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Re-thinking Credit Rating Agency Liability:

A Review of the Legal fiction of Gatekeeping under the Dodd-Frank Act

Russell Mutingwende Xavier,

M.Com (Stellenbosch), LL.M. Finance (Goethe Univ.)

Supervisor: Professor Dr. Matthias Goldmann, LL.M. (NYU)

Supervisor: Professor Dr. Brigitte Haar, LL.M. (Chicago)

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Abbreviations

Abbreviation/Term	Full spelling/ Function
ABS	Asset-backed securities
ABA	American Bar Association
ABS	Asset-Backed Securities
AFAANZ	Accounting and Finance Association of Australia and New Zealand
Atlantic	The Atlantic magazine
Att’y Gen.	Attorney General
Brookings Inst.	Brookings Institute
CalPERS	California Public Employees' Retirement System
CDO	Collateralized Bond Obligations
Cent. Fin. Stud	Centre of Financial Studies - Goethe University
CESR	Committee of European Securities Regulators
CFR	Code of Federal Regulations, codified rules and regulations of how the Executive branch will interpret the law, i.e. administrative law. 28 U.S.C. § 2072(b); see also Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541, 2561 (2011).
CFS	Center for Financial Studies
CLO	Collateralized Loan Obligations
CMBS	Commercial Mortgage Backed Securities
Comm. on the Global Fin. Sys	IOSCO's Committee on the Global Financial System
CRA	Credit Rating Agency
CRARA	Credit Rating Agency Reform Act
CRRA	Connecticut Resources Recovery Authority
DBRS	Dominion Bond Rating Service
DFA	Dodd-Frank Act
DFA	Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), (Pub. L. 111–203)

DMR	SEC's Division of Market Regulation
ECONOMIST	The Economist magazine
EJCL	Electronic Journal of Comparative Law
ERISA	The Employee Retirement Income Security Act of 1974, Pub. L. 93-406 codified as 29 USCS § 1002
ESMA	European Securities Market Authority
ESME	European Securities Market Experts
EU	European Union
F.	Federal
F. Supp.	Federal Supplement
F., F.2d, or F.3d	Federal Reporter
f.k.a.	formerly known as
FCA	Federal Court of Australia
FCIC	Financial Crisis Inquiry Commission
Fed.R.Civ.P.	Federal Rules of Civil Procedure
FIRREA	Federal Institutions Reform, Recovery and Enforcement Act
Fitch	Fitch ratings
FSA	Financial Services Authority (UK) [Please make sure to note that today, regulation in the U.K. is carried out by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA)].
GAO	Government Accountability Office
GFC	Global Financial Crisis
Govt. Sponsored Enterprises Sub-Comm. of the House Fin. Serv. Comm.	Government Sponsored Enterprises Sub-Committee of the House Financial Services Committee
H.R.	U.S. House of Representatives
HBS	Harvard Business School
HCA	High Court of Australia
HR	House of Representatives
ICMB	International Center for Monetary and Banking Studies

IEEE	Institute of Electrical and Electronics Engineers
IJPAI	An International Journal of Policy, Administration, and Institutions
ILF	Institute for Law and Finance – Goethe University
IOSCO	International Organization of Securities Commission
IOSCO Code	IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies. Frame-work Code of Conduct published on Dec. 23, 2004, subsequently revised, May 2008.
JCR	Japan Credit Rating Agency
MBS	Mortgage-Backed Securities
N.Y. Times	New York Times
NAL	No-Action Letter or No-Action Relief Letter
NBER	National Bureau of Economic Research
NRSRO	Nationally Recognized Statistical Rating Organization
NYT	New York Times
NZAE	New Zealand Association of Economists
O.R.C.	Ohio Revised Code
PSLRA	Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737, Scattered section of 15 U.S.C. to be specified
RAND	RAND Corporation
RMBS	Residential Mortgage-Backed Securities
S&P	Standard & Poor's
s.	Section
SEB	Skandinaviska Enskilda Banken
SEC	Securities and Exchange Commission
SLAPP	Strategic Lawsuit against Public Participation
SOX	Sarbanes-Oxley Act
U.S.C.	Code of Laws of the United States
UK	United Kingdom

US	United States
US Gov-GAO	US Government - Government Accountability Office report
Wall St. J.	Wall Street Journal
Wash. Post	Washington Post
WesCorp	Western Financial Corporate Credit Union of California
WPS	Working Paper Series

PART I: THE PAST

Chapter 1 Beyond the 2007 Global Financial Crisis

"If ratings are used ..., the underlying rationale would rest at least in part on thinking that such a use would help to prevent or alleviate financial crises. In that connection, it is worth recalling Braddock Hickman's concern that such a use might make a financial crisis worse than it otherwise might have been, or perhaps even cause a crisis when business contractions lead to ratings downgrades." – Richard Sylla, Stern School of Business (2001).[1]

1.1. Introduction

The 2007 real estate market-triggered global financial crisis (hereinafter "the GFC" or "the crisis"), reportedly brought the global economy to the edge of a depression similar to or worse than that of the 1930's.[2] "Starting in mid-2007, the GFC quickly metamorphosed from the bursting of the housing bubble in the US to the worst recession the world has witnessed for over six decades".[3] This experience served to highlight the extent to which the global financial markets have become exceedingly interconnected and therefore interdependent. Initial anecdotal forensic reviews into the causes of the crisis have singled out numerous participants for special mention; most notably investment bankers, credit rating agencies (hereinafter "CRAs"),[4] politicians and regulators as well

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[1] Richard Sylla, *A Historical Primer on the Business of Credit Ratings*, The Role of Credit Reporting Systems in the International Economy conference, World Bank, New York, March 1-2, 2001, at 27 (2001), http://www1.worldbank.org/finance/assets/images/Historical_Primer.pdf

[2] Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 YALE J. REG., 1 (2012).

[3] Sher Verick & Iyanatul Islam, *The Great Depression of 2008-2009: Causes, Consequences and Policy Responses*, FORSCHUNGSINSTITUT ZUR ZUKUNFT DER ARBEIT (IZA),[Transl. Institute for the Study of Labour], 3 (2010).

[4] Martin Hellwig, *The Causes of the Financial Crisis*, FOCUS, at 20-21 (2008) (noting the failure by CRAs to demonstrate adequate, comprehensive and timely understanding of the related risks); *Beyond the*

as private investors themselves. The most recent global financial crisis prior to the 2007 GFC had been the "Dotcom" crisis of 2001 which was to a large extent characterized by the exposure of intricate accounting scandals at leading global companies that included Tyco International, Enron and WorldCom, Adelphia and Peregrine Systems. The discovery led one commentator to conclude that while these corporate scandals had involved accountants and sell-side analysts colluding with firms to issue errant reports,"…[] no such striking misdeeds by rating agencies have been reported."[5]

The 2007 GFC drastically changed that perception. According to Akerlof and Schiller, "…there was thus an economic equilibrium that encompassed the whole chain, from the buyers of the properties, to the originators of the mortgages, to the securitizers of the mortgages, to the rating agencies, and finally to the purchasers of the mortgaged-backed securities".[6] Krugman cautioned against the false comfort of pretending that the crisis had been caused by a mere series of honest errors, because his view was that it

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Raters, N.Y. TIMES, Dec. 15, 2011, at A38 ("Ratings agencies were one of the culprits of the financial crisis…"); Martin Mayer, *Credit Rating Agencies In the Crosshairs*, BROOKINGS INST.(2010)("… [CRAs are the] one player for whom none of the survivors has a kind word".) http://www.brookings.edu/research/articles/2010/08/31-ratings-agencies-mayer (last accessed on May 24, 2014). *Contrast, CESR Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and The role of credit rating agencies in structured finance* (CESR Report) May 2008, at 58 (concluding that "there is no evidence that regulation of the credit rating industry would have had an effect on the issues which emerged with ratings of US subprime backed securities").

[5] YASUYUKI FUCHITA, FINANCIAL GATEKEEPERS IN JAPAN in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 47, Figure 2-2 (Yasuyuki Fuchita and Robert E. Litan (eds). Washington D.C., Brookings Institution Press, 2006) (positing why NRSROs, based on degree of influence on trades versus degree of uncertainty, lie between accountants /auditors and sell-side securities analysts on the assessment of the need to regulate them).

[6] GEORGE A. AKERLOF & ROBERT J. SCHILLER, ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM 37 (New Jersey, Princeton Univ. Press 2009).

wasn't: "… [I]t was, in large part, the result of a corrupt system. And rating agencies were a big part of that corruption".[7]

Furthermore, in a dissenting statement included in the FCIC's report on the causes of the crisis, three commissioners listed credit rating agencies among its top ten causes, noting that they had erroneously rated mortgage-backed securities and marketed their derivatives as safe investments. However, it is important to note that the commissioners' dissent also conceded that investors had failed to look beyond the ratings and carry out their own due diligence of the securities in question.[8] The combination of the two aforementioned factors in turn fueled the creation and subsequent distribution of even more low-quality mortgage-backed securities, thereby exacerbating the crisis.

The media's dogged focus on the trend of successive mass downgrades of corporate and structured finance debt products - in particular the politically sensitive downgrading of sovereign debt securities – further elevated the credit rating industry to the awareness and scrutiny of the general public.[9] For their part, CRAs have resisted pleading *mea culpa,*

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[7] Paul Krugman, *Berating the Raters*, N.Y. TIMES, April 26, 2010 at A23, *available at* http://www.nytimes.com/2010/04/26/opinion/26krugman.html?_r=0. *See also* Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. at ii (2009) ("All good, or at least interesting stories, have a villain, and as the Credit Crisis started to unfold in 2007, credit rating agencies ("CRAs") emerged as obvious targets for finger-pointing by regulators, scholars, and commentators alike".).

[8] FCIC, *Report on the Causes of the Financial Crisis*, at 417 (2011), http://fcic.law.stanford.edu/report ; and Jacques de Larosiere, *The High-Level Group on Financial Supervision in the EU*, at 19 (2009), available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (noting that CRA opinions have too often been substituted for rigorous due diligence by market participants) and at xxv ("This crisis could not have happened without the rating agencies") (last accessed Sep.16, 2014). *See also*, Anders Kvist, *Rating of Banks*, (construing Heineken's advice: "[R]atings should be enjoyed responsibly") (comment by Anders Kvist, Head of Group Financial Management in SEB, Sweden, at Conference on CRAs, Stockholm Uni., on June 14, 2012).

[9] *See .e.g.* Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies,* 77 WASH. U. L.Q. REV. (3) 619, *passim*, (1999) (citing articles from THE ECONOMIST as

even as they have equally failed to be entirely convincing when proclaiming their outright innocence. Unsurprisingly, their response has been to opt for the more popular but less eviscerating; 'mistakes were made, and lessons have been learned' refrain that has become the standard go-to phrase in public relations crisis management parlance.

1.2. The NRSRO liability problem

Nonetheless, the public outcry that accompanied the waves of disclosures of rating downgrades calling for greater CRA accountability grabbed media headlines and piqued political interest towards the introduction of more stringent regulatory reform in the CRA sector. This development culminated in the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, on July 21, 2010.[10]

This dissertation contends that the problem with the liability of NRSROs arises from a flawed market structure which was created by the regulators, or more specifically, by the SEC. The key characteristics of this market structure are (i) the inherent conflicts of interest in the issuance of ratings[11], (ii) the lack of competition as a result of generally selective and non-transparent access to the designation, and (iii) the exemption from civil liability of NRSROs which is exacerbated by the ineffectiveness of reputational capital constraints. All three aforementioned characteristics have been problematic since the

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being representative of the public awareness). Examples of such articles include *'Credit-Rating Agencies. AAArgh!,* THE ECONOMIST, Apr. 6, 1996, at 80; *Credit-Rating Agencies: Beyond the Second Opinion*, THE ECONOMIST, Mar. 30, 1991, at 80; *Rating the Rating Agencies,* THE ECONOMIST, July 15, 1995, at 53; *Room for Improvement: Ratings Agencies*, THE ECONOMIST, July 15, 1995, at 54; *Sovereign Debt: The Ratings Game*, THE ECONOMIST, Oct. 30, 1993, at 88; and *The Use and Abuse of Reputation,* THE ECONOMIST, Apr.6, 1996, at 18.

[10] Pub.L. 111–203, commonly referred to as the Dodd-Frank Act, Dodd-Frank or simply DFA.

[11] In particular, the unique characteristics that distinguish their rating of structured products from that of rating sovereigns, corporates or municipalities. Conflicts of interest are discussed in greater detail in Section 3.3.

inception of the designation, none more so than for non-accredited CRAs which continue to operate without this special dispensation. Consequently, in drafting the DFA, US legislators sought to redress the problems caused by the market structure by reconsidering the exemption from legal civil liability hereto afforded to NRSROs[12].

1.2.1. Conflicts of interest

The conflict of interest debate is one that is important and familiar in financial services generally; more so where a provider has an explicit or inferred fiduciary duty. During the last two decades, this has been as apparent when questioning the role of recognized gatekeepers such as auditors and equities analysts as it has been for the market-making and propriety trading functions of investments banks. And yet, by failing to more accurately define and legally distinguish the role of CRAs, the SEC's creation of the NRSRO designation and other legislative grandfathering[13] actions that followed have not only actively contributed to, but have also exacerbated the conflicts of interest in the CRA industry. Coskun posits that CRAs not only face similar conflicts of interest but that these conflicts of interest are most apparent when relating to structured products due to the dual structuring and ratings role which allows CRAs to earn fees at both ends of the transaction.[14] Chapter 3.3 expands on this debate.

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[12] Exemption from legal liability is revisited in Parts II – IV of this research.

[13] Lawrence J. White, *Markets: The Credit Ratings Agencies*, 24 J. ECON. PERS. (2), 211, 214 (2010); Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers,* 58, 89 (Uni. of San Diego, School of Law. Legal Studies Research Paper Series, Research paper No. 07-46, 2006) (regulators…" delegate significant authority and responsibility to the NRSROs".

[14] *See* Coskun, Deniz. "*Supervision of Credit Rating Agencies: The Role of Credit Ratings Agencies in Finance."* 24 J. INT'L BANKING LAW & REG., (5) 259 (2009). *See also,* de Larosiere, *The High-Level Group on Financial Supervision in the EU*, 2009 at 20, and Mai Hassan & Christian Kalhoeffer, *Regulation of the Credit Rating Agencies – Evidence from Recent Crisis*, Note,7 (German University in Cairo Working Paper No.26, 2011).

1.2.2. Lack of competition

The potential conflict of interest resulting from the discretionary NRSRO designation and status afforded by the SEC to a select group of rating agencies – which predominantly comprise the largest and most influential CRAs – was supposed to be counter-balanced by the potential loss of reputational capital if they failed to render accurate ratings. The underlying logic was that an NRSRO which issued ratings that were "flawed" – itself a disputed term that this dissertation will return to later on – would be punished by the market through consequential loss of reputational capital, which in turn would translate into loss of economic capital[15] as customers opted to use the services of competitors. The desire to avoid such negative economic (and reputational) impact was assumed to suffice in order to steer the commitment of NRSROs towards exemplary rating policies and practices.

However, the 2007 global financial crisis provided sufficient evidence to suggest that a lighter-touch self-regulatory approach relying on the constraining impact of reputational capital has, at least in the CRA industry, fallen short of the mark. In other words; the self-regulation model, as it currently stands, has simply not worked at all or at best, has not worked well enough in constraining the actions of the major CRAs. In fact, it can be well argued that the failure of the reputational capital model has exacerbated the conflicts of interest faced by NRSROs. The structural, legal and economic factors contributing to this failure are reviewed in greater depth in chapters 3 through to 6 of this dissertation.

1.2.3. Liability exemption

A few months prior to the enactment of the Dodd-Frank Act on July 21st, 2010, a company president at Standard and Poor's went on record stating that "rating agencies

[15] or revenue

face[d] the same liability standards as accountants and securities analysts"[16]. It is however commonly accepted that the handful of NRSRO-designated CRAs[17] not only enjoyed a unique and distinct legal advantage over non-NRSRO-designated CRAs, but also over other recognized gatekeepers. The legal advantage in question arose as a consequence of the exemption from a rule in the Securities Act of 1933 (as amended) (hereinafter Securities Act 33)[18] that NRSROs enjoyed. The exemption from civil liability effected by the rule and the general acceptance of the First Amendment defense by US courts, had practically afforded NRSROs immunity from prosecution for almost three decades. [19]

The Dodd-Frank Act rescinded the exemption rule[20] thereby nullifying the exemption from liability for NRSROs. Moreover, unlike the majority of DFA provisions, the rescission of the liability exemption was among the handful of provisions which was

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[16] Deven Sharma, (an S&P President*), Why Rating Requirements Don't Make Sense*, WALL ST. J., Jan. 18, 2010, http://online.wsj.com/article/SB10001424052748703959804575006694196038802.html.

[17] Ranging between three (original) and ten (current) in number, depending on the time period considered.

[18] 17. C.F.R. § 230.436 (g)(1) (2007) mandates an exemption from liability under Section 11 of the Securities Act of 1933. *Compare*, YASUYUKI FUCHITA, & ROBERT E. LITAN, (eds) in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? at 6 (arguing that CRAs enjoy virtual immunity from stakeholders).

[19] Rita M. Bolger, "The very notion that a bona fide publisher — whether it be BusinessWeek, The Wall Street Journal, or S&P — can be required under the threat of penalty or other retribution to obtain a government license, adhere to government dictates about its policies and procedures, and/or submit to intrusive examinations before being permitted to disseminate its opinions to the public, is inconsistent with core First Amendment principles" (statement of Rita M. Bolger, MD and Associate General Counsel for S&P in Testimony before the Capital Markets, Insurance, and Govt. Sponsored Enterprises Sub-Comm. of the House Fin. Serv. Comm., June 29, 2005, http://archives.financialservices.house.gov/media/pdf/062905rb.pdf; and Alec Klein, *Credit Raters speak against oversight*, WASH. POST, June 29, 2005, at A08 (citing Rita Bolger advocating that CRAs are de facto financial press members) , http://www.washingtonpost.com/wp-dyn/content/article/2005/06/29/AR2005062902944.html.

[20] H. R. 4173—508 Section 939 (g)

constructed to take immediate effect on July 21, 2010.[21] As the bulk of existing literature concerning CRA liability had previously been stonewalled by the liability exemption rule, this dissertation aims to contribute to the discussion by examining both the current and consequent impact of this rule's rescission.

This dissertation gives attention to the parallels and similarities that can be drawn between CRAs and the auditing and the securities analyst industries, pre- and post the implementation of the Sarbanes-Oxley Act (SOX), in particular when reviewing the civil liability developments faced by CRAs today in terms of the provisions outlined in DFA. Another key development introduced in DFA was that it – for the first time – identified CRAs as "gatekeepers", thereby putting them legally on par with auditors, securities analysts and investment bankers. This change in approach occurred even as DFA set into motion the process of removing the requirement for ratings from its securities rules and regulations.[22] The implications of this change are also investigated in this work.

1.3. Aim of the study

The unanimous refusal by NRSROs to issue credit ratings for asset-backed securities (hereafter, ABS) which in turn led to a temporary freeze of the ABS market immediately following the enactment of DFA in the US, not only presented the first and also the clearest example of a market failure involving structured financial products but resulted from a unique set of conditions that both created and sustain a problematic market structure. To this end, it served to crystallize the most contentious arguments on both sides of the exemption of NRSROs from civil liability debate. Subsequently, particular attention is

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[21] H. R. 4173—508 Section 939 (g)

[22] *See* H. R. 4173—508 Section 939 - Removal of statutory references to credit ratings., (e.g. by amending The Federal Deposit Insurance Act (12 U.S.C. 1811 et seq.) (1) in section 7(b)(1)(E)(i), by striking ''credit rating entities, and other private economic'' and inserting ''private economic, credit,''; (2) in section 28(d) — (A) in the subsection heading, by striking ''not of investment grade'' and inserting ''that does not meet standards of credit-worthiness as established by the Corporation'').

given in this dissertation to the process of rating structured financial products.[23] It is the aim of this dissertation to investigate the developments surrounding NRSRO civil liability pursuant to the enactment of the Dodd-Frank and to analyse the market structure as well as the underlying legal and economic factors that have resulted in this unique market failure incident with the goal of proposing an alternative to the impasse that currently prevails.

1.4. Structure of the work

Part I – The Past; discusses the origins of the credit rating industry, its evolution, its perceived role in the global financial crisis of 2007 and the major criticisms faced by the industry as a consequence of the problematic market structure. Part II – The Present: Legal Liability; investigates what has and is being been done in terms of introducing legal solutions to address the current criticisms by predominantly reviewing the impact of recent US court decisions which, in particular, have ruled on issues addressing the civil liability of CRAs as well as on the limitations to third-party liability. Part III – The Present: Economics of Legal Liability; explores both the normative and the potentially understated

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[23] See e.g., John C. Coffee Jr., *Ratings Reform: The Good, The Bad, and the Ugly*, 6 (ECGI Working Paper Series in Law, Working Paper No.162, 2010) ("... [T]he failure of the CRAs was almost uniquely with respect to structured financial products. Similar problems have not characterized the ratings of corporate bonds."); Sebastian Moffett & Brian Blackstone, *Europe Pushing for a Credit Rater*, WALL ST. J., Friday-Sunday July 1-3, 2011, at 4 (S&P cites its decision to start downgrading Greece as early as 2004 as an example of their sovereign record. By April 2010 Greece had a "speculative" grade rating, and the lowest CCC rating by July 2011); Jan Kleineman, Conference on Credit Rating Agencies, Stockholm Centre for Commercial Law, Stockholm Univ., (sovereign and corporate ratings are fine; only structured products have been a problem; reforms should only look at where the problems lie (i.e. within structured products) (unpublished comment, Panel discussion comments); Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform,* 3,12 (Research Handbook on the Economics of Corporate Law, San Diego Legal Studies Paper No. 12-082, 2012) (83% of AAA-rated mortgaged securities in 2006 were downgraded within 6 months).

economic impact of exposing CRAs to civil liability and reviews landmark court cases and decisions. Part IV - The Outlook; re-examines whether NRSROs and CRAs are needed at all, considers what can be done better in terms of current legislation, in positing different future scenarios, proposes an innovative model, and concludes.

1.5. Summing up

The legal ambiguity surrounding what CRAs generally - and NRSROs in particular - are, how they fit in the financial eco-system as well as the extent to which and to whom they are deemed accountable to, remains. This in turn has created a paradox in the attempt by CRAs to serve both the interest of the public and those of their own shareholders.[24] The issues arising out of the problematic market structure mentioned above are examined in greater detail in Chapter 3. Arguments concerning whether and, if then, the extent to which CRAs should be liable for civil lawsuits brought by either direct or third-party investors are reviewed by examining the relevant available case law. In so doing, this dissertation addresses two key research questions, namely: (i) Is liability an appropriate tool to complement the regulatory re-design of the CRA sector?; and (ii) Can liability be optimized to improve the quality and credibility of CRA ratings?

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[24] Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 71 (2004) ("One can't please everyone, and it's not completely clear whom the Rating Agencies are out to try and please"). *See also*, Heggen, Jonathan W., *Not Always the World's Shortest Editorial: Why Credit Rating Agency Speech Is Sometimes Professional Speech,* 96 IOWA L. REV., 1745-1766 (2011).

Chapter 2 The Evolution of CRAs

2.1. Credit Rating Agencies defined

As is the case with hedge funds,[25] the answer to what credit ratings actually are, depends on whom one asks. Younglai and da Costa regard the role of CRAs as being "little different from a credit bureau that hands out [credit] scores to individuals and households".[26] In *Jefferson County School District v. Moody's Investor Services, Inc.,* the court ruled that it was necessary for the plaintiff to identify a "more specific statement [by Moody's] … to demonstrate that Moody's implied statement about its creditworthiness is provably false".[27] Furthermore, the use of terms like "negative outlook" and "on-going financial pressures" by Moody's in the rating opinion, for example, were deemed by the court to not be necessarily too indefinite to imply a false statement of fact – as long as they were not used in conjunction with factual assertions. Because the distinction between fact and opinion is oftentimes a faint one requiring qualitative interpretation, its legal implications are significant and hence attaining clarity from the onset on the specific definition of what ratings are is of great importance.

2.1.1. Definition of credit ratings according to the SEC

According to the Securities and Exchange Commission (hereafter, SEC), a credit rating agency is "a firm that provides its opinion on the creditworthiness of an entity and

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[25] *E.g.,* Russell Mutingwende, *Hedge Funds: The Protean Survivalists,* 13 (unpublished comment, on file with the Institute for Law and Finance, Goethe University, 2006). *See also,* Johann A. van Rooyen and Russell Mutingwende, *Information Disclosure and Regulatory Issues: A Survey of South African Hedge Funds*, 4 J. CORP. OWNERSHIP & CONTROL (4), 74-80 (2007).

[26] Rachelle Younglai & Anna da Costa, *When Rating Agencies Judge the World – an Analysis*, INSURANCE J., Aug. 3, 2011, http://www.insurancejournal.com/news/international/2011/08/03/209191.htm.

[27] 175 F.3d. 848, 850-51 (10th Cir. 1999), at 34 n.31.

the financial obligations (such as, bonds, preferred stock, and commercial paper) issued by an entity. Generally, credit ratings distinguish between investment grade and non-investment grade".[28] The greater significance of this definition lies in the SEC's mission "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation".[29]

The SEC's mandate to facilitate capital formation has historically at times required its Commissioners to take leaps of faith when permitting new technologies and products, possibly even long before they themselves have gained expert knowledge and understanding about what they were legislating into existence. The Credit Rating of Cashflow Securities Concept Release of September 1994[30] highlighted some of the unconventional challenges faced by the SEC in terms of their duty to consider and evaluate new techniques and approaches adopted by market participants. For instance, upon being informed that certain NRSROs had developed techniques to rate the likelihood of a specified dollar payment by the maturity date without regard of whether such payment amount constituted an interest of a principal repayment, and noting that these new instruments constituted both a credit rating and a non-credit rating element, the SEC

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[28] SEC, 'NRSROs', http://www.sec.gov/answers/nrsro.htm (last accessed Sept. 16, 2014); *Compare,* CESR, IOSCO Code of Conduct's definition: [A credit rating] "is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system", http://www.esma.europa.eu/system/files/CESR_08_277.pdf (last accessed May 23, 2016).

[29] SEC, 'The Investor's Advocate', at http://www.sec.gov/about/whatwedo.shtml (last accessed May 23, 2016). Similarly, the ESMA's mission is to ensure "[i]ntegrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection", http://www.esma.europa.eu/page/esma-short (last accessed March 15, 2015).

[30] *E.g.,* of mortgaged backed securities

acknowledged that despite representing "a departure from traditional rating techniques", it was one which the Commissioners were required to evaluate.[31]

The SEC has until recently appeared to regard CRAs as a semi-autonomous extension of its own regulatory infra-structure[32] in that it has accepted the predominant role and function of CRAs as being that of providing "credit ratings [that] distinguish between investment grade and non-investment grade".[33] For their part, CRAs only proclaim their ratings to be just one of several tools that investors should use when making their investment decisions, and in particular emphasize that the ratings are only opinions on the relative credit quality of a security.[34] In addition, CRAs also concede that their ratings generally ignore other relevant information necessary for diligent investment decision-making such as "changes in money rates and general economic trends, as well as by the length of maturity …[]".[35]

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[31] SEC Release No. 33-7085; 34-34616; IC-2050, 3 (International Series Release No. 706. File No. S7-23-94, Aug. 31, 1994).

[32] David Segal, *Debt Raters Avoid Overhaul After Crisis,* N.Y. TIMES, Dec. 8, 2009 "[B]ut we don't want to kill the institutions (i.e. CRAs) because we have nothing to replace them with", [Representative Paul E. Kanjorski, Democrat of Pennsylvania, the Chairman of the Financial Services Sub-Comm]"., *available at* http://dealbook.nytimes.com/2009/12/08/debt-raters-avoid-overhaul-after-crisis/ (last accessed May 23, 2016)

[33] SEC, 'NRSROs', http://www.sec.gov/answers/nrsro.htm

[34] See e.g., Daniel Indiviglio, *Rating Agency Liability Wouldn't Have Prevented the Crisis*, THE ATLANTIC, Dec. 9, 2010 (CRA ratings are "…not infallible gospel.") http://www.theatlantic.com/business/archive/2010/12/rating-agency-liability-wouldnt-have-prevented-the-crisis/67810/ (last accessed May 23, 2016).

[35] Moody's, Limitations to Uses of Ratings, http://www.moodys.com/ratings-process/Ratings-Definitions/002002 (last accessed May 23, 2016).

2.1.2. Definition of credit ratings by the Big Three Credit Rating Agencies

Moody's, S&P and Fitch have each developed 'boilerplate' definitions of the role and function of credit ratings which go a long way towards highlighting the gap[36] in their interpretation compared to that adopted by the SEC. Although uniquely customized, the three firms' definitions still follow very similar themes. These themes are summarized in general below:

They state that credit ratings do/are:

- Opinions on the relative ability of an entity to meet its financial commitments, such as interest, preferred dividends, and repayment of principal.
- Relied upon as indicators of the likelihood of receiving the money back in accordance with the terms under which it is invested.
- Express risk in relative rank order, they are ordinal measures of credit risk[37] and are not predictive of a specific frequency of default or loss.
- Diligent efforts at looking at the "worst" possibilities in the "visible" future, rather than solely at the past record and the status of the present.

They state that credit ratings do/are not:

- Address any risk other than credit risk.

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[36] Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L. J., 620, *passim* (2006).

[37] Standard and Poor's, *The Fundamentals of Structured Finance Rating*, at 10 ("Ratings are ordinal, not cardinal, in that they rank issues in order of relative credit risk, but do not specify any particular expected default") (2007), www2.standardandpoors.com/spf/pdf/fixedincome/Fundamentals_SF_Ratings.pdf (last accessed, Sept. 16, 2015)

- Forecast absolute probabilities of default and therefore are not guarantees of credit quality or of future credit risk.[38]
- Deal with the risk of a market value loss on a rated security due to changes in interest rates, liquidity and other considerations.
- Have any value in forecasting the direction of future trends of market price.
- Investment advice, neither are they "buy, hold, or sell" recommendations. They are just one factor investors may consider when making their investment decisions. For example, on its "Limitations to Uses of Ratings" section, Moody's website cautions that: "During its life even the highest rated bond may have wide price movements, while its high rating status remains unchanged". [39]

As was shown above, in terms of wording, there is apparently little difference in terms of the SEC's definition when compared to those of the Big Three. While all four definitions reiterate that the role of credit ratings is to provide an opinion on the creditworthiness of debt securities, it is the SEC's definition and interpretation of (i) what credit ratings are, and (ii) how they are used, that is preeminent and thereby supersedes those held by CRAs. Accepting the SEC's definition of a credit rating agency as provided above, it then follows that a closer review of the creation of the NRSRO status as well as the role that the selective awarding of the designation played in both establishing and maintaining the existing market structure from which current the contentions regarding NRSROs' exemption from liability emanate, is necessary. In particular, an understanding of the NRSRO designation and its impact on the development of the CRA industry, sheds

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[38] Visitors to the S&P homepage requiring more information about Credit Ratings are directed in S&P's handbook -- *Guide to Credit Rating Essentials – What Are Credit Ratings and How do They Work?* -- to visit two further websites: www.AboutCreditRatings.com, and www.UnderstandingRatings.com (last accessed May 23, 2016).

[39] Moody's, About Moody's Ratings: Ratings Definitions, https://www.moodys.com/Pages/amr002002.aspx (last accessed May 23, 2016

light on why investors and other market participants (elect to) rely on credit ratings in the first place as well as the basis upon which NRSRO-designated CRAs were exempted from liability.

2.2. Origin of the NRSRO designation

At their inception, the Big Three had each adopted an investor-pays business model. The 1920s was a time when there was increased demand for credit ratings and the investor-pays model prevailed mainly due to the ability of the publishers to exercise physical control over the distribution of their published ratings. The stock market crash of 1929 brought the still fledgling CRA industry to a screeching halt as bonds, including some previously highly rated bonds, defaulted across the board, leaving investors heavily disappointed and questioning the usefulness as well as the reliability of credit ratings. Not surprisingly, investors, en masse, turned their back on the ratings industry.

Although CRAs survived this particular downturn, they continued pretty much unnoticed for the following forty-five years when they received an unexpected boon, courtesy of the Securities and Exchange Commission (SEC). In 1975 S&P, Moody's and Fitch became the first three recipients of the NRSRO designation when it was bestowed upon them by the SEC's Division of Market Regulation (DMR). In essence this meant that the three firms were each provided a 'No Action Relief'[40] letter which served to notify broker-dealers of their status as NRSROs.[41] After extensive lobbying efforts, the firms

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[40] a.k.a. No-action letter.

[41] *See,* Martha Coakley, *Rating Agency Consents and Regulation AB*, ("Legally, no-action letters are expressions of enforcement policy".), at 2 (2011) (letter from Massachusetts Att'y Gen. Martha Coakley to the Mary Schapiro, SEC Chairman). *Id.* "… [The NAL is a] statement of staff enforcement intent", at 6; and "…[N]ot intended to affect the rights of private parties", at 9(citing Thomas P. Lemke, *The SEC No-Action Letters Process*, 42 BUS. LAW 1019, 1042-43 (1987)).

Duff & Phelps Inc., Thomson BankWatch Inc., and IBCA Ltd and IBCA were eventually also designated NRSROs; albeit almost three decades later.

The creation of the NRSRO status was deemed a necessary requirement for adherence to the Net Capital Rule.[42] The SEC, under rule 15c3-1 of the Net Capital Rule, allowed for preferential treatment in the form of "reduced haircuts" for broker-dealers' proprietary positions in "commercial paper, nonconvertible debt securities and non-convertible preferred stock in instances where the instruments [we]re rated investment grade by at least two NRSROs".[43] Consequently, broker-dealers actively sought investment graded securities from at least two of the designated NRSROs.

By the SEC's own admission, the 'No Action Relief' letters were from the onset issued to CRAs subsequent to an "informal examination of the agency's operations, its position in the marketplace, as well as considering other factors". For example, the No Action Relief letter issued by the SEC to the Japan Credit Rating Agency (JCR) noted that among the requirements met in JCR's application documents included letters from 10 institutional investors "representing that they have "seriously considered" the credit ratings of JCR in the course of making investment decisions for at least the past three years".[44] Reliance on the nondescript phrases like "seriously considered" neither establish that institutional investors actually placed reliance on the ratings nor does it provide details as to what a "serious" consideration would involve. This merely underscores the level of

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[42] 17 C.F.R. 240.15c3-1 (Under the Securities Exchange Act of 1934, the Uniform Net Capital Rule, Rule 15c3-1 incorporated the use of ratings issued by the Nationally Recognized Statistical Ratings Organizations (NRSROs) in reference to determining certain provisions of the Net Capital Rule). *See also,* Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11497 (June 26, 1975), 40 FR 29795 (July 16, 1975).

[43] 17 CFR 240.15c3-1(c)(2)(vi)(E), (F), and (H). *See also* SEC Release No. 33-7085; 34-34616; IC-20508, 2 (International Series Release No. 706. File No. S7-23-94, Aug. 31, 1994).

[44] SEC, NRSROs general info, http://www.sec.gov/divisions/marketreg/ratingagency.htm.

vagueness and subjectivity exercised by SEC officials in issuing the much coveted NRSRO designation.

The acknowledged (high) level of informality in the designation award process notwithstanding, what the No Action Relief letters meant in practical terms for the fortunate recipients was that the SEC's Division of Market Regulation would not recommend censure or enforcement action to the Commission if the CRA had been waived for purposes of application of the Net Capital Rule. A 'No Action Relief' letter can thus be construed as being equal to a waiver. The result of the exemption from censure, the broker-dealer reduced haircuts and the opaqueness in the NRSRO designation award process, was that the early recipients of the designation were able to enjoy an essentially unchallenged advantage over their peers in the industry. This early advantage benefitted the Big Three to such an extent that it shaped the market structure of the credit ratings industry from then on.

Despite having been in use since 1975 the SEC had, more than two decades later,[45] still not settled the core issue of defining the terms and requirements necessary for qualifying for an NRSRO designation. Conceding that no actual definition of an NRSRO had been provided,[46] the SEC decided that all subsequent references to NRSROs should assume the interpretation considered for "purposes of the Net Capital Rule".[47] As can be deduced from the NRSRO title, the single criterion deemed most important by the legislators was the requirement for them to be "nationally recognized" by "predominant

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[45] NRSRO's definition was first provided by the SEC in CRARA 2006 Act, P.L. 109-291.

[46] SEC, *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market* (hereafter, Role and Function Report), 2003 at 15.

[47] Rule 2a-7 under the Investment Company Act of 1940, 17 CFR 270, 2a-7 (the term "NRSRO" is defined to mean any NRSRO "as that term is used in Rule 15c3-1…"), http://www.gpo.gov/fdsys/pkg/CFR-2012-title17-vol2/pdf/CFR-2012-title17-vol2-sec230-436.pdf

users of ratings in the United States as an issuer of credible and reliable ratings".[48] Moreover, the SEC in 1997 recognized that although "initially adopted by the Commission in 1975 for the narrow purpose of distinguishing different grades of debt securities under the Commission's net capital rule… [the] NRSRO concept ha[d] expanded beyond its originally intended use"[49].

The enactment of the Credit Rating Agency Reform Act of 2006[50] sought to add clarity to the matter by setting aside reliance on the No-Action Letters by requiring CRAs to register as NRSROs with the SEC. This change paved the way for other credit ratings firms like Egan-Jones whose initial application for NRSRO status accreditation had been submitted in 1997 to finally received accreditation in December 2007.[51]

2.3. Summing up

The creation of the NRSRO designation ensured that a select few accredited CRAs were able to increase their deal-flow, their revenue base and consequently their market share. This occurred predominantly because their opinions had become a legal

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[48] Appendix No.1 for full statement of requirements reviewed by the SEC when evaluating applications for NRSRO designation.

[49] SEC, 62 Federal Register 249, *Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934*, 68018-024, at 68019, http://www.gpo.gov/fdsys/granule/FR-1997-12-30/97-33402/content-detail.html.

[50] Public Law 109–291. 120 Stat. 1327 (2006).

[51] HERWIG M. LANGOHR & PATRICIA T. LANGOHR, THE RATING AGENCIES AND THEIR CREDIT RATINGS, 403 (John Wiley & Sons Ltd, 2008).

requirement for many market participants. Partnoy,[52] Hill[53] and other scholars[54] have postulated that the SEC's approach revolutionized the role and function of CRAs by driving them from being merely private party agents to becoming de facto licensing agents. The apparent absence of clarity and/or motivation from the SEC on the exact requirements necessary for other CRAS to qualify for NRSRO status meant that the initial designees enjoyed first-mover advantage which enabled them to both consolidate and expand their market share.[55]

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[52] Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers,* 58, 82 (Uni. of San Diego, School of Law. Legal Studies Research Paper Series, Research paper No. 07-46, 2006); Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies,* 77 WASH. U. L.Q. REV. (3) 619, 623 (1999).

[53] Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 81 (2004).

[54] e.g., IOSCO, *Ratings in structured finance: what went wrong and what can be done to address shortcomings,* Comm. on the Global Fin. Sys., No. 32, at 9 (2008). ("[A] credit rating, then, is occasionally viewed as not only a CRA's opinion of the loss characteristics of the security, but also as a seal of approval.").

[55] Aline Darbellay & Frank Partnoy*, Credit Rating Agencies and Regulatory Reform,* 3 (Research Handbook on the Economics of Corporate Law, San Diego Legal Studies Paper No. 12-082, 2012) (the poor performance of structured product ratings is primarily the result of executive directives to maintain and gain market share from competitors), and Fabian Dittrich, The Credit Rating Industry: Competition and Regulation, Note, at 80-81 (2007).

Chapter 3 The CRA market structure

3.1. General criticism levelled at CRAs

In 2007, the credit rating system was said to go "hand in hand with the development of large, deep and international markets. It is a precondition and a tool for ensuring the smooth functioning of these markets".[56] And yet, by 2008, CRAs - alongside references to "fat-cat (investment) bankers"[57] and "casino banking"[58] - were generally disparaged in publications by academic scholars and tabloid journalists alike. The notion of CRAs as a reliable and cost-efficient method of constraining and disciplining the behavior of asset managers and issuers[59] was quickly eroded as a consequence of the financial markets' heightened sensitivity to the successive downgrading of securities during the GFC. The heightened media exposure also highlighted the public's perception of the power and influence conveyed in CRAs' ratings, especially when concerning the downgrading of sovereign debt. However, not all of the criticism levelled against CRAs were either new or unique to the GFC.

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[56] Jonathan Katz, Emanuel Salinas & Constantinos Stephanou, *Credit Rating Agencies: No Easy Regulatory Solutions*, 8 CRISIS RESPONSE, Oct. 2009, at 7 (comments by Christian Noyer, Governor of the Bank of France).

[57] Keith R. McCullough, *Economic Commentary - Fat Cat Bankers,* FORBES, Dec. 14, 2009, http://www.forbes.com/2009/12/14/fat-cat-bankers-markets-economy-obama.html.

[58] *See e.g.,* Stephen Spratt, *Why King is right about Casino Banking*, GUARDIAN, Oct. 22, 2009 http://www.guardian.co.uk/commentisfree/2009/oct/22/mervyn-king-casino-banking-regulation; Howard Davies, *Casino banking' days are over*, TAIPEI TIMES, July 17, 2009 *available at* http://www.taipeitimes.com/News/editorials/archives/2009/07/17/2003448850; and Thomas Katzensteiner & Ulric Papendick, *Das Spiel Ist Aus [transl.:The Game is Over]*, MANAGER MAGAZIN, Dec. 2011, at 56-66.

[59] Richard Sylla, *A Historical Primer on the Business of Credit Ratings* (2001), at 27.

