See SEC NRSRO Rule, 17 C.F.R. § 240.17g-5 (2009). The seven prohibited conflicts are discussed in detail in Lynn Bai, *On Regulating Conflict of Interests in the Credit Rating Industry*, 13 N.Y.U. J. LEGIS. & PUB. POL’Y 253 (2010).

112. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 206, 116 Stat. 745, 774 (codified at 15 U.S.C. § 78j-1 (2006)).

113. *Id.* § 203.

114. See Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564, 33,598 (June 18, 2007) (codified at 17 C.F.R. § 240.17g-5(c)(1) (2011)).

115. Bai, *supra* note 111, at 279.

revenue, and more than \$1.1 billion in income before taxes.¹¹⁶ A client accounting for only 5% of Moody's 2007 gross revenue would generate more than \$110 million—surely enough to challenge a person's moral convictions.

The second SEC regulation targeted primarily at the issuer-pays conflict was adopted in February 2009.¹¹⁷ This regulation prohibits a rating agency employee who “negotiated, discussed, or arranged” the client's fee from “participating in determining credit ratings” for that client or from “developing or approving procedures or methodologies used for determining” that client's ratings.¹¹⁸ Again, this is a logical measure, but one that does not completely resolve the problem. Unlike SOX, which required the ultimate decision maker, the audit partner, to rotate off clients every few years, the current rules for rating agencies never require credit analysts to rotate off clients. Although individual rating analysts may not negotiate fee arrangements, they will certainly understand the importance of rating clients favorably. In 2007, Morgan Stanley issued 92 MBSs valued at more than seventy-five billion dollars.¹¹⁹ Only a feeble-minded credit analyst would not understand the importance of maintaining Morgan Stanley's MBS business, regardless of whether the analyst negotiated the fee structure. To the Commission's credit, it did at least draw a harder line than the one recommended by large rating agencies—the Commission outright prohibited fee discussion participants from approving credit ratings, rather than merely requiring the agencies to disclose and manage these conflicts.¹²⁰

Dodd-Frank also contained a provision attempting to address the issuer-pays conflict. Like SOX, Dodd-Frank attempted to curb conflicts of interest arising from rating agency employees going to work for agency clients—the “revolving door” issue.¹²¹ Dodd-Frank, however, softened SOX's approach; rather than outright barring CRA's from issuing ratings for clients employing former rating analysts, as SOX did to accounting firms, Dodd-Frank merely required rating agencies to create and enforce policies to ensure conflicts of interest would not influence credit ratings.¹²²

116. MOODY'S CORP., ANNUAL REPORT 2007, at 67 (2008), available at <http://ir.moody.com/annuals.cfm>.

117. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6,456 (Feb. 9, 2009) (codified at 17 C.F.R. pts. 240, 249b).

118. 17 C.F.R. § 240.17g-5(c)(6).

119. Coffee, *supra* note 14, at 9.

120. 17 C.F.R. § 240.17g-5(c)(6).

121. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1875 (2010) (codified at 15 U.S.C. § 78o-7 (Supp. IV 2010)).

122. *Id.*

Notably, neither SOX nor the regulatory measures addressing rating agencies altered the client-pays or issuer-pays systems. For the legislators drafting SOX, making major changes to the client-pays system was not considered because practical alternatives are nonexistent in the accounting context. In contrast, a number of reasonable alternatives exist for rating agency compensation—in fact, traditionally credit ratings were sold to investors, not issuers. At their inception in 1909, when John Moody offered the first publicly available rating, rating agencies sold their ratings directly to investors (i.e., an “investor pays” model).¹²³ This model persisted until the 1970s, when “the growing complexity of financial products and the sheer size of the debt market demanded staffing levels [such] that a subscription model couldn’t sustain.”¹²⁴ Thus, CRAs shifted to the issuer-pays model—a move that has been bitterly attacked by scholars who are now proposing a variety of potential modifications.¹²⁵ Many of these scholars are recommending a return to the traditional investor-pays compensation model, which the large rating agencies suggest would merely shift conflicts of interest from issuers to investors.¹²⁶

A hybrid between the issuer-pays model and the traditional user-pays model was considered by Congress during debates over the content of the then-pending Dodd-Frank Act. Senator Al Franken (D-Minn.) proposed the creation of a “Credit Agency Review Board,” which would select an initial rater for all structured financial products.¹²⁷ Under Franken’s proposal, issuers unsatisfied with their initial rating remained free to secure additional ratings from their preferred agency.¹²⁸ Additionally, all subsequent ratings would be generated by the rater of the issuer’s choice.¹²⁹ Despite giving the Franken Amendment serious consideration, Congress opted to pass on the opportunity to substantially change the issuer-pays model—avoiding the issue just as it avoided dealing with rating agencies

123. Richardson & White, *supra* note 6, at 102.

124. Jones, *supra* note 48.

125. See, e.g., Buiter, *supra* note 30, at 8 (recommending paying issuers with the securities they are rating); Coffee, *supra* note 14, at 30–40 (evaluating three alternatives: (1) having the government select the rater, (2) encouraging the subscriber-pays model, and (3) having a government body issue select ratings to provide a “yardstick” for users to evaluate the private rating agencies); Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91 (2010) (recommending paying rating agencies with the debt they rate).

126. KATZ, *supra* note 56, at 6; see also Richardson & White, *supra* note 6, at 107 (noting that the conflicts the rating agencies suggest would arise from an investor-pays model “seem much less severe than those for the ‘issuer pays’ model”).