This chapter introduces some of those most common criticisms that were already being leveled against the industry prior to the GFC, which are summarized in Figure 2 below. The diagram classifies the criticism along industry, internal, external and investor specific lines to demonstrate how these factors, which although falling short of asserting causality,[60]fc still highlight the interconnectedness and in some instances the co-dependency, of various intrinsic and extrinsic drivers that when taken together propagate the sustained production of poor quality ratings.

In the U.S., a bipartisan study by the U.S. Senate Subcommittee on Investigations led by Senators Levin and Coburn, reported that "… []high risk lending by U.S. financial institutions; regulatory failures; inflated credit ratings; and high risk, poor quality financial products designed and sold by some investment banks [had] contributed to the financial crisis".[61] In Europe, a February 2009 report by the 'High-Level Group on Financial Supervision in the EU' chaired by Jacques de Larosiere, had also listed credit rating agencies among the main contributors to the financial crisis.[62]

This report also cited the failure by senior executives to understand the "new, highly complex financial products they were dealing with"; and "the over-reliance on the risk

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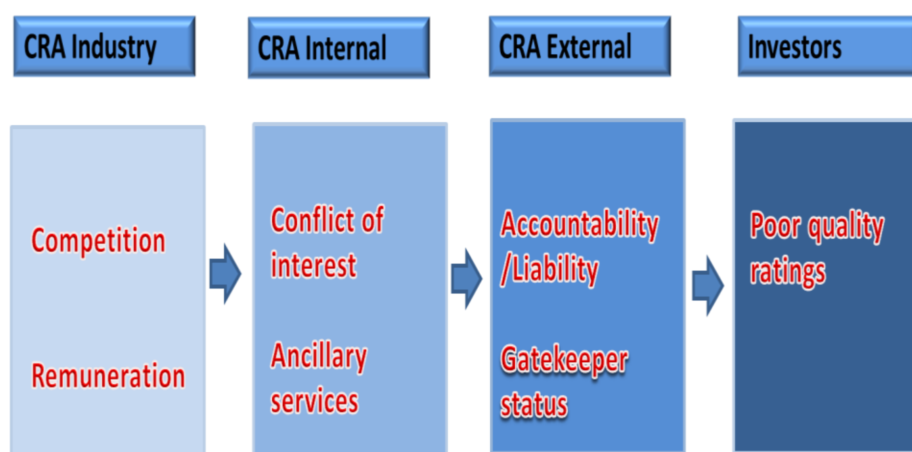
[60] *See e.g., Basic Inc. v Levinson*, 485 U. S. 224, 243 (1988) In order to establish liability ("[the] requisite causal connection between a defendant's misrepresentation and a plaintiff's injury" is necessary. *See also Aff'd Ute Citizens of Utah v United States,* 406 U. S. 128, 154 (1972) ("causation in fact" requirement).

[61] Carl Levin & Tom Coburn, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, SENATE COMM. HOMELAND AND GOVERMENTAL AFFAIRS, April 13, 2011, *passim,* http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

[62] The other contributors identified by the report were: macro-economic issues (e.g. ample liquidity and low interest rates); risk management failures (e.g. failures in assessing risk by market participants, regulators and supervisors); Corporate Governance failures (e.g. failure by senior executives to understand the "new , highly complex financial products they were dealing with"); and Regulatory, Supervisory and Crisis Management failures (e.g. "the over-reliance on the risk management capabilities of banks and the adequacy of ratings").

management capabilities of banks and the adequacy of ratings".[63] Next, the report also found that CRAs had lowered the perception of risk by assigning AAA ratings to structured products and thereby putting them on par with similar ratings assigned to standard sovereign and corporate bonds in the minds of investors. Support for this position is found in a 2009 study which concluded that the ABS risk properties differ systematically and significantly from those of similarly rated straight bonds.[64]

Figure 1: Criticism overview



A further criticism arose from the observed higher profitability margins earned by CRAs from rating structured products relative to other security types. AAA-rated

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[63] de Larosiere, Jacques, "The High-Level Group on Financial Supervision in the EU report" *European Commission*, 25 Feb., 2009, at 9-10 http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (last accessed May 23, 2016).

[64] *See e.g.,* Jan-Pieter Krahnen & Christian Wilde, *CDOs and Systematic Risk: Why Bond Ratings are Inadequate*, (CFS Working Paper No. 2009/11, June, 2009) at 16 ("risk management based on traditional bond ratings applied to structured finance transactions is not reliable").

structured products tended to pay relatively higher yields than the sovereign and corporate alternatives and thus attracted large numbers of investors. CRAs were often able to earn as much as three times more (e.g. $300K-$500K, and sometimes even up to $1 million per structured product rating) [65] from a rating structured financial product than from rating corporate bonds.

S&P and Moody's have experienced similarly excellent financial performance[66] and charge similar rates, in the region of 11 bps (i.e. basis points) for structured finance products as opposed to 4.25 bps for corporate bonds.[67] CRAs also earned fees for rating structured investment vehicles (i.e. SIVs) on top of the fees for rating their underlying assets. Moody's Structured Finance generated 43 % (i.e. $715 Mio) of the firm's revenue in 2005, and 53% in 2007. Such growth enabled Moody's to achieve stellar average operating margins of 53% in the period 2000-2007; higher than either Exxon or Microsoft. In fact, Moody's achieved the highest operating margins in the S&P 500 -- five years in a row.

In their defence, CRAs do not appear to have propagated the notion that AAA-rated structured products were as likely to default as AAA-rated German sovereign bonds. Furthermore, it is worth re-emphasizing that "any rating necessarily describes a real chance of default. In other words, a default per se says nothing on the quality of the rating analysis".[68] Hill asserts that the commonly-levelled accusation that CRAs have been

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[65] e.g., FCIC, *Report on the Causes of the Financial Crisis* (2011) (rating agency fees were typically between $250K and $500K for CDOs), at 146.

[66] *California Public Employees' Retirement Systems v. Moody's Corp*., 09-490241, Superior Court of California, County of San Francisco, at 8 (S&P revenue increased 800% (2002-2006), cited in Plaintiff's Complaint (hereafter "CalPERS Complaint) filed with the court), *available at* http://online.wsj.com/public/resources/documents/calpers.pdf; (S&P revenue increased 800% (2002-2006). Plaintiff's arguments in Complaint filed with the court), at 8.

[67] *Id., CalPERS Complaint*.

[68] Fabian Dittrich, The Credit Rating Industry: Competition and Regulation, Note, (2007) at 144.

willing to sell high ratings to the issuers "cannot in any straightforward way be correct"; suggesting instead that CRAs and other market actors erred in convincing themselves that the ratings awarded to subprime securities were in fact warranted.[69]

However, the implication from the afore-mentioned reports suggests that CRAs were either not deliberate enough about explaining the distinction between the classes of AAA-rated securities or even if they had been, that they nevertheless still unfairly benefitted financially from the public's continued misconception and ignorance about the material differences in inherent risk between the two security classifications. Either way, a compelling argument can be made to support the view that CRA rating quality under-performance has been correctly cited and that steps should now be taken to rectify the problem.

3.2. Market structure and competition

Alongside significant contributions by Partnoy, Hill and White, the body of academic literature on the criticisms leveled against CRAs is extensive.[70] A January 2003

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[69] Claire A. Hill, *Who Were the Villains in the Subprime Crisis, and Why it Matters?* 4 ENTREPRENEURIAL BUS. L.J. (2) 323, 341 (2010).

[70] John C. Coffee Jr., *Understanding Enron: It's About the Gatekeepers, Stupid* 12, 23 (Columbia Law & Economics Working Paper No. 207, 2002), http://ssrn.com/abstract=325240, (arguing that Enron was an example of "gatekeeper failure" as a result of over-reliance on "reputational intermediaries", such as auditors, securities analysts, attorneys, etc…); Lawrence J. White, *Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs Is a Better Response*, 25 J. INT'L BANKING LAW AND REG. (4), *passim*, (2010) (proposing that the elimination of regulatory reliance on ratings would promote the development of new methodologies, technologies, procedures, and potentially even new business models); Lawrence J. White, *Markets: The Credit Ratings Agencies*, 24 J. ECON. PERS. (2), 211, 214 (2010); Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers,* 58, 211 (Uni. of San Diego, School of Law. Legal Studies Research Paper Series, Research paper No. 07-46, 2006), (an overview about the origin of CRAs, their business models, industry dynamics and concentration as well as their controversial role in the 2007 subprime crisis); Jeffrey D. Manns, *Rating Risk After the Subprime*

SEC Concept Release noted that: "[C]oncerns had been expressed regarding the significant market power of the three NRSROs, their privileged access to non-public issuer information, their apparent lack of care and diligence in the Enron situation, and their very limited regulatory oversight".[71] As was mentioned above, the SEC's selective accreditation process of the NRSRO designation restricted competition in the industry and this in turn actively sustained a problematic market structure.

3.2.1. Market structure in the CRA industry

Like many other industries, the CRA industry is broadly defined by its founding and still existing players. The Big Three were the first CRAs to be recognized[72] as NRSROs

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Mortgage Crisis: A User Fee Approach for Rating Agency Accountability, 87 N.C.L. REV. 1011, 1015, 1022-23 (2009) (suggesting that a user-fee approach would alleviate the concerns regarding CRA accountability and their "interconnections of interest" with issuers);Lisbeth Freeman, *Who's Guarding the Gate? Credit Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 55 VT. L. REV. 585, 601-04 (2009) (posits that structured financial products are issued by very few issuers, almost exclusively by investment banks, which are as a result, able to exert more influence over CRAs, unlike corporate debt issuers). See also, Timothy Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. (2) 227, 227-228, 250-251 (2009) (Challenges the merits of relying on reputational incentives as a viable means of directing and ensuring CRA incentives because the inherent conflicts of interest increase the likelihood for profit-seeking credit rating agencies to over-rate securities).

[71] SEC, Role and Function Report, (2003) at 16 (considers the sources of conflicts of interest (i.e. issuer and subsriber influences, influence of advisory services and impact of abusive practices) and considers options to improve the dissemination of information and to improve competition by removing the barriers to entry).

[72] Fitch, ("Fitch Ratings was one of the three ratings agencies first recognized by the [SEC] as an [NRSRO] in 1975"), http://www.fitchratings.com/web/en/dynamic/about-us/about-us.jsp; and "… [T]he Commission first used the term NRSRO in 1975 in the net capital rule for broker-dealers (Rule 15c3-1) as an objective benchmark to prescribe capital charges for different types of debt securities." *See also,* SEC,

by the SEC in 1975;[73] and a further four were later accredited upon request thereafter. The SEC 2013 Annual Report on NRSROs reported that NRSROs had reported revenues of $4.27 Billion in 2011. S&P[74], Moody's Investor Services[75] and Fitch Ratings[76] reported $1.77 billion, $1.52 billion and $0.73 billion, respectively, representing 94% of revenues earned.

These revenues (in US dollars) underline the extent to which Moody's and S&P in particular, have remained significantly larger and more dominant in the market than their competitors. The gap between these two and Fitch[77] was significantly much larger initially. Recognizing its inability to compete due to the gross disparity in size motivated Fitch[78] to, through a series of successive mergers and acquisitions, acquire the other smaller NRSROs; namely IBCA Ltd., (December 1997), Duff & Phelps Credit Rating Co., (April 2000) and Thomson Financial BankWatch (December 2000) and create one firm - Fitch Ratings.[79] This development had reduced the number of then designated

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'Briefing paper: Roundtable to Examine Oversight of Credit Rating Agencies', April 14, 2009, http://www.sec.gov/spotlight/cra-oversight-roundtable/briefing-paper.htm (last accessed May 23, 2016).

[73] 17 C.F.R. 240.15c3-1 (i.e. SEC promulgated rules regarding bank and broker-dealer net capital requirements).

[74] *See,* S&P 2011 Annual Report, at 14, http://media.mhfi.com/documents/ar2011.pdf

[75] *See,* Moody's 2011 Annual Report, at 2, http://files.shareholder.com/downloads/MOOD/0x0x549102/63FE2998-B052-4E99-B69F-60165C7944E2/MOODY_S_2011AR_FINAL.PDF

[76] *See,* Fitch 2011 Annual Revenue Report, http://www.fimalac.com/regulated-information.html

[77] Then, still known as the Fitch Publishing Company.

[78] Dieter Kerwer, *Holding Global Regulators Accountable: The Case of Credit Rating Agencies*, 18 GOVERNANCE: INT'L J. POL'Y, ADMIN., & INST'S (3), 453, 463 (2005) (the initial NRSROs had shrunk from seven to six by 1997 as a result of a merger).

[79] Edward I. Altman, Sabri Oncu, Anjolein Schmeits & Lawrence J. White, *What Should Be Done about the Credit Rating Agencies?*,(NYU Stern Regulating Wall Street blog, April 6, 2010),

NRSROs back to three by 2003. The new-look Fitch Ratings appears to now have attained critical mass to offer substantive competition to Moody's and S&P, even as it remains with 15 percent of the NRSRO outstanding ratings market share compared to the near 40 percent, a-piece enjoyed by its larger rivals. [80] A 2013 ESMA report shows that the Big Three have a combined market share of 87.02% in the EU, with the fourth and fifth largest market shares of 4.65% and 2.60% held by The Economist's Intelligence Unit Ltd., and CERVED Group S.p.A., respectively.[81]

3.2.2. Competition

3.2.2.1. Credence and experience goods

In his seminal publication titled Information and Consumer Behavior, Nelson introduced the concept and classification of "search goods" and "experience goods"[82]. Nelson defined search goods as those products or services where a consumer can ascertain its value prior to purchase and experience through inspection[83] and the cost of quality detection is low[84]. In contrast, experience goods are defined as those products or services whose true value can only be determined by experiencing or consuming them. Subsequently, experience goods exhibit high pre-costs in that one has to pay for that initial

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http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/04/what-should-be-done-about-the.html#more (last accessed May 23, 2016).

[80] *S&P warning puts damper on Eurogroup plans,* DEUTSCHE WELLE, 5 July 2011, http://www.dw.de/sp-warning-puts-damper-on-eurogroup-plans/a-15212433 (last accessed May 23, 2016).

[81] ESMA, *CRAs' Market share calculation according to Article 8d of the CRA Regulation* report, 16 Dec. 2013, at 6, http://www.esma.europa.eu/system/files/esma_cra_market_share_calculation.pdf.

[82] Phillip Nelson, *Information and Consumer Behavior*, 78 J. POL. ECON. 311, 311-29 (1970). (Also referred to as 'search goods' and 'experience goods').

[83] Phillip Nelson, *Information and Consumer Behavior*, 78 J. POL. ECON., 311, 312 (1970)

[84] Andresen, Esben S. & Kristian Philipsen, *The evolution of credence goods in customer markets: exchanging 'pigs* in pokes', at 2 (Jan., 1998) (unpublished manuscript, on hand with authors).

consumption or experience. However, the post-costs are expected to be relatively low as the latter buying decisions are informed by the initial experience.[85] Experience expenditure becomes the viable option for buyers once the cost of search is deemed expensive.[86]

Building on this earlier work Darby and Karmi in 1973 added a third classification term, "credence goods"[87] which they ascribed to those goods where consumers are not able ascertain the quality of a product even after having consumed it. Consequently, the consumer's inability to adequately evaluate the intrinsic characteristics of the product makes their purchase decision reliant on a level of trust that they place in an expert seller or service provider who is able to make an informed and accurate determination of the product's quality. Wolinksy[88] contends that sellers of credence goods are in fact the experts who determine the customers' needs, as the customers are completely reliant on the former's recommendations when making a purchase decision.

Anecdotal evidence in the lead-up to the 2007 GFC of the overall reliance on and general acceptance of credit ratings by private investors, institutional investors and regulators strongly indicates that credit ratings are indeed credence goods. Credence goods expose the limits set on the market mechanism by informational asymmetry, and as a

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[85] Andresen, Esben S. and Kristian Philipsen, *The evolution of credence goods in customer markets: exchanging 'pigs* in pokes', at 2 (Jan., 1998).

[86] Phillip Nelson, *Information and Consumer Behavior*, 78 J. POL. ECON., 311, 318.

[87] Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. LAW AND ECON. (1), 67, 69 (1973). *See also*, Gillian K. Hadfield, Robert Howse & Michael J. Trebilcock, *Information-Based Principles for Rethinking Consumer Protection Policy*, 21 J. CONSUMER POL'Y (2) 131, 142 (1998), and Uwe Dulleck, Rudolf Kerschbamer & Matthias Sutter, *Credence goods markets: An Experimental Analysis*, NZAE, (2011) http://nzae.org.nz/wp-content/uploads/2011/08/nr1215138742.pdf (last accessed May 23, 2016).

[88]Asher Wolinsky, *Competition in Markets for Credence Goods*, 151 J INST. & THEORETICAL ECON. (1), 117, *passim* (1995).

result, the mechanism cannot be relied on. Consequently, reputational constraints become increasingly important. Haar concurs with the view that credit ratings are credence goods, but adds that the quality of ratings, unlike that of typical credence goods, is actually determinable ex-post by the investor since the ratings can later be (fairly easily) correlated with actual defaults. Haar also further qualifies this view by noting that credence good markets are based on reputational risk which is itself subject to free-market access to competitors and an unobstructed demand for a product. It is fair to say that the NRSRO designation and the accompanying rules and regulations have served to hinder access to the free-market for non-NRSRO competitors.

3.2.2.2. Features of the competitive landscape

Although von Schweinitz describes the CRA market structure as a "triopoly";[89] most literature makes reference to Moody's and S&P's relationship which has been termed a duopoly, monopoly, co-monopoly, "partner monopoly" ,[90] "global oligopoly"[91] as well as a "cartel[]".[92] As if to counter growing criticism about enabling an oligopoly to manifest and persist within the industry, the SEC initially responded by adding the Canadian rating agency, Dominion Bond Rating Service (DBRS) in 2003, and the

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[89] OLIVER VON SCHWEINITZ, RATINGS AGENCIES: THEIR BUSINESS, REGULATION AND LIABILITY UNDER U.S., U.K. AND GERMAN LAW 88 (Unlimited Publishing LLC, Bloomington, Indiana, 2007).

[90] 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, 119, 132 (2009). *See also* Freeman, Lisbeth, *Who's Guarding the Gate? Credit Rating Agency Liability as "Control Person" in the Subprime Credit Crisis,* 55 VT. L. REV. 585, 600 (2009) (Dept. of Justice has referred to the Big Two as a "partner monopoly").

[91] Sebastian Moffett & Brian Blackstone, *Europe Pushing For a Credit Rater,* WALL ST. J, July 1-3, 2011, at 4.

[92] Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA L. & BUS. REV. 10, 23 (2006)(discussing the cartelization process similarities between the auditing and CRA industries).

insurance rating specialist A.M. Best in 2005, to the list of accredited NRSROs. The CRA landscape continues to be characterized by features, which when taken together, convincingly give merit to the oligopoly charge. Economic theory has identified perfect knowledge; few active firms; profit maximization; ability to set prices; long run profits; interdependence; and barriers to entry as the main distinguishing characteristics of an oligopolistic market structure.

None of the literature suggests that NRSROs possess "perfect knowledge" of their own cost and demand functions, although it remains a feature that is commonly ascribed to oligopolistic systems pro forma.[93] However, a quick review of other features that mark oligopolistic systems shows that a robust case can be made to suggest that the NRSRO designation has indeed created and sustained a structure with oligopolistic[94] characteristics and this has deterred competition. To date, the Big Three have managed to attain approximately 95 percent of the market share in the US, and 87 percent market share in the EU. This statistic gives merit to the argument that despite numerous other NRSROs being registered in recent years, there remain, for most intents and purposes, still few (significantly) active firms in the sector.[95]

Although it is hardly surprising that the profitability of the Big Three has thus far comfortably outstripped that of their smaller peers, it is however somewhat unexpected to

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[93] CHIARELLA, CARL, FERENC SZIDAROVSZKY, AND PEIYUAN ZHU, *The Interaction of Uncertainty and information Lags in the Cournot Oligopoly Model*, in OLIGOPOLY DYNAMICS: MODELS AND TOOLS, 233, 233(Tönu Puu & Irina Sushko, Berlin: Springer-Verlag, 2002.)

[94] *See e.g.*, JEFFREY M. PERLOFF, MICROECONOMICS THEORY & APPLICATIONS WITH CALCULUS*,* 445 *(*Pearson, 2008) (profit maximization and ability to set prices); ANTHONY I. NEGBENNEBOR & JAMES F. WILLIS, MICROECONOMICS, THE FREEDOM TO CHOOSE, 291 (CAT Publishing,2001) (product differentiation).

[95] MARK HIRSHEY, MANAGERIAL ECONOMICS*, Rev. Ed.,* 451(Dryden Press, 2000) (small number of firms).

note that their ability to maximize profits[96] has in recent years exceeded that of traditionally faster growing industries. For example, as a testament of their ability to achieve long run profits, the Big Three achieved higher operating margins than the Exxon and Intel corporations over the 2000 - 2006 period. Restricted access to the NRSRO designation enabled the Big Three to capture excess profits over a sustainably long period.

In addition, similarly high operating margins demonstrated by the Big Three also suggest that the only interdependence[97] of significance within the sector would be among the same three firms. Several of the factors already mentioned above would have also contributed to the ability of the Big Three to set prices[98], including the small number of significantly active firms in the industry as well as the interdependence that can be construed to exist between the firms. Legislative prescription, commencing initially with the Net Capital Rule and later expanding to encompass investment guidelines for pension funds, asset managers and other investors, as has been discussed in Section 2.2 above has significantly facilitated this development.

And finally, the Big Three have greatly benefited from the benevolence of the SEC to restrict other CRAs from attaining the NRSRO designation, thereby creating barriers to entry. This single act, which may initially have been intended as a cautious and controlled approach to subsequent liberalization of the sector by the SEC, has in retrospect turned out to be the root cause of competition problems experienced in the sector. The barriers to entry as sanctioned by the SEC through the selective NRSRO accreditation process have

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[96] JEFFREY M. PERLOFF, MICROECONOMICS THEORY & APPLICATIONS WITH CALCULUS, 445 (Pearson, 2008) (profit maximization).

[97] MICHAEL MELVIN AND WILLIAM BOYES, MICROECONOMICS 267 (Boston: Houghton Mifflin, 5th ed., 2002) (interdependence); and DAVID C. COLANDER, MICROECONOMICS 288 (McGraw-Hill, 7th ed., 2008) (interdependence).

[98] JEFFREY M. PERLOFF, MICROECONOMICS THEORY & APPLICATIONS WITH CALCULUS, 445 (Pearson, 2008) (ability to set prices).

not only directly influenced the creation and maintenance of the existing market structure, but have also directly contributed to the NRSRO liability problem.

3.2.2.3. Barriers to entry

Despite earlier attempts to improve market access for new entrants and to promote competition amongst CRAs, the US GAO concluded in its "Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures 2010" report that the barriers to entry for structured products in particular remained especially high.[99] Dittrich[100] and Haar[101] have attributed the lack of competition among CRAs to 'network effects', the underlying 'lock-in effects', and 'lack of product differentiation' opportunities between firms.

Each of these is discussed in greater detail below:

- **Network Effects:**

Because CRA ratings are ostensibly a measure of relative risk, both direct and indirect network effects[102] are acutely relevant. For an elementary example that helps to visualize the importance of economies of scale and power of direct network effects, one

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[99] US Gov-GAO-b, *Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures*, U.S. Government Accountability Office, at 96-97, Sept. 2010, *available at* http://www.gao.gov/assets/310/309849.pdf.

[100] Dittrich, Fabian, The Credit Rating Industry: Competition and Regulation, Note (4 June 2007) at 73.

[101] Brigitte Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung? - Zur Regulierung und ihrerImplementierung im Ratingsektor./ Transl.: Sustainable quality ratings by profit-skimming? For the regulation and its implementation in the rating industry,* 21 ZBB (3) 177, 179 (2009).

[102] *See e.g.,* International Center for Monetary and Banking Studies (ICMB), *The Fundamental Principle of Financial Regulation: Geneva Reports on the World Economy* 11(Geneva , Switzerland, Jan., 2009) at 50 (CRAs have a "franchise value or network value…").

need only consider the telephone. The utility of the very first telephone was essentially zero; its network worth was zero since with no-one to call, the instrument held no value for any potential consumer. With the introduction of a second handset, the utility of the first telephone would surely increase exponentially. This trend of an increase in marginal utility would continue relatively unabated with the addition of each new handset to the network. Each additional unit increases member utility and strengthens the entire network, a feature that McKnight and Bailey referred to as a "network externality".[103]

The availability of numerous ratings (and by default the generation of a large volume of securities to be rated), allows for greater breadth which enhances a rating system that evaluates risk on a relative basis. Dittrich[104] notes that the ability to compare a large volume of different debt securities is valued by investors, and hence, the theory is that more ratings allow for better (i.e. "higher quality") ratings to be issued. Alongside direct network effects, Katz and Shapiro identify two other forms of positive consumption externalities; namely indirect network effects and, in the case of durable goods, the availability of and experience in a post-purchase servicing system.[105]

Regarding indirect network effects, Katz and Shapiro provide an example of a PC buyer having to consider the number of other similar hardware units that have been sold as this would have a direct influence on the amount and variety of software supplied and would be available for him to buy. In addition, Katz and Shapiro developed a simple, static model of oligopoly to analyse markets where consumption externalities are present.[106] They find that consumers are willing to pay more for a firm's product if their expectation

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[103] Lee W. McKnight & Joseph P. Bailey, *Internet Economics: When Constituencies Collide in Cyberspace*, 1 IEEE, INTERNET ECON. (6), at 31 n.3 (1997)("[A] network externality is the benefit gained by incumbent users of a group when an additional user joins the group").

[104] Dittrich, Fabian, The Credit Rating Industry: Competition and Regulation, Note, *passim,* (4 June 2007)

[105] Michael L. Katz & Carl C. Shapiro, *Network Externalities, Competition and Compatibility*, 75 AM. ECON. REV. (3), 424, 424 (1985).

[106] *Id.,* 75 AM. ECON. REV. (3), 426-432 (1985).

leads them to believe that the firm is dominant in its market. By acting on this perception, the consumers ensure that the perceived dominant player does become dominant. Moreover, CRAs in general - and NRSROs in particular - have benefitted from indirect network effects which can be observed in the expedited growth of the ancillary services businesses. Parallels can be drawn to the legal requirements favouring NRSROs as the NRSRO status served to elevate the designated CRAs to a position of perceived market domination by consumers, thereby resulting in consumers choosing them over non-NRSRO firms as well as more recently accredited NRSROs.

In addition, Veljanovski makes mention of "induced (i.e. endogenous) network effects"[107] by which a network participant incentivises existing and potential network users of the network by offering lower transaction rates for interactions within the network (i.e. on-net) than with those on a rival network. Veljanovki finds that a network externality characterised by availability of large volume of cheap on-net calls increases switching costs which in turn are advantageous to the larger network. The final effect is that this creates a lock-in effect for consumers in the network.

For the home video game industry with the two dominant competitors Nintendo and Sega, limits to the advantages of a larger network were found. [108] Unlike CRAs which rely on similar but differentiated rating methodologies, the two firms in that study competed with entirely incompatible product technologies. So whereas an investor might be willing to use ratings from different CRAs interchangeably, a video game consumer's post-purchase product and service options would be restricted once his purchase is concluded. The study also examined the impact of network effects as determined by network size (i.e. measured by customer base) and network strength (i.e. measured by the marginal impact

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[107] Cento Veljanovski, *Network Effects and Multi-Sided Markets* 6, SSRN (2007), available at http://ssrn.com/abstract=1003447.

[108] Venkatesh Shankar & Barry L. Bayus 23-27, *Network Effects and Competition*, 24 STRATEGIC MGMT J., 375-384 (2002).

of a unit increase in network size on demand). An asymmetric relationship which exists between network size and network strength, was identified.

Despite having a larger customer base than Nintendo, Sega's network strength was found to be lower. The authors proposed this as a possible explanation for Nintendo, despite its smaller network, being able to overtake the sales of its larger network competitor. These findings seem to suggest that by focusing on developing their network strength, smaller CRAs could similarly increase their market share and offer the Big Three greater competition. The findings also appear to indicate that a threshold is eventually reached where the marginal utility of each new additional handset becomes negligible. In fact, it could possibly even become negative, for instance where the additional marginal transaction costs exceed the marginal benefit from each additional handset (i.e. diminishing marginal returns); where each additional handset slows down or depreciates the network in some form. It can then be argued that three large NRSROs might indeed be this threshold, and recognizing additional large NRSROs might actually entail introducing negative marginal utility. This rationale might explain the failure of the other seven NRSROs to take significant market share away from the Big Three.

- **Lock-in Effects:**

Lock-in effects refer to "the cost of switching to a different service",[109] i.e. the cost that consumers would incur when substituting one CRA for another. Hadfield et al., are of the view that the attributes of a credence good are discovered, if at all, a significant period of time after consumption.[110] The cost of making an ex-post determination can also be significant. For issuers, the cost of switching is considered significant because of the reputational value in ratings, especially if the switch is away from either Moody's or S&P.

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[109] OZ SHY, THE ECONOMICS OF NETWORK INDUSTRIES 4 (Cambridge Univ. Press, 2001).

[110] Gillian K. Hadfield, Robert Howse & Michael J. Trebilcock, *Information-Based Principles for Rethinking Consumer Protection Policy*, 21 J. CONSUMER POLICY (2) 131, 142n .17 (1998).

Such a move is almost certain to arouse suspicions of rate-shopping (i.e. avoiding close scrutiny generally by selecting an agency of lesser reputation, and by assumption, lesser capability) by investors.[111] This is more-so since Moody's and S&P are established joint market leaders, both in terms of size and quality of service. A.M. Best conceivably is a beneficiary of the same advantage for insurance company ratings where they are the recognized industry leader.

▪ **Product Differentiation:**

The lack of product differentiation opportunities is a further barrier of entry for new entrants into the CRA industry. Investors anecdotally want high quality ratings; ratings that are accurate, timely and efficient to use:[112] Dittrich[113] and Haar[114] both note that specialising in either good risk or bad risk is not an option for CRAs. The nature of the credit ratings as a product means that there simply isn't a viable market for a CRA that would aim to provide lower quality ratings.

Accepting, as argued by both Dittrich and Haar, that no market for lower quality ratings exists, new entrants are thus restricted to competing either within specific sectors (e.g. A.M. Best in covering insurance companies, and Morningstar (f.k.a. Realpoint) in

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[111] Brigitte Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung? - Zur Regulierung und ihrer Implementierung im Ratingsektor,* 21 ZBB (3) 177, 179 (2009) (discusses how switching from a Big Three CRA creates a 'lock-in effect' for issuers). *But see,* Efraim Benmelech & Jennifer L. Dlugosz, *The Credit Rating Crisis* 27 (NBER, May 15, 2010) (find that tranches rated solely by one of the Big Three (in this instance, S&P, who have a leading reputation and are considered among the most able among CRAs, were most likely to be downgraded by January 2008).

[112] Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA L. & BUS. REV. 10, 20 (CRA can cost-effectively monitor issuers).

[113] Dittrich, Fabian, The Credit Rating Industry: Competition and Regulation, Note, *passim,* (4 June 2007) at 93.

[114] Brigitte Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung? - Zur Regulierung und ihrer Implementierung im Ratingsektor,* 21 ZBB (3) 177, 179 (2009).

covering asset backed securities), or within specific geographic regions (e.g. the Japan Credit Rating Agency).

3.2.2.4. Increasing competition

The series of consolidations that resulted in the number of NRSROs shrinking from eight to four by 1988 also makes a case for a more anti-competitive possibility; namely that the industry, much like a natural monopoly, may – in fact – be a natural oligopoly.[115] Posner asserts that the term "natural monopoly" holds regardless of the actual number of participants in a given market, as long as the entire market's demand can be satisfied at low cost by just one firm. The ability of one single firm to cause long-run average total costs to decrease as output increases means that the presence and participation of other firms in the market only contribute to more inefficient outcomes. Posner surmises that under natural monopoly conditions, competition ceases to be a valid regulatory mechanism.[116]

Numerous markets, such as water, electricity suppliers and the airline industry have often been classified by governments as "public utilities"[117]. They have been accorded enduring protection from competition by governments' certification requirements that

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[115] *Measuring the Measurers*, THE ECONOMIST, May 21 2007 (arguing that new entrants are unable to distinguish themselves by offering differentiated products); SEC, 'Role and Function report', at 24 (citing Hearing participants' views that high investment and longer track record requirements created natural entry barriers for newcomers).

[116] Richard A. Posner, *Natural Monopoly and its Regulation*, STAN. L. REV 540, 542-46 (1969). *See also*, Peter Coy, COLUM. LAW SCH. MAGAZINE, Richard Posner J., U.S. Court of Appeals, Nov. 2008 comments at Columbia Law School ("[Y]ou can have rationality, and you can have competition, and you can still have disasters."), http://www.law.columbia.edu/magazine/162123/global-positioning (last accessed May 25, 2016).

[117] Thomas J. DiLorenzo, *The Myth of Natural Monopoly*, 9 REV. AUSTRIAN ECON. (2), 43, 46-50, (1996). (disputing the entire concept of a *natural* monopoly and concluding it is a 'confused rationalization' for 'the sinister forces of private privilege and monopoly).

have limited the participation of new entrants. Similarly, the NRSRO designation has also served to protect the designated firms against competition from non-NRSRO designated CRAs.[118] The GAO 2010 report noted that while increased competition[119] among NRSROs improved information availability, its impact on the quality of ratings was nonetheless still unclear.[120] A 2007 article in The Economist magazine noted that "new entrants to the industry might have no option but to offer a level of choice that investors simply do not want".[121] Significant support for this view can be found in academic literature by Dittrich[122] and Haar who both consider the anti-competitive barriers to entry faced by new entrants by examining the 'network effects', the underlying 'lock-in effects', as well as the 'lack of product differentiation' in the industry to be problematic.

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[118] FRANK PARTNOY, *CREDIT RATING AGENCIES VERSUS OTHER GATEKEEPERS, in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 95(Yasuyuki Fuchita & Robert E. Litan eds., Brookings Institution Press, 2006) (130 non-NRSROs would be open to compete with the NRSROs).

[119] *See e.g.,* Stephen Foley, *Rating agencies clash over standards*, FINANCIAL TIMES, Nov. 6, 2012, at 25 ("[T]he ratings agencies are at war").

[120] USGov-GAO-a. (Government Accountability Office) *Action Needed to Improve Rating Agency Registration Program and Performance-related Disclosures*, at 56 (2010) http://www.gao.gov/new.items/d10782.pdf (last accessed May 23, 2016).

[121] *Measuring the Measurers,* THE ECONOMIST (2007)

[122] Fabian Dittrich, The Credit Rating Industry: Competition and Regulation, Note, at 73-87 (2007); Brigitte Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung,* 177, 177-182 *(2009). Contrast*, studies by Rachel E. Kranton, *Competition and the Incentive to Produce High Quality*, 70 ECONOMICA 385, 399 (asserting that restricted entry can actually enhance quality); Alexander W. Butler & Kimberly J. Rodgers, *Relationship Rating: How Do Bond Rating Agencies Process Information?* 19 (EFA 2002 Annual Conference Paper No.491, 2003) (empirical study suggesting benefits of relationship rating, e.g. access to additional "soft" information about the issuer); and Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 REV. OF FIN. STUD. (4), 653, 677 (1999) (analyzed 391 IPOs and found no evidence that over a two-year post IPO holding period, ratings by non-underwriter analysts outperform those of underwriter analysts by 50%).

Although the preceding sections above have generally demonstrated the anti-competitive market that resulted as a consequence of the NRSRO designation in terms of first-mover advantages, entrenched network effects and lock-in effects, it is important to note that in economic theory, it is generally acknowledged that under certain conditions reputational constraints can replace competition.[123] The question that remains however is whether this concept applies equally under the specific circumstances and conditions under which NRSROs operate. The anecdotal evidence from the GFC strongly suggests that reputational constraints were particularly ineffective in that instance.

This outcome ties-in with Shapiro's observation that where buyers cannot observe product quality prior to purchase, there is an incentive for sellers to reduce the product's quality while quickly taking the short-run gains before buyers come to that realisation and take corrective action.[124] Shapiro's view that a firm may have "a good reputation [or patronage if consumers believe its products to be of high quality"[125], is convincing. Nonetheless, it is equally credible to suggest that in place of a good reputation, a firm may also have good patronage if - in spite of an unsatisfactory product delivered by the firm - consumers believe that they do not have a viable alternative to the firm. In a competitive market, dissatisfied buyers would simply be able to respond by seeking alternative sellers to buy from. The exclusive NRSRO status designation excludes this option for dissatisfied buyers and as a consequence, they are obligated to do repeat business even when they have knowledge of either perceived or confirmed inferior product quality ratings. The unparalleled network effects of the Big Three in particular, make the option to seek alternative sellers to the Big Three significantly less viable.

Shapiro's study is relevant and insightful for this dissertation on several issues: For one, it aligns with the general consensus that consumers of NRSRO ratings typically have

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[123] Shapiro, Carl. "*Premiums for High Quality Products as Returns to Reputations*." 98 Q.J. ECON. (4), 659, at 660-679 (1983)

[124] *Ibid.* at 661, 666.

[125] *Ibid.* at 659.

imperfect information regarding the product (i.e. ratings) quality. His equilibrium price-reputation model assumed perfect competition, free market entry, and quality choices by firms found that as a mechanism for assuring quality, reputational constraints could only operate imperfectly.[126] However, Shapiro's model appears to have limited relevance to NRSROs in particular, as the review of the pre- and post-GFC evidence presented in the sections above underscores the argument that reputational constraints - even when allowing for the more accommodating free-market competition environment, as opposed to one characterized by perfect competition traits - have not been effective in moderating the behaviour of NRSROs. In addition, the absence of both free market entry (i.e. for the NRSRO designation) and quality choices by firms, exacerbate the difficulty in relying on the model with respect to NRSROs.

In summary, the issue of "experience goods" as introduced by Nelson, and of "credence goods" by Darbi and Karni, form the basis for the problems in the credit rating sector. Ratings are a classic example of experience and credence goods in that their quality is only revealed after purchase, and even after purchase and examination (i.e. experience), the buyers remain uncertain of the product's quality as this can only be ascertained subsequent to the security's maturity. Moreover, the creation and perpetuation of an anti-competitive market structure continues to be the stand-out legacy of the NRSRO designation.

As a result, although reputational mechanisms have been relied on by the CRA industry to replace plain market mechanisms, the problematic market structure that evolved as a consequence of the aforementioned factors has in fact served to blunt the effectiveness of reputational constraints as a mechanism for assuring quality. However, under the prevailing market structure, any buyer dissatisfaction with the product quality

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[126] *Ibid*. at 661. (For the implications of reputation in a perfectly competitive environment in which sentence incomplete).

cannot actually and truly be expressed due to the unavailability of credible alternatives[127] to NRSROs, or more adroitly, the Big Three. That is why barriers to entry - such as the SEC's strict control over the NRSRO designation - are so detrimental. The limiting of access to the NRSRO designation coupled with on-going regulatory requirements for buyers to purchase NRSRO-sourced ratings disempowers consumers and entrenches market inefficiencies which can only lead to market failure further down the line.

In rounding-off this section on competition, while this dissertation supports policies premised on the view that more competition among NRSROs would be distinctly better in terms of market efficiency and stakeholder accountability than less, it is worth bearing in mind that a lot more competition would not necessarily be the panacea for the ills facing the sector. To this end, the research of Becker and Milbourn provides compelling evidence regarding the more problematic effects which an increase in competition would have on the rating sector. The study analyzed the elevation of Fitch Ratings to the top tier of CRAs to study the potential impact of increased competition on legislation by focusing on two dimensions of quality, namely: (i) the ability of ratings to transmit information to investors; and (ii) the ability of ratings to classify risk. Their findings suggested the existence of an inverse relationship between ratings quality and competition. In other words, the quality of ratings was observed to decrease as market competition was increased.[128] This result would suggest that accreditation of more NRSROs as was previously suggested in pre-Dodd-Frank literature[129] or the opening up of the market

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[127] *See*, Thomas J. DiLorenzo, *The Myth of Natural Monopoly*, 9 REV. AUSTRIAN ECON. (2), 43, 43-44, 51-53 (1996).

[128] Bo Becker & Todd Milbourn, *How did Increased Competition affect Credit Ratings?* (HBS, WPS 09-051, 2010) at 4; *See also*, Jonathan Katz et al., *Credit Rating Agencies: No Easy Regulatory Solutions*, 8 CRISIS RESPONSE, Oct. 2009, at 6.

[129] *See e.g.*, Marcin T. Kacperczyk & Harrison G. Hong, *Competition and Bias*, *passim*, (NYU Working Paper No. FIN-08-016; AFA 2009 San Francisco, 2009), http://ssrn.com/abstract=1101626; Jeffrey D. Kubik & Harrison Hong, *Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts*, 58 J. FINANCE (1), 313, 313, (2003); Judith Chevalier & Glenn Ellison, *Career Concerns of Mutual Fund*

through the elimination of the NRSRO status altogether as has been suggested in post-Dodd-Frank literature are the two viable options available.

However, neither option may result in the change of the industry's dynamics desired, particularly as far as market share and profit allocation go, due to the legacy advantages that prevail.

3.2.3. The regulation of market structure in the CRARA of 2006

3.2.3.1. Regulatory goals and development

Managers, Q. J. ECON., 144 (1999). *See also,* Vasiliki Skreta & Laura L. Veldkamp, *Rating shopping and asset complexity: A theory of ratings inflation*, 56 J. MONETARY ECON. (5), 678, 678-95 (2009) (an increase in the variance of the ratings observed that when products are complex it provides issuers with incentives to shop for ratings. Inversely, less complicated products exhibit high levels of correlation and thus there is less incentive for rate shopping); Patrick Bolton, Xavier Freixas & Joel Shapiro, *The Credit Rating Game*, 67 J. FIN., (1) 85, 102, 106 (2009), (increased competition from new entrants worsens the problem of rate shopping. The "feedback effect" identified by their model shows that increases in asset complexity prompted ratings shopping as it encourages issuers to create increasingly complex structured products); and Richard Cantor & Frank Packer, *The Credit Rating Industry*, Fed. Res. B.N.Y. Q. Rev. 21 (1994) (increased competition may actually increase rate shopping as investors decide between differentiated ratings). *Contrast,* John M. Griffin et al., *Rating Shopping or Catering? An Examination of the Response to Competitive Pressure for CDO Credit Ratings,* Rev. Fin. St., 2270-2310, (2013) (distinguish rate shopping from rate catering, positing that rate shopping is done by issuers looking to attain the highest possible rating for their securities, it does not impinge on the rating guidelines and methodologies applied by the rating agencies whereas rate catering occurs when rating agencies adopt their rating processes by loosening their controls or stretching their protocols in order to match their competitors and accommodate their clients.

The CRARA of 2006[130] was enacted with the goal of improving the quality of credit ratings; the protection of investors and public interest[131] through improved accountability (e.g. by retaining records of any complaints regarding the performance of credit analysts); transparency (e.g. by prohibiting NRSROs from structuring and also rating the same products); and competition within the industry by, for example, requiring the publication of performance statistics over periods of one, three, and ten years) within each of the recognized rating categories thereby enabling comparison of the NRSRSOs by consumers.[132] The legislation also sought to promote the SEC as the new locus for overseeing and ensuring the accountability of CRAs.[133] The SEC's adoption in 2007 of the CRARA rules was followed in 2009 by the SEC's rule amendments that were introduced subsequent to the roundtable discussions, congressional hearings and receipt and review of comments received from the public.[134] Amended regulations designed to enhance the integrity of the rating process for structured finance products were

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[130] The Credit Rating Agency Reform Act, Public Law 109–291. 120 Stat. 1327 (2006); Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation,* Note, 4 June 2007, at 142 (concludes that CRARA is "a good piece of legislation" but laments that CRARA is not based on statistical quality control given the prevailing concern over quality of ratings).

[131] Pub. L. No. 109-291, 120 Stat. 1327, 1327 (2006).

[132] SEC, 'Briefing paper', April 14, 2009, http://www.sec.gov/spotlight/cra-oversight-roundtable/briefing-paper.htm . *See also*, CRARA §78o7(a)(1)(B)(ii), which compels CRAs to publicly disclose their rating methodologies; and (§ 780-7(a)(1)(B)(vi), which requires disclosure of any potential conflicts of interest. Reinhard H. Schmidt, *Ratingagenturen entmachten – aber wie?* (Goethe Univ., House of Finance Policy Platform, July 2011) (posits that an economically viable option is to have a few credible raters providing ratings rather than a multitude of new entrants (market for lemons), however Schmidt does not confront the choice of what the ideal number would be, if not three).

[133] Fuchita, Yasuyuki; Litan, Robert E., (eds). In *Financial Gatekeepers: Can They Protect Investors?*, edited by Yasuyuki Fuchita and Robert E. Litan (eds), 157 (Washington D.C.: Brookings Institution Press, 2006).

[134] Lynn Bai, *On regulating Conflicts of Interest in the Credit Rating Industry*, 13 J. LEGIS. & PUB. POLICY, 253, at 312 (2010).

promulgated in February 2009.[135] Crucially, prior to the enactment of the CRARA in 2006, there were no federal statutes directly addressing CRAs,[136] and the "industry was largely unregulated".[137]

Although the CRARA expressly denied the SEC authority to regulate the substance of the credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings, it did however empower the SEC to introduce a registration program effective from June 2007. Subsequently, both previously NRSRO-accredited and non-accredited CRAs were able to apply for registration as NRSROs.[138]

Two Japanese rating agencies: Japan Credit Rating Agency, Ltd., and Rating and Investment Information, Inc. (R&I) as well as Egan-Jones Rating Agency (EJR) were also accredited as NRSROs in 2007. Further additions to the exclusive club have included Kroll Bond Rating Agency (Kroll) and Realpoint LLC (later rebranded as Morningstar, Inc. in May 2010) such that by October 1, 2011 there were ten NRSROs in total. Somewhat unexpectedly, R&I voluntarily withdrew its NRSRO registration on October 14, 2011[139]; HR Ratings de Mexico was added to complete the ten on November 5, 2012.[140]

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[135] "Amendments to Rules for a Nationally Recognized Statistical Rating Organization", Exchange Act Release 34-59342; 74 F.R. 6456, Feb. 9, 2009.

[136] Timothy M. Sullivan, *Federal Pre-emption and the Rating Agencies: Eliminating State Law Liability to Promote Quality Ratings*, 94 MINN. L. REV., 2136, 2143 (2010).

[137] Timothy Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. (2) 227, 248 (2009).

[138] *See, Appendix 5*: 'Registered NRSROS and their registration dates'

[139] R&I's withdrawal of NRSRO registration, Oct. 14, 2011, http://www.r-i.co.jp/eng/body/regulatory_affair/info/2011/10/info_20111014_557626781_01.pdf (last accessed, May 25, 2016).

[140] SEC Registration Release No. 34-68160, *available at* https://www.sec.gov/rules/other/2012/34-68160.pdf (last accessed, May 25, 2016).

3.2.3.2. Regulatory impact

As noted above, the SEC has responded to ensure increased competition for rating services. However, with a mere five percent[141] of the outstanding NRSRO ratings market (excluding the Big Three), the question remains as to whether substantive competition among CRAs in general and NRSROs in particular truly exists. Hill suggests that the regulatory stipulation, until recently, required pension funds for example, to get ratings from two NRSROs, thereby creating a "two-rating norm".[142] Consequently, the two-rating norm was entrenched in the duopoly of Moody's and S&P within the US by not requiring them to compete on price and thus allowing them to enjoy sustainably high profit margins.[143] On occasions when Moody's and S&P have offered divergent (i.e. split) ratings, Jewell and Livingston found evidence showing that a rating from Fitch is typically sought as the tie-breaker.[144]

Outside of the US, where the two-rating norm is not established, Moody's and S&P are usually in true competition with each other. This is because non-US regions typically require a single rating from a CRA; and where two ratings are desired then a local rating agency is often selected as the second rater.[145] Fitch, in particular, has been able to increase

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[141] Gary Shorter & Michael V. Seitzinger, *Credit Rating Agencies and Their Regulation* 6 (Congressional Research Service, 3 Sept. 1-24, 2009)(the Big Three accounted for 98 percent of all outstanding ratings and 90 percent of the total rating revenue).

[142] Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L.Q. 43, 75-79 (2004) (posits that the two-rating norm actually deters capture of the CRAs by the issuers as the latter cannot convincingly threaten to seek a rating from another CRA outside the duopoly; although noting that the increase in providing an ancillary diminishes the effectiveness of this deterrent).

[143] *Id.* Hill, 82 Wash. U. L.Q. 43, 75-79 (2004) at 61.

[144] Jeff Jewell & Miles Livingston, *A Comparison of Bond Ratings from Moody's, S&P and Fitch IBCA*, 8 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS (4), 1, 22 (2002).

[145] Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L.Q. 43, 73-76 (2004).

its market share by predominantly focusing on lucrative structured finance issues and by charging fees that are cheaper than both Moody's and S&P: Critics contend that Fitch has also grown its business by being more prepared to provide more favourable ratings for issues.[146]

In contrast, Egan-Jones Rating (EJR)[147] has built-up its market share by not only offering monthly rating updates, but also by generally awarding more conservative (i.e. less favourable ratings) than its competitors, as shown in Figure 2: Egan-Jones' conservative ratings

, below.[148] The stricter rating approach adopted by EJR does not preclude the suggestion of "competitive laxity"[149] wherein CRAs may compete to give originators, particularly structured-finance arrangers, the high ratings they seek. Dittrich, for instance, concludes that insurgent CRAs, i.e. new entrants, while generally issuing more conservative ratings than their peers on an absolute scale, over time tend towards issuing increasingly less

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[146] *Id.* Hill, 82 Wash. U. L.Q. 43, 73-76 (2004).

[147] *Egan-Jones v. SEC,* No.12-00920, U.S. District Court, District of Columbia, 1-66 (2012). (This complainant requesting a trial by jury in Federal court was filed in response to an earlier administrative proceeding against Egan-Jones and its founder Sean Egan filed by the SEC. The complainant also seeks to secure affirmation that the SEC will not retroactively apply punitive provisions provided in DFA. The SEC claim is that Egan-Jones misrepresented their experience by overstating their outstanding ratings for ABS (150) and government securities (50) in their 2008 NRSRO accreditation application, an allegation contested by Egan-Jones who assert that the SEC provided no prescriptive guidelines or definitions for the firm to rely on, ergo, it cannot be held at fault).

[148] Stephen Foley, *Rating agencies clash over standards*, FINANCIAL TIMES, Nov. 6, 2012, at 25 (Kroll's CEO seemingly incredulous that his firm produces thicker, and by inference, more informative rating reports than two of their NRSRO peers, an assertion that is roundly dismissed by the Big Three).

[149] John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis: The Limits of Reputation, The Insufficiency of Reform, and a Proposal for Improvement*, COLUM. BUS. L. REV., (1), 109, 120 (2009).

conservative ratings as they themselves experience competition from entry into the market by other new insurgent CRAs.[150]

Figure 2: Egan-Jones' conservative ratings

Tough Guys

Egan-Jones Rating Co. often gives lower ratings to bonds than larger rivals such as Standard & Poor's Ratings Services

	Rating	
Company	Egan-Jones	S&P
Ambac Financial*	BB–	AA
Walt Disney	A	A
Wells Fargo	AA–	AA+
United Parcel Srv.	AA–	AA–
General Electric	AA	AAA
General Motors	CCC	B
Amazon.com	A–	BB

*S&P has a AAA rating on the financial strength of Ambac's insurance unit

Sources: Egan-Jones; S&P

Source: Lucchetti, A.,The Wall Street Journal, 9 February, 2008[151]

3.2.3.3. SEC registration requirements and resulting evidence

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[150] Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*, Note, (2007) at 137.

[151] Aaron Lucchetti, *Tiny Firm gives Ratings Giants Another Worry*, WALL ST. J. 9 February 2008. http://online.wsj.com/article/SB120251672233155415.html (last accessed, May 25, 2016).

Subsequent to the enactment of the CRARA,[152] SEC rules required that a credit rating agency "by statutory definition, must apply to be registered in one or more of the classes of credit ratings identified in section 3(a)(62)(B) of the Exchange Act".[153] NRSROs that were already registered at the time of enactment for less than the full complement of five available classifications could, through the provisions of paragraph (b) of Rule 17g-1, apply to be registered under additional classes.

A further approach advanced by regulators to level the competitive landscape was to require greater transparency and disclosure by NRSROs. For instance, new rule amendments adopted by the SEC in December 2009 - effective from June 2010 onwards - were designed, in part, with the aim of increasing competition in the rating of asset-backed securities. The amendments required any NRSRO hired by an arranger to rate a structured finance product to not only disclose on a password-secured section of its own website each structured finance product that it has been hired to rate, but also to detail the structured finance product type, the name of the issuer, the date the rating process began, and the website at which the issuer will disclose the information it has provided to the NRSRO for the rating. The amended rule further requires the issuer to provide representations to the hired NRSRO that it would permit other NRSROs to access the same data availed for the rating or review, in order for them to be able to generate unsolicited ratings of the same structured products.

High concentration is also a feature of the banks and financial advisory firms that are involved in the issuing of structured financial products. Their propensity for repeat business with NRSROs motivated the SEC's view that such a provision was necessary as it was feared that some arrangers could potentially exert more influence on the NRSROs when rating structured finance products relative to when rating other corporate securities.

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[152] Publ. Law 109–291 120 Stat. 13272006 --signed Sept.26, 2006-- was designed to encourage competition among CRAs by facilitating the entry of new firms by allowing eligible firms to register with the SEC as NRSROs. The Act also abolished the ability of the SEC to designate NRSROs.

[153] *See,* 15 U.S.C. 78c (a)(62).

Figures 3, 4, and 5 below demonstrate the split along the five recognized rating classes among the 10 NRSROs as prescribed by the SEC. The values in purple highlight the rating sector classification wherein each NRSRO provides the most ratings, respectively

Figures 3, 4 and 5, below, show the outstanding ratings reported by NRSROs for their respective Form NRSRO annual certification submissions for the fiscal years ending September 2008 and September 2010. Noteworthy observations from Figure 3 and Figure 4 include the following:

▪ A.M. Best: 68 and 71 percent of its outstanding ratings (in 2008 and 2010, respectively) cover the Insurance Companies class, and thus underpin its reputation as the insurance industry 'specialist' among NRSROs. This however represents a mere 0.3 percent of the total outstanding NRSRO "market share".

▪ DBRS, the fourth largest NRSRO, albeit with a meagre 1.4 and 1.5 percent market share, predominantly covers the Financial Institutions class and Sovereigns, Governments and Municipalities (i.e. SGMs) and its class ratings amount to an average of 66 percent over the two periods. In contrast, almost 90 percent of Kroll's ratings come from issuing ratings in the Financial Institutions class.

▪ EJR (Egan Jones, founded 1955) [154] covers the 'Corporate' issuers class with 86 and 84 percent of its ratings, albeit with less than 0.1 percent of NRSRO market share. Egan Jones wholly earns its revenue from investors (i.e. subscriber-pays fee model). Addressing the US Congress on October 22, 2008, EJR founder Egan Jones said that issuers of complex securities shopping for ratings had led to a "race-to-the-bottom" in terms of credit rating agency transparency.

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[154] Katie Benner & Christopher Tkaczyk, *8 Who Saw the Crisis Coming*, FORTUNE, Aug. 8, 2008 ranked EJR in first place on their list. In contrast, Moody's, S&P, and Fitch (labelled, "The Enablers" [of the crisis]) were listed in third place on the accompanying list of the *8 Who Didn't [see the crisis coming]*, http://money.cnn.com/galleries/2008/fortune/0808/gallery.whosawitcoming.fortune/index.html (last accessed, May 25, 2016).

▪ The trend that persists when we examine the other smaller NRSROs is that each firm appears to specialize in one of the five classes recognized by the SEC. Morningstar (f.k.a. Realpoint), is the one 'pure' specialist among the group, with its entire business solely covering the ABS class.

▪ The Big Three all have over half of their market share from SGMs, and between them retain the lead position in each of the other four ratings classes. The Big Three also accounted for 96 and 94 percent of the outstanding rates for the maligned ABS class that was considered the epicenter of the real estate crisis.

▪ And finally, the Herfindahl-Hirschman Index (HHI), (see Figure 3) is a further approach advanced by regulators to level the competitive landscape by requiring greater transparency and disclosure by the NRSROs. For instance, new rule amendments adopted by the SEC in December 2009 - effective from June 2010 onwards - were designed, in part, with the aim of increasing competition in the rating of asset-backed securities. The HHI is a commonly used economic indicator to express the depth of competition between firms.[155] The US Department of Justice considers an HHI between 1000 and 1800 to be "moderately concentrated" and those above 1800 to be "concentrated".[156] Moreover, mergers, no matter how large in dollar value, resulting in a post-merger HHI of less than

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[155] *See,* Stephen Calkins, *The New Merger Guidelines and the Herfindahl-Hirschman Index*, 71 Cal. L. Rev. (2), Art.6, 402, 402 (1983) for description of the "HHI, its principal properties, and its use in the guidelines, the literature, and the case law". SEC, Annual Report on Nationally Recognized Statistical Rating Organizations, (hereafter '2008 Annual NRSRO Report'), at 35 (2008)("[M]arket concentration is generally measured by economists using the Herfindahl-Hirschmann Index …").

[156] USGov-DoJ, n.d. Testimony: *The Herfindahl-Hirschman Index*, www.justice.gov/atr/public/testimony/hhi.htm (last accessed, Jan. 16, 2015). See also 4 P. AREEDA & D. TURNER, ANTITRUST LAW 913, at 74-75 (1980). The CR4 (A measurement of the concentration ratio of the sector's four leading firms' sales relative to total sales in the market) and the HHI are the two most widely accepted measures of concentration.

1000, are unlikely to be challenged by the Department of Justice.[157] The NRSROs' HHI range for 2008 in lying between 2,467 and 3,550, clearly underscores how concentrated the industry is. In their 2014 updated final rules report, the SEC, covering the period 2007 to 2013, determined that since 2010, the HHI inverse as calculated per each of the five classes, has decreased thereby confirming that the NRSRO industry concentration has in fact increased.[158]

Figure 3: 2008 NRSRO outstanding ratings report

[157] Stephen Calkins, 71 CAL. L. REV. (2), Art.6, 402, 406 (1983); 1984 Guidelines § III(A)(1)(a), 47 Fed. Reg. at 28,497. See also ABA Antitrust Section, Monograph No. 12, HORIZONTAL MERGERS: LAW AND POLICY, 1, 175-82 (1986) and KEITH N. HYLTON, ANTITRUST LAW: ECONOMIC THEORY AND COMMON LAW EVOLUTION, Cambridge University Press, 328-30 (2003).

[158] *See,* SEC, Nationally Recognized Statistical Rating Organizations - Final Rules, 17 CFR Parts 232, 240, 249, and 249b Release No. 34-72936; File No. S7-18-11, Oct. 14, 2014, http://www.sec.gov/rules/final/2014/34-72936.pdf, at 26.

NRSRO	Financial Insti.'s	Insurance Companies	Corp. Issuers	ABS	Govt., Munis & Sov's	Total	%
A.M. Best	3	6.009	2.710	54	0	8.776	0,3%
DBRS	18.040	110	7.080	7.470	10.560	43.260	1,4%
EJR	62	46	803	14	9	934	0,0%
Fitch	83.649	4.707	14.757	77.480	491.264	671.947	21,5%
JCR	155	31	544	71	71	872	0,0%
Kroll (LACE)	18.000	100	2000	0	300	20.400	0,7%
Moody's	84.773	6.277	31.126	109.261	880.880	1.112.317	35,6%
R&I	100	32	600	210	100	1.042	0,0%
Realpoint	0	0	0	9.200	0	9.200	0,3%
S&P	47.300	6.600	26.900	198.200	976.000	1.255.000	40,2%
Total Ratings	**252.082**	**24.002**	**86.520**	**401.960**	**2.359.184**	**3.123.748**	**100,0%**
HHI	2,686	2,467	2,636	3,550	3,539	3,347	

Source: U.S. SEC – Annual Report on Nationally Recognized Statistical Ratings Organizations for year-ending 2008, at 9 (2009). The leader by size of outstanding ratings in each segment is highlighted.

Figure 4: 2010 NRSRO outstanding ratings report

NRSRO	Financial Insti.'s	Insurance Companies	Corp. Issuers	ABS	Govt., Munis & Sov's	Total	%
A.M. Best	N/R	5.062	2.043	54	N/R	7.159	0,3%
DBRS	14.941	156	3.863	10.091	13.533	42.584	1,5%
EJR	89	47	877	13	19	1.045	0,0%
Fitch	61.550	1.657	13.385	65.535	363.897	505.024	17,9%
JCR	159	30	495	N/R**	52	736	0,0%
Kroll (LACE)	16.515	48	1.002	0***	59	17.624	0,6%
Moody's	61.581	4.540	30.285	101.546	841.235	1.039.187	36,9%
R&I	503	48	2836	N/R	1.031	4.418	0,2%
(fmr.Realpoint) Morningstar	N/R	0	0	8.322	0	8.322	0,3%
S&P	54.000	8.200	44.500	117.900	965.900	1.190.500	42.3%
Total Ratings	**209.338**	**19.788**	**99.286**	**302.461**	**2.185.726**	**2.816.599**	**100,0%**

Source: Summary Report of Commission Staff's Examination of Each Nationally Recognized Statistical Rating Organization for year ending 2010, at 6 (2011).**R&I withdrew their NRSRO registrations in asset-backed securities on June 28, 2010, *** Kroll is registered for asset backed securities, but did not report ratings in this class for the year ending 2010.

Figure 5:2013 NRSRO outstanding ratings report

NRSRO	Financial Insti.s	Insurance Companies	Corp. Issuers	ABS	Govt., Munis & Sov's	Total	%
A.M. Best	N/R	4.492	1.653	56	N/R	6.201	0,3%
DBRS	13.624	150	3.790	10.706	16.038	44.308	1,8%
EJR	104	46	877	N/R	N/R	1.027	0,0%
Fitch	49.821	3.222	15.299	53.612	204.303	326.257	13,4%
HR Ratings	N/R	N/R	N/R	N/R	189	189	0,0%
JCR	150	27	463	N/R	56	696	0,0%
Kroll (LACE)	15.982	44	2.749	1.401	25	20.201	0,8%
Moody's	53.383	3.418	40.008	76.464	728.627	901.900	37,0%
Moningstar (fmr. Realpoint)	N/R	N/R	N/R	11.567	N/R	11.567	0,5%
S&P	59.000	7.200	49.700	90.000	918.800	1.124.700	46,2%
Total	**192.064**	**18.599**	**114.539**	**243.806**	**1.868.038**	**2.437.046**	100,0%

Source: SEC 2014 Updated Final Rules Report for year-ending 2013, at 25 (2014). Following the departure of R&I in 2010 HR Ratings de México, and S.A. de C.V. (HR Ratings) were registered on November 5, 2012 and thus completed the ten on the NRSRO list.

In tandem with the requirement for NRSROs to register their rating offerings, within the prescribed five classifications is the requirement in the amendment for NRSROs to also disclose their methodologies. To this demand S&P has already cautioned against unintended consequences, such as that the requirement could inadvertently dis-incentivise

CRAs from either competing with each other or pursuing innovative approaches aimed at improving their risk models.

Moreover, they contend that this could lead to a "more homogenized rating opinion and, ultimately, deprive investors of valuable, differentiated opinions on credit risk".[159] The potentially greater concern created by homogenized rating opinions is that the reliance on either a uniform or similar set of risk models would create ideal conditions for concentration risk to manifest thereby creating systemic risk exposure in the event that a significant risk scenario is over-looked. The viability of requiring CRAs to share such valuable proprietary information has also been disputed by legal experts, with one commentator equating the requirement for CRAs to verify ratings - potentially making them liable for errors made by other CRAs - to joint liability.[160]

Taken together the above three diagrams (i.e. Figures 3, 4 and 5) serve to not only highlight the market dominance of the Big Three relative to the other NRSROs, but also to emphasize the very high concentration within the industry as reflected by the HHI levels which are well above the threshold 1800 level. Underlying the need for greater competition is the observation that S&P also leads with the most outstanding credit ratings in each of the five classes. In addition, the fact that in 2014, as in 2010 (i.e. Figure 7) the

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[159] Jesse Westbrook & Alison Vekshin, *Regulators Would Oversee Credit Ratings in Senate Plan*, BLOOMBERG, May 13, 2010, http://www.bloomberg.com/news/2010-05-13/senate-passes-proposal-to-create-ratings-board-for-asset-backed-securities.html (last accessed, Dec. 16, 2014). *See also*, Frank Partnoy, *Congress should open up credit ratings to competition,* FINANCIAL TIMES, June 29, 2005 ("[M]ore than 130 credit-rating agencies that have not qualified are waiting outside the gate. They rate debt, but their ratings do not matter."), http://www.ft.com/cms/s/0/4fb2354e-e839-11d9-9786-00000e2511c8.html (last accessed, May 25, 2016).

[160] USGov – *Hearing: House Comm., Credit Rating Agencies and The Next Financial Crisis*, at 94 (Statement by constitutional legal expert, Floyd Abrams), https://house.resource.org/111/gov.house.ogr.20090930.pdf. *See also*, Jagot, J.'s decision in *Bathurst Regional Council v. Local Government Financial Services Pty NSD1268/2010*, Federal Court of Australia to award damages against ABN Amro, S&P and LGFS to be paid in equal proportions.

sum total of the other seven NRSROs – excluding the Big Three – amounts to less than three per cent of outstanding NRSRO ratings, suggests that competition within the industry is currently, and barring regulatory intervention or some other external factors, likely to remain an unfulfilled quest.

3.3. Market structure and conflicts of interest

3.3.1. Remuneration mechanisms

"The payment model is the root cause of the dysfunction we have seen. Without an investor-based payment system it won't be possible to create liability for the product. Only if the investor pays will there be a contractual relationship between the [rating] agency and the investor."- Markus Krall, Partner at Roland Berger, Germany.[161]

The subscriber-pays remuneration model, initially adopted by the Big Three CRAs, was a natural development from the earlier period when CRAs were de facto publishing houses. Their ability to control and manage the printing and distribution of the rating reports that they generated was eroded by technological advancements. In particular, the production of affordable photocopying equipment[162] ensured that mass duplication of once privately distributed reports could easily be made by third-parties and distributed without limit. The initial advent of personal printers, and more recently the ready availability of both personal computers and access to the internet, compounded this problem for CRAs. In addition to the difficulty in restricting the availability of rating information to paying-subscribers-only, also came the demand from issuers for more

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[161] Rachel Wolcott, *Financial Regulatory Forum: Start-up rating agencies urge national regulators to promote competition, change*, REUTERS, Aug. 15 2011, http://blogs.reuters.com/financial-regulatory-forum/2011/08/15/start-up-rating-agencies-urge-national-regulators-to-promote-competition-change/ (last accessed, Sept. 9, 2018).

[162] Xavier Freixas & Joel Shapiro, *The Credit Rating Industry: Incentives, shopping and regulation,* Mar. 18, 2009, online at http://www.voxeu.org/index.php?q=node/3286 (last accessed, Sept. 9, 2018).

resource-intensive analytical reports by NRSROs as the former strove to further distinguish themselves from their competitors and attract potential investors by providing greater transparency.[163]Furthermore, legally-binding references to NRSROs continued to increasingly permeate both the US Federal securities laws[164] and international securities laws[165] thereby greatly expanding their adoption. For instance, Section 183e(d)(4)(A) of the Federal Deposit Insurance Act only recognized corporate debt securities as being of an investment grade when rated in "one of the four highest categories by at least one NRSRO".[166]

White also suggests that in the aftermath of the large Penn-Central Railroad's bankruptcy in 1970 that issuers were motivated to pay for their bonds to be rated in order to ease the fears of a then chastened and reluctant investing public.[167] In response to the aforementioned technological and economic developments, the majority of CRAs adopted an issuer-pays model, and it remains to-date the remuneration fee model predominantly applied by the NSRSOs. Of the currently registered NRSROs, all but the three most recently accredited have adopted an issuer-pays remuneration model.

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[163] SEC, NRSROs 'General info', http://www.sec.gov/divisions/marketreg/ratingagency.htm at 41.

[164] The Secondary Mortgage Market Enhancement Act of 1984 required for a mortgage related security - among other conditions - to also be rated in one of the two highest categories by at least one NRSRO.

[165] Patrick van Roy, *Credit Ratings and the Standardised Approach to Credit Risk in Basel II*, 7, 10 (ECB, Working paper Series No. 517, 2005).

[166] SEC, SEC Release No. 33-7085; 34-34616; IC-20508, 3 (International Series Release No. 706. File No. S7-23-94, Aug. 31, 1994). The SEC issued a 'Concept Release' which is the first of three steps in the rule-making process of the SEC. See Appendix No.2 for break-down of the rule-making steps.

[167] Lawrence J. White, *Markets: The Credit Ratings Agencies*, 24 J. ECON. PERS. (2), 211, 214 n.31 (2010).

Egan-Jones,[168] Kroll[169] and Morningstar (f.k.a. Realpoint), have instead adopted variations of the subscriber-pays model. For instance, Kroll, which contends to independently rate over 17,000 institutions, defines its model as being “subscriber-based” and asserts that by deriving most of its revenues from subscription agreements, it ensures that its clients receive unbiased ratings.[170] Morningstar term their model “subscriber-paid”[171] and Egan-Jones attests that it is paid “solely by institutional investors”.[172] As per Figure 3 above, the three subscriber-pays model adoptees accounted for approximately one percent of the outstanding NRSRO ratings in the 2009 SEC report.[173]

The IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, May 2008, report states that:

> *“[E]xcept for “private ratings” provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities, or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.”*

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[168] Egan-Jones, NRSRO accredited, Dec. 21, 2007, http://www.sec.gov/rules/other/2007/34-57031.pdf

[169] Kroll acquired LACE Financial Corp, and received NRSRO accreditation on Feb. 11, 2008, http://www.sec.gov/rules/other/2008/34-57300.pdf (last accessed, Sept 7, 2018).

[170] Kroll-Bond-Rating-Agency, Fundamentals: Kroll Bond Rating Agency, http://srs.krollbondratings.com/Out/about/fundamentals.aspx (last accessed, May 25, 2016).

[171] Robert G. Dobilas, President and CEO or Realpoint LLC, *Statement to the United States House of Representatives' Sub. Comm. On Capital Markets, Insurance and Government Sponsored Enterprises' Hearing on Approaches to Improving Rating Agency Regulation*, May 19 2009, at 3, available http://financialserv.edgeboss.net/wmedia/financialserv/hearing0930092pm.wvx (follow “Mr Robert Dobilas - Hse Comm. on Fin. Serv” hyperlink, May 19, 2009) (last accessed, Sept 7, 2018).

[172] Egan-Jones-Rating-Agency, *NRSRO* (2012), http://www.egan-jones.com/nrsro.aspx (last accessed, Sept 7, 2018).

[173] SEC, *Annual Report on Nationally Recognized Statistical Rating Organizations,* SEC DIVISION MARKET REGULATION, Sept. 2009) http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf (last accessed, Sept 7, 2018).

Taken at face value, the above recommendation to publicly disclose ratings can be construed as an indirect economic rationale for endorsing the issuer-pays model over the subscriber-pays model. Furthermore, a requirement for CRAs to rely solely on publicly disclosed information,[174] as securities analysts are required to do, would in all likelihood dilute the - albeit contested - informational value of the ratings. At a more extreme interpretation such a development could also dissuade investors from relying on the ratings at all, because part of their attraction has been because investors are cognizant of the access to non-public information that CRAs conceivably rely upon when determining ratings.

Summarily, it is therefore conceivable that economies of scale may simply favour the issuer-pays model. For starters, under the issuer-pays model the NRSRO merely has to agree to terms with a single counterparty, which is undoubtedly a more resource-efficient approach than requiring it to contract with each and every consumer individually. However, the issuer-pays model has often been cited as being the source of the inherent conflict of interest that CRAs face when they provide ratings for securities issued by the same parties that pay them.[175] As Paul Krugman states regarding CRAs: "[I]t was a system that looked dignified and respectable on the surface. Yet it produced huge conflicts of interest".[176]

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[174] 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., (1), 109, 129, n.67.

[175] Refer to Section 1.2.1., above on CRA conflicts of interest.

[176] Paul Krugman, *Berating the Raters*, N.Y. TIMES, Apr. 26, 2010 at A23, http://www.nytimes.com/2010/04/26/opinion/26krugman.html?_r=0. *See also, Newby v. Enron Corp.,* 2005 U.S. Dist. LEXIS 4494, 216 (S.D. Tex., Feb. 16, 2005) (Court noted potential conflict of interest arising from issuer-pays compensation model).

3.3.1.1. Transparency, disclosure and competitive advantage

It is evident that CRAs have at great expense developed financial risk models that allow them (together with other factors) to quantify a security's risk profile and subsequently issue a rating opinion. While each CRA has been dependent on its own risk models for continued business flow, the Dodd-Frank Act under Title IX, Section C, sub-section Q[177] and other SEC proposals[178] currently under consideration would, once

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[177] The Dodd-Frank Wall Street Reform and Consumer Protection Act (i.e. Pub. Law No.111-203, H.R. 4173), June 11, 2010 (Title IX, Section C Improvements to the Regulation of Credit Rating Agencies SEC.931, Subsection Q:Transparency of Ratings Performance - requires NRSROs to "publicly disclose information on the initial credit ratings for each type of obligor, security and money market instrument, and any subsequent changes to such credit ratings, for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different nationally recognized statistical ratings organizations"). *See also*, US Gov-GAO-b, *Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures*, Sept. 2010, at 96-97, http://www.gao.gov/assets/310/309849.pdf, at 96-97 (Amendment to Exchange Act rule 17g-5 by SEC now requires issuers to disclose the underlying data as well as oral information to enable non-hired NRSROs to generate unsolicited ratings).

[178] USGov-House, 2010 Improvements to the Regulation of Credit Rating Agencies, Pub. Law No.111-203, §931-939 H, 124 Stat.1872-90, (July 21, 2010). *See also,* Haar, Brigitte Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung?* 21 ZBB (3) 177, 182 (2009) (Haar notes that the new SEC regulations would only permit payment of a structured finance transaction fee once all the information provided to the CRA has been openly disclosed in the eXtensible Business Reporting Language ("XBRL") format and availed to the market. Paragraph (d)(2) of Rule 17g-2 further requires that this information be made public on the NRSRO's corporate Internet Website in "XBRL" format.); Matthias Lampe & Michelle Yeo-Mokhtar, *'A Practioner's View of the Rating Process for Asset-Backed Securities'* (Conference on Credit Rating Agencies, Stockholm Univ., June 14-15, 2012) (non-US granted temporary exemption from Rule 17g-5 until December 2, 2012; but no non-US exemptions from Rule 17g-7's requirement for selected CRAs to prepare and avail report with "extracts of representations, warranties and enforcement mechanisms to investors). Similarly, in Europe, ESMA has created CEREP (Central Repository where historical and periodic ratings from the 16 registered CRAs are available for the public and ESMA calculates performance statistics. *See also,* ESMA, 'About CEREP', http://cerep.esma.europa.eu/cerep-web/homePage.xhtml (last accessed, Mar. 15, 2016).

adopted, require CRAs to disclose their rating methodologies and models to both regulators and competitors. As opposed to the full disclosure of records to the public called for by some commentators,[179] CRAs had been still only required to disclose a randomly-selected ten percent of ratings paid for by issuers, and could delay disclosure thereof by up to six months.[180]

Critics of this requirement pointed to the potential for a free-riding problem that could reasonably be expected to arise as a consequence;[181] objections which Partnoy argues are far outweighed by the benefits from increased disclosure.[182]

However, an update of the SEC Final Rules issued set in accordance with the Dodd-Frank Act by the SEC on October 14, 2014 eliminated the ten percent rule[183] along with other prescriptions aimed at increasing transparency in the credit rating process generally while further enhancing the governance guidelines role of NRSROs as gatekeepers. [184] Moreover, the disclosure of subscriber-paid ratings and unsolicited ratings is currently exempted.

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[179] *See e.g.,* Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform,* (Research Handbook on the Economics of Corporate Law, San Diego Legal Studies Paper No. 12-082, 2012) at 9.

[180] *See*, 17 CFR 240.17g-2(c), para. (d) (2), the "10% Rule". *See also*, SEC, *Nationally Recognized Statistical Rating Organizations - Final Rules*, 17 CFR Parts 232, 240, 249, and 249b Release No. 34-72936; File No. S7-18-11, Oct. 14, 2014, at http://www.sec.gov/rules/final/2014/34-72936.pdf, at 207-11.

[181] Dieter Kerwer, *Holding Global Regulators Accountable: The Case of Credit Rating Agencies*, 18 GOVERNANCE: INT'L J. POL'Y, ADMIN., & INST'S (3), 453, 469 (2005).

[182] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, CII (April, 2009), at 11.

[183] *See*, SEC, Nationally Recognized Statistical Rating Organizations - Final Rules, 17 CFR Parts 232, 240, 249, and 249b Release No. 34-72936; File No. S7-18-11, Oct. 14, 2014, http://www.sec.gov/rules/final/2014/34-72936.pdf, at 1, 211-12.

[184] *See,* SEC, Nationally Recognized Statistical Rating Organizations - Final Rules, (2014) at 11, 18.

Although the premise of such a proposal is meant to introduce greater transparency and increase competition between CRAs, two aspects that the SEC would like to further promote, it does appear to gloss over the fact that divulging rating methodologies to competitors may be regarded as an open invitation to erode the respective CRAs' competitive advantage over their peers. A further complication potentially arising from this proposal could be that of a convergence towards the adoption of a single 'leading rating methodology' as this could result in increased model concentration risk; such concentration risk would elevate the risk of systemic failure.

3.3.1.2. Economic alternatives to disclosure: Going dark and going private

Unenthused by the prospect of the afore-mentioned scenarios and motivated by the desire to retain their intellectual property and competitive advantages, it is conceivable for some of the CRAs that have invested significant resources into creating and developing complex methodologies might instead opt – to borrow a phrase ascribed to companies that elect to de-list from leading stock exchanges in order to avoid onerous compliance requirements and their financial impact – to "go dark"[185], go private[186] or even revoke their NRSRO accreditation.

In response to studies on firms opting to either go private or go dark, one commentator makes a convincing argument that changes to the NYSE and NASDAQ

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[185] *See e.g*., Kaufmann-RAND, *Do the Benefits of Sarbanes-Oxley Justify the Costs?* RAND 158 (2007) (reducing the shareholders to less than 300 by paying out small shareholders).

[186] *Id.,* Kaufmann-RAND, at 158. *See also*, William, J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private"* 2, 14 (Emory Law & Economics Research Paper No. 05-4, Feb. 2005), at 14 (on the advantages of going private for a company such as reducing regulatory costs and increasing liquidity for large stake sellers); and Andy Serwer, *Stop whining about SarbOx!,* FORTUNE, Aug. 7, 2006 (onerous costs of SOX, loss of IPO business for US, and increase in firms going private) http://money.cnn.com/magazines/fortune/fortune_archive/2006/08/07/8382589/index.htm (last accessed May 25,2016).

listing rules at the time SOX was enacted were also a critical factor that would have affected the listing decision of firms.[187] A possible outcome of such a development which would see the firms with established market reputation and size elect to depart from the market for issuing public ratings and return to an investor-pays model. As well as potentially encouraging the free-rider problem,[188] another observed downside of the subscriber-pays model is that it appears to favour wealthy private investors and institutional investors[189] as they have the financial resources to pay higher prices for rating opinions. The ability to pay high subscription fees would enable wealthier investors to benefit from CRAs' risk rating know-how as well as the private (i.e. non-public) information gathered from their privileged research access to issuers over other private investors.[190]

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[187] Christian Leuz, *Was the Sarbanes-Oxley Act of 2002 really this costly? A Discussion of Evidence from Event Returns and Going Private Decisions*, 44 J. ACCT. & ECON.,146, 150-152 (2007). *See also,* Joy Begley, Qiang Cheng and Yanmin Gao, *The Impact of the Sarbanes-Oxley Act on Information Quality in Capital Markets*, AFAANZ (changes to stock exchange rules, at 7-8 or the growth of private-equity funds industry and resources for debt financed buyouts cannot be ignored), at 21 (2007), *available at*, http://www.afaanz.org/openconf/2007/papers/242.pdf (last accessed July 12, 2012).

[188]*See e.g*., Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, CII, April 2009, at 11; Dieter Kerwer, *Holding Global Regulators Accountable: The Case of Credit Rating Agencies*, 18 GOVERNANCE: INT'L J. POL'Y, ADMIN., & INST'S (3), 453, at 469 (2005).

[189] *See e.g*., Jeffrey D. Manns, 87 N.C.L. REV. 1011, at 1061 (a disproportionately large number of smaller creditors and investors would have to rely on alternative risk proxies or be priced out of the market entirely if CRAs were to increase fees affordable only by larger institutions).

[190] JOHN A., FLOOD, *RATING, DATING, AND THE INFORMAL REGULATION AND THE FORMAL ORDERING OF FINANCIAL TRANSACTIONS: SECURITIZATIONS AND CREDIT RATING AGENCIES*, PRIVATISING DEVELOPMENT: TRANSNATIONAL LAW, INFRASTRUCTURE AND HUMAN RIGHTS 162 (M. Likosky, ed., Martinus Nijhoff Publishers, 2005) (2005) (CRAs have an unfair advantage over securities analysts, investors and other market participants because they are privy to private non-public information from issuers), *available at* http://ssrn.com/abstract=873878. *See also,* 17 C.F.R. 243.100-243.103 (Regulation Fair Disclosure

3.3.1.3. Free-riders and higher fees

Furthermore, while newer and less established rating firms could foreseeably try to replace the firms exiting to meet the demand for ratings, their initial lack of established reputations might foster a market for lemons. Such a development would lead investors to either require punitively higher fee discounts from CRAs which would in turn erode revenue or they might ignore the CRAs altogether. In contrast, Listokin and Taibleson posit that removing the regulatory requirement and incentivizing competition would address the aforementioned market for lemons problem.[191] Even if one assumes that the established CRAs do remain in the market, the more stringent disclosure requirements that have been proposed might still encourage them to be more selective regarding the securities that they rate by only rating very large issues to the detriment of smaller issuers.

In addition, due to the very real challenge faced in trying to deny free-riders access to rating opinions under a subscriber-pays model, CRAs can reasonably be expected to demand much higher upfront fees and this too would have the effect of excluding large numbers of smaller private investors. The economic drivers potentially influencing the decision-making process of CRAs will be revisited in greater detail in Part III of this dissertation.

However, under the issuer-pays model the issuers will conceivably - if not always - favour an as high as possible rating as that would inevitably make the security issue more attractive to potential investors. The ability of issuers to directly and indirectly unduly pressurize and/or influence CRAs towards inflating ratings in exchange of continued business deals was highlighted in the US Senate investigation chaired by Senators Coburn

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("Regulation FD") exemption gave CRAs inside information denied to securities analysts and investors. The DFA requires the rescission of the Regulation FD exemption for CRAs).

[191] Yair Listokin and Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 103 (2010).

and Levin[192] into the causes of the financial crisis, has also been extensively covered in the literature.[193] In their defence, CRAs have cited study findings that support their contention that concerns about the reliability and independence of the issuer-pays model as a remuneration mechanism are unfounded because any potential conflicts of interest from the model have either not materialized or have been convincingly managed.[194]

Admittedly, a subscriber-pays model is also not without its own flaws, for whoever pays will understandably always aim to get a rating that favours their specific investment needs. Under the subscriber-pays model, acceptable levels of required accuracy notwithstanding, it can be assumed that subscribers would prefer as relatively low a rating as possible in order that they may acquire an essentially high quality security (i.e. with an effective low probability of default) with a high yield at a lower price. Conversely; subscribers would prefer as high a rating as possible in order to ensure a more viable secondary market and strengthen their balance sheets with higher-tiered capital assets.[195]

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[192] Carl Levin and Tom Coburn, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, SENATE COMM. HOMELAND AND GOVERMENTAL AFFAIRS, *passim*, April 13, 2011.