127. Coffee, *supra* note 14, at 32.

128. *Id.*

129. *Id.*

under SOX.¹³⁰ Instead, Congress required various studies be conducted to determine the feasibility of proposed alternative compensation models.¹³¹

B. SOXing the Ancillary Business Activity Conflict of Interest

SOX was heavy handed in addressing the conflict of interest arising from accounting firms providing ancillary business services for audit clients. Rather than defining appropriate ways to engage in such activities, SOX completely banned ancillary services such as book-keeping, designing financial information systems, providing actuarial services, performing internal audits, assuming management or human resources functions, and providing broker, investment, and legal services.¹³² These draconian restrictions were, in part, based on concerns that accounting firms providing ancillary services would be more likely to fear that delivering an unfavorable audit report would result in lost non-audit business.¹³³ Regulators were also concerned that an accounting firm would be less likely to correct financial statements that the firm played a substantial role in creating.¹³⁴

Based on similar concerns, in 2009 the SEC adopted a rule prohibiting rating agencies from issuing ratings for a client if an agency employee “made recommendations . . . about the corporate or legal structure, assets, liabilities, or activities” of the issuer.¹³⁵ Permitting rating agencies to provide advice about product structuring was problematic because, according to the SEC, the agencies would be “in effect, rating their own work.”¹³⁶ The Commission believed that this was not a conflict that could be effectively managed; thus, only an outright prohibition would suffice.¹³⁷ The 2009 prohibition built upon the SEC’s previous restriction against

130. See *supra* notes 68–72 and accompanying text.

131. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939D, 124 Stat. 1376, 1888 (2010) (requiring the Comptroller General to conduct a study on alternative means for compensating NRSROs); *id.* § 939E (requiring the Comptroller General to conduct a study on the feasibility of creating a government operated independent rating organization); *id.* § 939F (requiring the Commission to conduct a study regarding the feasibility of having an independent body assign issuers to a rating agency).

132. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 745, 771 (codified at 15 U.S.C. §§ 78j-1, 7231 (2006)).

133. See Prentice & Spence, *supra* note 108, at 1879–80; Romano, *supra* note 107, at 1533–34.

134. See Prentice & Spence, *supra* note 108, at 1879–80; Romano, *supra* note 107, at 1533–34.

135. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6,456, 6,466 (Feb. 9, 2009) (codified at 17 C.F.R. § 240.17g-5(c)(5) (2011)).

136. *Id.*

137. *Id.*

rating agencies conditioning or modifying a company's rating based on the company's willingness to purchase ancillary business services.¹³⁸

Dodd-Frank did not modify the SEC rules or take any further action to address the ancillary business services conflict. However, Congress did require the SEC to conduct a study evaluating the impact of the current rules prohibiting such services.¹³⁹ Scholars tend to believe the SEC's current outright prohibition against agencies providing ancillary services should ensure that this conflict is "unlikely to remain [a] substantial concern[] in the future."¹⁴⁰ However, Congress's probe into the impact of the current prohibition may indicate a belief that the SEC's stance is too strong. The mandated report is not due until late 2013;¹⁴¹ therefore, it will likely be a while before this issue is addressed again.

VIII. CONCLUSION

Regulators responding to the Enron-era scandals did not sufficiently recognize the extent to which conflicts of interest in the credit rating industry could destabilize future financial markets. These regulators failed to adopt stronger controls for credit rating agencies when they were establishing controls for the accounting industry, and this failure proved to be a costly error. Although the substantial damage incurred cannot be undone, long-overdue changes are, at the least, now underway.

Recently enacted SEC rules imposed a complete prohibition on a rating agency's ability to provide ancillary consultative services to its clients. This prohibition mirrors the ancillary business restriction imposed by SOX, and all indications are that this effort will be an effective response to the problems this issue has created.

In contrast, efforts to mitigate conflicts of interest arising out of the issuer-pays compensation model have failed to adequately address the problem. The newest regulatory measures, which should probably have been even more stringent than those included in SOX, carry much less force than the regulations imposed on the accounting industry after Enron. This insufficiency exists despite the fact that the issuer-pays conflict likely poses a greater concern for rating agencies than it ever did for accounting firms. Agencies rating structured financial products operate in a highly concentrated market where a small number of investment banks control the

138. Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564, 33,599 (June 18, 2007) (discussing Exchange Act Rule 17g-6(a)(1) that was aimed at eliminating abusive practices such as those discussed in note 86 *supra*).

139. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 939C, 124 Stat. 1376, 1888 (2010).

140. Bai, *supra* note 111, at 292.

141. Dodd-Frank Wall Street Reform and Consumer Protection Act § 939C(c).

vast majority of the deal flow. Furthermore, unlike with the accounting industry, various alternatives exist to the current issuer-pays model—including holding investors responsible for purchasing ratings, a method employed for the first fifty years of the credit rating industry.

Yet Congress has again elected to wait until a later date to address the issuer-pays conflict, instead opting to conduct a study regarding alternative compensation models. The decision to conduct a study rather than take immediate action is startling—especially given that the last time a rating agency study was mandated (when Congress enacted SOX), subsequent congressional action was too late to be of any use and likely would have been ineffective even if timely. One could perhaps be hopeful that this time the study will be the first step in establishing permanent structural change, but given the congressional track record in this area, such hope is likely to disappoint.

D. Andrew Hatchett