[193] *e.g.,* Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV., 1145. *See also,* Frank Partnoy, THE PARADOX OF CREDIT RATINGS, RATINGS in RATINGS AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65 (in R.M. Levich, G. Majnoni & C.M. Reinbart, eds., New York, Springer (2002)).

[194] Vickie A. Tillman, *Assessing the Current Oversight and Operation of Credit Rating Agencies: Hearing Before the Senate Comm. on Banking Housing, and Urban* Affairs., 109th Cong., Senate CRA Oversight Hearings, at 10, 2006 (prepared testimony of Vickie A. Tillman, Executive Vice President, S&P..), at 10; Patrick Bolton, Xavier Freixas and Joel Shapiro, *The Credit Rating Game*, 67 J. FIN., AM. FIN. ASSOC. (1) at 4, 28 (2009), (the "Cuomo Agreement" reached between , Andrew Cuomo, then Att'y General of New York and the Big Three in 2008 required that issuers pay for the ratings upfront, it also faced a moral hazard challenge in terms of overlooking incentives for post-issuance monitoring by the CRAs).

[195] *See e.g*., Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*, Note, at 144 (Figure 6.5, overview of the contrasting expectations towards ratings held by different stakeholders).

Recognizing that Moody's had switched from an investor-pays to an issuer-pays model in 1970, four years earlier than S&P, the study by Jiang et al.,[196] used Moody's ratings as a benchmark to compare bonds rated by both firms over the period 1971 to 1978.[197] Their study found that Moody's ratings were higher than S&P's prior to 1974 during the period when only Moody's used the issuer-pays model. They also observed that upon adopting the issuer-pays model in 1974, S&P's ratings increased, matching those provided by Moody's, with the increase most apparent for bonds that suggested either higher fees or were of relatively lower credit quality. All in all, the study concluded that the switch to an issuer-pays model had resulted in the inflation of ratings by S&P of twenty percent.[198]

3.3.1.4. Remuneration model preferences and flaws

Since both remuneration models reflect alternate preferences and incentivize different behaviours,[199] the challenge for legislators and regulators is rather to establish rules and regulations that would reward those behaviours that they wish to encourage. During Senate Committee hearings,[200] when clarifying his response that he was unsure whether his bank's relationship with CRAs which he had earlier described as "multi-

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[196] John Xuefeng Jiang, Mary Harris Stanford and Yuan Xie, *Does It Matter Who Pays for Bond Ratings? Historical Evidence*, 105 J. FIN. ECON. (3) 607, 609, 619-620, (2012).

[197] Jiang et al., (inferences consistent with two later studies (i.e. Xia (2010) and He, Qian and Strahan (2011)) that utilize more recent data on ratings for mortgage-backed securities to compare CRAs (2010).

[198] Id. Jiang et al., at 614.

[199] *See*, Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*, Note, Figure 9, 2007, at 147.

[200] USGov-Senate-Hearing, *The Role of Investment Banks. Hearing Before the Senate Permanent Sub-Comm. on Investigations on Wall Street and the Financial Crisis*, April 27, 2010 *available at* http://www.senate.gov/fplayers/I2009/urlPlayer.cfm?fn=govtaff042710&st=945&dur=39420 (last accessed Nov. 25, 2015).

faceted"[201] represented a conflict of interest, Goldman Sachs' David A. Viniar[202] said: "There is an argument that you are making that if the issuer of securities is paying the rating agencies there could be a conflict, as opposed to when the purchaser of securities [does]. So ... there is an argument on both sides of that."[203]

Viniar's argument was essentially that neither the issuer-pays nor the subscriber-pays (i.e. investor-pays, a.k.a. purchaser-pays) remuneration model is free from conflict of interest. Katz and Stephanou refer to an "investor-pays" model in their work in place of the "subscriber-pays model" term adopted in this study. They suggest that the implementation of an investor-pays model would cause a stark reduction in the number of securities receiving ratings and that this would disproportionately and negatively affect less liquid issues and smaller issuers. To counteract this effect, they recommend a hybrid solution wherein after an initial rating is (paid for, and) received) from an appointed CRA, an issuer would then also be able to seek a second rating, either from another CRA for a "subscriber fee" or alternatively from a hybrid CRA, namely one that would be "owned and supervised by a consortium of institutional investors".[204] Figures 3, 4 and 5 above

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[201] Referring to "the multi-faceted relationship" through which CRAs are paid fees when they rate Goldman Sachs' security issues and the securities issued by Goldman Sachs' clients. The interaction includes instances when CRAs rate Goldman Sachs and when Goldman Sachs advises its clients when they issue securities.

[202] Executive Vice President and Chief Financial Officer of Goldman Sachs Group, Inc.

[203] USGov-Senate-Hearing, *supra* note 200, at 445:00-447:00/657:00 (video-link) (from statements made during the Panel 2 Senate Committee on Homeland Security and Governmental Affairs hearings held to investigate the role of banks in the 2007 financial crisis. See also USGov-Senate-Hearing). *The Role of Investment Banks. Hearing Before the S. Permanent SubComm. on Investigations on Wall Street and the Financial Crisis.* Edited by Senator Tom Coburn, Senator Carl Levin, Craig Broderick, April 27, 2010, http://www.senate.gov/fplayers/I2009/urlPlayer.cfm?fn=govtaff042710&st=945&dur=39420(last accessed Nov. 15, 2015).

[204] Jonathan Katz, Emanuel Salinas and Constantinos Stephanou, *Credit Rating Agencies: No Easy Regulatory Solutions*, 8 CRISIS RESPONSE, Oct. 2009, at 6 n.8.

underline the position that the different CRAs have different areas of specialization and as such, the onus of determining the appointment of the initial CRAs in both a fair market-based as well as in a cost-efficient manner becomes a challenge for the institution charged with allocating the assignments. Equally, while the "hybrid CRA" proposal could advance concerns surrounding conflicts of interest faced by independent CRAs, there is not no evidence of support for such a development.

3.3.1.5. Alternative remuneration models

Another performance-based proposal that has been put forward is one that would require issuers to pay a minimum initial rating fee, with the balance of the fee being earned by the CRA based on the ultimate accuracy of the rating within a pre-agreed time horizon.[205] The advantage of adopting such a staggered payment approach is that it would allow qualifying dissatisfied issuers to withhold further payment from a CRA should the rating diverge significantly from the security's actual performance.[206] A parallel can be

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[205] *See e.g.,* John Kiff, *Reducing Role of Credit Rating would aid markets* 10, IMF Global Financial Stability Report (2010); Bowden, Roger and Peter Posch. "Quality signalling and ratings credibility: regulatory reform for the ratings agency". http://www.wellesley.org.nz/uploads/Signalling%20value%20of%20registration_2.pdf (last accessed March 5, 2015), at 6, 13 (proposing a partial sequester of the fee earned by CRAs to be set as a performance bond over agreed horizon, (i.e. subject to a due diligence defense)). *See also*, James C. Spindler, *IPO Liability and Entrepreneurial Response*, 14-17 (Univ. of Chi. John M. Olin Law & Econ., Working Paper No. 243, 2005) (proposing embedding put options into issue not clear (i.e., "IPO" securities to protect investors against poor firm performance.), at 14-17 (2005), *available at* http://ssrn.com/abstract_id=719768 and at http://www.law.uchicago.edu/Lawecon/WkngPprs_226-50/243-jcs-ipo.pdf (on file with the Columbia L. Rev.)

[206] *See,* Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, CII, April 2009, at 12-13 (a fee-for-service format would allow CRA to earn-out their fees based on meeting agreed thresholds); Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Rating Accuracy Through Incentive Compensation*, 27 YALE L. J. ON REGULATION 91, 112 (2010) (deferred instalment payments is the "only way" to ensure CRAs are appropriately incentivized

drawn from the February 2013 announcement from the US investment bank, Morgan Stanley, that it planned to pay its bankers bonuses staggered over "four equal installments.[207] Other proposals include a variation of a"Subsidy Reserve Plan" to serve a reserve fund against losses from flawed ratings[208] and a performance-based suggestion which would see CRAs compensated with the debt that they rate[209] while requiring CRAs to hold these to maturity[210] in order to ensure that their earnings are directly impacted if it overrates a debt security. At first blush the two aforementioned performance-based compensation approaches seem significantly less complicated and potentially less litigious than alternative approaches that would place reliance on the successful disgorgement-of-fees as has been suggested by some authors:[211] but that would be overly

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through to maturity). *Contrast,* Katherina Pistor, *Towards a Legal Theory of Finance* 7 (Columbia Public Law Research Paper No. 12-323, 2012) (asserting that due to fundamental uncertainty, long horizon inflexible commitments and contracts are actually counter-productive and potentially system-threatening).

[207] *See e.g.*, Brett Philbin, *Wall Street's $20 Billion Pile*, WALL ST. J., Feb. 28, 2013, at 25.

[208] William Isaac & Cornelius Hurley, *At Last – how America can solve the 'too big to fail' problem*, FINANCIAL TIMES, Feb. 18, 2012, at 9.

[209] Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Rating Accuracy Through Incentive Compensation*, 27 YALE L. J. ON REGULATION 91, 94-95 (2010), (inaccurate over-ratings directly impact CRA income; the downside is that under-rating may consequently be incentivised. The authors suggest that requiring the rating CRA to write call options on the debt could dissuade under-rating by CRAs).

[210] *Id.* Listokin & Taibleson, at 111 (2010).

[211] *See* e.g., Brigitte Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung? - Zur Regulierung und ihrerImplementierung im Ratingsektor* 21 ZBB (3) 177, 185-86 (2009); Brigitte Haar, *Civil Liability of Credit Rating Agencies - Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence,* 19 (University of Oslo Faculty of Law Legal Studies Research Paper Series No.2013-0, 2013) (disgorgement of profits as alternative to drawbacks of exposing CRAs to excessive liability); 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., (1) 109, 191-92, 195 (on novel products, and three advantages of disclosing or other alternatives: i) ignores scienter; ii) foregoes

simplistic.[212] For instance, Listokin and Taibleson conclude that competition and collusion cause over-rating in both the debt compensation model and the cash model that is currently in use.[213]

Since 2007, CRAs for their part have also recognized and taken expedited steps to incorporate new regulatory proposals in their own corporate practices in order to better manage the potential conflicts of interest posed by the issuer-pays model. S&P for example, have compared their adoption of a distinct "separation of function between those who negotiate the business terms for the ratings assignment and the analysts who conduct the credit analysis and provide the ratings opinions[214] […] to the way newspapers distinguish their editorial and advertising sales functions, since they report on companies from which they may also collect advertising fees".[215] A further safeguard provision that has been highlighted is the rating by the committee process aimed at limiting the influence any single analyst or executive can have on S&P's ratings opinions. The role of the committee is to review and assess the lead analyst's recommendation for a new rating or

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determining ex ante "reasonableness", and iii) disgorgement preferable to damages remedy as it dis-incentivizes production of low-quality ratings); and Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV., 1779, 1806 (2011) (citing the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) §954 10D amendment to the Securities Exchange Act permitting the clawing back of incentive-based compensation).

[212] Listokin & Taibleson, *If You Misrate, Then You Lose: Improving Rating Accuracy Through Incentive Compensation*, 27 YALE L. J. ON REGULATION 91, 105-107, (see debt compensation model mechanics). *Id.,* at 109 (use of puts and call options to discipline under- and over-rating).

[213] *Id.* at 107.

[214] *Contrast,* Matt Taibbi, *The Last Mystery of the Financial Crisis*, ROLLING STONE, June 19, 2013 (on negotiations between S&P's rating analysts and its executives managing the business terms of the CRA with issuers), *available at* http://www.rollingstone.com/politics/news/the-last-mystery-of-the-financial-crisis-20130619, (last accessed May 9, 2016)

[215] Standardandpoors, *Understanding Ratings: Guide to Credit Ratings Essentials* (last accessed Nov. 15, 2013)

a rating revision thereby providing additional checks and balances regarding adherence to the agency's ratings criteria.[216]

Krugman posits that a fundamental change to the incentive drivers for CRAs is necessary in order to "end the fundamentally corrupt nature of the issuer-pays system".[217] He lends qualified support to the proposal authored by Matthew Richardson and Lawrence White of New York University which would require the SEC itself to determine which CRA should provide the initial credit rating to any issue[218]. Their model aims to deter the practice of "rate-shopping" and to improve transparency as multiple rating issues could be allocated to different CRAs.[219]

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[216]Richard Cantor & Frank Packer, *The Credit Rating Industry*, Federal Reserve Bank of New York, Q. Rev. 5, (1994), at 5 (ratings are decided by staff committee majority's vote on the recommendation by a senior analyst following a presentation and subsequent debate). For a general discussion on rating issue process see Louis H. Ederington & Jess B. Yawitz, *passim*, *The Bond Rating Process* (Working Papers Series 85 (2),1985). *See also,* FCIC, comments by Jay Siegel, a former Moody's MD, to FCIC Committee in FCIC Report at 121 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[217] Paul Krugman, *Berating the Raters*, N.Y. TIMES, Apr. 26, 2010 at A23. *See also* Matt Taibbi, *The Last Mystery of the Financial Crisis*, ROLLING STONE, June 19, 2013, (comments by Brain Clarkson, later S&P President regarding power of issuers to rate shop), available at http://www.rollingstone.com/politics/news/the-last-mystery-of-the-financial-crisis-20130619(last accessed, May 9, 2016)

[218] Jacques de Larosiere, *The High-Level Group on Financial Supervision in the EU*, at 9 (2009) ("Issuers shopped around to ensure that they could get a [CRA to issue] an AAA rating for their products"). *Contrast,* Efraim Benmelech & Jennifer L. Dlugosz, *The Credit Rating Crisis* 27, NBER, May 15, 2010, at 25 (study of ABS CDOs found no clear evidence that rating shopping led to the ratings collapse).

[219] Edward I. Altman, et al., *What Should Be Done about the Credit Rating Agencies?* (NYU Stern Regulating Wall Street Blog, April 6, 2010)

CRARA (2006) [220] tasked the Government Accountability Office to prepare a report providing a framework for evaluating alternative models for compensating NRSROs.[221] In keeping with CRARA's directive for the GOA to review the Act's implementation, in September 2010 the GOA published the 'Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures' report[222]. The report was addressed to congressional committees with recommendations such as the removal of the NRSRO's designation and developing workable alternative compensation models for existing NRSROs.[223]

The five alternative methods identified by the GOA report included:

i. the Random Selection method (NRSRO selection for rating an issue to be done by a clearing house (i.e. non-profit organization, a governmental agency such as the SEC, or a private-public partnership));[224]
ii. an Investor-Owned CRA model (operated by highly sophisticated institutional purchasers of ratings) to publish a rating alongside that of the issuer-selected NRSRO;

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[220] Pub. L. No. 109-291, 120 Stat. 1327, 1327 ("An Act [t]o improve ratings quality for the protection of investors and in the public interest…").

[221] Pub. L. No. 109-291, 120 Stat. 1327 (Sept. 29, 2006) (amending the Securities Exchange Act of 1934 and codified at various sections of title 15 of the U.S. Code).

[222] US Gov-GAO-b, *Action Needed to Improve Rating Agency Registration Program and Performance-Related Disclosures*, U.S. Government Accountability Office, at 96-97, Sept. 2010, *available at* http://www.gao.gov/assets/310/309849.pdf (last accessed May 9, 2016)

[223] *Id.,* USGov-GAO-b, at 79.

[224] *See e.g.,* Otmar Issing, Jörg Asmussen, Jan-Pieter Krahnen, Klaus Regling, Jens Wiedmann & William White, *New Financial Order Recommendations by the Issing Committee, Part II* 23 (CFS White Paper, Mar., 2009) (positing the IMF or the BIS as suitable supervisory bodies to oversee the registration and regulation of the CRA industry).

iii. a Stand Alone model (where the NRSRO would not be able to charge fees for providing advice, but would earn fees from transactions' revenue in primary and secondary markets);
iv. a Designation model (all CRAs would be able to rate an issue, but a central third-party administrator would decide on the allocation of the issuer-paid fee to one or several participating CRAs);
v. a User-pays model (which requires all users to pay, and defines a 'user' as any entity that included a rated security, loan, or contract as an element of its assets or liabilities as recorded in an audited financial statement").[225] Without venturing to assess the viability of either model, the report however outlined a framework of seven[226] attributes by which ostensibly Congress and others could evaluate and determine the most appropriate model.

In practice however, the challenge between an equitable allocation of rating issues among CRAs and differences in expertise and capacity cannot be ignored. For example, this author is not aware of evidence suggesting how the SEC would deal with situations such as that presented by A.M. Best's industry leading position as the eminent specialist among CRAs for rating insurance securities and firms[227] when a rating is required. In addition, the question of how the proposed model would deal with the possibility that CRAs would instead become more incentivized to lobby the SEC in order to get allocations of the large and attractive issues, remains unclear.

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[225] US-Gov.-GAO-a, *Action Needed to Improve Rating Agency (2010)* at 84.

[226] US-Gov.-GAO-a, at 85-93 (7 factors: Independence; Accountability; Competition; Transparency; Feasibility; Market acceptance and choice; and Oversight).

[227] *See,* Figure 3 and 4 above, (A.M. Best; 68 percent and 71 percent of its outstanding ratings -- in 2008 and 2010, respectively -- cover the Insurance Companies class).

The option proposed by Richardson & White could surely expose the SEC to litigatory charges of bias if patterns were to arise which could be interpreted to reflect favouritism for one firm over another. Furthermore, by selecting the CRA, the SEC could also be charged as a co-defendant in a gross negligence case if it could be later claimed that the selected CRA was not able to adequately rate the security. Although Section 939F of the Dodd-Frank Act, also commonly referred to as the Franken Amendment, was restricted to the rating of structured financial products, there could be merit in the SEC implementing the lottery allocation system proposed to get around this legal exposure. Issuers could then be offered two or three CRAs to choose from.

For such a model to work one would have to assume that all CRAs registered as having expert competence in rating a given class of security would be acceptable to the issuers and subsequently to the market. At the moment, because of its established position as an industry leader, an option of CRAs that did not include A.M. Best for the rating of an insurance company might not be acceptable to issuers due to their recognized expertise. It is conceivable that either issuers or potential investors would still approach A.M. Best for an additional rating if they were not included among the selection options resulting in duplication and thus higher transaction costs.

Subsequently, the argument that allowing the allocation to be automated via a lottery process in order to increase transparency and avoid accusations of bias, while intended to improve fairness, might just not be practical. Premised on the view that all CRAs avail equal competence in the absence of agreed standards is literally putting the cart before the horse and hoping for the best. Moreover, a recommendation to introduce a comply or disclose approach along the lines of the Code of Conduct Fundamentals for Credit Rating Agencies[228] proposed by the IOSCO in December 2004, would not reduce the

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[228] IOSCO's voluntary Code of Conduct Fundamentals for Credit Rating Agencies (Dec. 23, 2004), is voluntary and therefore is neither binding on CRAs nor does it carry the threat of sanctions. *See* Frank Partnoy, *Credit Rating Agencies versus Other Gatekeepers,* in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS?, 97 (Yasuyuki Fuchita & Robert E. Litan eds., Brookings Institution Press, 2006).

accountability gap[229] in the absence of agreed standards.[230] Nonetheless, if the market is efficient in successfully sorting out the "winners" from "losers", the process could over the long-term be useful: the question is, at what cost, and to whom would these costs accrue?

Other alternative payment methods that have been put forward include: the proposal of a "bond-pays"[231] model which would deny the issuers the option of choosing a CRA to rate their issue to negate the conflict of interest argument, while forcing issuers to pay a fee in order to finance the ratings; and Germany-based consultancy Roland Berger's proposal of a variation of the investor-pays model[232] that requires issuers to disclose information to a shared platform. Under the Roland Berger model, CRAs could then access the information, assess and subsequently disclose their rating on the platform. Investors could then access the ratings for a fee.

The proposal's reported reliance on the success of Roland Berger's lobbying attempts for regulatory changes that would either require issuers to disclose data to the

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[229] Dieter Kerwer, *Holding Global Regulators Accountable: The Case of Credit Rating Agencies*, 18 GOVERNANCE: INT'L J. POL'Y, ADMIN., & INST'S (3), 453, at 466 (2005) (proposes limiting their scope of operation because he does not see solutions to the accountability gap – mismatch between supply and demand of accountability).

[230] Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L.J. 620, at 660 (2006).

[231] Jérôme Mathis, James McAndrews & Jean-Charles Rochet, *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?* 56 J. MONETARY ECON. 657, 657-674 (2009) (proposing a model where an issuer approaches a clearing house with a set fee and the clearing house responds by allocating a CRA to rate the debt instrument).

[232] See e.g., Rachel Wolcott, *Financial Regulatory Forum: Start-up rating agencies urge national regulators to promote competition, change*, REUTERS, Aug. 15 2011, *available at* http://blogs.reuters.com/financial-regulatory-forum/2011/08/15/start-up-rating-agencies-urge-national-regulators-to-promote-competition-change/

platform or force investors to buy ratings from the platform would appear to be a hindrance in seeing the measure eventually adopted in the EU.[233]

Among the proposals reviewed thus far, the "issuer-and-investor-pay" model along the lines adopted by the Municipal Securities Rulemaking Board (MSRB),[234] which is funded by primary and secondary market transaction fees, or the version proposed by Kotecha et al.,[235] which in part straddles the issue, appears to achieve the desired objective of incentivizing both parties to share the costs and the benefits accruing from a rating issue. This seems to be a most convincing proposal, particularly in terms of addressing the inherent conflicts of interest that arise from both the issuer pay and investor pay models.

Within the EU, Germany and Sweden have openly voiced their resistance against the introduction of a transaction tax. Sweden in particular experienced significant loss of business to London when it introduced a similar tax; moreover, the business did not return even when the tax was later rescinded.[236] In the absence of an acceptable and superior alternative to the issuer-pays model, one that is free of the documented conflicts of interest

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[233] See e.g. Jérôme Mathis et al., *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?* 56 J. MONETARY ECON. 657, 657-674 (2009).

[234] See annual financials and Rule A-13, *available at* http://www.msrb.org

[235] Mahesh Kotecha, Sharon Ryan, Roy Weinberger, Roy & Michael DiGiacomo, *Proposed Reform of the Rating Agency Compensation Model*, 18 J. STRUCTURED FIN. (1) 71, 71-75 (2012).

[236] Harald Kindermann, *Rating of States – A German perspective*, Conference on Credit Rating Agencies, Stockholm Uni., June 14, 2012 (comments by German Ambassador to Sweden, Harald Kindermann, on EU's worries that a transaction tax will scare business to move to the US and similarly not return).

s identified and adopted, regulators market participants and scholars are advised to prioritize improving the disclosure, surveillance[237] and enforcement mechanisms.[238]

3.3.1.6. Conflicted interests

The two preceding sections above, addressing the remuneration mechanism and lack of competition, together form the basis of the conflict of interest argument that is leveled against CRAs. Moreover, in 2011 US regulators affirmed their intention to achieve two aims, namely: (i) to legally curtail the influence of CRAs by removing the requirement for ratings from legislation, rules and regulations; and (ii) to address the conflict of interest driving CRA incentive structures by re-aligning and strengthening the liability associated with their ratings. [239] Fitch's president, Paul Taylor, cautioned however that even if the removal of regulatory references was implemented, strong demand for CRA ratings would nonetheless remain.[240]

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[237] See e.g., SEC, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008, at 21-23 (CRA surveillance process is less robust than its ratings issuance process; and Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1024 n.7 (2009) (absent effective reputational risk impulsion, CRAs may be tempted to underinvest in surveillance in order to increase profits, or may leverage autonomy to elicit greater profits from issuers).

[238] Lynn Bai, *On regulating Conflicts of Interest in the Credit Rating Industry*, 13 J. LEGIS. & PUB. POLICY, 253, 296 (2010).

[239] Phil Mattingly & Jesse Hamilton, *Sovereign Ratings Should Be Free of Politics: S&P,* BLOOMBERG, July 27, 2011 (noting the SEC's adoption of its first rule to remove a requirement for CRA ratings from securities offerings rules on July 26th, 2011), *available at* http://www.bloomberg.com/news/2011-07-26/sovereign-ratings-should-be-free-of-politics-s-p-s-sharma-says.html (last accessed Mar. 15, 2016).

[240] Francesco Guerrera, *Current Account: Here's How to Fix Those Credit Ratings,* WALL ST. J. ASIA, Aug. 16 2011, at 8.

Bai examines the conflicts of interest at the level of the credit analyst and at the rating agency level.[241] At the analyst level, these conflicts of interest include concerns arising from analysts' ownership of securities of rated entities and analysts' compensation based on rating fees.[242] At rating agency level, the conflicts of interest arise from CRAs' affiliation to issuers, the provision of ancillary services[243] and the compensation models they have adopted.[244] This dissertation has explored the advantages and disadvantages of the issuer-pays and the subscriber-pays model, and finds that the literature strongly suggests that neither model is free from conflict of interest.[245] Consequently, the adoption of a hybrid model to address the challenges would appear to present the most credible solution.

Mann investigates the conflict posed by "interconnections of interest" between ratings agencies and their commercial clients, as well as a perceived disconnect between

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[241] Lynn Bai, *On regulating Conflicts of Interest in the Credit Rating Industry*, 13 J. LEGIS. & PUB. POLICY, 253, 260-65 (2010).

[242] *See,* 17. C.F.R. § 240.17g-5(c) (2) (2009) (prohibits the issuing of rating by an NRSRO if provided by a credit analyst who participated in the rating decision or a person responsible for approving the rating, except for sovereign states or their agencies, who directly holds the rated security. However, the rating of indirect holdings (e.g. mutual funds or blind trusts) is not prohibited).

[243] *See e.g.*, Gregory W. Smith, *Approaches to Improving Credit Rating Agency Regulation*, May 19, 2009 (testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services calling for NRSROs to be prohibited from providing ancillary services), http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg51592/html/CHRG-111hhrg51592.htm (last accessed Mar. 15, 2016).

[244] Lynn Bai, *On regulating Conflicts of Interest in the Credit Rating Industry*, 13 J. LEGIS. & PUB. POLICY, 253, 272-77 (2010).

[245] *See e.g.,* Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 403 (2008) ("In any event, there is no easy solution to the dilemma of how rating agencies can be paid without creating conflicts with either issuers or investors.").

ratings agencies and beneficiaries of their screening roles, i.e. investors.[246] To address this challenge, some commentators have proposed a model that relies on a user-fee financed clearing house to finance ratings,[247] although the model's merits for the SEC to base its selection of a CRA solely on the lowest price, are open to challenge.[248] While acknowledging that such a set-up would lay a significant - albeit manageable - burden on CRAs, Mann suggests that these burdens would be outweighed by the added benefits from increased accountability that would result from the adoption of certification and mandatory reporting requirements for CRAs. However, more convincing were his proposals to deter frivolous litigation from empowered creditors by capping such liability - primarily because they benefit relatively little from issuer misconduct - and to limit it to cases of gross negligence.[249]

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[246] Jeffrey D. Manns, *Rating Risk After the Subprime Mortgage Crisis*, 87 N.C.L. REV. 1011, 1014-15 (2009).

[247] *Id.* Jeffrey D. Manns, 87 N.C.L. REV.. at 1061-63 (2009) (discusses merits of user-fee model in conjunction with capped liability to incentivize sound gatekeeping); Jérôme Mathis et al., *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?* 56 J. MONETARY ECON. 657, 669 (2009). *Compare,* Yair Listokin and Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91,102 (2010) (challenge that the user-fee model is burdened by the question of whether shareholders, bondholders or employees should be the payers of the user-fee); and also Dwight M. Jaffee, *Comment on "Rating the Raters: Are reputation concerns powerful enough to discipline rating agencies?"* J. MONETARY ECON. 56, 675- 677 (2009) (noting the challenge to identify acceptable rating criteria for allocating the rating issues among CRAs, or recourse to a second opinion if the issuer is not satisfied with the initial rating issued through such a system).

[248] Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1064 (2009) (notes risk of underinvestment in due diligence as a result of reliance on price competition, and suggests a cost-based method as a potentially costlier but more flexible and thorough method of effecting due diligence; even though the ability of the SEC to fairly and/or efficiently select between competing CRAs remains unclear).

[249] Jeffrey D. Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*. 87 N. C. L. REV. 1011, 1033-34, 1069, 1076 (2009).

3.3.1.7. The Franken and Cantwell Amendments

As mentioned earlier, the Franken amendment[250] proposed that CRAs be assigned on a lottery basis by a Ratings Advisory Board (i.e. RAB) appointed by the SEC to rate securities.[251] In instances where an issuer would insist on an additional rating by a CRA of their choice, then the amendment would require any differences between the ratings to be disclosed publicly. Since the RAB's lottery allocation system would take into account CRAs' past performances, it is unclear to this author how this would not either favour the longer established CRAs or encourage CRAs to rate less complex securities or those issued by more financially sound issuers.

In the absence of an allocation system capable of taking the complexity of the rated security into account, opting to rate plain vanilla securities instead of more complex securities would offer CRAs with a higher probability of achieving a greater ratings accuracy track record.[252] While attractive in principle, scoring, taking into account the complexity of rated securities, will remain difficult to implement in practice.

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[250] Restore Integrity to Credit Ratings amendment (S.A.3991).

[251] See also, Jérôme Mathis et al., *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?* 56 J. MONETARY ECON. 657, 669 (2009) (suggest addressing conflicts of interest and curtailing rate-shopping by creating an independent central exchange "platform" that would be paid by issuers and be responsible for assigning securities to one or more rating agencies for rating.)

[252] Larry P. Ellsworth & Keith V Parapaiboom, *Credit Rating Agencies in the Spotlight: A New Casualty of the Mortgage Meltdown*, 18 BUS. L. TODAY (4) 1, 1-4 (2009) (noting that SEC's July 2008 study found that the sharp increase in volume and complexity of subprime residential mortgage-backed securities and collateralized debt obligations overwhelmed CRAs), *available at* http://apps.americanbar.org/buslaw/blt/2009-03-04/ellsworth.shtml; SEC, *'July 2008 Summary Report of Issues Identified'* (substantial increase in complexity of RMBS and CDO deals since 2002), at 10-13; and Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L.Q. 43, 49 (2004) (noting that CRAs struggle to determine whether an instrument is in fact debt or equity – this creates an opportunity for market participants to game the system). *See also*, FRANK PARTNOY, *Credit Rating Agencies versus Other Gatekeepers,* in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS?, 74-80 (Yasuyuki Fuchita &

In keeping with the "bitter medicine" solution suggested by Partnoy, White and others,[253] the Cantwell Amendment proposed removing all references to credit ratings from the Securities Exchange Act, the Investment Company Act of 1940 and the Federal Deposit Insurance Act. Although the Amendment sought to eliminate credit ratings in regulations, it did not offer alternatives to the status quo. The Cantwell Amendment instead called for agencies such as the FDIC or the Comptroller of the Currency to "come up with appropriate standards of creditworthiness and not rely on the monopoly of the rating agencies".[254] While apparent that something significant needed to be done to address the standing problems, the post-GFC political and economic climate presented legislators with a unique opportunity to introduce far-reaching legislative changes with bi-partisan support; this author finds significant shortcomings in both of the proposed amendments.

Three potentially negative consequences of adopting the Franken Amendment come to the fore: Firstly, the proposal would require either the SEC or RAB to measure and publish rating performance itself, both before the selection of the CRA to determine who gets to rate, as well as afterwards to keep track of the quality of rating offered. The Ministry of Finance in Japan is one institution that not only rates the performance of its CRAs but also publishes censures for failure to meet expected standards of CRA performance. It should also be noted that unlike the Fair Fund provision established under the Sarbanes–Oxley Act SOX,[255] the penalties collected by the Ministry of Finance are

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Robert E. Litan eds., Brookings Institution Press, 2006)(for general overview of the role of CRAs in the CDO and RMBS markets leading up to the 2007 crisis).

[253] Frank Partnoy, *The Siskel and Ebert of Financial Markets* 77 WASH. U. L.Q. REV. (3) 619, 624 (1999). *See also*, Lawrence J. White, *Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response*, 25 J. INT'L BANKING LAW AND REG., 170-180 (4)(2010).

[254] David M. Herszenhorn, *Senate Amends Financial Overhaul Bill*, N.Y. TIMES, May 13, 2010, at B2.

[255] 15 U.S.C. § 7246(a) (the provision gave the SEC the right to distribute penalties at its discretion to defrauded investors). *See also,* Pub. L. 107–204 (SOX 2002), §308 (Fair funds provision).

not paid-on to private investors as compensation.[256] Although their penalties tend to be relatively small in dollar value (i.e. up to several hundred thousands of dollars), the public loss of face suffered by the CRA as a result of censure disclosure is considered by both the authorities and market participants to be the greater, if not "truer", punishment.[257]

This contention is further advanced by the findings from an empirical 2011 study by Armour et al.,[258] which determined that while the penalties charged by the UK's Financial Services Authority ("FSA") and London Stock Exchange ("LSE") for securities misconduct were a relatively limited deterrence,[259] and the ostensibly unwelcome dose of peer and public embarrassment experienced by guilty parties notwithstanding, it was investors, through their actions on the market, who effected the significantly greater punishment on bad actors. Their study, which observed a sizeable fall in the stock price of firms that were sanctioned, on average almost nine times larger than the actual financial penalty amount imposed by regulators, makes a very compelling and convincing argument

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[256] Russell Mutingwende, Interview with Professor T. Harada from Kansai University, Japan, Goethe Univ., Frankfurt am Main, Germany, April 2, 2012.

[257] *Id.,* Harada interview (2012).

[258] John Armour, Colin Mayer, & Andrea Polo, *Regulatory Sanctions and Reputational Damage in Financial Markets*, passim (Oxford Legal Studies Research Paper No. 62/2010; ECGI - Finance Working Paper No. 300/2010, April 2011), *avialable at* http://ssrn.com/abstract=1678028.

[259] *Id.,* John Armour et al., at 2 ("The threat of fines from the FSA are seen as a **footling expense, just another cost of doing business, no different from paying the quarterly phone bill. The embarrassment factor no longer counts for much, alas.** There is not much shame in being on the receiving end of a fine. Only the size of the fine has come to matter. In some areas, this has proved laughably inadequate in producing better behaviour.") citing THE TIMES, July 7, 2009 (emphasis added). *See also,* John C. Coffee Jr., *Law and the Market: The Impact of Enforcement* 39-41, nn.73-75 (Colum. Law & Economics Working Paper No. 304, 2007) (noting that in 2005/06, the financial penalties imposed by the SEC exceeded those imposed by the U.K.'s Financial Services Agency by a thirty-to-one ratio, and a ten-to-one ratio after adjustment for differences in market capitalization), *available at* SSRN: http://ssrn.com/abstract=96748; and Howell E. Jackson, *Response. The Impact of Enforcement: A Reflection*, 156 UNIV. OF PENN. L.REV. 400-411 (2008).

for the true effectiveness of regulatory sanctions.[260] This point was well illustrated in the recent fallout following S&P's self-reported admission of "inconsistencies" arising from potentially conflicting methodologies of the rating process for new and existing CMBS deals. Not only did the S&P share price fall by at least five percent,[261] but issuers also responded by withholding their CMBS business from the firm.[262]

For instance, Goldman Sachs and Citigroup cancelled a $1.5 billion commercial mortgages securitization transaction in July 2011. Firstly, such actions allow a real fear of credible sanctioning to exist, and secondly, it allows for greater efficiency in re-allocating any collected penalty amounts by relying on the market rather than on regulators. The second potential consequence lies in merit in the assertion that there would merely be a shift of lobbying focus and effort by the issuers away from CRAs and towards the RAB

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[260] Id., John Armour et al., at 27 (Judge rules that S&P misled derivative investors).

[261] *See,* Aline Darbellay, *Competition and CRAs*, Credit Rating Agency Conference, Stockholm University, Stockholm, Sweden, June 14, 2012.

[262] See, e.g., Stephen Foley, *Rating agencies clash over standards*, FINANCIAL TIMES, Nov. 6, 2012, at 25; Nicole Bullock, *S&P to overhaul property bond ratings*, FINANCIAL TIMES, June 4, 2012 ("… [N]o issuer has since hired S&P to rate a commercial property deal backed by a pool of loans …"), *available at* http://www.ft.com/intl/cms/s/0/a1eb1e3a-ae8d-11e1-94a7-00144feabdc0.html (last accessed May 5, 2016).

panelists,[263] which would present a less efficient outcome.[264] The third potential consequence is that the proposal seems to ignore the fact that one of the main reasons why the banks were able to game the ratings process prior to the 2007 crisis was because disclosure and insight into the CRA's rating models and methodologies, however acquired (i.e. either through knowledge transfer, personnel transfer or by trial and error), allowed the banks to reverse-engineer their securities in order to gain higher ratings. The *Bathurst Regional Council v. Local Government Financial Services Pty Ltd.* (No 5) (2012)[265] case

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[263] *See e.g.,* Sarah N. Lynch, *S&P balks at SEC proposal to reveal rating errors*, REUTERS, Aug. 10, 2011 (noting an OpenSecrets.org report that the Big Three spent over $1 million to lobby Congress and federal agencies in the eight months to August 2011 to influence changes and revisions to the DFA regulations), *available at* http://www.reuters.com/article/2011/08/10/us-financial-regulation-sandp-idUSTRE77901S20110810 (last accessed Aug 15, 2012). *See also,* Coffee, *97 Cornell L. Rev., 10 January: 1019,* 1029-30 (2012) (arguing against the mandatory sunset system suggested by Romano, and instead favouring the oscillative characteristics - which he terms the "Regulatory Sine Curve" - of the relationship between the enactment of tough legislation as a response to public outcry and the subsequent period of parrying back or rescission of these clauses in response to political lobbying directed by and on behalf of the regulated industry's players). *Contrast,* Robert Teitelman, *'John Coffee and his theory and practice of financial reform'*, (comment, The Deal Economy, 13 Mar. 2012)(critical review highlighting several possible conflicts in Coffee's 'regulatory sine curve' proposition, and concluding that with all stakeholder groups lacking in trust, whether, even in a democracy, finance is too important to be entrusted to voters), *available at* http://www.thedeal.com/thedealeconomy/john-coffee-and-his-theory-and-practice-of-financial-reform.php#ixzz2Eff52bhM (last accessed Dec 18, 2015).

[264] Coffee, *97 Cornell L. Rev., 10 January: 1019,* 1026 (2012) (suggesting that the implementation process, which may be construed to include the impact of lobbying efforts, results in a refinement (read, improved efficiency and effectiveness) of the original legislation).

[265] *Bathurst Regional Council v Local Government Financial Services Pty Ltd.* (No 5) (2012) (No 5) [2012] FCA 1200, Nov. 5, 2012, (Court noting that ABN Amro had employed two former S&P employees with knowledge of the S&P rating model to reverse engineer the rating, and thereby game the S&P model), at 1, remark 13 and 14, *available at* http://www.austlii.edu.au/au/cases/cth/FCA/2012/1200.html, (last accessed May 5, 2016); and Jan-Pieter Krahnen, *In Rating Regulation, Sometimes Less is More*, CENT. FIN. STUD., (2) at 2, 2009 (disclosure of rating methodologies encourages banks and companies to devise financial products that game the CRA models).

is a landmark case which looked at the aforementioned issues, and this dissertation reviews the case in greater detail under chapter 6 and 7.

On the other hand, the Lemieux–Cantwell Amendment sought to erase the grandfathering problem by removing references to CRAs from the rules and regulations. However, it does so without offering an alternative. The absence of a practical alternative will more likely than not lead consumers towards the Big Three (and the other more established CRAs), thereby further entrenching their market positions. Moreover, it shifts the burden of creating such an alternative to other governmental agencies. The greater governmental role championed by both amendments also shifts the discussion towards the question of the government's own exposure to liability lawsuits in the event that investors are dissatisfied with a rating generated by a CRA which has been selected by the RAB. Overall, it is worth noting that the final version of the Dodd-Frank Act preferred the more accommodating Lemieux–Cantwell Amendment[266] over the seemingly stricter measures proposed in the Franken Amendment.

3.3.2. Ancillary services

Next to the fees earned from rating securities, the provision of ancillary services is also a major source of revenue for CRAs and this further complicates the remuneration debate. A Goldman Sachs executive described the relationship between his bank and CRAs as one constituting a "multi-faceted relationship".[267] The interconnections referred to in his statement revolve around instances where: (i) CRAs rate Goldman Sachs itself; (ii) CRAs rate the securities products that the bank constructs, and where; (iii) CRAs rate

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[266] Passed in Senate vote 61 to 38 in favour, with one abstention. *See also*, Bainbridge, *supra* note 211, at 1796-97 (citing the Cantwell- Schumer Shareholder Bill of Rights as an example, Bainbridge acknowledges that tougher measures were either excluded entirely or only their drastically watered-down versions were included in the final version of the bill).

[267] See, section 3.3.1.4. above.

securities for issuers for whom the bank acts as an advisor. The ancillary services[268] are often understood to refer to consultative and advisory services that CRAs make available to clients, but which also include providing risk management software, economic analysis, training and professional services which transcend the period from pre- to post-rating of a security instrument. Moody's Analytics was created in January 2008 by Moody's Corporation as a reportable segment to house the ancillary non-rating commercial activities of the firm by providing products and services to support the risk management activities of the firm's institutional clients. More typical when rating structured financial products than other instruments, is that discussions are held in an iterative or 'offer and counter offer' process cycle until a structure and a matching rating is agreed to by both parties (i.e. the CRAs on one side of the transaction and the issuers or their advisors on the other).

It should be noted that financial services firms have over time acquired significant expertise in structuring securities in order to optimize the credit ratings assigned by CRAs to securities. In essence, the process itself involves a series of submissions of potential structures to CRAs who in turn respond with comments and hypothetical scenarios and the potential ratings such structures and adjustments would receive.[269] This process allows issuers to gain an indication of both the security's potential rating in order for them to be able to better gauge investors' appetite for the envisaged product.

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[268] S&P define ancillary service to mean "a product or service that S&P Ratings Services provides or sells that is not a Credit Rating or Credit Rating Activity and is either a market forecast, an estimate of economic trends, a pricing analysis, other general data analysis, or distribution services related to a Credit Rating, a market forecast, an estimate of economic trends, a pricing analysis, or general data analysis", *available at* http://www.standardandpoors.com. Similarly, Moody's define ancillary services as those products and services that "are market forecasts, estimates of economic trends, pricing analysis, or other general data analysis, as well as related distribution services", and are not therefore not directly considered as credit rating services, *available at* http://www.moodys.com.

[269]See e.g., Jesse Eisinger, *Moody's Ratings Fiasco,* PORTFOLIO.COM, (2007).

However, it is this behind-the-scenes horse-trading that most clearly underlines the conflict of interest charge leveled at CRAs. The IOSCO 2008 report noted that, when compared to traditional bonds, the rating process for structured products appears to be in reverse.[270] The reversal in question refers to the point at which the rating is determined in the rating process; namely, whereas the rating of traditional bonds starts with a bond that seeks an 'objective' CRA rating; the rating of structured products starts first with a desired target rating for the respective tranches and then financial engineering specialists proceed to structure a constellation of these tranches (within acceptable limits) into a product tailored to "fit" the desired rating. AAA-rated securities are coveted because they are significantly more liquid and have a larger market than lower rated securities. Not surprisingly, as reported by Fitch in 2007, 60 percent of all global structured products were AAA-rated, in contrast to less than one percent for corporate issuers.[271]

Rate-shopping is a practice by which either the issuers or the advisory firms representing them seek out the CRA prepared to assign their securities the highest possible credit rating, or obtain several ratings and only elect to disclose the highest rating. It seems likely to have occurred in instances where issuers or their advisors were able to simply walk away from a rating agreement, or merely threaten to do so, when faced with the prospect of receiving a rating that they were not satisfied with. As a consequence of this practice CRAs came under significant pressure to ensure that their ratings would be attractive enough so as not to impede their future rating transaction pipeline with the clients or their advisors.[272]

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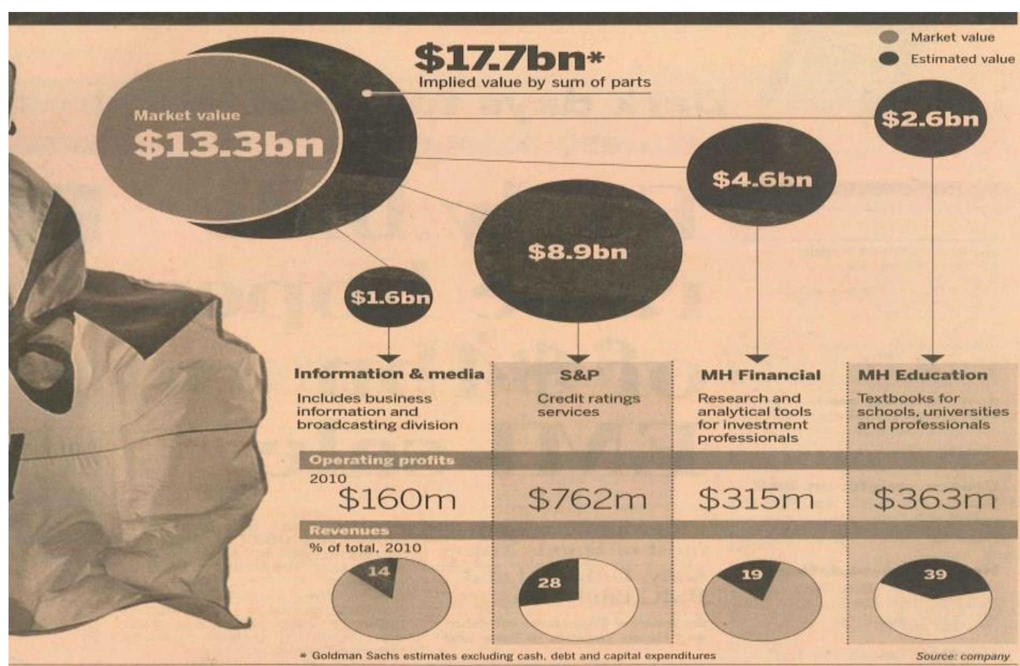
[270] IOSCO, *Ratings in structured finance: what went wrong and what can be done to address shortcomings,* Comm. on the Global Fin. Sys., No. 32, at 5 (2008).

[271] Joshua D. Coval, Jakob Jurek & Erik Stafford, *The Economics of Structured Finance* 5 (HBS Finance Working Paper No. 09-060, 2008).

[272] *See,* Carl Levin & Tom Coburn, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, SENATE COMM. HOMELAND AND GOVERMENTAL AFFAIRS April 13, 2011.

Figure 6 below depicts the McGraw-Hill Group of Companies' revenue distribution for 2010 in which S&P's contribution to total group revenue was 28 percent. This placed it behind MH Education with 39 percent but comfortably ahead of both MH Financial and the Information & Media groups with 19 percent and 14 percent, respectively. S&P's high operating margins allowed it to earn $84 million more in 2010 than for MH Financial and MH Education combined. It is because of the high and sustained profitability of S&P's business that the accompanying article called for the McGraw-Hill Group of Companies to be split-up as a means of unlocking a projected additional $4.4 billion in market value implied by the value of the sum-of-parts as calculated by Goldman Sachs. The projection estimated the market value of a stand-alone S&P of $8.9 billion, just over 50 percent of the envisaged sum-of-the parts total of $17.7 billion, largely driven by its very high operating margins.

Figure 6: McGraw-Hill revenue distribution 2011



Source: Financial Times, Sept.11, 2011, at 9.

Figure 7: Profitability (Moody's vs. Fitch Ratings)

Source: Fitch Ratings – About us, available at www.fitchratings.com (last accessed Sept. 15, 2013)

Figure 7 (above) compares Moody's revenues with those of Fitch between 2001 and 2010. The graph shows that Moody's, similar to S&P, enjoys very high operating margins, averaging between 40 percent and 60 percent over the last five years. However, Fitch's operating margins which have averaged between 30 percent and 20 percent, are still significantly lower than those of the Big Two. Nonetheless, all three firms are incomparably more profitable than other publishing houses to which they often compare themselves; so much so that their profitability and share price performance has over the last two decades even outstripped that of large investment banks.[273] Moody's also cites financial services firms like Alliance Bernstein and Blackrock in its Annual Report's Compensation Discussion and Analysis section for example, with the McGraw-Hill Companies, Inc., Morningstar Inc., and MSCI only constituting a minority of its listed

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[273] Frank Partnoy, *Credit Rating Agencies versus Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? at 97 (2006).

comparable peers.[274] The comparison itself is not surprising, particularly when one notes the gross discrepancy in size and profitability between the Big Three and the other NRSROs.

The question which then arises is whether the stellar economic performance by these CRAs is due to superior strategy and execution or due to a market failure?[275] The extent to which CRAs can truly be objective and independent in light of the evident assistance and guidance that they provide issuers in the course of structuring securities through the iteration process[276] has become a recurring but still unanswered question.[277] In other words; can a chef be expected to objectively assess the quality of a meal in which he himself has participated in preparing, more-so where the result of such an assessment is directly tied to their own financial well-being?[278] This question has been relied upon to

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[274] Moody's 2011 Schedule 14A, (2011), *available at* http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=8466665&SessionID=IxycFCg1k65_KE2#D290401DDEF14A_HTM_TOC290401_37 (last accessed Mar. 10, 2015).

[275] Justin Pettit's comment to Chapter 3 in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? at 100-102 (2006).

[276] Ben Protess and Lagan Sebert, *Courts examine credit raters' 'intimate' relationship with bankers* THE CENTER FOR PUBLIC INTEGRITY, Dec. 4, 2009, citing Frank Raiter, a former managing director for Standard & Poor's, (referred to "constant contact" between issuers and CRAs). *Id.,* Comment by Frank Partnoy, former investment banker ("It's one thing to come in after the fact and say, 'What a beautiful building.' But it's another if they first helped build the building."). *See also,* Freeman, Lisbeth, *Who's Guarding the Gate?* 55 VT. L. REV. 585, 603 (2009) (noting how iterative process between CRAs and issuers became a "negotiation", quoting Paul Stevenson, former Moody's executive).

[277] Ben Protess and Lagan Sebert, *Courts examine credit raters' 'intimate' relationship with bankers* THE CENTER FOR PUBLIC INTEGRITY, Dec. 4, 2009)(in meetings with rating analysts, financial institutions would be told what they "need[ed] to do to get as many of the senior bonds rated triple-A"). The authors also assert that despite the give and take, critics insist that CRAs do not structure the securities.

[278] The Dodd-Frank Act at H. R. 4173-510, Section 939F, (a) and (c), requires the SEC to carry out and study the "credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models" and to present a report to the Committee on Banking,

anchor numerous lawsuits that have been brought against CRAs, as will be addressed in Chapter 4.

3.3.3. Gatekeeper status

In November 2003 SEC Commissioner Goldschmid in his lecture to the Bar Association of the City of New York conceded that:

"[T]he checks and balances that we thought would be provided by independent directors (acting pursuant to the monitoring model), independent auditors, securities analysts, investment and commercial bankers, rating agencies, and lawyers too often failed."

Regarding the corporate governance role of lawyers in gatekeeping specifically, Goldschmid explained that to him the term 'gatekeeper' suggested "a guardian with independent professional responsibilities, including a responsibility for protecting the institution".[279] If the SEC ascribes such a responsibility and/or a duty to protect the institution, and we assume that the institution referred to in this instance is a CRA as a corporation then, to what effect? For, if the implication is that CRAs have a duty to protect their institution's constituents, then who exactly are these "constituents"? Moreover, if, as could somewhat more abstractly be argued, among the CRAs' responsibilities a duty to protect the whole market system is included, then further questions must arise: Should such a function be entrusted to a privately-owned and profit-oriented enterprise? And what of a private enterprise's standing economic obligations towards its own shareholders and employees for shareholder value maximization?

Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives within 24 months of the enactment of the Act.

[279] Harvey J. Goldschmid, *A Lawyer's Role in Corporate Governance: The Myth of Absolute Confidentiality and the Complexity of the Counseling Task* (SEC Commissioner Speech, Nov. 17, 2003), *available at* http://www.sec.gov/news/speech/spch111703hjg.htm.

Corporate governance theory and agency theory clearly assert that a corporation belongs to its shareholders while the shareholders engage expert managers to run the company on their behalf.[280]

Or should such an institution, as suggested by Gavras,[281] become a government-run utility? The fear of governmental overreach notwithstanding,[282] public policy theory suggests that when such a business model exists, then it should ideally be under the control of the state to guard against abuse or exploitation by private entities. The definition offered by Gavras that recognizes accurate ratings as a public good echoes the definition by Stiglitz regarding non-rivalness and non-excludability.[283]

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[280] *See,* ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, 113-114 (U.S. Transaction Publ., 1932) (1932) ("If we are to assume that the desire for personal profit is the prime force motivating control, we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit-seeking controlling group"). *See also*, Michael C. Jensen & William, H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. (4), 305, *passim* (1998) (agency theory and its relationship to the "separation and control" issue); and Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review,* 14 ACAD. MGMT. REV. (1) 57, 68-69 (1989) (compares the positivist with the principal-agent stream and concludes that agency theory is a useful complement to organizational theory).

[281] Panayotis Gavras, *Regulatory abdication as public policy: government failure and the real conflicts of interest of credit rating agencies*, 10 S.E. EURO. & BLACK SEA STUD. (4) 475, 482 (2010).

[282] Peter Wallsten, *Obama plans to turn anti-Wall Street anger on Mitt Romney, Republicans*, WASH. POST, Feb. 22, 2012 ("GOP leaders say the Wall Street law is government overreach") (*available at* https://www.washingtonpost.com/business/economy/obama-plans-to-turn-anti-wall-street-anger-on-mitt-romney-republicans/2011/10/14/gIQAZfiwkL_story.html (last accessed September 20, 2018).

[283] JOSEPH E. STIGLITZ, *KNOWLEDGE AS A GLOBAL PUBLIC GOOD*, in *GLOBAL PUBLIC GOODS: INTERNATIONAL COOPERATION IN THE 21ST CENTURY.* 1st ed. USA: Oxford University Press, 308-25 (1999); and Joseph E. Stiglitz, *The Theory of International Public Goods and the Architecture of International Organizations* (U.N. Background Paper 7, 1995) (Stiglitz identifies five global public goods, namely; (1) international economic stability; (2) international security (political stability); (3) the international environment; (4) international humanitarian assistance; and (5) knowledge), (1995). *See also,* Jeffrey D. Manns, 87 N.C.L.

The non-rivalness criterion is based on the premise that since the public good does not lose value when consumed by an additional person, the marginal cost of benefiting from it is therefore zero, and like air, the stipulation that none therefore should be excluded from consuming it, too, is both met and convincing. However, the argument that the non-excludability criteria,[284] by which no-one can be effectively excluded from enjoying goods, while also being met, seems less plausible. This is because NRSROs in particular not only have the option to charge prohibitively high fees for their ratings but they may also elect either to only provide ratings on a subscriber-pays basis or to restrict the ratings to private use. In making his argument, Stiglitz posits that knowledge is a global public good which can only be efficiently consumed by public provision thereof and for which he recommends compulsory taxation to address the free-rider problem that typically arises from the consumption of public goods. Similarly, Gavras argues that accurate ratings are themselves public goods,[285] and hence views the role hereto afforded to CRAs as a consequence of the abdication of duties by the government.[286]

REV. 1011, 1060-61 (2009) (on the non-rival consumption and non-exclusion of non-payers characteristics of CRA ratings). *Contrast,* Thomas J. DiLorenzo, *The Myth of Natural Monopoly*, 9 REV. AUSTRIAN ECON. (2) 43, 58 (1996) (asserts that the concept of a *public utility* is merely an ex post rationalization of monopolistic power).

[284] John C. Coffee Jr., *Ratings Reform: The Good, The Bad, and the Ugly*, 31, 58 (ECGI Working Paper Series in Law, Working Paper No.162, 2010).

[285] *See also,* Jeffrey D. Manns, *Rating Risk After the Subprime Mortgage Crisis*, 87 N.C.L. REV. 1011, 1060 (2009) ("[R]atings squarely fit within understandings of what constitutes a public good"); and Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Rating Accuracy Through Incentive Compensation*, 27 YALE L. J. ON REGULATION 91, 102 (2010) (ratings have similar characteristics as public goods).

[286] Panayotis Gavras, *Regulatory abdication as public policy: government failure and the real conflicts of interest of credit rating agencies*, 10 S.E. EURO. & BLACK SEA STUD. (4) 475, 482 (2010). *See also,* Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L.Q. 43, 81, 91 (2004) (Partnoy refers to CRAs as a "paradox", and Hill to an "analytic puzzle"; the latter noting that though CRAs "may resemble regulatory agencies in some respects, but….they are (however) not regulatory agencies") and ("Ratings are not an

Figure 8 below shows both the shareholding breakdown of S&P and Moody's and in particular highlight the very extensive cross-shareholding by private investors in S&P and Moody's while Figure 9 shows that of Fitch Ratings. Cantor and Packer, for instance, refute that such ownership structures would generally present a conflict of interest problem.[287] This notwithstanding, in November 2012, the EU Parliament and Council agreed to limit cross-shareholding at a five percent threshold.[288] The argument that these private investors, alongside the issuers of debt securities, are the parties to whom a duty of care or performance can or should be owed seems reasonable. Less convincing is the claim put forward by typically third-party private investors that they too are duly owed a duty of care.[289] Owing to the absence of a contractual obligation[290] binding CRAs and

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insurance against changes in the world"). *See also, Shape shifters*, THE ECONOMIST (2012) (Although acknowledging that the audit firms dispute the label, a former SEC chief accountant similarly referred to audit firms as "public utilit[ies]")

[287] Richard Cantor & Frank Packer, "The Credit Rating Industry." *Federal Reserve Bank of New York, Q. Rev.*, Summer 1994: 1-26, at 2. *See also,* Jone Engh, *'Control of Ownership and Related Matters in the EEA'* (Stockholm Centre for Commercial Law, Stockholm Univ., June 14-15, 2012) (EU regulators have no rules on "ownership control" as their sole obligation is to inform on the ownership structure; E.C. Reg. No. 1060/2009). *Compare,* Manon Malhère, *Credit ratings agencies: Consensus on stricter rules*, EUROPOLITICS, Nov. 28, 2012 (EU regulations that prohibit CRAs from rating their own shareholders - albeit, above a 10 percent of capital threshold - and instruments in which their shareholders are invested), *available at* http://www.europolitics.info/europolitics/credit-ratings-agencies-consensus-on-stricter-rules-art345670-46.html (last accessed Dec. 4, 2013).

[288] *See e.g.,* Manon Malhère, *Europolitics.info.* 2012. ("[A]n investor who holds a share of at least 5% in a credit ratings agency will not be authorised to hold shares of 5% or more in another ratings agency").

[289] *Compare,* Martha Coakley, *Rating Agency Consents and Regulation AB*, SEC Letter (2011) at 1 (arguing that the DFA advances the "duty of competence" NRSROs owe investors under §11 of the Securities Act).

[290] *See e.g.,* Lohman H.A. de Savornin & M.G. van't Westeinde, *Control and Liability of Credit Rating Agencies under Netherlands Law*, ECJL (discussing contractual liability and non-contractual liability under Dutch law which would recognize a service contract, ("overeenkomst van opdracht") between CRA and issuer, governed by Articles 400-413 of Book 7 of the Dutch Civil Code (DCC)) (2007).

private investors, dissatisfied investors have sought compensatory redress from courts by claiming "near privity". The "near privity" claims are because the privity doctrine clearly states that "a contract cannot, as a general rule, confer rights or impose obligations arising under it on any person except the parties to it".[291]

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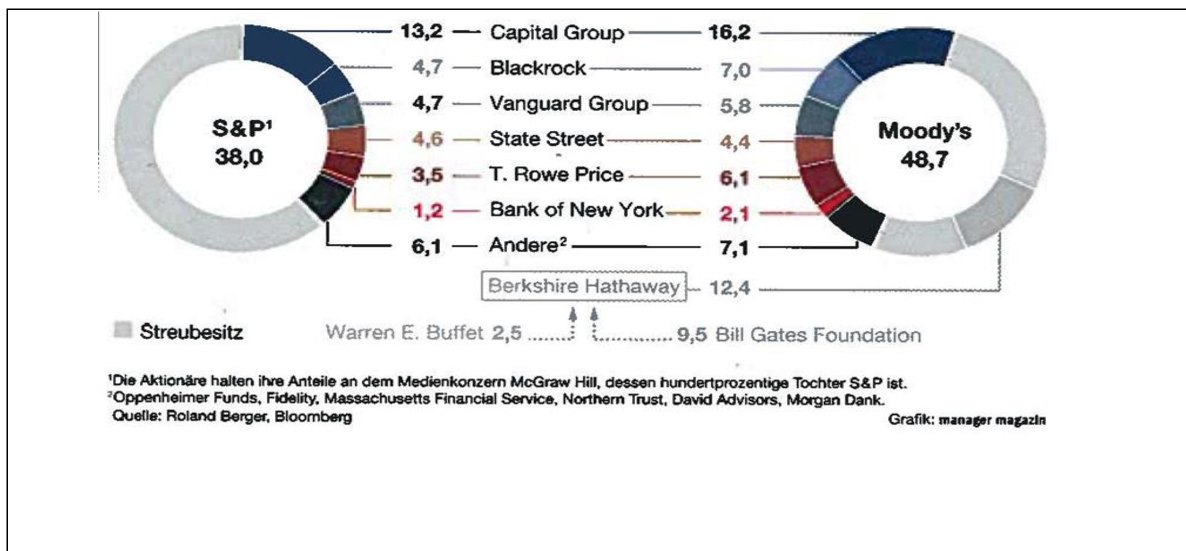
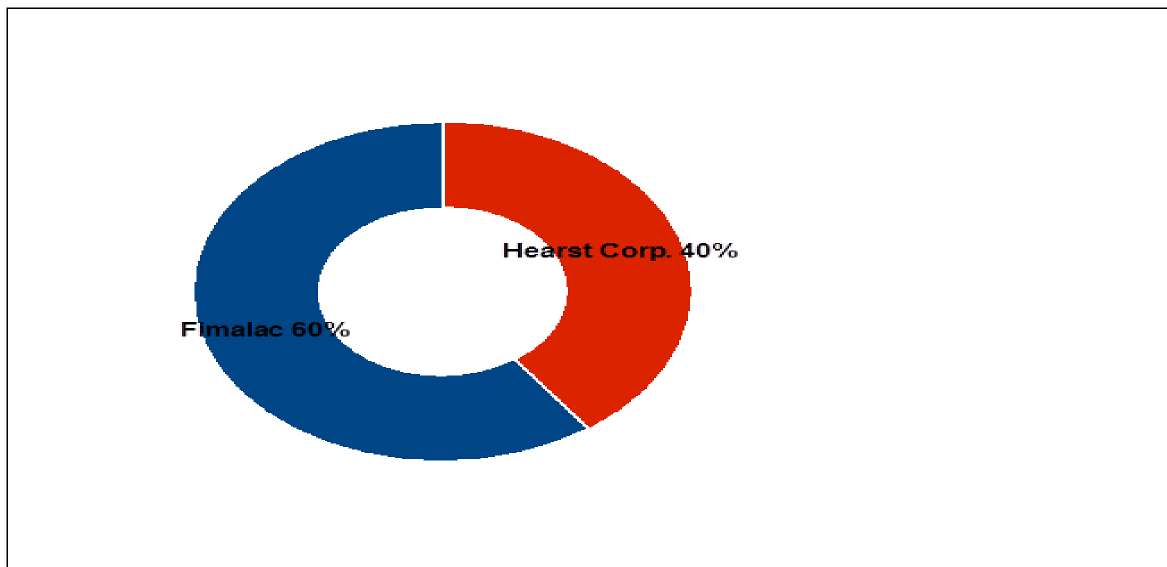
[291] G.H. TREITEL, THE LAW OF CONTRACT, Sweet & Maxwell, London, UK (2003), (discussing, generally, the doctrine of privity and the exemptions allowed under it, e.g. for collateral contracts). *See also,* Lisbeth Freeman, *Who's Guarding the Gate? Credit Rating Agency Liability as "Control Person" in the Subprime Credit Crisis*, 55 VT. L. REV. 585, 593, 604 (2009) (positing the "Control Person Liability" provisions under §20(a) of SEC Act 1934 as offering best odds of successful litigation against CRAs; also notes the plaintiff's burden of proof is complicated by the requirement to plead with particularity before courts). *Contrast, Boca Raton Firefighters & Police Pension Fund v. Bahash, et al.,* Case number 12-cv-1776, U.S. Court of Appeals 2nd Cir.(2012), (dismissing control person liability claim under Rule 10b-5.); and see 2nd Cir. Court's summary order, at 7, *available at* http://www.structuredfinancelitigation.com/files/2012/12/Second-Circuit-SP.pdf.

Figure 8:(Cross)-shareholding in S&P and Moody's



Source: Manager Magazin

Figure 9: Shareholding in Fitch Ratings



Source: FitchRatings.com – About us.

Additionally, the privity doctrine requires that the promisee must have given the promisor some consideration as was ruled in *Dunlop Pneumatic Tyre Co. Ltd.,* (1915) A.C. (H.L.)[292] Among the exemptions provided for under the doctrine, includes one that caters for third parties who have a claim on the merit of being the intended beneficiaries of a contract between two other parties, for example, between a CRA and an issuer. Judge Cardozo first applied the near-privity test to define the extent and scope of an accountant's duty - as a gatekeeper - to non-clients for negligence in the decision in *Ultramares Corp. v. Touche* (1931).[293] The near privity doctrine has since been considered in several recent lawsuits involving auditing firms and CRAs.[294]

However, the decision in *United States v. Arthur Young & Co.,* (1984)[295] starkly contrasts with the privity doctrine. In that case, the Supreme Court ruled that by virtue of its watchdog (i.e. gatekeeper) status, Arthur Young – an independent public accountant or auditor hired by a corporation – owed "ultimate allegiance"[296] to the corporation's creditors, stockholders, as well as the investing public at large which transcended their

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[292] *Dunlop Pneumatic Tyre Co. Ltd. v. Selfridge & Co. Ltd.,* (1915) A.C. 847, 853 (H.L.) (UK). *See also,* John N. Adams, Deryck Beyleveld & Roger Brownsword, *Privity of Contract - the Benefits and Burdens of Law Reform* (1997) 60:2 MOD. L. REV. 238, 248; and *Currie v. Misa*, (1875) 10 L.R. Exch. 153 (Ex.), 162 (UK) (defining "valuable consideration" as consisting of "either in some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other").

[293] *Ultramares Corp., 255 N.Y. 170, 179 (1931).*

[294] *See e.g., Credit Alliance Corp. v. Arthur Anderson & Co.*, 65 N.Y.2d 536, 553 (1985) (modified *Ultramares* by introducing a 3-prong test; namely (i) The [CRA] must have known that their work product was to be used for a specified purpose; (ii) The work product was intended to be relied upon by a known party (or parties); (iii) There must have been some conduct on the part of the [CRAs] linking them to that party or parties, which evinces their understanding of that party or parties' reliance. *See also, LaSalle Nat'l Bank v.Duff & Phelps Credit Rating* (1996).

[295] 465 U.S. 805, (1984).

[296] 465 U.S. 805, 818 (1984).

employment contract with their client.[297] In other words, in this decision, the Supreme Court held that gatekeepers are deemed as owing an assumed allegiance of service performance to third-parties who may rely on their service, irrespective of the absence of a contractual obligation between the gatekeeper and said the third parties. Recognizing CRAs as gatekeepers brings them under this ruling and creates the premise upon which their liability for erroneous ratings can be challenged.

3.4. Market structure and liability

3.4.1. Civil liability

Following a broad overview of the CRA industry in general and the criticisms levelled therein, we now examine their impact on the key issue of the civil liability[298] of CRAs. For most of their existence CRAs generally, and NRSROs in particular, have robustly contended that as publishers, their ratings were merely opinions that are protected by Article I of the amendments to the U.S. Constitution; Article I prohibits Congress from making laws "… abridging the freedom of speech, or of the press…". Among the suggestions put forward for improving CRA accountability includes putting in place a regulatory framework to encourage competition and litigation in the industry.[299] Exposure

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[297] 465 U.S. 805, 817 (1984).

[298] §11 (SEC '33) imposes "strict civil liability" on gatekeepers for materially false registration statements. *See, e.g.,* Jonathan S. Sack & Stephen M. Juris, *Rating Agencies: Civil Liability Past and Future*, 238 N.Y.L.J. (88) (2007).

[299] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, CII, April 2009, at 14 (liability exposure encourages gatekeepers away from acting negligently, recklessly or fraudulently). *Compare*, Jeffrey D. Manns, *Rating Risk After the Subprime Mortgage Crisis*, 87 N.C.L. REV. 1011, 1047 (2009) (at least pre-DFA, CRAs had responsibility without accountability which posed a moral hazard threat). *But see,* Timothy M. Sullivan, *Federal Pre-emption and the Rating Agencies,* 94 MINN. L. REV., 2136, 2151-53 (2010) (introducing liability will not correct or improve rating quality any better than the market).

to civil liability has often been suggested as the antidote to the perceived lack of accountability exercised by CRAs.[300] For instance, two forms of liability-enhancing rules proposed by Coffee involve introducing either negligence-based liability or a modified form of strict liability.[301] Partnoy posits that the latter is the superior of the two options as it would encourage CRAs in their role as gatekeepers to investigate the issuers more purposefully, ensure that the social cost for any fraud would also be borne by the issuers, and avoid the reliance on the court system to adjudicate the fallout from dysfunctional gatekeeper behavior, *ex post.*[302]

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[300] *See e.g*., Jeffrey D. Manns, *Rating Risk After the Subprime Mortgage Crisis,* 87 N.C.L. REV. 1011, 1024 (2009) (imposing liability as the conventional solution for addressing gatekeeper noncompliance).

[301] A "strict-liability crime" is defined as "[a] crime that does not require a *mens rea* element." Black's Law Dictionary 429 (9th ed. 2009). Hence it refers to the legal responsibility for damages, or injury, even if the person found strictly liable was not at fault or negligent, such as in cases involving damages caused by livestock. *See e.g., Greenman v. Yuba Power Products*, 59 Cal. 2d 57, 377 P.2d 897 (1963) (California Supreme Court's adoption of strict tort liability to cover defective products). *See also,* Leonid Traps, *Knowingly": Mens Rea Distribution in Federal Criminal Law after Flores-Figueroa*, 112 COLUM. L. REV. 628, 630 (2012), for an examination of *mens rea* application by state courts in cases involving offenses involving "offenses involving minors, felon-in-possession offenses, and immigration offenses".

[302] Partnoy, '*Not Like Other Gatekeepers'*, 2006, at 96. *See also,* John C., Coffee, Jr. *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B. U. L. REV. 302–364 (2004); John C. Coffee, Jr., "*Partnoy's Complaint: A Response*", 84 B.U. L. REV. 377, 377-80 (2004) (arguing that unlike Partnoy's suggestion to hold the gatekeeper liable for a percentage of the damages due from the issuer, under a true strict liability rule proposed by Partnoy (in *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U.L. Q. 491 (2001)) in order to be properly incentivize, the gatekeeper should be held liable even when the issuer is not; Jeffrey D. Manns, *Rating Risk After the Subprime Mortgage Crisis,* 87 N.C.L. REV. 1011, 1077-78 (2009) (positing that strict liability is more efficient than the alternative litigation route through the courts as it would - by default - require CRAs to determine the optimal levels of compliance) (2009). *Contrast,* Assaf Hamdani, *Gatekeeper Liability*, 77 S.CAL. L.REV. 53 (2003) (preferring the restoration of aiding and abetting liability over strict liability); and Jennifer Arlen & Reiner Kraakman, *Controlling Corporate Misconduct: An analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 689-91 (1997) (suggesting that the traditional strict liability and duty-

The legal arguments regarding the extent to which CRAs can be held civilly liable for the ratings opinions subsequent to enactment of the Dodd-Frank Act, will be specifically addressed in chapter 4 of this dissertation, as will the two predominantly conflicting schools of thought regarding rating agency liability[303]. The first argues that liability is necessary in order to curtail and counteract the impact of the prevailing perverse incentives that reward CRAs for providing purposefully inflated ratings. The second argues that ratings are merely opinions on the relative credit risk of securities and are not guarantees of performance and that reputational risk is a controlling and sufficient factor in the governance of CRA actions.

The arguments in favor of increasing the accountability and liability of CRAs post the 2007 crisis have with increasing frequency been made by legislators, academics and other commentators.[304] It is concerning that the terms ‘accountability’ and ‘liability’ have been applied both simultaneously as well as inter-changeably when discussing possible remedies for correcting this impasse. The concern is because, while both of the aforementioned terms infer a requirement for a party to account and accept responsibility for its acts of omission or commission, only liability introduces the prospect of an enforceable civil remedy or criminal punishment against a party.[305] The arguments that a rating is comparable to any other product that “has been paid for”, and suggestions that referring to a rating as an “opinion” merely – and possibly unfairly – shield it from any

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based liability both fail to incentivize gatekeepers to monitor, investigate or report wrongdoing, and therefore recommend a mixed or composite liability where gatekeeper liability is reduced if they execute their surveillance role satisfactorily).

[303] Timothy M. Sullivan,“Federal Pre-emption and the Rating Agencies: Eliminating State Law Liability to Promote Quality Ratings.” *94 Minn. L. Rev.*, 2136, 2146-47 (2010).

[304] *See e.g*., H.R. 4173- 497, §931 (5). See also footnote 8, above.

[305] *See e.g.,* Jules L. Coleman, *The Morality of Strict Tort Liability*, 18 WM. & MARY L. REV. (2) 259-286 (1976), and Jules L. Coleman, "Liability and Assignability", podcast seminar presented at the workshop "Tort Law, Morality and Social Justice", held at the University of Girona on December 17 and 18, 2012, available at https://www.youtube.com/watch?v=W8_2L2OEITo (last accessed Sept. 20, 2018).

liability whatsoever, even when the rating later proves to be faulty have been made by scholars and commentators.[306] These arguments dovetail with current literature[307] and recent court decisions that either reasoned or have been decided on the premise that for CRAs to be considered liable, one has few alternatives in law but to regard the rating opinions as consumer products against which damages may legally be sought by plaintiffs. Such a line of argumentation leads us to the tort provisions under Common Law.

Part II of this dissertation will expand on this premise by identifying, reviewing and critiquing the principles held in the key court case decisions to date.

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[306] *See e.g.,* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV., 1553, 1687 (2008) ("[R]ating agencies have been eminently successful in avoiding liability on account of allegedly incorrect ratings they issue."); Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L., 541, 352 (2006). ("[C]redit rating agencies have generally been able to avoid liabilities …."); and Markus Krall., *Europe Needs a Rating Agency,* (comment, in Frankfurt Main Finance e.V. magazine, at 54 (2011).

[307] *See e.g.,* Kenneth C. Kettering, *Securitization and Its Discontents,* 29 CARDOZO L. REV, 1553, 1687 n.202 (citing a 2002 Congressional staff study which asserted that CRAs were "officially shielded from liability for all but fraud under their securities law' [and are not] held even to a negligence standard of care for their work."); and Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 13 J. LEGIS. & PUB. POLICY, 253, 286 (2010) (NRSROs are "not held to a negligence standard of care."); Theresa Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation,* 94 MINN. L. REV., 140, 167 (2009) ("…[S]o the rating agencies should not escape liability by hiding behind a First Amendment shield to which they are not entitled.")

3.4.2. Poor ratings quality

"What is a better rating? To an issuer, it's an AAA rating. To an investor who holds a bond, it's a rating that is never reduced. To potential buyers of the bond, it's a rating that accurately reflects default probabilities and that is comparable across issuers and industries." – Bo Becker. Professor, Harvard Business School[308]

"Poor quality ratings", as represented in Figure 2 above, reflect criticism of the quality of rating opinions themselves. Rating quality refers in part to the question of the informational value of rating even as Partnoy asserts that "there is overwhelming evidence that credit ratings are of scant informational value".[309] Partnoy makes reference to survey data which finds that: (i) Most purchases of rated debt instruments are by sophisticated

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[308] Rachel Wolcott, *Financial Regulatory Forum: Start-up rating agencies urge national regulators to promote competition, change*, REUTERS, Aug. 15 2011, http://blogs.reuters.com/financial-regulatory-forum/2011/08/15/start-up-rating-agencies-urge-national-regulators-to-promote-competition-change/ (last accessed Sept. 20, 2018).

[309] FRANK PARTNOY, THE PARADOX OF CREDIT RATINGS in RATINGS AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65 (in R.M. Levich, G. Majnoni & C.M. Reinbart, eds.) New York, Springer, (2002). *See also*, Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, CII, April 2009, at 5 (suggesting that the CRA paradox is due either to the absence of informational value of ratings as a controlling factor in the profitability of ratings, or because of the exemption from civil liability enjoyed by CRAs either under § 11 of the 1933 Act or under CRARA of 2006). *Compare,* Christian Hirsch & Christina E Bannier, *The Economics of Rating Watchlist: Evidence from Rating Changes* 19 (CFS Working Paper No. 2008/02, 2007) (study found that the CRA watchlist procedure increases overall information content and thus creates higher informational quality); Benedikt Carl Frey, Peter Neuhäusle & Knut Blind, *Patent Information and Corporate Credit Ratings: An Empirical Study of Patent Valuation by Credit Rating Agencies,* at 29, Oct. 18, 2011 (study of intangible assets (i.e. patents) on the positive contribution of CRAs to informational efficiency. Frey et al, conclude that the mixed findings on the informational efficiency of CRA ratings arises due to the difference between how stock markets and CRAs value forward citations differently due to the economic distinctions that exist between debt and equity).

institutional investors who do their own investigation into the instruments; and (ii) Investors and issuers consider the informational value of ratings to be low.[310] Hill disagrees with Partnoy on this account, arguing instead that the rating agencies are in fact doing exactly that which they have long claimed to be doing, which is to rank virtually all debt issues (and the companies issuing the debt) by quality as per the veracity of the company statements and documents provided to them.[311] If one accepts the regulatory license argument as put forward by Partnoy and others, then it stands to reason that the decision to remove regulatory requirements for rating from securities regulations was the correct one.[312] Although the DFA's excise of regulatory requirements does not include insurance firms whose holdings of corporate, municipal and foreign bonds is approximately double that of the banks, the decision to remove regulatory requirements would still be correct in order to address the regulatory license concern.[313]

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[310] Frank Partnoy, THE PARADOX OF CREDIT RATINGS, in RATINGS AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 65 (2002). *See also* Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA L. & BUS. REV., 10, 24 (2006)

[311] Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, 1145-1156 (2003). *See also*, Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L. J. 620, 644 (2006) (CRAs are "information intermediaries" that contribute to capital market efficiency by reducing informational asymmetry between issuers and investors); and Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose* 27 YALE J. ON REG. 91, 97 (2010) (CRAs reduce the monitoring burden of debtors for creditors). *But see,* Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, CII, April 2009, at 4 (argues that CRAs have long ceased to behave as information intermediaries as they evolved into their current roles as "regulatory licensors").

[312] SEC, *SEC Final Rules* (2011) (adoption of amendments removing references to credit ratings in rules and forms promulgated under the Securities Act and the Exchange Act), *available at* http://www.sec.gov/rules/final/2011/33-9245.pdf (last accessed Sept. 20, 2018). *See also,* Dodd-Frank Act, H. R. 4173-510, Section 939, Removal of Statutory References to Credit Ratings (2010).

[313] John Patrick Hunt, *Credit Ratings In Insurance Regulation: The Missing Piece of Financial Reform*, 68 WASH. & LEE L. REV. (4) (Art. 3) 1667, 1667 (2011).

In contrast, the response of the European Parliament and Council on Credit Rating Agencies was to propose an EU regulation that would require CRAs to apply for registration by 7 September 2010 in order for their ratings to be valid for regulatory purposes with the EU.[314] The absence of a market for poor quality ratings strongly infers that existing and new entrants are incentivized to produce high quality ratings as inflated ratings (i.e. low quality ratings) would diminish their informational value and eventually erode CRAs' reputation among potential clients.[315]

3.4.2.1. Market-based rating alternatives

Proponents for a more market-based structure to replace the NRSRO ratings system have pointed to the reportedly greater reliance placed by institutional investors on credit spreads for measuring default risk and hence determining a more relative quality than the ratings provided by CRAs.[316] The main arguments for the significant support for such a market-based approach are that it would ostensibly reduce the role, power and influence of CRAs generally – and of NRSROs in particular - while at the same time encourage greater competition between them.[317] In this regard, the Universal Credit Rating Group

[314] EU-Parliament, Article I, Regulation (EC) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, at 1-31, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF (last accessed Sept. 20, 2018).

[315] See section 3.2. above.

[316] *See e.g.,* Frank Partnoy, *The Siskel and Ebert of Financial Markets?* 77 WASH. U. L.Q. REV. (3) 619, 624 (1999) (suggesting that permitting arbitrage could mitigate manipulation and would establish true economics of CDOs in a competitive environment).

[317] Stephan Horan, *Credit ratings agencies come under the microscope*, FINANCIAL TIMES, Sept. 11, 2011 ("Some Europeans have proposed reducing the influence of the Big Three (S&P, Moody's and Fitch Group) by breaking them up") *available at* http://www.ft.com/intl/cms/s/0/e7be74d4-d2f1-11e0-9aae-00144feab49a.html (last accessed Mar. 16, 2016). *See also*, *China Seeks International Debt Rating Agency*, BLOOMBERG, Sept. 6, 2011 (on China's Dagong proposal to create a 'super-sovereign' multinational CRA

(i.e. UCRG), an international credit rating consortium founded by Beijing-based Dagong Global Credit Rating, Russia's RusRating and U.S.-based agency Egan-Jones Ratings, is one such development that could over time possibly become a credible challenger to the Big Three.[318] One advantage of greater competition resulting from a market-based approach, more-so in fairly concentrated markets like those of CDOs, is that the potential financial rewards made possible through the use of arbitrage strategies would attract more participants and help to curtail the likelihood of market manipulation by a single or even several players, for example. On the other hand, volatility, liquidity and the backward-looking nature of the market-based approach[319] are also arguably its most recognized weaknesses.

One major shortcoming of relying on credit spreads is that they are not informative when the market is either extremely volatile or when it is illiquid. Volatility at times appears to be a choice between large volatility swings resulting from big infrequent re-grades on one hand, and consistent small volatility swings typical of spread adjustments from actively traded securities on the other. Partnoy suggests that the illiquidity problem is however surmountable as both Moody's and Fitch "use equity-based measures when bonds are not sufficiently liquid".[320] Moreover, the overall market illiquidity experienced

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to compete with Big Three), *available at* http://www.bloomberg.com/news/2011-09-06/china-seeks-international-debt-rating-agency.html (last accessed Sept. 20, 2018).

[318] Tim Hume, *Hong Kong-based credit rating agency launched to challenge 'Big Three*, CNN, June 25, 2013, *available at* http://edition.cnn.com/2013/06/25/business/universal-credit-rating-group/index.html (last accessed last accessed Sept. 20, 2018)

[319] Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers,* 58, 90 n.68, 2006. See also, Lynn Bai, *On regulating Conflicts of Interest in the Credit Rating Industry*, 13 J. LEGIS. & PUB. POLICY, 253, 295 (2010) (noting empirical studies by Norden and Weber, Center for Economic Policy Research, Discussion Paper No. 4674, 2004, that found evidence of the independent information complementary benefit of credit ratings to the information implied by CDS), *available at* http://www.ifk-cfs.de/fileadmin/downloads/publications/wp/04_20.pdf (last accessed last accessed Sept. 20, 2018).

[320] Frank Partnoy, '*Not Like Other Gatekeepers'* at 93, (2006).

in the 2007 crisis exposed the limitations of many models, especially those relying on marking-to-market[321] as a central function of their risk management, resulting in the increased shift towards marking-to-model approach instead.

3.4.2.2. Frequency of rating upgrades and downgrades

Even though credit default swaps (CDS) impound information quickly and are considered by some as a valid substitute for credit ratings, a question mark remains over their suitability as a tool for forecasting.[322] Partnoy finds the backward-looking argument "preposterous" since ratings are forward-looking anyway. His view is that the backward looking nature of credit spreads can be an advantage as it allows the regulator flexibility to decide which aspect of the backward-looking measure to use.[323] This distinction is key to the contention put forward in this dissertation that the forward-looking nature of credit ratings and the time horizon for such projections set CRAs generally, and NRSROs in particular, apart from other gatekeepers. Hence a nuanced metric is required when considering their obligations and duties as gatekeepers, especially when liability is introduced.[324]

Other criticisms of the reliance on credit spreads include that; at issuance, the bid price equals the ask price and hence there is no spread at all (i.e. zero spread);[325] structured

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[321] Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, 17 J. ECON. PERS. (2) 3,10 (2003).

[322] See e.g., Mark J. Flannery, Joel F Houston, and Frank Partnoy. "Credit Default Swap Spreads as Viable Substitutes for Credit Ratings." 158 U. PA. L.REV., San Diego Legal Studies Paper No. 10-031, 2010 at 2109, 2111; Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1037 n.95 (noting the higher rate of risk assessment reversals demonstrated by CDS markets).

[323] Frank Partnoy, '*Not Like Other Gatekeepers'* at 93-96 (2006).

[324] Part II and part III expand on the introduction of liability.

[325] "New issuers, new issues, and speculative grades are where the ratings are most important, and that is where market data [for credit spreads] …is lacking due to the absence of historical spreads", Justin Pettit's comment to Chapter 3 in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? at 101 (2006).

products in particular tend to have unique compositions of underlying assets and very often constitute unique structures for which no history of sufficiently similar products may be available on which to base substantive comparisons.[326] A further criticism deals with the frequency at which ratings are reviewed. CRAs have since inception adopted a through-the-cycle rating approach. During the 2007 crisis, CRAs were accused of irresponsibly bludgeoning a teetering global economy with successive mass downgrades of swathes of securities which the very same CRAs had not long before accorded high credit ratings. The main charge, then, was that the downgrades were too deep and were executed too quickly for the ratings to have been accurate when issued.[327]

Figure 10 below shows that two firms may retain an identical long-term rating within a given time frame even as opinions on their near-term outlooks may vary. The recognition that a time lag exists between the risk pricing and underlying credit analyses and market realities is well established,[328] contention arises from disagreements on how quickly a rating update is to be provided by the CRA which in turn depends on whether the CRA has assessed whether the impact on the security will be temporary or enduring.[329] Although CRAs give both near-term indications in addition to the standard longer-term ratings, they do not revise ratings continually, unlike the share price of an actively traded and hence liquid security on an exchange. However, CRAs are expected to adjust their ratings whenever new material information that was not accounted for at the time of the

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[326] Frank Partnoy, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS?, at 91-93 (2006).

[327] *See e.g.*, Reinhard H. Schmidt, *Ratingagenturen entmachten – aber wie?* (Goethe Univ., House of Finance Policy Platform, July 2011), (whereas CRAs were considered to be re-rating too slowly pre- 2007 crisis, post-crisis they are considered to be re-rating too quickly, esp. with respect to the downgrades of sovereign debt ratings).

[328] Mai Hassan & Christian Kalhoeffer, *Regulation of the Credit Rating Agencies Evidence from Recent Crisis* 9 (German Univ. in Cairo, Working paper No.26, Feb. 2011).

[329] Fabian Dittrich, "*The Credit Rating Industry: Competition and Regulation*", Note, *SSRN*, June 4, 2007, at 147 (advantages of rating through the cycle; less rating-induced transactions and avoiding negative chain reaction triggers).

initial rating comes to the fore. Examples of such material information would include developments such as, "the acquisition or divestiture of a line of business, a change of policy by a government, or erosion in the credit markets that was not foreseen".[330] The charge, this time, was that the downgrades by CRAs were being done too quickly and as a result set-off rating triggers[331] which propelled a systemic downward spiral on the market.

Yet, in stark contrast, Enron's bankruptcy declaration in December 2001 is often cited as a defining moment for CRAs and their preference of the through-the-cycle rating method.[332] Despite being downgraded in the months preceding its collapse, Enron still held an "investment grade" rating, albeit a BBB rating, a mere four days before it declared bankruptcy.[333] Subsequent to Enron's collapse, CRAs were particularly criticized for not having downgraded the company to below investment grade (i.e. junk status) promptly enough. It's worth noting that Egan-Jones Rating Company ("Egan-Jones") and Kroll Bond Rating Agency ("Kroll"), two of the smaller and more recently accredited NRSROs, actively market their ability and readiness to provide more frequent reviews of their ratings as a distinct advantage over the service offered by the Big Three, for instance.

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[330] Standard&Poors, *Ratings Manual,* at Standard & Poors.com, at http://www.standardandpoors.com/aboutcreditratings/RatingsManual_PrintGuide.html (last accessed Sept. 20, 2018).

[331] Fabian Dittrich, "*The Credit Rating Industry: Competition and Regulation*", June 4, 2007, at 107.

[332] *See e.g.,* Gunter Loeffler, *Can Rating Agencies Look Through the Cycle?* 40 REV. QUANT. FIN. & ACCT. (4) 623, 642 (2013) (test the claim by CRAs that they are able to separate trend components of default risk from transitory ones and are thus able to rate through-the-cycle and finding that ratings do help identify the current split into trend and cycle). *See also*, Edward I. Altman and Herbert A. Rijken, *Effects of Rating Through Cycle on Rating Stability, Rating Timeliness and Default Prediction Performance* (find that CRAs focus on the permanent aspect of credit quality and disregard the temporary component), at 24. (NYU Working Paper No. FIN-04-032, Dec., 2004), available at http://ssrn.com/abstract=1294487.

[333] Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L.Q. 43, 60 (2004).

Egan-Jones cite a Stanford University study that reportedly found that their "results make a strong case that the non-certified agency [Egan-Jones] is the leader and the certified agency [Moody's] is the laggard".[334] New York University's Stern School of Business' finance professor, Edward I. Altman, concurs that "the big agencies will always be slower".[335]

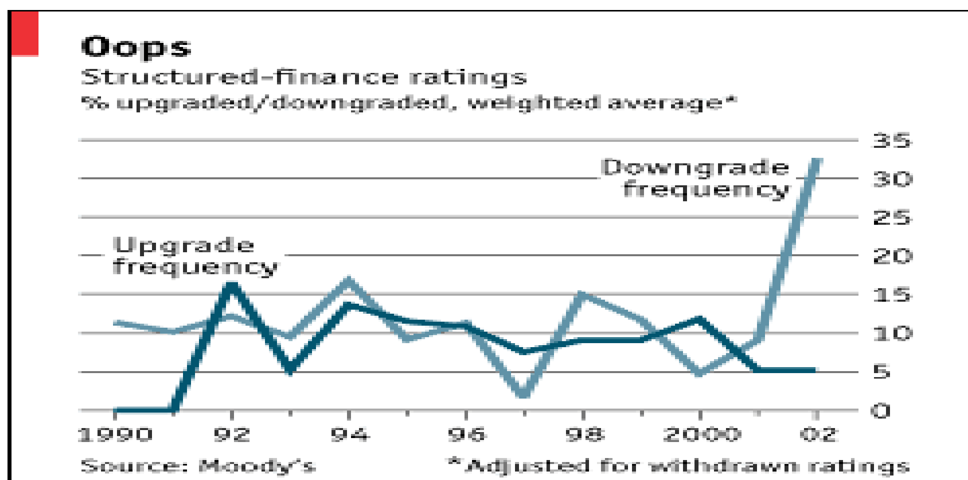
The potential gain from providing more timely rating revisions and thereby enabling investors to recognize problems with a security's performance earlier on has to be weighed against the high transaction costs that would be incurred as a consequence of the churning that would inevitably result if rating revisions were to be done too frequently. To underline the difference in the two competing approaches one can look at the example in the figure below provided by Hempel et al, which highlights an instance where within a 21-month period Egan-Jones "rated Pfizer Inc. AA, then lowered it to AA-, only to raise it again to AA, all while S&P held steady at AAA".[336]

[334] Egan-Jones-Rating-Agency, *Letter from Egan Jones Rating Agency to Jonathan G. Katz, SEC Secretary*, May 26, 2005, *available at* http://www.sec.gov/rules/proposed/s70405/eganjones052605.pdf; Aaron Lucchetti, *Tiny Firm gives Ratings Giants Another Worry*, WALL ST. J., Feb. 9, 2008 (last accessed Mar. 17, 2015)

[335] Jessi Hempel & David Henry, *Ranting at the Rating Agencies,* BUSINESSWEEK, Aug. 14, 2005, *available at* http://www.businessweek.com/magazine/content/05_33/b3947099_mz020.htm 2008 (last accessed Mar. 17, 2015). *See also*, Claire A. Hill, 4 J. BUS. & TECH. L. (2) 286 (2009) ("belief perseverance" – holding one's views notwithstanding disconfirming evidence").

[336] Jessi Hempel & David Henry, *Ranting at the Rating Agencies,* BUSINESSWEEK, Aug. 14, 2005.

Figure 10: Criticism of rating frequency

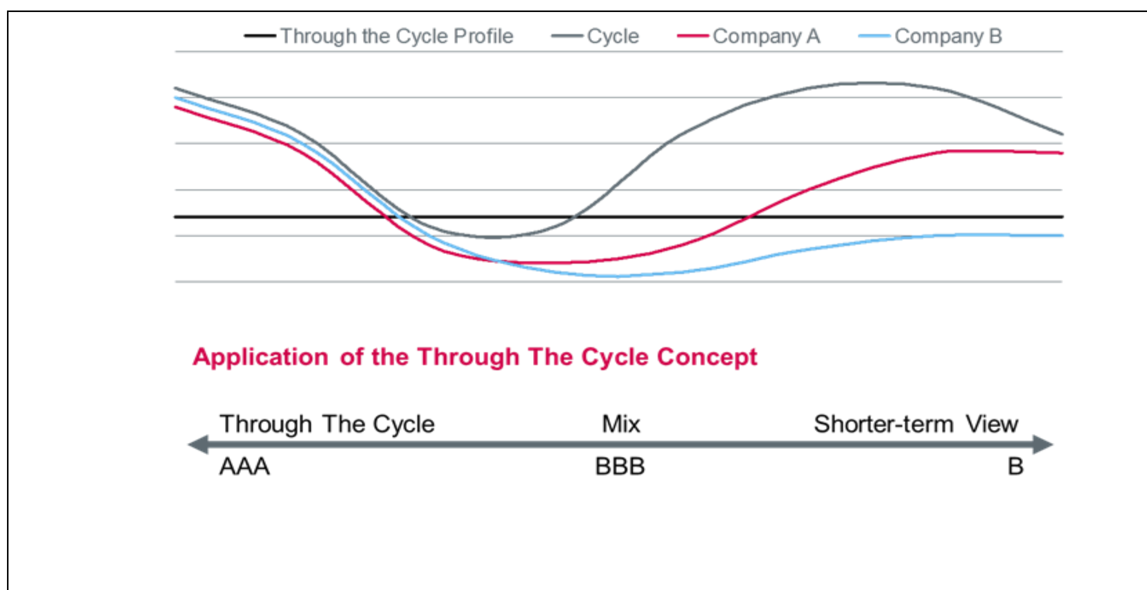


Source: The Economist. Exclusion Zone: Regulators promise a Belated Review of Ratings Oligopoly, Feb. 6, 2003, available at http://www.economist.com/node/1564776.

Some banks and corporates have categorically stated that although they review CRA ratings for informational purposes, they do not make investment decisions based on CRA ratings at all, preferring instead to look to credit spreads.[337] Nonetheless, the accuracy of credit spreads appears to be as equally dependent on the liquidity available in the market as any normal share stock. As has been seen during past crises, liquidity is the one commodity that can reliably be expected to go missing when most needed, leaving the market again dependent on CRA ratings updates at times of crisis. See Figure 11 below.

[337] JEFF MADURA, FINANCIAL MARKETS AND INSTITUTIONS, 501 (11th ed, Cengage Learning, 2014).

Figure 11: Rating through-the-cycle



Source: Fitch Ratings, Ratings and Research, available at www-fitchratings.com (last accessed Mar. 15, 2015)

At the October 2007 Oversight Committee hearings, Moody's President, Ray McDaniel, raised a more fundamental issue in his memorandum, stating that:"…[T]he real problem is not that the market …underweight[s] ratings quality but rather that in some sectors, it actually penalizes quality. … It turns out that ratings' quality has surprisingly few friends: issuers want high ratings; investors [who ostensibly can be expected to have a preference for pessimistic ratings before they acquire the bonds] don't want ratings downgrades; short-sighted bankers labor shortsightedly to game the ratings agencies".[338]

Assessing the quality of a rating on the economic premise alone is not always a straightforward matter either because, despite the term 'default' being a potential lightning

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[338] SEC, *Competition in the Credit Rating Industry,* Roundtable to Examine Oversight of Credit Rating Agencies, April 15, 2009 *available at* http://www.sec.gov/comments/4-579/4579-20.pdf.

rod, a defaulted CDO could still have a profitable ultimate recovery.[339] As a consequence, even rating "downgrades" (i.e. "write-downs") should not be regarded in the same light as realized or actual losses. This distinction was brought to the fore by the Financial Crisis Inquiry Commission (FCIC) in their 2011 report, stating: "[A]lthough this could not be known in 2007, at the end of 2010 most of the triple-A tranches of mortgage-backed securities have avoided actual losses in cash flow through 2010 and may avoid significant realized losses going forward";[340] which suggests that the securities potentially broke even, or were eventually profitable.[341]

The argument put forward by Altman et al.,[342] that neither a single letter grade nor a numerical estimate of a product's probability of default[343] within a specified time period is able to convey sufficient information to enable investors to make well-reasoned investment decisions, is convincing. One of the remedies they propose calls for the

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[339] Holman W. Jenkins, Jr., *S&P and the Lehman Tsunami,* WALL ST. J., Feb. 11, 2013, at 15.

[340] FCIC, *Report on the Causes of the Financial Crisis*, at 228 (2011).

[341] Mark Wahrenburg & Björn Imbierowicz, *Credit Rating Announcements – The Impact of the Agency's Reason, Public Information, and M&A*, 4-5 (House of Finance Newsletter, 2nd Quarter 2010) (asserting that rating downgrades which result in increased leverage would be positive according to Modigliani F & Miller M.H., *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV., 261-297 (1958), as this would result in an increase in shareholder wealth to the detriment of bondholders) (2010), *available at* http://ssrn.com/abstract=1363920.

[342] Edward I. Altman et al., *What Should Be Done about the Credit Rating Agencies?* (NYU Stern Regulating Wall Street Blog, April 6, 2010).

[343] John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis,* COLUM. BUS. L. REV., (1) 109, 159 (2009) ("… [A] given rating is not supposed to reflect any specific probability of default or level of expected loss".). *But see, e.g.,* Anno Stolper, *Regulation of Credit Rating Agencies*, 33 J. BANKING & FIN. (7), 1266, 1268-71 (2009)(positing a model reliant on regulator's ability to observe the default probabilities of CRAs where large default would signal inflation of ratings by the CRA); and Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*, Note, 2007, at 21-22, 71 (computing the correlation between rating level and default rate and a rating level based on assigned numerical values to each credit rating level benchmarked to the default probability rates of traditional bonds).

introduction of a "degree of certainty" indicator to accompany each rating. Another remedy requires the inclusion of "what if" scenarios so that investors can better assess the product's potential reaction to changes in market conditions and valuations.

Undoubtedly, the disclosure of Fitch's admission in 2007 that their rating models would break down completely if home prices decreased by between one and two percent, or that a two percent depreciation in home prices would potentially harm AA- and AAA-rated tranches, would enable investors to make significantly better informed investment decisions.[344] A clear drawback appears to be that the proposal assumes that CRAs are both able and willing to start allocating ratings based on [definitive] probabilities of default rather than on the relative probabilities of default that they have traditionally preferred. However, discussions regarding the delicate margins of error in the calculations invoke images of rearranging the deck chairs aboard the Titanic, albeit post collision, particularly when one considers certain poignant email disclosures that have since come to the fore.[345] In the *Abu Dhabi* case, the reported internal emails directing staff to "tweak" (i.e. manipulate) the existing CRA rating models in order to secure rating business or the acknowledgement by the lead rating analyst that he lacked sufficient data necessary to substantiate the firm's current model assumptions, are two examples that stand out.[346]

A recommendation favouring a phased acceptance of structured product ratings to enable more data to be gathered on the rating models' ability to properly evaluate also falls short of determining how much data is deemed necessary to accomplish that task.[347]

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[344] Joshua D. Coval, Jakob Jurek & Erik Stafford, *The Economics of Structured Finance* 5 (HBS Finance Working Paper No. 09-060, 2008).at 5.

[345] Jeannette Neumann, *Markets: Call to Downsize Credit-Ratings Giants*, WALL ST. J., Aug. 11, 2011, *available at* http://online.wsj.com/article/SB10001424053111904480904576498493884494956.html

[346] Gretchen Morgenson, *Court Papers Undercut Ratings Agencies' Defense*, N.Y. TIMES, July 2, 2012, at B1; Matt Taibbi, *The Last Mystery of the Financial Crisis*, ROLLING STONE, June 19, 2013.

[347] MK Datar, *Regulation of Credit Rating Agencies: New Business Models or Stringent Regulatory Use*, 19-26 (46 (XLVI) Economic & Political Weekly (6), Feb. 5, 2011).

Prior to the bubble collapse in 2007, the real estate market had several decades' worth of historical default rates data and yet this still resulted in a failure to trigger warning signals.[348] Donlan highlights examples from a report to the US Senate subcommittee on Investigations of a CRA analyst at S&P discussing the need to adjust their rating model criteria "because of the on-going threat of losing deals", while another suggested that he needed to "massage" the numbers in order for the firm to "preserve market share".[349] It seems clear that a key component of curtailing the likelihood of similar conflict of interest scenarios from reoccurring requires regulators and legislators to consider changes targeted at addressing the incentive drivers under which CRAs currently operate. In addition, the slow change in accepting the ratings of NRSROs and other CRAs other than those from the Big Three, remains a hurdle when contemplating new and actionable approaches. This gap in market perception and acceptance of the contributions of smaller CRAs was most apparent when Egan-Jones, a full three weeks before S&P, downgraded the long-term US government debt from AAA to AA; whereas Egan-Jones's downgrade was generally ignored by the market, S&P's downgrade made headline news around the globe.[350]

3.5. Summing up

It has been well argued, both in the literature and in the courts, that CRAs were not as concise or forthcoming about their active roles and the nature of their relationships with issuers. The boiler-plate disclaimers issued by CRAs notwithstanding, of particular

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[348] SEC, *'Summary Report of Issues Identified'*, July 2008, at 21-23 (reliance on historical corporate bond default rates). *See also,* Joshua D. Coval et al. *The Economics of Structured Finance* 5, 2008 at 5.

[349] Thomas G. Donlan, *What Price for a Rating*, BARRON'S, Aug. 13, 2011, available at http://online.barrons.com/article/SB50001424052702303524504576502530656323312.html (last accessed Mar. 24, 2015).

[350] Jeannette Neumann, *Markets: Call to Downsize Credit-Ratings Giants*, WALL ST. J., Aug. 11, 2011, *available at* http://online.wsj.com/article/SB10001424053111904480904576498493884494956.html.

concern has been the opaque process by which the structuring and rating of financial products is currently done, as well as the informational content and relevance of the credit ratings for the financial system. What is however not in dispute is that continued reliance by regulators, investors and numerous intermediaries on CRA ratings as a proxy for calculating loan associated risk persists.[351] Our financial system's structure requires that certain participants with the requisite resources (i.e. information, personnel and expertise) act as gatekeepers in order to ensure its efficiency and sustainability by acting both as quasi-governmental supervisors of the system as well as for their own commercial interests. In the gatekeeper role, both NRSROs and regular CRAs (i.e. non-NRSROs) have made it possible for the transaction costs associated with providing ratings (i.e. predominantly research and monitoring costs) to be lowered, thereby making ratings significantly more accessible to a larger pool of potential creditors. Black Monday (October 19, 1987); LTCM (1997); the real estate crisis (2007-2009); and "the London whale" incident (2012), are all examples of crises that have been blamed on model-failure. One commentator has underlined the importance of keeping in mind that the rating models used are merely complex attempts to simplify and thereby understand an increasingly mind-bogglingly complex world, writing:

> "[C]riticising the maths is easy. The models are not the problem, it is how we think about the models, and how we use them as a result [that is]".[352]

The rub lies in the fact that despite what many potential creditors, regulators, legislators and observers have suggested, CRA ratings, while they consider a broad range of non-credit risk factors, remain reasoned forecasts on the relative likelihood of a

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[351] Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose*, 27 YALE L. J. ON REGULATION 91, 97 (2010) (ratings provide a proxy for loan associated risk) (2010). *See also,* Carol Alexander's presentation comments to the WHU New Year's Conference 2011, Campus for Finance, ("…[M]odels are used to replace common sense") (2010).

[352] James Weatherall, *It is not the maths that causes crises but the trust we put in it*, FINANCIAL TIMES, Feb. 15, 2013, at 9.

successful loan repayment and an ordinal measure of credit risk.[353] In addition, credit risk is just one of several risks (e.g. liquidity risk, operational risk, business risk, market risk and engagement risk) that can impact the likelihood of a full and timely repayment.

Although regulators, investors and other market participants have for long valued the cost savings achieved by relying on CRA ratings, post the 2007 crisis, it is now more apparent that the aforementioned parties appear to also have erroneously assumed a stable relationship between ratings and default probabilities.[354] One proposed solution for this demands that they should become critical users of ratings by undertaking more due diligence for themselves.[355] Albeit with varying degrees of success, numerous displeased investors and stakeholders have sought redress by challenging the liability exemption hereto enjoyed by CRAs in the US state courts[356]. The legal basis of their challenges are addressed in the next chapter.

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[353] Katherina Pistor, *Towards a Legal Theory of Finance* 4 (Columbia Public Law Research Paper No. 12-323, 2012, (on fundamental uncertainty, i.e., the inability to quantifiably measure risk,…as they fall beyond the reach of calculable probability). *See also,* FCIC, *Report on the Causes of the Financial Crisis*, at 121 (2011) ("[O]verall, the model has to contemplate events for which there is no data", (comments by Roger Stein, a Moody's managing director).

[354] Richard Cantor & Frank Packer. "The Credit Rating Industry." *Federal Reserve Bank of New York, Q. Rev.*, Summer at 21. (1994).

[355]Richard Cantor & Frank Packer. "The Credit Rating Industry." *Federal Reserve Bank of New York, Q. Rev.*, Summer at 22. (1994).

[356] See, e.g., Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*, Note, at 142-45 (2007), and Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L.Q. 43, 57 (2004).

PART II: THE PRESENT – LEGAL LIABILITY

Chapter 4 Liability: Legal review

4.1. Evolution of the Big Three

In order to better appreciate the challenge faced by regulators to legislate assigning liability to CRAs, it is imperative to briefly review the evolution of S&P, Moody's and Fitch from their origins as publishers to institutions of unparalleled influence, if not, power.[357] While it is commonly accepted that the rating of securities by CRAs originated in the late 19th century, some scholarship contends that Louis Tappan's mercantile credit rating agency business established in 1841 was the true origin of the rating enterprise.[358] Tappan's firm, acquired by Robert Dun in 1859, consolidated with John Bradstreet's firm to establish Dun & Bradstreet, which in 1962 acquired Moody's Investor Service before spinning off the latter as publicly listed company in 2000.

While working as the editor of the American Railway Journal which was owned by his younger brother John, Henry Varnum Poor wrote and published *History of Railroads and Canals in the United States of America – Exhibiting their Progress, Cost, Revenue, Expenditures & Present Condition* in 1860.[359] Addressed to the American Geographical & Statistical Society, this tome was a state-by-state[360] financial analyst's review of the

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[357] Thomas L. Friedman, ("There are two superpowers in the world today in my opinion. There's the United States and there's Moody's bond rating service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."), PBS television broadcast, The News Hour with Jim Lehrer (1996).

[358] *See e.g.*, Richard Cantor, and Frank Packer, "The Credit Rating Industry." *Federal Reserve Bank of New York, Q. Rev.*, at 1-2 (1994).

[359] Standard&Poors, *available at* https://www.spratings.com/about/who-we-are/what-we-do.html.

[360] The 11 states covered in "*History of Railroads & Canals*" were: Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New Jersey, Pennsylvania, Delaware and Maryland.

then existing railroad and canal infrastructure in the United States. In 1868, Poor followed up this earlier publication with the *Manual of the Railroads of the United States*[361] (hereafter, The Manual) wherein he opined on the quality of the bonds issued, observing that:

"[A] single statement, as experience has shown, is very unsafe ground upon which to base an opinion. A high degree of apparent prosperity that one report may show, has not unfrequently (sic) been followed by bankruptcy before the annual occasion for another."[362]

The Manual was the forerunner for Henry Varnum Poor's decision to regularly publish corporate railroad bond ratings.[363] After merging with Standard Statistics in 1941, the H.V. & H.W. Poor[364] publishing business evolved into the current Standard & Poor's business, which was itself acquired by the McGraw-Hill group of companies in 1926.

Another American, John Moody, founded 'John Moody & Co.' in 1900. That same year he issued a seminal publication: *Moody's Manual of Industrial and Miscellaneous Securities* which was an agglomeration of information and statistical information on the property, capitalization, and management of companies; most notably on the "stocks and bonds of financial institutions, government agencies, manufacturing, mining, utilities, and food companies".[365] It reportedly sold out in two months and was nationally renowned by 1903. However, Moody's early success turned out to be fleeting and he was forced to sell the firm during the financial market crash of 1907. John Moody's forced 'sabbatical'

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[361] Poor, H.V. Central Pacific Railroad Photographic Museum, (1868), *available at* http://cprr.org/Museum/Poors_1868.html (last accessed Mar. 30, 2015).

[362] *Id.* Poor, (1868).

[363] *Id.* Poor, (1868).

[364] Henry Varnum and his son, Henry William Poor.

[365] Moody's, About Us: Moody's History, *available at* http://www.moodys.com/Pages/atc001.aspx (last accessed Mar. 5, 2015).

lasted until 1909 when he returned to the market with a newly incorporated company registered simply as “Moody’s”. His new and improved product offering changed the ratings analysts’ landscape for all time. Rather than merely collating financial data and statistics of selected firms, Moody’s published *Analyses of Railroad Investments*, “a book about railroad securities, used letter grades to assess their risk”.[366] The use of letter grades made Moody’s the first what? to rate public market securities on a quantifiable scale.[367]

Through Moody’s lettering classification system, the branch transitioned from merely reporting on the financial data and statistics to providing a calibrated scale for quantifying opinions on the data, hence creating what today is commonly referred to as a credit rating. With the incorporation of Moody’s Investors Service in July 1914, Moody’s proceeded to introduce the coverage of bonds issued by US cities and municipalities. Moody’s US bond market coverage level was reaching close to 100 percent by 1924 while coverage of commercial paper and bank deposits was later introduced in the 1970s. Fitch Ratings, the smallest of the Big Three, was founded in New York City on December 24th, 1913, by John Knowles Fitch. Similar to Poor’s and Moody’s, the Fitch Publishing Company was also founded in the United States of America. Having also started out as a publisher of financial statistics, it later introduced the “AAA” to “D” ratings scale in 1924.[368] In 1997, Fitch approached the French-owned (i.e. owned by Fimalac S.A.) but London-based rating agency, IBCA, with the intention of acquiring it and thus expanding its own European footprint. However, IBCA surprisingly turned the tables on its potential suitor and had by December of the same year, itself acquired the Fitch Publishing

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[366] Alec Klein, *Smoothing the Way for Debt markets: Firms' Influence Has Grown Along With World's Reliance on Bonds,* WASH. POST, Nov. 23, 2004, at A18.

[367] *Id.,* Klein, 2004 at A18.

[368] Fitch Ratings, *Fitch Ratings*, *About us* (2011) *available at* www.fitchratings.com.

Company. Subsequently, Fitch Ratings, part of the Fitch Group, is today a majority-owned subsidiary of Paris-based Fimalac S.A.[369]

The fact that each of the Big Three was originally founded as a publishing house is important to note as it would later strongly influence the manner in which they perceived and interpreted their roles as CRAs, as well as the manner in which they would predominantly rely on the First Amendment defense when facing lawsuits charging flawed ratings.

4.2. First amendment protection from liability

To-date, none of the US lawsuits[370] that have been brought against CRAs seeking compensation for financial losses suffered by plaintiffs have thus far been decided in favour of the plaintiffs. Historically, such lawsuits have either been dismissed or settled out of court.[371] Two lawsuits brought to New York courts, *Public Employees' Ret. Sys. v. Merill Lynch & Co.* (2010)[372] and *In re Lehman Brothers Securities & Erisa Litigation*

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[369] Fimalac, *About Fimalac*, (2011), *available at* www.fitchratings.com.

[370] Limited case law in the EU generally, and only France among the member states has explicit rules on the civil liability of CRAs. See e.g., de Savornin & van't Westeinde, *supra* note 290 (on absence of CRA liability case law in the Netherlands).

[371] *See e.g.,* Michael A. Meltz, *J.P. Morgan North America Equity Research on Moody's Corp*., at 4, April 2011 (over 20 lawsuits against Moody's Corp., have either been dismissed or withdrawn); Partnoy, CII, April 2009 at 14 (citing lawsuits related to the Washington Public Power Supply System's default) (1983); Executive Life's bankruptcy (1991), Jefferson County School District case against Moody's (1995); and County of Orange against S&P (1996) (noting that the striking element among all the cases was that "the rating agencies won"); Francis A. Bottini Jr., 30 SAN DIEGO L. REV. 579 (2009) (for review of class action suit brought against WPPSS for bond default in which a settlement was ordered by the court (1993); and *County of Orange v. McGraw-Hill Co.,* No. SA 94-22272 JR, June 11, 1996).

[372] *See*, *Public Employees' Ret. Sys. v. Merill Lynch & Co.,* 714 F.Supp.2d 475, No. 08 Civ. 10841(JSR), (S.D.N.Y. 2010) (the court was unconvinced that CRAs had acted as underwriters and "dismissed with prejudice" all claims against S&P and Moody's).

(2010)[373] were both dismissed "with prejudice"; the S.D.N.Y. court refuted the plaintiffs' contention that CRAs' involvement and role in the securities in question was comparable and equivalent to that of underwriters.

In re Lehman Brothers Mortgage-Backed Securities Litig., (2011),[374] the 2nd Circuit Court of Appeals in May 2011 dismissed the plaintiffs' complaints seeking to hold CRAs liable as underwriters or control persons for misstatements or omissions in securities offering documents in violation of §§ 11 and 15 of the Securities Act of 1933 ("1933 Act"). [375] The court found that the plaintiffs had failed to demonstrate that CRAs participated in a statutorily listed distributional activity as defined by the 1933 Act.[376] The court ruled that:

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[373] *See*, *Lehman Brothers, In re Lehman Brothers Securities & Erisa Litig.,* 681 F.Supp.2d 495, 499 (S.D.N.Y. 2010) (Rakoff, J., dismissed the case "with prejudice", after ruling that the plaintiff's extremely broad interpretation of what constitutes an underwriter in fact contradicted the interpretations of "underwriter" recognized by both the SEC and by the statutory definition itself). *See also*, *Public Employees' Ret. Sys. V. Merrill Lynch & Co.*, 714 F.Supp.2d 475 (S.D.N.Y. 2010) (Rakoff, J.'s court rejected "extremely broad" view of underwriter).

[374] *See, In re Lehman Brothers Mortgage-Backed Securities Litig.;* W*yo. State Treasurer v. Moody's Investors Serv., Inc*.; *Vaszurele Ltd. v. Moody's Investors Serv.,* (2nd Cir.), Nos. 10-0712, 10-0898, 10-1288 (2011) (the 2nd Circuit Court of Appeals upheld three judgements handed down by Kaplan J., L.A. in the S.D.N.Y court).

[375] The §15 claim rested on the merits of determining that CRAs exercised control over the primary violators, which was rejected by the court. *See* 15 U.S.C. §§ 77k (a)(5), 77o(a). *See, Harrison v. Dean Witter Reynolds* 974 F.2d 873, 877 (7th Cir. 1992) ("[T]he ability to persuade and give counsel is not the same thing as 'control' . . . []". (internal quotation marks omitted)). *See also, New Jersey Carpenters Health Fund v. Residential Capital, LLC,* No. 08 CV 8781, 2010 WL 1257528 (S.D.N.Y. 2010), at 7 (dismissing plaintiffs' control person claim against underwriters because their ability to persuade issuers was deemed insufficient); and Freeman, 55 VT. L. REV. 585, 612 (2009) (§15 of the Securities Act addresses Control Person Liability, but Rule 436 exempts NRSROs from this).

[376] *See, In re Lehman Brothers Mortgage-Backed Securities Litig.,* at 31(2nd Cir. 2011).

"… [M]erely commenting on draft offering documents does not constitute the requisite participation [necessary to qualify CRAs as underwriters under federal securities laws, even if their ratings facilitated other parties to do so]".[377]

The court did however acknowledge that CRA liability could still be contested under securities fraud provisions of § 10(b)[378] of the Securities Exchange Act of 1934 (hereafter, 1934 Act).[379]

The numerous case dismissals can generally be characterized as falling into three clusters of defenses often relied upon by CRAs: (i) their journalistic privilege; (ii) the inability of plaintiffs to prove scienter;[380] and, (iii) their distinction from other expert professionals. By drawing on their initial roots as publishing houses, the Big Three, in

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[377] *In re Lehman Brothers Mortgage-Backed Securities Litig.,,* at 29 (2nd Cir. 2011). *Also see,* Caleb M. Deats, *'Talk that Isn't Cheap'*, 110 COLUM. L. REV., at n. 99 (citing LARRY D. SONDERQUIST & THERESA A. GABALDON, SECURITIES LAW 110, 137 (3 ed. 2007)), who posit that underwriters are protected from liability under Securities Law and not from the Constitution. *See, e.g., In re Refco, Inc. Securities Litig.,* No. o5 Civ. 8926 (GEL), 2008 WL 3843343, at *3 (S.D.N.Y. Aug. 14, 2008) ("Plaintiffs do not cite any case in which a court has held that a party participated in the drafting of a registration statement, … has been held liable under § 11 as an underwriter"); *In re Wells Fargo Mortgage-Backed Certificates Litig.,* 712 F.Supp.2d 958 (N.D. Cal. 2010) (CRAs' participation in creation and structuring of securities, "no matter how extensive" not accepted as engendering underwriter liability; and *In re Lehman Brothers Securities and ERISA Litig.,* 681 F.Supp.2d 495) (S.D.N.Y. 2010) (claim of participating in the relevant "undertaking" of purchasing securities by CRAs not accepted by the court).

[378] § 10(b) provision can be brought against "any person" [i.e. a "catch-all" provision] using deception in connection with securities sale. *See, Herman & MacLean v. Huddleston*, 459 U.S. at 382 (1983).

[379] *In re Lehman Brothers Mortgage-Backed Securities Litig.,* at 34 (2nd Cir. 2011).

[380] *See, Herman & MacLean v. Huddleston*, 459 U.S. 375, 380-82 (1983) (in order to establish a cause of action, a plaintiff must prove that the defendant acted with "scienter") (emphasis added). *See also, Ernst & Ernst v. Hochfelder,* 425 U.S. 185 201-06 (1976) (Under §10b of 1934 Act, liability cannot be claimed on negligent conduct alone; it is necessary to prove "scienter" – i.e. the plaintiff must demonstrate an intention to deceive, manipulate or defraud by the defendant), and John C. Coffee, Jr., *Boston U. L. Rev.* 84:377, 378 (2004) ("… scienter must be proven before the issuer can be held liable under Rule 10b-5").

particular, succeeded in presenting their businesses as media enterprises to regulators[381] and to the courts. The 1993 ruling in *re Pan Am Corp.,*[382] established that credit rating agencies were "journalists", and as such they were to be duly protected by reporter's privilege. Consequently, this recognition in the ruling enabled CRAs to enjoy constitutional protection for expression and free speech as their rating opinions were equated to traditional journalism.[383]

Only since the 1990s has it become apparent that successive lower court decisions have trended away from recognizing CRAs as qualifying for journalistic protection and privilege. Subsequently, a case arguing reporter's privilege has only come before the Supreme Court once thus far. The Court considered whether a journalist could rely on the Press Clause of the First Amendment to legally withhold his testimony from federal courts in a criminal grand jury trial. In a 5-4 majority decision, the Supreme Court invalidated the First Amendment defense in instances where journalists were summoned to testify before a grand jury. Writing for the majority, Justice White noted that the decision to decline the petitioners request was based on the Court's reluctance "to grant newsmen a testimonial privilege that other citizens do not enjoy".[384]

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[381] Stephen W. Joynt, ("… [W]e are similar to other members of the "**media**" (emphasis added) who derive revenue from subscribers and advertisers that include companies that they cover. "**Like other journalists**" (emphasis added*)*, we emphasize independence and objectivity because our independent, unbiased coverage of the companies and securities we rate is important to our research subscribers and the marketplace in general. … [W]e are no different from other members of the "**financial media**" (emphasis added)), Senate Hearing: Before the Comm. on Banking, Housing & Urban Affairs, 109th Cong. (prepared statement of Stephen W. Joynt, President & CEO, Fitch Ratings) at 7- 9 (2005).

[382] *See, In re Pan Am Corp.,* 161 B.R. 577, 580-82 (S.D.N.Y. 1993).

[383] Frank Partnoy, '*Not Like Other Gatekeepers'*, 58, 82, (2006); and Heggen, *96 Iowa L. Rev.*, July: 1745, 1759, 1964 (2011).

[384] *Branzburg v. Hayes,* 408 U.S. 665, 691 (1972).

4.2.1. Journalistic privilege

Prior to the 1990s, the court decisions sided overwhelmingly with the notion of journalistic privilege for rating agencies. In *County of Orange v. The McGraw-Hill Companies* (1999),[385] for example, the District Court found that because of their impact on "expression" and because rating opinions involved a "matter of public concern", it could thus be successfully argued that S&P's "preparation and publication of ratings"[386] was indeed protected by the First Amendment.[387] In recognizing the welfare value of financial reporting and analysis, the District Court saw no reason to deny CRAs First Amendment protection; further holding that the distributional nature of the rating is what gave ratings a public function; as was in the ruling in *Scott Paper*,[388] where it was held that S&P (a non-party to the lawsuit), was entitled to First Amendment qualified privilege because it was considered to be a news publication.

The court recognized that "[t]he value to society of financial reporting and analysis is beyond question …" and saw no reason why disseminators of corporate financial information should not have as strong a claim to First Amendment protection as do disseminators of other kinds of information.[389] In the *County of Orange* decision, the court denied the lawsuit's claim for professional negligence, following which the county reached a settlement with CRAs for $140,000. The settlement amount represented only a

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[385] *County of Orange v. The McGraw-Hill Companies*, C.D. Cal. 154, 156 (1999).

[386] *Id., (County of Orange),* at 157.

[387] "Congress shall make no law … abridging the freedom of speech, or of the press..."- US Constitution, Amendment 1.

[388] *In re Scott Paper Co. Sec. Litig.,* 145 F.R.D. 366, 369-70 (E.D.Pa.1992).

[389] *In re Scott Paper Co. Sec. Litig.,* 145 F.R.D. 366, 369-70 (E.D.Pa.1992). *See also, Jaillet v. Cashman,* 235 N.Y. 511; 139 N.E. 714; 1923 N.Y. LEXIS 1219 (where the court held in the matter involving the unintended - albeit erroneous - report publication, "the relation of defendant to the public was the same as that of a newspaper and that [the defendant] was not liable to one with whom [he/she] had no contract or fiduciary relationship for an unintentional mistake in its report").

partial reimbursement of the rating fee paid[390] by the county for the rating and was approximately 0.007 percent of its initial claim for damages of $2bn.[391]

The aforementioned selected cases underline the premise that the First Amendment defence has allowed CRAs to seek freedom of speech protection from the courts by claiming – and thus far with great success[392] - that their ratings were merely journalistic opinions that for all intents and purposes should be deemed comparable to newspaper editorials.[393] The Supreme Court clearly stipulated in *Central Hudson* that the "[F]irst Amendment's concern [is] for the free flow of commercial information".[394] The First Amendment defense emanates from the constitutional protection of commercial speech[395] established on the concept of promoting the market for ideas, although it precludes "false

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[390] Bai, 13 J. LEGIS. & PUB. POLICY 253, 288. (2010).

[391] *County of Orange*, C.D. Cal. 154, 156. (1999).

[392] Joshua Levine, *The Hot Seat,* FORBES, Mar. 6, 2008 at 100 (concluding that recent lawsuits have shown that it is "almost impossible" to win a lawsuit against the credit rating agencies), *available at* http://www.forbes.com/forbes/2008/0324/100.html (last accessed Mar. 25, 2016).

[393] *See e.g., In re Enron Corp. Sec., Derivative & ERISA Litig.,* 511 F. Supp. 2d 742, 825-30 (S.D. Tex. 2005) (wherein the court determined that "even if negligently prepared", the combination of "subjective opinions" and "verifiable facts" that constitute CRA ratings involved matters of "public concern" and were therefore protected by the constitution). *See also,* Aaron J. Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L. J. (1), 77, 124-25 (2008) ("The leading [CRAs] have been immune from liability…Judicial treatment of [CRAs]… has equated them to journalists").

[394] C*entral Hudson Gas & Electric Corp. v. Public Serv. Comm'n. of N.Y.,* 447 U.S. 557, 593 (1980) (Rehnquist, J., dissenting); and at n.4.

[395] *Central Hudson Gas & Electric Corp. v. Public Serv. Comm'n of N.Y. No 79-565,* 445 U.S. 557, 1005 S. Ct. 2343, 65 L. Ed. 2d. (1980) (4 prong test: (i) Is expression protected by the First Amendment, i.e. speech must concern lawful activity and not be misleading? (ii) Is the asserted governmental interest substantial? ; (iii) Does the regulation directly advance the Government interest substantially?; iv) Is the regulation more extensive than is necessary to serve that interest?).

and misleading commercial speech [from] First Amendment protection".[396] It has been argued by some commentators that this concern should supersede the "…state's interest in compensating relying investors".[397] At the time of writing, this author is aware of but only a couple of lawsuits brought against CRAs that have resulted in settlements. Among those lawsuits includes a settlement reached in August 2011 involved a negligent claim lawsuit brought by CalPERS in which the Big Three were listed as co-defendants.[398] What set the case apart from earlier settlement agreements in which either two or all of the Big Three were listed as co-defendants, is that in this lawsuit, and to the explicit exclusion of the other two, only Fitch was party to the settlement agreement.[399]

The terms of the settlement did not require Fitch to make any payment to CalPERS but instead to provide CalPERS with documents and a transcript from another on-going class action-case brought against Fitch, S&P and Moody's in New York.[400] It will be interesting to observe whether this occurrence was a once-off for lawsuits involving the Big Three, or whether, going forward, we can expect to see CRAs separately defending lawsuits in which they have been jointly charged. Such a development would certainly provide substantial support to the on-going attempts by legislators and regulators to reduce

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[396] *Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n. of N.Y.,* 447 U.S. 557 (1980) (established constitutional protection for commercial speech). See e.g. Caleb M. Deats, *'Talk that Isn't Cheap'*, 110 COLUM. L. REV. 1818, 1858, n.246 (2010) (commercial speech allows the legislature and courts to investigate whereas actual malice standard forbids the imposition of a duty to investigate).

[397] Gregory Husisian, *What Standard of Care Should Govern the World's Shortest Editorials? An Analysis of Bond Rating Agency Liability,* 75 CORNELL L. REV. 410,411 (1990). *See also, Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Investor's Services*, 175 F.3d 848, n.3 (10th Cir. 1999).

[398] *Cal. Pub. Empl. Ret. Sys., v. Moody's Corp.,* No.CGC-09-490241. (Cal. App. Dep't Super. Ct. 2009).

[399] *See,* BusinessWeek, *Fitch Settles CALPers suit over SIV Ratings,* (report on Fitch's settlement with CALPers. ("[CALPers] can still fully recover its damages it if prevails against Moody's or S&P, which will not be able to avoid liability through the Fitch dismissals.").

[400] *See, Abu Dhabi Com. Bank v. Morgan Stanley & Co.,* 651 F.Supp.2d 155 (2009).

the oligopolistic market power[401] enjoyed by the Big Three. Such curtailment may be achieved by removing the requirement for ratings from not only securities rules and regulations but also from insurance rules and regulations and thereby encouraging greater competition between CRAs.[402] Following the settlement agreement between Fitch and CalPERS, reports confirming sharpened acrimony[403] between the Big Three may prove to be a leading indicator in the dynamic among them, even at this early stage. It also appears reasonable to expect plaintiffs to aggressively pursue a 'divide-and-conquer' strategy in future lawsuits involving CRAs, especially those brought against the Big Three.

4.2.2. First Amendment protections challenged

Subsequent to the 2007 crisis, the premise of the constitutional protection hereto afforded CRAs and their ratings has increasingly begun to be tested in the courts while also being more acutely questioned in academic literature. It has been argued that U.S. courts have applied the matters-of-public-concern test established in *Dun & Bradstreet* (1985) to determine whether the market-place-of-ideas theory was being upheld and whether a CRA (or other party) merited First Amendment protection.[404] An alternative recommendation by Heggen[405] calls for the setting aside of the actual malice standard by the courts and instead advocates for focussing on a functional analysis to determine the extent of the active role played by CRAs, particularly in the process of designing and

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[401] *See*, Pub. L. No. 109-291, 120 Stat. 1327.

[402] *See* Section 3.2. above

[403] Stephen Foley, *Rating agencies clash over standards*, FINANCIAL TIMES, Nov. 6, 2012, at 25 ("They are actually acting like competitors"; Jules Kroll, noting Moody's has twice been critical of S&P ratings within a month, and Fitch has criticised AAA ratings awarded by the Big Two to the CMBS 'North Star').

[404] *See,* Jonathan W. Heggen, *Not Always the World's Shortest Editorial: Why Credit Rating Agency Speech Is Sometimes Professional Speech*, 96 IOWA L. REV., 1745, 1763 (2011) ("... [T]he market-place-of-ideas theory is the free-speech theory that courts believe is relevant to CRAs").

[405] *Id.,* Heggen, 2011, at 1759 (2011).

constructing structured products. Other commentators have suggested that CRA claims for First Amendment protection should instead be measured against a "press test"[406] standard. Additionally, *In re Fitch,* 330 F.3d 104 (2d Cir. 2003)[407] – discussed below – the Second Circuit court introduced an assessment formula that takes into consideration the issuers' remuneration for the purpose of determining the extent of CRA liability.

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

Background: The plaintiff was the American Savings Bank, FSB (hereinafter, ASB), a federally-chartered savings bank based in Hawaii and regulated by the Office of Thrift Supervision (hereinafter, OTS). OTS regulations prohibited savings banks like ASB from buying and holding non-liquid and non-investment grade rated securities.[408] The defendant, UBS PaineWebber, Inc. (hereinafter, PaineWebber) had been one of ASB's long-serving brokers. In 1999, PaineWebber created "principal protected" securities for ASB that were based on equity in a "Collateralized Loan Obligation" (i.e. "CLO")[409] structure, specifically designed to be in compliance with OTS requirements. The structure was meant to allow ASB to earn an equity-like rate of return while complying with the statutory requirement of not actually holding any equity.

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[406] e.g. Larry P. Ellsworth & Keith V Parapaiboom, *Credit Rating Agencies in the Spotlight: A New Casualty of the Mortgage Meltdown*, 18 BUS. L. TODAY (4) 1, 3 (2009) (stating the two-factor press test requisites: scope of reporting and role in transaction); and Alec Klein, *Credit Raters speak against oversight*, WASH. POST, June 29, 2005, at A08 (CRAs are "members of the financial press").

[407] *In re Fitch, Inc.* 330 F.3d 104 (2d. Cir. 2003) (per curiam), *(In Re Fitch, American Savings Bank, Fsb, v. UBS PaineWebber).*

[408] *See,* 12 C.F.R. § 560.40 (2002).

[409] A Collateralized Loan Obligation is created by aggregating large numbers of commercial debt obligations (i.e. CDOs), dividing the rights to the repayment stream into many sub-divisions referred to as "tranches", and selling those tranches as tradable securities.

Between 1999 and 2000 ASB invested $83 million into several CLO products, after which the OTS informed them that the CLOs were in violation of the regulations as they were considered non-investment grade and that ASB should therefore dispose of them. When PaineWebber refused to accept the return of Trust Certificates from ASB, the latter sued. ASB had received a private letter rating of the swap agreements from Moody's as to the likelihood of getting its principal repaid. The CLOs had been rated by both Moody's and Fitch.

The lawsuit against Fitch arose from ASB's failure to get satisfactory compliance from Fitch concerning a subpoena requiring disclosure of the extent of their communication with PaineWebber regarding:

> *"(i) whether Fitch would rate the Trust Certificates; (ii) whether this type of security could ever be rated investment grade;*[410] *(iii) the methodology of the modelling used to perform the ratings; and (iv) what changes to the deal's structure would be required to achieve the desired rating".*[411]

Argumentation: Fitch's defence primarily relied on the principle of "journalistic privilege" established in *O'Neill v.Oakgrove Construction, Inc.* (1988)[412] in which the court determined that information obtained by the press, such as the identity of confidential sources, is generally not subject to subpoena. New York state law codified

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[410] *See,* JOHN C. COFFEE JR., in GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 303, Oxford University Press, 2006 (2006) ("[F]or over a century institutional investors have been found by courts to have satisfied their due diligence obligation as fiduciaries when they relied on investment grade ratings from the ratings agencies."). *See also*, Caleb M. Deats, *'Talk that Isn't Cheap'*, 110 COLUM. L. REV. 1818, 1858, (2010).

[411] *In re Fitch,* Inc. 330 F.3d 104, n.181 (2d. Cir. 2003) (per curiam).

[412] *O'Neill v. Oak Grove Const.,* 71 N.Y.2d 521, 526-27, 528 N.Y.S.2d 1, 523 N.E.2d 277 (1988).

this in its Shield Law[413] which provides journalists[414] who refuse to comply with a non-party subpoena with protection from being held in contempt of court in instances where the subpoena aims to discover information provided to the journalist in confidence.[415] Additionally, the law also prohibits discovery of unpublished non-confidential information. A party seeking the subpoena is required to make a "clear and specific declaration showing that the [information] sought: (i) is highly material and relevant; (ii) is critical or necessary to the maintenance of a party's claim, defence or proof of an issue material thereto; and (iii) is not obtainable from any alternative source".[416]

In their defence, Fitch highlighted two earlier district court decisions involving S&P; *In re Pan Am Corp.,* 161 B.R. 577 (1993)[417] and *In re Scott Paper Co. Sec. Litig.,* 145 F.R.D. 366 (1992),[418] in which S&P was recognized by the courts as meriting journalistic privileges and protections. In both cases the courts accepted the argument that because S&P rated almost all public debt, whether issued by clients or not, their actions were similar to those of regular journalists who would cover all stories and transactions considered newsworthy and as such merited journalistic protection.

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[413] Shield Law, N.Y. Civ. Rights Law § 79-h (McKinney 2002).

[414] The Shield Law defines professional journalist as "one who, for gain or livelihood, is engaged in gathering, preparing, collecting, writing, editing, filming, taping or photographing of news intended for a newspaper, magazine, news agency, ... or other professional medium or agency which has as one of its regular functions the processing and researching of news intended for dissemination to the public", at § 79-h(a)(6).

[415] Shield Law, § 79-h (b).

[416] Shield Law, § 79-h (c).

[417] *In re Pan Am Corp.,* 161 B.R. 577, 580-82 (S.D.N.Y.1993).

[418] *In re Scott Paper Co. Sec. Litig.,* 145 F.R.D. 366, 369-70 (E.D.Pa. 1992).

Decision: In ruling against Fitch, the Appeal Court highlighted two objections to its defence. Firstly, the court concurred with the S.D.N.Y. District Court's decision in *re Pam Am* in finding that S&P had been considered a journalist in part because it rated "virtually all public debt financing and preferred stock issues whether they were done by S&P clients or not".[419] However, as the court could not find evidence supporting Fitch's claim that it had regularly analysed or published ratings for transactions for which it was not paid to rate,[420] it ruled that S&P's defence was not applicable to Fitch's position and this in turn "weigh[ed] against treating Fitch like a journalist".[421] In reaching its decision, the court also relied on an earlier testimony to a state court by a Managing Director for Asset-Backed Securities at Fitch who stated the following:[422]

A: "It is not our [Fitch's] regular practice to rate transactions ... that we are not paid [for] by the underlying issuer initially. There are transactions that we have commenced on that we have not been paid to rate …"

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[419] *In re Pan Am Corp.,* 161 B.R., 577, 583 (S.D.N.Y.1993) ("We believe, however, that Fitch's information-disseminating activity does not seem to be based on a judgement about creditworthiness, **but rather on client needs**")(emphasis added).

[420] *In re Fitch,* Inc. 330 F.3d 104, 110 (2d. Cir. 2003), (per curiam). *See also,* Phillippe Jorion, Zhu Liu, Zhu & Charles Shi, *Informational effects of Regulation FD: Evidence from Rating Agencies*, 76 J. FIN. ECON. (2) 309, 316-20 (2005 (noting that CRA ratings rely on both public and non-public information, although the explanations given for a rating only refer to public information).

[421] *In re Fitch,* 330 F.3d 104, 110 (2d Cir. 2003). *See also, American Savings Bank, FSB v. UBS Paine Webber, Inc., 2002* U.S. Dist. LEXIS 24012, 2-3 (S.D.N.Y. Dec. 16, 2002) ("… [T]he journalist privilege is a **qualified** one. Fitch is not primarily engaged in newsgathering generally, nor was it doing so when procuring information sought by the subpoenas. The Court finds that Fitch is not entitled to the protections offered by the journalist privilege").

[422] *In re Fitch,* 330 F.3d 104, 110 (2d Cir. 2003) (court citing the testimony of Kevin Duignan, Managing Director of Fitch's Asset-Backed Securities testimony), in Koch Reply Aff'd at Ex. L (Duignan Dep. at 49:13-17, 51:3-11).

Q: So, is it a fair statement then that the underlying transactions you are rating without a fee are still part of a larger transaction for which Fitch is getting paid a fee by somebody?

A: Yes.

Q: Any other instances that you're aware of where Fitch rates a transaction without being paid a fee by somebody?

A: On a transaction level basis, I can't recall any."

The aforementioned testimony excluded Fitch from claiming that, unlike S&P, their decision to provide ratings was contingent on a corresponding claim for payment in return of the service. Hence, Fitch could not be considered as being on a par with journalists.

Secondly, construing correspondence showing Fitch officials commenting on proposed transactions and offering suggestions about how to model the transactions in order to reach a desired rating, the court ruled that Fitch's role had been inconsistent with traditional journalism as it had exceeded the bounds of an acceptable relationship between a journalist and the activities upon which the journalist typically reports. Moreover, the court found that the plaintiff's claim regarding Fitch's allegedly active role in the transaction's structuring process to have been "extremely credible."

The two-factor "press test" relied upon by the Appeal Court in deciding this case hinged on two determinants: (i) whether the CRA only "reported on" specific transactions for which it had been hired (as opposed to covering a broad array of significant and relevant securities and transactions as a more traditional journalist/press outlet would); and (ii) whether the court examined the agency's role in the transaction, to determine whether there is evidence of a level of involvement with the client's transactions that is atypical of the regular relationship between a journalist and the activities upon which the journalist reports. Other subsequent decisions[423] have drawn on the Appeal Court's

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[423] *See e.g., King County v. IKB Deutsche Industriebank AG*, No. 09 Civ. 8387 (SAS) (S.D.N.Y. 2012); and *In re Fitch*, 330 F.3d 104, 106, n.18 (2d Cir. 2003) (citing Securities and Exchange Commission, Report on

reluctance *In re Fitch* to extend media protection to CRAs in instances where they were hired and paid a fee in exchange for either providing a solicited rating or where CRAs have been shown to have actively participated in the structuring of the transactions.[424]

4.2.3. Protection and compensation

The Oklahoma Court of Appeals held in *Hennessee v. Mathis* (1987) that statements made as mere opinions, and not as statements of fact, were incapable of being false.[425] In the decision in *Commercial Financial Services*,[426] the Oklahoma Civil Appeals court ruled that solicited bond ratings of investments rated in exchange for compensation were not

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the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, 5-8 (Jan. 2003) *available at* http://www.sec.gov/news/studies/creditratingreport0103.pdf); *American Savings Bank v. UBS Financial Services*, 347 F.3d 436 (2d Cir., 2003); *Compuware Corp. v. Moody's Investors Services,* 324 F.Supp.2d 860, 862 (E.D. Mich., S.D. 2004) (discussed under 4.2.2 and 4.3); *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.* 651 F.Supp.2d 155, 166, n.12 (S.D.N.Y. 2009) (discussed under 4.2.1 – 4.3.4.); and *Baker v. Goldman Sachs & Co.,* 669 F.3d 105, 108, 112 (2d Cir., 2012) (Affirming that qualified privilege for journalists is recognized with regard to news that is both unpublished and not obtained under a promise of confidentiality).

[424] *In the 330 F. 3d 104 - Fitch Inc., FSB v. UBS Paine Webber*, 2nd.Cir. 2003) (the Second Circuit Appeal Court at note 31 cited correspondence highlighting the active role on the part of a Fitch employee commenting on proposed transactions and offering suggestions about how to model the transactions to reach the desired ratings as not improper, but guiding in their decision. *See also,* e.g., Freeman, *supra* note70, at 602 supra (active participation by CRAs in structuring process to maximize final rating valuations)).

[425] *See, Hennessee v. Mathis,* 737 P.2d 958, 962 (1987). *See also*, John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis,* 2009 COLUM. BUS. L. REV., (1)109, 162 (2009) (arguing that CRA opinions, although untestable, cannot be equated to truly unprovable assertions like “dogs are better than cats”.).

[426] *Commercial Fin. Servs., v. Arthur Andersen LLP*, 94 P.3d 106, 109 (Okla. Civ. App. 2004). (CRA ratings “fall somewhere between those opinions which receive constitutional protection and those that do not”).

protected by the First Amendment,[427] even as it recognized that the CRA had the duty of rating the securities accurately.[428] However, the same court also ruled that unsolicited ratings produced by a CRA – which by definition would exclude participation of the latter in the structuring of the structured financial products – owed no such duty to issuers and thereto qualified for First Amendment protection.[429]

Subsequent court decisions have regularly reached divergent outcomes when ruling on the question of whether journalistic protection should be extended to CRAs. For instance; compare, *In re Fitch,* 330 F.3d 104[430] where the Second Circuit court ruled that a CRA that takes an active role in the structuring of the transactions[431] that it rates and "only covers its own clients"[432] was unlike a journalist, with the ruling in *Compuware v. Moody's Investors Services,* (affirmed on appeal by the Sixth Circuit Court of Appeal, on

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[427] *Commercial Fin. Servs.*, 94 P.3d at 110-11 (Court distinguishes that a journalist writing an article for a newspaper about the bonds would (presumably) receive First Amendment, unlike a journalist hired by [CFS] to write a company report as the latter would be considered to be in privity and thereby reflecting a relationship akin to that between a client and the client's certified public accountant. *See Stroud v. Arthur Andersen & Co. OK 76, 37 P.3d 783 (2001).*

[428] *Commercial Fin. Servs.,* 94 P.3d, at113. (CRAs owed CFS a duty to issue the [accurate] rating which the securities deserved.)

[429] *Commercial Fin. Servs.,* 94 P.3d, at 111. (The court did not accept the argument that "having agreed to rate the bonds for a fee, the [CRAs] owed no duty of care to ... the entity paying for the rating"). *Contrast, Jefferson County School District. v. Moody's Investor Services,* 175 F.3d. 848, 850-51 (10th Cir. 1999) (lawsuit arising out of unsolicited public ratings deemed "inaccurately low"). *See also Jefferson County School District. v. Moody's Investor Services, Inc.,* 175 F.3d. 848, 850-51 (10th Cir. 1999) (a case claiming inaccurately low and unsolicited "public" ratings by Moody's where court ruled that the CRA "owed the plaintiffs no duty").

[430] *In re Fitch*, 330 F.3d 104 (2d Cir. 2003).

[431] *In re Fitch,* 330 F.3d 104 at 111 (Court finds (from what the sealed documents provided) evidence alleging Fitch's active role in structuring the transaction to be "extremely credible").

[432] *In re Fitch,* 330 F.3d 104 at 110.

August 23, 2007)[433] where because it was found not to have "participate[d] in the structuring of the debt it was rating" … "[and had therefore not stepped] outside its role as information gatherer",[434] journalistic protection was extended to the CRA.

One commentator has posited that by taking compensation from their 'research subjects', participating in the transactions' structuring process, as well as due to the general acceptance of ratings as "certifications"[435] and "benchmarks"[436] by financial market participants constitutes the distinctions upon which CRAs so significantly differ from journalists so as to render them ineligible for First Amendment protection.

Based on the aforementioned observations, a recommendation for the use of a "three-pronged test"[437] when assessing CRA liability was proposed. The test requires that the CRA meets three criteria in order to be eligible for First Amendment protection, namely: (i) It must not have received compensation in order to rate the transaction at issue; (ii) It must demonstrate that it did not take an active role in the planning, structuring and construction of the transaction at issue, and; (iii) It must show that its ratings are more characteristic of an opinion than of a "certification" or "benchmark." Hence, only where a CRA is not paid to rate the transaction; does not participate in the structuring process; and can adequately demonstrate that its reports are more like opinions and less like certifications or benchmarks would it then be deemed to qualify for First Amendment protection under the conditions of the proposed three-pronged test.

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[433] *Compuware Corp. v. Moody's Investors Services, Inc.,* 499 F.3d 520, 2007 Fed.App. 0336P. (Aff'd on appeal from E.D. Michigan, No. 03-70247, Feikens, District J.).

[434] *Compuware v. Moody's Investors Services*, at 862.

[435] Certification refers to the distinction drawn from CRA ratings between "investment" and "non-investment "grade securities.

[436] Benchmark refers to the reliance on a ratings trigger in contract documents or regulation guidelines, e.g. for mutual fund portfolio holdings.

[437] Theresa Nagy, *Credit Rating Agencies and the First Amendment* 94 MINN. L. REV. 140, 163-64 (2009).

And yet, even if one accepts the proposal's contention that the third prong helps to "account for the substantial market value the market places on the ratings"[438] as being fundamentally sound, the supporting argumentation put forth by the aforementioned commentator remains unconvincing. The huge profits earned by CRAs notwithstanding,[439] more convincing is the argument that the use of and reliance on certifications and benchmarks is one that legislators, regulators and investors have over time collectively adopted or defaulted to because it allowed them to simplify their own due diligence process and thereby reduce the transaction costs[440] that would otherwise have arisen from more engaged investment decision-making processes.

Moreover, it is also apparent that although CRAs provide ratings of relative risk on a scale ranging from AAA to BBB-[441] for "investment grade" securities, risk profiles and risk appetites among investors differ significantly. This is in part exemplified by the existence of an active market even for "non-investment" grade-rated bonds, including those that are rated "D" and are in default.[442] Under the proposed three-pronged test

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[438] *Id.,* Nagy, at 164.

[439] *Id.,* Nagy, at 165. ("The rating agencies have made huge profits from the financial market's dependence on their certifications of quality…").

[440] Frank Partnoy, *Barbarians at the Gatekeepers?* 79 WASH. U. L. Q. 5, (2001) (positing reputable gatekeepers to bridge gap between investors and issuers who otherwise find evaluating securities too expensive). *See also*, Nagy, 94 MINN. L. REV. 140,143 (2009) (Ratings have been described as '"an efficient interface between investors and issuers" that reduces the cost of securities research for individual investors) citing Amy K. Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies*: *Well-Placed Reliance or Free market Interference*? 20 SETON HALL LEGIS. J. 293-94 (1996).

[441] From AAA to BBB- for S&P and Fitch; AAA to Baa3 for Moody's. *See,* http://www.standardandpoors.com/aboutcreditratings/; http://www.fitchratings.com/creditdesk/public/ratings_defintions/index.cfm?rd_file=intro#primary_sum; and http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004 (last accessed Apr. 1, 2015).

[442] David J. Ward & Gary L. Griepentrog, *Risk and Return in Defaulted Bonds*, 49 FIN. ANALYSTS J. (3), 61, 61-65 (1993) (on the risk and returns from the defaulted bonds market). *See e.g.,* Stefan Kueffner,

criteria, structured products – for which CRAs are typically actively involved in the structuring process and compensated by the issuer – would then only be decided based on the third prong; the similarities to an opinion as opposed to a certification or benchmark.

The proponent of the three-prong test criteria further asserts that where "investment-grade ratings [are] required by the [investor]",[443] then the third prong would influence the decision against CRAs. However, such a premise appears to only hold if one assumes CRA ratings to be equivalent to guarantees of investment performance of the various rated securities.[444] CRAs have neither presumed nor professed the ability to provide such a level of certainty of expected returns, even for their AAA ratings.[445] Instead, the literature confirms that CRAs have extensively highlighted the fact that their ratings are ordinal, and not cardinal, by issuing ratings based on relative credit risk as opposed to those explicitly stating a particular expected default.[446]

Ecuador buys back 91% of 2012, 2030 Bonds in Default, BLOOMBERG, June 11, 2009, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aOqMjXvGDEK8 (last accessed, Apr. 1, 2015).

[443] Theresa Nagy, 94 MINN. L. REV. 140,166 (2009).

[444] Steven L. Schwarcz, *Protecting Financial Markets* 93 MINN. L. REV. 373, 403-04 (2008), (ratings are judgment calls by humans, who by their nature, are fallible).

[445] *e.g.* Moody's defines its highest rated AAA what? for both long-term obligations and structured finance as those "judged to be of the highest quality, with minimal credit risk", as opposed to zero credit risk, at 4, *available at*, http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004 .

[446] *See e.g.,* StandardandPoors.com, "The Fundamentals of Structured Finance Ratings", at 10 *available at* http:// www2.standardandpoors.com/spf/pdf/fixedincome/Fundamentals_SF_Ratings.pdf.

Deats (2010)[447] extends the earlier argument developed by Nagy (2009)[448] by citing several examples where First Amendment protection has been extended by courts to cover non-media related parties as evidence that the court decisions have been motivated more by the premise of ensuring protection for statements that infer a public concern rather than on the merit of characteristics that distinguish CRAs from traditional journalists. The number of lawsuits that have been decided by the courts so far is still statistically small[449] giving credence to Kettering's[450] caution that because CRAs', First Amendment defence has not yet been litigated often enough, it therefore does not permit confident predictions to be made on what the courts will ultimately decide. Although a confident prediction may not yet be achievable, several lawsuits pre- and post- 2007 have given indication of the various courts' leanings and an observable pattern has started to emerge.

A key area where in recent times CRAs have seemed to hold a divergent view to that of the SEC is on the legal interpretation of the rights, duties, obligations and protections accruing to and associated with the term "opinion". Some lower US courts have ruled against the contention advanced by CRAs over several decades that ratings opinions are not provably false and should therefore not be avenues by which liability can be extended to them.[451] Up until the 2007 GFC, whether on the basis of failing to meet an

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[447] Caleb M. Deats, *Talk that Isn't Cheap*, 110 COLUM. L. REV. 1818, 1821 N.16 (2010). *See e.g. Bigelow v. Virginia,* 421 U.S. 809, 822-25 (1975) (protecting advertisements for abortion services in New York, which was published in Virginia, from regulation as it "conveyed information of potential interest and value to a diverse audience").

[448] Theresa Nagy, 94 MINN. L. REV. 140,166 (2009).

[449] Frank Partnoy, *Not Like Other Gatekeepers,* at 95 (2006) ("[U]nfortunately, private litigation has not yet generated any decisive cases and it remains unclear what protections credit rating agencies should receive").

[450] Kenneth C. Kettering, *Securitization and Its Discontents,* 29 CARDOZO L. REV., 1553, 1690 (2008).

[451] *e.g., County of Orange v. McGraw Hill Co., Inc.,* 245 B.R. 151, 154-56 (1999) ("S&P again attempts to persuade the Court its ratings are opinions which are not provably false. The Court has rejected this argument in the past and does again today. *See* Order of March 18, 1997 at 21 fn. 7; Order of June 2, 1997").

"actual malice" or a "misrepresentation" standard, almost all major US court decisions had been decided in favour of CRAs. The premise of the key court decisions in this regard will be reviewed in greater detail later in the dissertation.

4.3. Civil liability lawsuits

As was mentioned above, lawsuits brought against CRAs for financial losses suffered by investors have historically been struck down, dismissed (both outright[452] and in-part[453]) or settled out of court.[454] Zhang finds that in the thirty-year period until 2010, of the 19 federal cases[455] that had been brought against the Big Three, investors' claims

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[452] *See e.g. Lehman Brothers, In re Lehman Brothers Securities & Erisa Litig.,*681 F. Supp. 2d 495, 499 (S.D.N.Y. 2010) ("…[T]here is nothing in the complaint to suggest that [the ratings agencies] participated in the relevant `undertaking'—that of purchasing the securities here at issue, the Certificates—from the issuer with a view to their resale". Hence, the court ruled that the claims against the ratings agencies "must be dismissed with prejudice"), and *New Jersey Carpenters Health Fund v. Novastar Mortg., Inc.,* 08 Civ. 5310 (S.D.N.Y. 2012) (dismissed with prejudice, a putative class action claiming misrepresentations and omissions in connection with the sale of RMBS under the 1933 Act). *See also, In re Enron Corp. Securities, Derivative & "ERISA" Litig.,* (2005)(The Connecticut Att'y General sued on behalf of Connecticut Resources Recovery Authority (CRRA), a public entity, to recover approximately $200 million which it lost in a transaction with Enron for "negligent misrepresentation" and for failing to demonstrate reasonable care or competence in their role as assessors of Enron's true creditworthiness. Ruling in favour of the Big Three, the court found that the plaintiff's complaint had not properly alleged actual malice and therefore ruled to dismiss the negligent misrepresentation claims).

[453] *e.g. Abu Dhabi Commercial Bank, King County, Washington v. Morgan Stanley & Co.,* 08 Civ.7508 (SAS), at 64 (S.D.N.Y. 2012) ("…[D]efendants' motions to dismiss are hereby granted in part and denied in part".).

[454] *e.g.,* Karen Gullo, '*Fitch Settles CALPers suit over SIV Ratings*', BUSINESSWEEK, Aug. 29, 2011.

[455] *See e.g*., Sisi Zhang, *Legal Liability of U.S. Credit Rating Agencies under Section 11 of the Securities Act: The Long and Winding Road toward Accountability*, n. 58 (2010) Note (Uni. of Toronto, listing the 19 federal cases).

were only successfully litigated in a single case and were only partly granted in two other cases.

In the noted successful case, *Abu Dhabi Comm. Bank*, the plaintiffs' common law fraud plea was initially allowed to proceed by S.D.N.Y. court before a settlement agreement was reached on April 26th, 2013. One of the two partly granted cases was *In re National Century Financial Enterprises* involving pleas of negligent misrepresentation towards investors and where the plaintiffs' Ohio Blue sky law claims were granted by the court[456].

In the second case, *County of Orange*, the court granted a summary judgement favouring the plaintiffs' claims of contractual breach and professional negligence claims.[457] At the onset, the typical charge made by plaintiffs in such lawsuits had been that CRAs awarded private and public ratings which the plaintiffs deemed to be 'too low'.[458]

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[456] *In re National Century Financial Enterprise Inc. Investment Litigation,* 580 F.Supp.2d 630, 656 (S.D. Ohio 2008) (Blue sky laws and aiding and abetting claims survived the motion to dismiss).

[457] Sisi Zhang, *Legal Liability of U.S. Credit Rating Agencies under Section 11 of the Securities Act*, Note at 20-21(2010).

[458] *See e.g., Dun & Bradstreet, Inc. v. Greenmoss Builders,* 472 U.S. 749, 751 (1985) (for solicited) check bracketsprivate ratings deemed 'too low'*)*; and *Jefferson County School District. v. Moody's Investor Services,* 175 F.3d. 848, 850-51 (10th Cir. 1999) (lawsuit arising out of unsolicited public ratings deemed "inaccurately low"). *See also*, Patrick Behr & Andre Guettler, *The Informational Content of Unsolicited Ratings*, 32 J. BANKING & FIN. 587, 590-93 (2008) (empirical study evidence that stock markets register a negative reaction to initial unsolicited ratings for smaller [corporations]). *Contrast,* Markus Wiemann, *Rating based Performance Pricing in Loan Contracts: How much influence have credit ratings on borrowers in monetary terms* (New Year's Conference 2011, Campus for Finance, WHU Otto-Beisheim Sch. of Management, Jan. 12-13, 2011 presentation) (comparing Accounting-based and Rating-based Performance Pricing, and suggesting that lower ratings awarded to unsolicited ratings might be simply due to limited or no access to company management for clarification of information) (on hand with author).

However, the post-2007 crisis lawsuits have exhibited a trend reversal towards charging CRAs with ratings of securities that are retrospectively being deemed to have been "too high".[459] The latter has been observed in numerous bankruptcy cases.[460]

For example, in the *Anschutz Corp. v. Merrill Lynch & Co., Inc.* (2009) decision,[461] Chief Judge Preska granted a motion-to-dismiss, with prejudice, on behalf of Merrill Lynch companies and the Big Three. In granting the motion-to-dismiss the court ruled that the plaintiff's claim amounted to "no more than allegations of a general business motive to make profit" and therefore fell short of the "motive and opportunity standard" [462] necessary to prove scienter. However, because the lawsuit had been filed and was being contested in multiple jurisdictions, the S.D.N.Y. court's order was only communicated to, but was not binding on courts in other jurisdictions.[463]

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[459] See e.g., *Ohio Police & Fire Pension Fund v. Standard & Poor's Fin. Serv.*, n.214 (2011); and *Public Employees' Ret. Sys. v. Merrill Lynch &Co. Inc.,* 714 F.Supp.2d 475 No. 08 Civ. 10841(JSR) (S.D.N.Y. 2010).

[460] E.g. *County of Orange v. McGraw-Hill Cos. Inc.,* 245 B.R. 151 (C.D. Cal. 1999) (County alleged that inappropriately rated issue caused it to suffer damage); and *Commercial Financial Servs. Inc., Arthur Andersen LLP,* 94 P.3d 106 (Okla. Civ. App. 2004) (auditors defending a lawsuit from a bankrupt firm cross-claimed for a contribution from CRAs).

[461] *Anschutz Corp. v. Merrill Lynch & Co., Inc.,* Case No. 1:2009cv09888 Doc 40 (S.D.N.Y. Dec. 2, 2009).

[462] *Id., Anschutz Corp.,* at 22.

[463] *Id., Anschutz Corp.,* at 36. (As per Rule 7.6 of the Rules of Procedure of the Judicial Panel on Multidistrict Litigation, a copy of the order was sent to the transferor court (i.e. N.D. of Cal.,) and to the Judicial Panel on Multidistrict Litigation on Feb.9, 2011. *See* Patricia D. Howard, *A Guide to Multidistrict Litigation* 124 F.R.D. 479, 485-86 (1989)). The S.D.N.Y. court consolidated the case into a then pending MDL proceeding *In re Merrill Lynch & Co., Auction Rate Sec. (ARS) Marketing Litig., No. 09–md–2030* (LAP) (S.D.N.Y. Dec. 2, 2009), Doc. No. 33, where the motion to dismiss was granted by the District court. A subsequent appeal, *Anschutz Corp. v. Merrill Lynch & Co., Inc., Ca Docket No. 11–1305–cv, US 2nd Cir. 2012* also failed. The court held that both the market manipulation claim (citing *Wilson v. Merrill Lynch & Co., 671 F.3d 120 (2d Cir.2011)*) and the negligent misrepresentation claim (ruling that "New York law

The disparate outcomes achieved by the two abovementioned courts in this particular instance serve to highlight the uncertainty faced by both plaintiffs and defendants as a result of the divergent legal standards and interpretations adopted across the US state court system highlighting the real potential for starkly different legal outcomes.

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controls, and that Anschutz fails to allege an actionable misrepresentation under New York law") both failed to overturn the lower court's motion to dismiss ruling.

Consequently, some legal scholars, including Romano,[464] Fischel,[465] and Easterbrook[466] among others, have advanced the pro-federalism position in favour of competition first offered by Judge Ralph K. Winter.[467]

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[464] *e.g.*, Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. LAW, ECON. & ORG. (2), 225-284 (1985) (empirical event study of Delaware's competitive advantage over other states which found that such firms attained statistically significant positive cumulative abnormal returns from reincorporating in Delaware); Robert Daines, *Does Delaware Law Improve Firm Value?,* 62 J. FIN. ECON., 525, 540-42 (2001) (event study of Tobin Q (i.e. the ratio of a firm's market value to its book value) on 4,481 firms demonstrating that firms incorporated in Delaware had a higher Tobin's Q than non-Delaware incorporated firm, in the period 1981-1996). *See also*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14 *(AEI Studies in Regulation & Federalism)*. 1st ed. Wash. D.C.: AEI Press., 1993 (2002), Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters (ECGI Law Working Paper Series, No 34*;(2*3* YALE J. REG.2005) at 11, 26-27 (2005)) (Romano makes a case for federalism as the essence of enabling states to be the metaphorical laboratory for legislation), and Roberta Romano, *Regulating in the Dark*, 23, 30 (Yale Law & Economics Research Paper No. 442, 20 Mar. 2012, 2012), *available at http://ssrn.com/abstract=1974148* (recommending (i) automatic review of legislation to determine efficiency, and (ii) waivers (e.g. Sarbanes-Oxley Act § 301 empowering the SEC to grant exemptions to the statutory requirement on independent directors) and exemptions to allow small scale experimentation before a full roll-out of legislation (i.e. the laboratory approach). Coffee in turn refutes the reliability of this argument noting that Romano provides "no empirical evidence that sunshine laws provide any benefits on balance". *See also* Roberta Romano, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES 48-49, 63 *(AEI Studies on Financial Market Deregulation)*, Washington D.C., AEI Press, (2002).

[465] Daniel R. Fischel*, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 917-20 (1982) (contends that the Berle-Means-Cary theory is based on an irrational behavior concept by which investors would decide to invest in a firm (located in Delaware) to the detriment of their own investment goals).

[466] Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law,* J. LAW & ECON. 395, 398 (1983) ("Our conclusions on federal rules…, reflec[t], perhaps, the power of competition among jurisdictions to produce legal doctrines beneficial to shareholders"). *Id.* at 419, ("...[T]he presumption is that federal regulation is welfare decreasing").

William L. Cary's argued that inter-state regulatory competition[468] was detrimental to efficient outcomes because it allegedly reduced US corporate law to its lowest common denominator while incentivising am undesired race-to-the-bottom[469]. Judge Winter at the time ruled that such outcomes which would result in harm to the interest of shareholders.

In contrast, Bebchuk & Ferrell (1999) for example, have directly challenged the theses propagated by the main proponents of intra-state competition.[470] Bebchuk[471] in particular, has highlighted the influence of managerial opportunism and externalities on the adoption of undesirable corporate law rules by states that result in the failure of state competition, and hence proposes an expansion of federal regulation to redress the

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[467] See e.g., RALPH K. WINTER JR., GOVERNMENT AND THE CORPORATION 28-42 Aer Pr, (1978). *See also*, Ralph K. Winter Jr., in *Corporate Governance Proposals Debated by Lawyers, Economists*, 15 SEC. REG. & L. REP. (BNA) 1823 (Sept. 30, 1983); and Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256, 289-92 (1977).

[468] BERLE & MEANS, *supra* note 280, at 112-13 (on the separation of control and ownership under the modern theory of the firm).

[469] See, *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311(1932), (Brandeis J., dissenting, refers to regulatory competition as the "laboratories of democracy" through which states may "…try novel social and economic experiments without risk to the rest of the country..."); *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 588-89 (1933) (Brandeis, J., agreed with the race-to-the-bottom theory of corporate law); and Simon Johnson & James Kwak, *'Why companies do stupid things, credit rating edition'*, WASH. POST, Oct. 10, 2009 (market solution would result in a race to the bottom as competitors elect to cut quality to maximize revenue), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/10/20/AR2009102000035.html (last accessed Sept. 20, 2018).

[470] Lucian Bebchuk & Allen Ferrell, *Federalism and Takeover Law: The Race to Protect Managers from Takeovers*, COLUM. L. REV. 99, 1168-98 (1999) (countering arguments made by Winter, Fischel, Easterbrook and Romano, at 42-50, and citing anti-takeover state laws as an example of Cary's state competition's race-to-the-bottom argument), at 15-19 and 32-33.

[471] Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARVARD L. REV. (7) 1443, at 1483-85 (1992).

prevailing asymmetry.[472] The market for corporate control theory, which is essentially premised on investors actively and freely exercising their choice to invest in firms that best meet their investment interests on the one hand, and management teams being wary of the threat of a takeover if they fail to meet investors' expectations[473] on the other hand, appears to have ensured that the weight of the arguments in the foregoing debate favour the race-to-the-top thesis propagated by those in Winter's camp.

However, as was mentioned in Section 3.2.2 above, the absence of credible competition in the CRA industry and the regulatory reliance on NSRSO ratings by investors negate the contention that investors can exercise their vote merely by withholding funds from a specific firm. In addition, the reported decrease in quality as [CRA] competition increases[474] would suggest that support for the proponents of the 'race-to-the-bottom' argument also warrants examination. A further observable development in court decisions has been the evolution from the "shibboleth"[475] treatment of CRA opinions akin to First Amendment speech immunity, to one where the courts have set aside this constitutional protection and have instead sought to consider a practical basis for assessing the liability charges as was demonstrated by the aforementioned functional analysis and "press tests". In so doing the courts have in part relied on the standards for

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[472] *See also,* Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies*, CII, April 2009, at 7-13 (calling for consolidation of CRA regulations under an empowered overseer similar to the PCAOB to mitigate the shortcomings of piecemeal regulations on state and federal level in the current structure); SEC, SEC Roundtable to Examine Oversight of Credit Rating Agencies, (statement by Gregory W. Smith before the April 8, 2009 proposing housing a CRA oversight organisation in a similar model to the PCAOB) *available at* http://www.sec.gov/comments/4-579/4579-5.pdf; and Timothy M. Sullivan, *Federal Pre-emption and the Rating Agencies* 94 MINN. L. REV., 2136, 2143 (2010).

[473] Daniel R. Fischel, *The "Race to the Bottom" Revisited,* 76 NW. U. L. REV. 913, 919 (1982).

[474] *See,* also Section 3.2.2. above.

[475] *Jefferson County School District. v. Moody's Investor Services, Inc.,* 175 F.3d. 848, 850-51 (hereinafter Jefferson County), ("shibboleth" is a term for a custom, principle, or belief distinguishing a particular class or group of people referred to in the court decision).

"actual malice" and "negligent misrepresentation" under Common Law's tort provisions when considering plaintiffs' claims for damages suffered.[476]

4.3.1. Actual malice standard

Three cases that best highlight the actual malice standard being applied by courts of interest to the CRA liability debate are the examples provided by the decisions in *New York Times Co. v. Sullivan* (1963),[477] *Jefferson Cty. Sch. Dist. v. Moody's Inv. Serv., Inc.,* (1999)[478], and *In re Enron Corp. Sec., Deriv. & "ERISA" Litig.* (2005).[479]

- *New York Times Co. v. Sullivan*

In *New York Times Co. v. Sullivan* (hereinafter, *NY Times*), a Montgomery County Circuit Court verdict in favour of the plaintiff[480] which was upheld on appeal by the Alabama State Supreme Court, had ruled in favour of Sullivan, awarding him $500,000 in damages, led to this appeal by the New York Times to the U.S. Supreme Court. Sullivan initially sued on the premise that the New York Times Company had been libellous in an

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[476] *See*, Caleb M. Deats, *Talk that Isn't Cheap*, 110 COLUM. L. REV. 1818, 1831 (2010) (Deats considers (i) the actual malice standard, (ii) professional speech for selected clients, and (iii) commercial speech to be the three main First Amendment defences relied upon by CRAs in lawsuits).

[477] *New York Times Co. v. Sullivan* U.S. 376 U.S. 254, (1964) (9-0 decision).

[478] *Jefferson County,* 175 F.3d, at 848.

[479] *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, 511 F. Supp. 2d 742 (S.D. Tex. 2005) cited in Larry P. Ellsworth & Keith V Parapaiboom, *Credit Rating Agencies in the Spotlight,* 18 BUS. L. TODAY (4) 1-4 (2009).

[480] A motion for a new trial was denied by the Cir. Ct, Montgomery County; *Aff'd,* 144 So. 2d 25 (Ala. 1962); certiorari granted, 371 U.S. 946 (1963).

article concerning a civil rights event[481] which had allegedly contained several factual inaccuracies.

In reaching its decision in favour of the New York Times, the U.S. Supreme Court distinguished between three levels of defendants, namely; private individuals, public figures and the media. Concerning private defendants; the Court ruled that libellous statements were not automatically protected by the First Amendment[482] while reiterating that absent malice, the mere fact that a statement was false, did not exclude it from protection.[483] Concerning public officials and public figures;[484] the Court ruled that they could only claim libel for "false and defamatory statements" in instances where plaintiffs could demonstrate that the statement had been made with actual malice.[485]

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[481] U.S. Const. Amend. XIV.

[482] *NY Times*, 376 U.S. 254, at 301-02.

[483] *NY Times,* 376 U.S. 254 at 279-83 (Court held that "[F]actual error, content defamatory of official reputation, or both, are insufficient to warrant an award of damages for false statements unless "actual malice" …is alleged and proved").

[484] *See Gertz v. Robert Welch Inc.,* 418 U.S. 323 (1974) (5-4 decision) (U.S. Supreme Court's establishment of the standard for First Amendment protection from defamation of private individual's claim, where plaintiff was also required to show fault in order to prove liability. The states were given freedom to set their own standards for liability, but where these standards fell below the standards required to show "actual malice" (as in libel lawsuits concerning "public figures"), then the state courts could only award for actual damages and not for punitive damages. However, the Court has hesitated to apply the public figure designation). *See,* Caleb M. Deats, *Talk that Isn't Cheap*, 110 COLUM. L. REV. 1818, 1832 (2010). *See also, Masson v. New Yorker Magazine, Inc.,* 111 S. Ct. 2419, 2429 (1991) (a plaintiff who is a public figure is required to provide clear and convincing evidence demonstrating actual malice).

[485] *NY Times*, 376 U.S. 254, n. 3/4, 305 ("refers to malice as an "elusive concept"). *See also, Coleman v. MacLennan*, 78 Kan. 711, 723, 98 P. 281 (1908) (on appeal) (opinion, Burch, J.:) "[A]ny one claiming to be defamed by the communication must show actual malice or go remediless. This privilege extends to a great variety of subjects, and includes matters of public concern, public men, and candidates for office.").

4.3.1.1. Proving actual malice

In order to prove actual malice,[486] a plaintiff had to prove that the publisher had "knowledge that the information was false" or proceeded to publish it "… with reckless disregard of whether it was false or not".[487] Additionally, regarding media defendants, the Court placed the onus on the plaintiff to not only prove that the statement in question was false, but also that the defendant had the "requisite state of mind [in order to effect the falsehood]".[488] Although the Court in this instance agreed that the New York Times had been negligent in failing to discover misstatements,[489] it still found that such negligence from poor fact-checking fell short of the standard of recklessness that is constitutionally required in order to find for actual malice[490]. This was moreso because successfully proving actual malice rests on the requirement to establish that there had been doubt in the publisher's mind regarding the truthfulness of the contentious statement.[491]

In this regard, the U.S. Supreme Court ruling in *St. Amant v. Thompson,* 390 U.S. 727 (1968) is particularly instructive in that the Court determined that for purposes of

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[486] *See Army Aviation Heritage Foundation and Museum v. Buis,*_504 F. Supp. 2d 1254, 1266, No. 3:03cv554-RS-MD (N.D. Fla. 2007open bracket) ("Common law malice focuses on the defendant's feelings toward the plaintiff, unlike express malice which concerns the defendant's knowledge of the truth or falsity of a publication ..."). *See also,* Cornell U. L. Sch., at 280 (2010). (The term "actual malice" as used by the court should not be confused with "legal" or "common law malice", which infers ill-will or spite. *In Masson v. New Yorker Magazine, Inc.*, 501 U.S. 496 (1991), took account of the confusion raised in using the term "actual malice" and called for judges to use the phrases "knowledge of falsity" and "reckless disregard as to the truth" when giving jury instructions.)

[487] *NY Times*, 376 U.S. 254 at 280.

[488] *NY Times,* at 287.

[489] *NY Times,* at 288.

[490] *NY Times,* at 288.

[491] *See Harte-Hanks Comm's v. Connaughton* 491 U.S. 657, 688, 109 S.Ct. 2678, 105 L.Ed.2d 562 (1989) (proof of "a deliberate effort [by the defendant] to avoid the truth is required" to be shown).

proving actual malice the standard for establishing reckless conduct is not predicated on whether a reasonably prudent individual would have published the contested statement, or would have investigated more thoroughly before publishing,[492] but rather on their ability to provide sufficient evidence to demonstrate that the defendant "in fact entertained serious doubts as to the truth of his publication".[493] Justice Brennan further explained that an "erroneous statement is inevitable in free debate," and therefore even false statements must therefore "…be protected if the freedoms of expression are to have the 'breathing space' that they 'need … to survive'".[494]

The *New York Times* decision is regarded by most scholars as a landmark decision that revolutionised First Amendment jurisprudence[495] and as a result it has been cited in

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[492] *St Amant v. Thompson,* 390 U.S. 727,731-33, 88 S.Ct. 1323, 20 L.Ed.2d 262 (1968) (as Certio. to the S. Ct. of Louisiana, reversing the state court's ruling because of a misunderstanding and misapplication of the "actual malice" standard).

[493] *St Amant v. Thompson* 390 U.S. 731. *See also*, *Garrison v. Louisiana,* 379 U.S. 64, 74 (1964); *Rice v. Charles Schwab,* No. SACV 10-00398-CJL (MLG, 2010); *In re IndyMac Mortgage-Backed Securities Litig.,* No. 09 Civ. 4583 (LAK), 2010 WL 2473243 (S.D.N.Y. June 21, 2010); *Freidus v. ING Groep N.V.,* No. 09 CIV. 1049 (LAK), 2010 WL 3554097, at *12 (S.D.N.Y. Sept. 14, 2010) (holding that the opinion-giver may be liable if they entertain "serious doubts" about the veracity of their opinion/statement at the time of issue).

[494] *NY Times,* 376 U.S. 254, 272 (Brennan, J., quoting *NAACP v. Button,* 371 U.S. 415, 433 (1963); and Goldberg, J., with Douglas, J. concurring, at 297); *See also Compuware Corp. v. Moody's Investors Servs.,* Inc., 499 F.3d 520, 525, 531 (6th Cir. 2007) (the "actual malice" standard established in *NY Times* was applied to a defamation and breach of contract claim against the rating agency).

[495] The decision contradicted earlier US Supreme Court rulings. *See e.g., Chaplinsky v. New Hampshire*, 315 U.S. 568, 571-72 (1942) (concerning (…lewd, obscene, profane, and…) libellous utterances as having no role in the market for ideas therefore not meriting constitutional protection); and *Beauharnais v. Illinois,* 343 U.S. 250 (1952) (libellous statements are not constitutionally protected).

numerous subsequent Supreme Court[496] and lower court[497] decisions. As is the intended role of the Supreme Court, one of the key contributions to jurisprudence of the decision in *NY Times* was the streamlining of the disparate First Amendment freedom of speech protection as it was applied under divergent state laws.[498] For example, the decision's embrace of an analytical approach[499] that seeks to protect freedom of expression and speech ahead of the more traditional approach thereto, which had concentrated on

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[496] *See e.g., Gertz v. Robert Welch Inc.,* 418 U.S. 323,337 (1974) (recognition of the limitation of *New York Times v. Sullivan* for actions brought by private individuals, irrespective of public concern raised); *U.S. v. Alvarez No. 11-210,* Certi., to the U.S. Court of Appeals (9th Cir., 2012) (ruling that speech that can disparage (e.g. to falsely claim being the recipient of distinguishing military honour medals) is still protected by the First Amendment, even when proven to be false, and ruling the Stolen Valor Act, 18 U.S.C. § 704 to be unconstitutional); *Masson v. New Yorker Magazine, Inc.,* 501 U.S. 496, 509-511 (1991) (Supreme Court recommends as a "better practice" that instructions to juries refer to publication of a statement with knowledge of falsity or reckless disregard as to truth or falsity rather than to actual malice); and *New York Times Co. v. United States* 403 U.S. 724 (1971) (United States government efforts to enjoin a newspaper from publishing information (i.e. "the Pentagon papers") in its possession is contrary to the First Amendment requirement that public questions of a public nature should be facilitated by permitting "uninhibited, robust, and wide-open" debate (Brennan, J., concurring)).

[497] *See e.g., Pfeiffer, v. CIA and United States,* United States Court of Appeals, (Dist. of Columbia Cir. 1995) No. 94-5107; Aff'd Appeal from United States District Court for the Dist. of Columbia (No. 91cv00736) (dismissing an ex-CIA employee's claim to intellectual information gained while employed by the CIA); and *Little, v. Breland, Mobile Press Reg., Inc.,* United States Court of Appeals, No. 94-6668 (11th Cir. 1996) (*Aff'd* S.D. Alab. No. 92-0820-CB-C), ruling that a "limited purpose public figure" is required to meet the actual malice standard in order to successfully claim defamation. *See Gertz v. Robert Welch, Inc.,* 418 U.S. 323, 351 41 L.Ed.2d 789 (94 S.Ct. at 3013) (1974).

[498] Ken Paulson, First Amendment Center, Oct. 11, 2011, (unpublished comment, by Ken Paulson to Justice Scalia: reflections on New York Times v. Sullivan) *available at* http://www.firstamendmentcenter.org/justice-scalia-reflections-on-new-york-times-v-sullivan (last accessed Apr. 1, 2015)

[499] Kermit L. Hall, *New York Times Co. v. Sullivan*. The Oxford Companion to the Supreme Court of the United States (2012).

determining whether the egregious statements constituted protected or unprotected speech, has also been highlighted as a novelty.

- *Jefferson Cty. Sch. Dist. v. Moody's Inv. Serv., Inc.,* (1999)[500]

The Jefferson County School District (hereafter, Jefferson County) selected S&P and Fitch to rate its bond issue. However, Jefferson County was dissatisfied with an unsolicited low rating awarded to the issue by Moody's and duly sued the latter for "intentional interference with contractual relations, intentional interference with prospective contractual relations, and publication of an injurious falsehood".[501] Jefferson County cited the reports which appeared on 'The Dow Jones Capital Market Reports' website within a few minutes of Moody's disclosure affirming a negative outlook rating for its bond issue, as the trigger for the cessation of purchase orders and the cancellation of standing orders by buyers. As a result, Jefferson County was forced to re-price its bonds at a higher interest cost in order to complete the sale, a process through which it attests to have suffered a loss of $769,000.

Ruling in favour of Moody's, the Tenth Circuit court contrasted the US Supreme Court ruling in *Milkovich v. Lorain Journal Co.,* (1990)[502] with the First Amendment's provisions as follows: The decision in *Milkovich* provides for a plaintiff's right to action for reputational damage arising from provably false statements, whereas the First Amendment establishes protection for the "unfettered interchange of ideas for the bringing

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[500] *Jefferson Cty. Sch. Dist. No. R-1 v. Moody's Inv. Serv., Inc.,* 175 F.3d 848 (10th Cir. 1999).

[501] *Jefferson Cty. Sch. Dist. No. R-1*, at 856.

[502] *Milkovich v. Lorain Journal Co.,* 497 U.S. 1, 11-14, 110 S.Ct. 2695, 111 L.Ed.2d 1 (1990) (a perjury case where the court, on ruling in favour of the plaintiff, found that because the journal article's comments were neither couched in hyperbole, presented figuratively or in any other way that would mean the writer didn't seriously mean it, where such statements had been asserted as opinions could have been easily verified, could not therefore be regarded as opinions as they had been asserted as matter of objective fact).

about of political and social changes desired by the people".[503] The Tenth Circuit court also noted that the First Amendment's guaranteed protection of freedom of expression clause limited the scope of state defamation laws[504] and thus required aggrieved public officials and public figures to demonstrate that the contentious statements in question had been made with actual malice as a condition for them to successfully claim for damages regarding statements deemed false or defamatory.[505]

For defamation claims against media defendants, the court established an even higher threshold for plaintiffs. As well as carrying the burden of identifying and proving actual malice (i.e. the falsity of the statement),[506] plaintiffs in defamation cases brought against media defendants were also required to show that the latter "had the requisite state of mind"[507] to issue a false statement. In other words, the court ruling placed the onus on the plaintiff to not only provide proof that a media defendant chose to publish a libellous

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[503] *See, Roth v. United States,* 354 U.S. 476, 484 (1957) (where the Supreme Court upheld Roth's conviction when ruling that obscenity was not protected by the First Amendment); Caleb M. Deats, *Talk that Isn't Cheap*, 110 COLUM. L. REV. 1818, 1852 n.298 (2010) citing the decision in *Whitney v. California*, 274 U.S. 357, 377 (1927) (and that discourse and the interchange of ideas will "correct any inaccuracies in that speech and diffuse the changes such inaccuracies pose"); *Gertz v. Robert Welch Inc.* 418 U.S. 323, 339, 341 (1974), (Cert. 7th Cir.) (Powell Justice: "Under the First Amendment, there is **no such thing as a false idea** . . . (it) requires that we protect some falsehood in order to protect speech that matters")(emphasis added).

[504] *Jefferson Cty. Sch. Dist. No. R-1,* at 852.

[505] *Jefferson Cty. Sch. Dist. No. R-1,* at 857.

[506] Oliver von Schweinitz, *Ratings Agencies: Their Business, Regulation and Liability Under U.S., U.K. and German Law* 186 Unlimited Publishing LLC, Bloomington, Indiana (2007) notes that under German law §824 BGB renders a person liable for dissipation of a wrongful statement endangering the credit of another if the opinion-giver should have been aware of the statements falsity, although he expresses doubt that the courts would consider CRA opinions under this provision. *Id.,* at 188-89, he adds that §826, which provides compensation for pecuniary damages, would require plaintiffs to demonstrate that CRAs, as expert opinion-givers, had been grossly negligent when issuing an unsolicited rating, or merely negligent when issuing a solicited rating.

[507] *Jefferson Cty. Sch. Dist. No. R*-1., at 852.

article despite having "knowledge of the falsity of the statement or with reckless disregard of whether it was false or not" - as had been established in *New York Times*, but also that the publisher entertained actual doubt as to the statement's truthfulness.[508]

- *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*[509]

The Connecticut Attorney General sued on behalf of the Connecticut Resources Recovery Authority (i.e. CRRA) – a public entity – to recover approximately $200 million of losses arising from a transaction with Enron. The CRRA claim alleged that the Big Three were liable for "negligent misrepresentation" and for failing to demonstrate reasonable care or competence in their role as assessors of Enron's true creditworthiness. In ruling in favour of the Big Three, the court found that the plaintiff's complaint had failed to properly allege actual malice[510] and therefore ruled to dismiss the negligent misrepresentation claims. In contrast to the West Virginian Appellate court decision in *Jones v. Credit Bureau of Huntington,* which determined that proof of malice was not required by the court when assigning punitive damages,[511] numerous other state court

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[508] *Jefferson Cty. Sch. Dist. No. R-1.,* at 852.

[509] *In re Enron Corp. Securities, Derivative & "ERISA" Litigation,* 511 F. Supp. 2d 742 (S.D. Tex. 2005).

[510] "[I]n allegations alleging fraud . . ., a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally" (the heightened pleading standard set out in Federal Rule of Civil Procedure 9(b)). See also *In re Enron Corp. Sec., Deriv. & "ERISA Litig"* at 518 (2005). The court wrote: "The plaintiff must plead specific facts, not merely conclusory allegations, to avoid dismissal", (citing *Collins v. Morgan Stanley Dean Witter,* 224 F.3d 496, 498 (5th Cir. 2000), to highlight the need to plead with "particularity", as per Rule 12(b)(6), dismissal resulting from failure to state a claim). *See, Lovelace v. Software Spectrum, Inc., 78 F.3d 1015, 1017* (5th Cir. 1996)).

[511] *See, e.g. Jones v. Credit Bureau of Huntington* 399 S.E.2d 694, 703, Supr. Court of Appeals of W.Virg.1990). ("[U]nder 15 U.S.C. § 1681n (1988), punitive damages for wilful violations were within the discretion of the court and "malice or evil motive need not be found for such award").

decisions[512] have required actual malice to be proven in order to find a defendant liable or to allow a court to assign punitive damages.

The Southern District of Texas court ruling in *re Enron Corp. Sec., Derivative* (2005)[513] established that a plaintiff was required to show that a statement made by a publisher regarding matters of public concern must be shown to have been made with actual malice in order to impose liability on a defendant. The actual malice standard protects publishers from liability for "either innocent or negligent misstatement" so as not to chill the press' exercise of constitutional guarantees.[514] In its *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.,* (2009) ruling, the District Court (i.e. S.D.N.Y) held that, absent particular proof of actual malice, CRAs could only receive First Amendment protection if they had distributed their ratings to the public at large, and not only to a select group of private investors.[515] This contrasted with the same District court's decision in *re Ambac* (2010) where it ruled that "[m]alice … and other conditions of a person's mind may be alleged generally".[516]

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[512] *See e.g., Compuware v Moody's; County of Orange v McGraw-Hill; Gertz v Robert Welch Inc.; Dun & Bradstreet, Inc. v Greenmoss Builders*; (the courts required plaintiffs in all cases to prove "actual malice").

[513] *In re Enron Corp. Sec., Deriv.,* 511 F.Supp.2d 742, 810 (2005), MDL No. 1446, Civil Action Nos. 11-01-3624, H-03-1580, H-03-1579, H-03-1558 (S.D. Tex., Hou. Div. 2005).

[514] *See e.g., County of Orange v. McGraw Hill Co., Inc.,* 245 Bankr. 151, 155 (C.D. Cal. 1999) (also held that the First Amendment barred claims for negligence and breach of contract. *See also, Time v. Hill, 385* U.S. 374, 389, 87 S.Ct. 534, 17 L.Ed.2d 456 (1967); *Hustler Magazine v. Falwell,* 485 U.S. 46, 56, 108 S.Ct. 876, 99 L.Ed.2d 41 (1988) (cited in *In re Enron Corp. Sec., Deriv.,* 511 F.Supp.2d 742, 810, 811(S.D. Tex., Hou. Div. 2005); *Jefferson County School Dist. R-1 v. Moody's Investor's Servs., Inc.,* 175 F.3d 848, 856-57 (10th Cir. 1999) (claims for publication of an injurious falsehood barred because of First Amendment protections).

[515] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.,* 651 F.Supp.2d 155, 176 (S.D.N.Y. 2009).

[516] *In re Ambac Financial Group, Inc.,* 693 F.Supp.2d 241, n.24 (S.D.N.Y. 2010).

The court's ruling requiring a plaintiff to plead with particularity is especially onerous when the defendant is a CRA that is privy to non-public information and more so when the security in question is a structured product due to opaqueness surrounding the structuring and the potential conflicts of interest that have been raised.

4.3.1.2. Pleading with particularity

Further confounding the position on whether plaintiffs are required to plead with particularity or generally, a New Mexico District Court in *Genesee County Employees Ret. System* in 2011 ruled that the actual malice standard would only apply where the contested statements implicated the First Amendment provisions.[517] Rule 9 (b) of the Federal Rules of Procedure provides: "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud[518] or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally".[519]

In order to satisfy the requirement of pleading fraud allegations with particularity,[520] "… a plaintiff must (i) specify the statements that the plaintiff contends were fraudulent, (ii) identify the speaker, (iii) state where and when the statements were made, and (iv) explain why the statements were fraudulent."[521]

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[517] *Genesee County Employees Ret. System v. Thornburg Mortgage,* 825 F.Supp.2d 1082, 1234-35, 1238 Case No. CIV 09-00300-JB/KBM (D. N. Mex. 2011).

[518] *Publ. Empl. Ret. Sys. of Mississippi v. Goldman Sachs Grp.,* No. 09 CV 1110 (HB) (claims premised on fraud Rule 9(b) the Fed. R. Civ. P. However, Securities Act claims that "sound in negligence" are governed by the standard notice pleading requirements of Rule 8. *See, In re Morgan Stanley Info. Fund Secs. Litig.,* 592 F.3d 347, 358 n.4 (2d Cir. 2010)).

[519] Fed.R.Civ.P. 9(b).

[520] Fed. R. Civ. P. 9(b)(under Rule 9(b), when alleging fraud)

[521] *See Anschutz Corp. v. Merrill Lynch & Co*., 690 F.3d 98, 108 (2d Cir. 2012).

These requirements notwithstanding, the particularity standard, when it has been deemed relevant and/or necessary,[522] has only been found to be controlling where fraud is neither alleged[523] nor established.[524] Furthermore, the inability of plaintiffs to either prove that the defendants in question had "knowledge of the falsity of the statement or [proceeded to publish with] reckless disregard of whether it was false or not", or to assert a defendant's "state of mind"[525] at the time of publishing, have hampered the argument presented by plaintiffs in a multitude of lawsuits resulting in successive legal victories for CRAs.[526]

In the decision in *LaSalle Nat'l Bank* (1996)[527], Judge Knapp affirmed the judge's opinion in toto with its recommendation regarding the critical First Amendment issue by rejecting the claim that the actual malice standard was applicable when a credit rating was "privately contracted for and intended for use in the private placement Offering

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[522] *See e.g., In re AMBAC Fin. Grp.,* 693 F.Supp.2d 241, 275 (S.D.N.Y. 2010) (held that Plaintiffs met the Rule 9(b) standard by specifying the "who, what, when, where and how" of the alleged misstatements", therefore court found no need to determine for fraud).

[523] *See e.g., New Jersey Carp. Vac. Fund. v. Royal Bank of Scot. Grp.,* No. 08 CV 5093 (HB), n.6 (S.D.N.Y. 2010) (court refutes applicability of Rule 9(b) of the Fed.R.Civ.P. (pleading with particularity) because plaintiff does not allege fraud).

[524] *See e.g., In re Countrywide Fin. Corp. Sec. Litig.* 588 F.Supp.2d 1132, 1201 No. CV-07-05295-MRP (MANx) (C.D. Cal. 2008) (court ruled that control element does not constitute fraud and hence finds no need to plead with particularity); *In re LDK Solar Sec. Litig.,* 2008 WL 4369987, at *12, 2008 U.S. Dist. LEIS 80717, at *38 (N.D.Cal. Sept.24, 2008); and *New Jersey Carpenters Vac. v. Harborview Mortg.,* 581 F.Supp.2d 581 No. 08cv5093 (HB) (S.D.N.Y. 2008) (dismissed for failing to state a claim).

[525] *See e.g., Genesee Cty. v. Thornburg Mortg. Sec.* 825 F.Supp.2d 1082, 1241 (D. New Mex. 2011) (court notes that rule 9(b) does not require alleging a person's knowledge or other states of mind with particularity, citing Fed.R.Civ.P. 9(b));

[526] *See e.g., Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.,* 472 U.S. 749 (1985), Aff'd 461 A.2d 414 (Vt. 1983), Cert. granted, 464 U.S. 959 (1983); and *County of Orange v. McGraw-Hill Co.,* 245 B.R. at 156

[527] *LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co.* 951 F. Supp. 1071 (S.D.N.Y. 1996).

Memoranda rather than for publication in a general publication". The *LaSalle* district court however, took recognition of CRAs' active role in the structuring process[528] as its basis for recognizing a premise for the "near privity" argument. The importance of the District court's recognition of the near privity doctrine is that it permitted for claims of a duty owed between the CRA and investors in private placement security offers[529] to be raised.

The district court in *Anschutz Corp v Merrill Lynch and Co.* (2011) court held that the actual malice standard had applied in *Compuware* "only because Compuware was a public figure"[530] and ergo, was a matter of public concern: and yet, the question of what actually constitutes a public concern remains unclear. The answer appears to rest on whether one interprets public concern to be premised on the content of the ratings themselves or the extent to and manner in which said ratings are distributed to larger as opposed to smaller groups of investors. Alternatively, it could be a product of the two aforementioned interpretations. Going by the district court's definition, as large corporate organizations, CRAs generally and NRSROs in particular, could also be considered to be public figures and their ratings could be deemed issues of public concern. The debate regarding the implications of classifying ratings as an issue of public concern will be revisited in greater detail under section 4.3.3. below.

What is clearer from the body of legal decisions that have been handed down – including the three cases highlighted above – is that in lawsuits brought against CRAs, courts have had to primarily make a determination in each instance on whether the CRA is to be classified on par with media functionaries, public figures or private defendants.[531]

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[528] *LaSalle Nat'l Bank,* at 1076.

[529] *LaSalle Nat'l Bank,* at 1092-93.

[530] *Compuware Corp. v. Moody's Investors Servs.,* 499 F.3d at 522, 525; *(as cited in Anschutz Corp. v. Merrill Lynch and Co.* 785 F.Supp.2d 799, 831 (N.D. Calif. 2011)).

[531] *See e.g., NY Times,* 376 U.S. 254.

Qualifying under the general umbrella of media functionaries[532] CRAs have historically received the highest level of protection from the courts in lawsuits, even as more recent court rulings handed down over the last 15 years have acknowledged that journalists' protection is not unqualified.[533] Equally determinant among the lawsuits that have been dismissed has been the failure by plaintiffs to go beyond providing "conclusory statements"[534] and to identify specific falsities in order to meet the heightened standard of

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[532] *See,* Joynt, S.W., Senate Hearing: Before the Comm. on Banking, Housing & Urban Affairs, 109th Cong. (Prepared statement of Stephen W. Joynt, President & CEO, Fitch Ratings).

[533] *See e.g., County of Orange v. McGraw Hill Co.,* 245 B.R. 154 (C.D. Cal. 1999): "S&P's status as a financial publisher does not necessarily entitle it to heightened protection under the First Amendment"; and *Newby v. Enron Corp.,* U.S. Dist. LEXIS 4494, at 3 (S.D. Tex., 2005) (Court ruled that First Amendment protection for credit ratings was "qualified," not absolute).

[534] *See e.g. Eclectic Properties East, LLC. v. Marcus & Millicap Co.,* (N.D. Cal., San Jose Div. 2012) (court dismissed claim on finding that the plaintiffs' RICO claim lacked plausibility despite being embellished with particularities); *In re Countrywide Fin. Corp.* 554 F.Supp.2d 1044, 1057 (C.D. Cal. 2008) (PSLRA requires pleading "with particularity facts giving rise to a strong inference" of scienter, a mental state that embraces the intent to deceive, manipulate, or defraud); *see also Ernst & Ernst v. Hochfelder, 4*25 U.S. 185, 194 n. 12, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976) (court dismisses conclusory statements); and *Publ. Empl. Ret. Sys. of Mississippi v. Goldman Sachs Grp.,* No. 09 CV 1110 (HB) (S.D.N.Y. 2011) (court dismisses conclusory statements).

pleading with particularity[535] as is required under the Private Securities Litigation Reform Act of 1995 (hereinafter, PSLRA).[536]

As was mentioned in Section 4.1 above, the ruling in *In re Fitch* (2003) stipulated that CRAs could no longer expect to automatically be granted the same First Amendment constitutional protection as traditional media. The merits of this position appear sound and convincing, particularly when one considers instances involving structured products where CRAs not only continue to provide ratings in exchange of payments, but where they also actively participate in the structuring of securities. Although the level of CRA collaboration associated with the structuring and rating of structured products is extensive, the actual malice standard is demonstrably so high as to restrict the ability of plaintiffs to

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[535] *See e.g., In re The Goldman Sachs Grp., Shareholder Litig.,* Civil Action No. 5215-VCG, Court of Chancery of Delaware (Oct.12, 2011) (plaintiffs failed to demonstrate with specificity the claims of Goldman's undue influence on CRAs); *New Jersey Carp. Vac. Fund v. Royal Bank of Scot. Grp. Plc,* (S.D.N.Y. 2010) (dismissed, for failing to state claim (with particularity) against CRAs); *Genesee Cty. v. Thornburg Mortg. Sec.,* 825 F.Supp.2d 1082, 1241 (D. N. Mex. 2011) (rejected, Plaintiff's argument noting that Rule 9(b) requires pleading claims with particularity only when fraud or a mistake is alleged, citing Fed.R.Civ.P. 9(b)); *In re Thornburg Mortg., Inc. Sec. Litig.,* 695 F.Supp.2d 1165, n.24 *In re Thormburg Mortg., Inc. Sec. Litig.*, No. CIV 07-0815 JB/WDS (D. New Mex. 2010) ("a plaintiff must state with particularity facts giving rise to a strong inference of scienter [to the] defendant"); *Ohio Pol. & Fire. v. Standard & Poor's Fin.,* 813 F.Supp.2d 870, Case No. 2:09-cv-1054 (S.D. Ohio, E. Div. 2011)(Ohio Funds' claim under O.R.C. § 1707.43 dismissed for failing to plead a violation with particularity at 879); *In re Enron Corp. Sec., Deriv.,* 511 F.Supp.2d 742, *In re Enron Corp. Sec., Deriv. & "ERISA" Litig.,* (2005) (to allege scienter defendants must specify with particularity the content, time, and place of the alleged misrepresentations); *Shain v. Duff & Phelps Credit Rating Co.,* 915 F.Supp. 575,578, No. 94 Civ. 0721(WK) (AJP) (S.D.N.Y. 1996) (Plaintiff's claims dismissed for failure to state a claim and failure to plead with particularity, i.e. Rules 12(b) and 9(b)).

[536] PSLRA, Pub. L. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). 15 U.S.C. § 78j(b) (1982). *See also,* Douglas M. Branson, *Securities Litigation in State Courts - Something Old, Something New, Something Borrowed*, 76 WASH. U. L. Q., 509,514 (1998) (Plaintiffs must state "with particularity" facts giving rise to a "strong [causal] inference" that the defendant acted with the requisite state of mind").

successfully plead their lawsuits with sufficient particularity (as per the PSLRA's heightened standards of pleading)[537] to convince the courts to rule in their favour. It is worth noting that the "state of mind" requirement for a private securities fraud action seeking money damages from a CRA (or controlling person), was modified and effectively loosened by the Dodd-Frank Act.[538] As a result, post-DFA, it now suffices for a plaintiff to state, with particularity, facts demonstrating that the CRA knowingly or recklessly failed to carry out reasonable investigations of a rated security.[539]

While not comprehensive, the above example of court decisions serve to highlight the anecdotal evidence demonstrating that pleading fraud has not proven to be a successful approach for plaintiffs in lawsuits brought against CRAs., The reason for this appears to arise from the very onerous standards of proof required. In particular, the need for plaintiffs to plead with particularity with regard to the alleged fraud committed or by the need to prove scienter on the part of the defendant. However, some courts have ruled that a special relationship does exist wherein a CRA is assumed to have the responsibility of a fiduciary and is thus deemed to owe a duty of care exercised through the provision of

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[537] 15 U.S.C. § 78j (b) (1982). *See* Branson, *supra* note 536, at 514 (Plaintiffs must state "with particularity" facts giving rise to a "strong [causal] inference" that the defendant acted with the requisite state of mind").

[538] Caleb M. Deats, *Talk that Isn't Cheap*, 110 COLUM. L. REV. 1818, 1837 n.110 (2010) (DFA applies a lower liability standard than presented by actual malice jurisprudence).

[539] Dodd Frank Act, § 933 (State of Mind in Private Actions reads:"[I]n the case of an action for money damages brought against a credit rating agency or a controlling person under this title, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complainant **state with particularity facts giving rise to a strong inference** that the credit rating agency knowingly or recklessly failed --

''(i) to conduct a **reasonable investigation of the rated security** (emphasis added) with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or

''(ii) to **obtain reasonable verification of such factual elements** (emphasis added) (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.'').

accurate ratings has been recognized. Similar to the privity approach demonstrated in the decision in *Compuware*, that would regard CRAs as public figures is a premise here to regard credit ratings as a public concern.

However, there does not yet appear to be consensus among the judgements handed down whether the matter of being a large company alone would suffice to qualify a CRA for recognition as a public figure or whether the ratings become public by the extent to which they are distributed and made available to the general public. At the heart of the debate is at what point does a rating achieve public status. For example, given an CRA that issues a rating on a security that was only made available to a private group of investors on one hand, and a privately held CRA which issues a rating on a security that is made available to all investors on the other hand. Would CRAs be regarded as "public figures", and their ratings as "public concerns", or whether they would be treated differently by the courts; and if differently, in what manner? The answers to these questions are not yet clear at the moment and are beyond the scope of this paper.

4.3.2. Negligent misrepresentation[540]

Given the high threshold for proving actual malice and determining scienter against the CRAs, it is not surprising that plaintiffs have tended to more often than not plead for negligent misrepresentation. Negligent misrepresentation relies on establishing that the CRA owes a duty of care in providing accurate information in the form of ratings whereas fraud relies on determining that the CRA knowingly issued false or misleading ratings.[541]

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[540] See e.g., *Ziegler v Findlay Indus.,* Inc., 464 F.Supp.2d 733, 738 (N.D. Ohio 2006)(negligent misrepresentation claims usually involve a defendant "who is in the business of **rendering opinions to others for their use** in guiding their business") (emphasis added); *Bellios v. Victor Balata Belting Co.,* 724. F.Supp. 514, 519 (S.D. Ohio 1989) (negligent misrepresentation typically refers to those "**rendering a professional opinion**") (emphasis added).

[541]Timothy M. Sullivan, *Federal Pre-emption and the Rating Agencies* 94 MINN. L. REV., 2136, 2147 (2010) (citing *Quinn v McGraw-Hill Cos.,* 168 F.3d.331, 334-36 (7th Cir. 1999)).

- *Ohio Police & Fire Pension Funds v Standard & Poor's Fin. Serv.* (2011)[542]

A lawsuit brought by five Ohio pension funds alleging that they had suffered losses of $475 million as a result of their reliance on high credit ratings (i.e. AAA ratings) assigned by the Big Three CRAs that purportedly were "false, negligently assigned, and based on flawed methodologies",[543] was dismissed by the Southern District of Ohio, Eastern Division's District Court. The plaintiffs argued that the structural nature of the issuer-pays remuneration model adopted by the Big Three as well as their on-going "collaborations" with issuers, particularly when issuing ratings for structured products, had heightened the conflict of interest dynamics and incentives to the detriment of the five pension funds. However, the court noted that unlike the U.S. Court of Appeals' Sixth Circuit court's ruling in *Compuware Corp v. Moody's Investors Serv. Inc.*,[544] wherein the court extended First Amendment protection to ratings of publicly-held companies, courts in more recent decisions[545] had declined to extend similar protection for ratings that are considered a product of an issuer-pays model and are only meant for or marketed to a few select investors at the stage where a motion-to-dismiss claim is sought. The complainant also asserted a claim under the Ohio Securities Act,[546] which extends secondary liability to anyone who "participated in or aided the seller in any way" in making an unlawful sale

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[542] *See, Ohio Police & Fire Pension Funds v. Standard & Poor's Fin. Serv., LLC*, 813 F.Supp.2d 871, 885 Case No. 2:09-cv-1054 (S.D. Ohio, E. Div. 2011) (CRAs' motion-to-dismiss granted as court ruled that they cannot be held liable for alleged negligence in their methodologies).

[543] *Id., Ohio Police & Fire Pension Funds*, at 872 (2011).

[544] *e.g., Compuware Corp. v. Moody's Investors Serv. Inc.,* 499 F. 3d. 520, 525-26 (6th. Cir. 2007); *In re Enron Corp. Securities, Derivatives & ERISA Litig.,* 511 F. Supp. 2d. 742, 825-26 (S.D. Tex. 2005).

[545] *See e.g., In re Nat'l. Century Fin. Enterprises, Inc. Inv. Litig.,* 580 F. Supp. 2d.630, 639-40 (S.D. Ohio 2008); and *Abu Dhabi Comm. Bank v. Morgan Stanley & Co. Inc.,* 651 F. Supp. 2d. 155, 175-76, n.1 (S.D.N.Y. 2009).

[546] § 1707.43.

of securities to the Ohio Funds. Ohio's "Blue sky" laws prohibit sellers of securities from making material misrepresentations or omissions of material fact in printed materials that are reasonably relied on by purchasers.[547] Regarding the negligent misrepresentation claim in particular, the plaintiffs alleged that the CRAs owed "a duty to act with reasonable care[548] in preparing, assigning, maintaining, and disseminating the AAA credit ratings assigned to each of the securities" purchased by the funds.

The Ohio district court ruled that the CRAs were not liable because the statute requires that profits in question must accrue only from the sale of securities (to the CRAs) and not from fees earned in the preparatory structuring process of an offering where the fee itself is not contingent upon an actual sale.[549] That is to say, under Ohio State law, CRAs are only liable if they receive profits: (i) arising from the sale of securities, and (ii) from work done by the CRAs post-issue, i.e. subsequent to the offering. Because CRAs earn the bulk of their income from work done pre-issue (i.e. consulting and rating) as opposed to post-issue (i.e. monitoring),[550] the bulk of fees earned by CRAs occur in the very preparatory structuring process prior to the issuing of securities that Ohio law exempts from liability. If the aim is to compensate the plaintiffs, then limiting the extent of liability solely to post-issue profits would appear to grossly undercut that objective.

Supposing that one was to decide to equate the issuing of securities to an actual sale, then an argument could possibly be made that monitoring and/or recurring fees generated post-issue by a CRA could therefore be considered as profit arising from the sale of the

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[547] O.R.C. § 1707.41(A).

[548] *Ohio Police & Fire Pension Funds v. Standard & Poor's Fin. Serv., LLC*, 813 F.Supp.2d 871, 885 Case No. 2:09-cv-1054 (S.D. Ohio, E. Div. 2011) at11 n. 238.

[549] Ohio Funds' claim under O.R.C. § 1707.41; dismissed by court.

[550] *e.g.* Moody's Investors Services, the division that generates the credit ratings, research, and risk analysis tools generated 58% of its 2011 revenue from transactions and 42% from recurring revenues earned over the life of the rated security. *See* Moody's.com, 'Events and Presentations', Investor Presentation Q4 and FY 2011. (2012) (last accessed Apr. 1, 2015).

security. Under that premise, however unlikely, the monitoring fee income could allow plaintiffs to meet the requirements of the statute's profit requirement, allowing plaintiffs to access a larger liability claim. Getting around this statute would still be easy for CRAs to achieve. For example, CRAs could simply opt to front-load the fees in such a manner so as to make the portion of fees arising post-issue to be so low as to become negligible relative to potential claims. In addition, a further claim of aiding and abetting under § 1707.43 of the Ohio Securities Act was also dismissed due to the plaintiff's failure to plead with particularity. It is worth noting that similar aiding and abetting claims have also been dismissed by courts in two high profile cases brought by CalPERs and by the Abu Dhabi Commercial Bank involving the Cheyne and Rhinebridge SIVs, respectively.[551] The issues concerning aiding and abetting are re-examined in greater detail under section 4.3.4. below.

4.3.2.1. Actionable misrepresentation

The Ohio district court proceeded to grant the rating agencies the motion-to-dismiss, predominantly on the basis of the plaintiff's failure to successfully claim that a duty[552] was owed to it by the CRAs.[553] Such a duty, the court ruled, required for "there [to] be an

[551] Settlement in this case was reached on April 26, 2013.

[552] … [A] provider of information owes no duty "to the extensive, faceless, and indeterminable investing public-at-large." *See, Federated Mgmt. v. Coopers Lybrand* 137 Ohio App.3d at 385, 738 N.E.2d (citing *Haddon View Investment Co. v. Coopers & Lybrand* (1982), 70 Ohio St.2d 154, 24 O.O.3d 268, 436 N.E.2d 212).

[553] *Ohio Police & Fire Pension Funds* (noting multiple arguments for dismissal presented by the CRAs, the court resolved to focus on two "most clearly fatal to the negligent misrepresentation claim": (i) that the CRAs did not owe a duty to the Ohio pension funds, and (ii) that the ratings did not constitute actionable misrepresentations).

'actionable misrepresentation'",[554] which in-turn had to "relate to an existing or pre-existing fact which is susceptible of knowledge".[555]

Additionally, with regard to absent of privity of contract or a fiduciary duty, the court ruled that "a special relationship" must exist between the parties in order to create a duty and satisfy what? §552(2)(a).[556] The Ohio District court did not recognize that the existence of a special relationship had been established by the plaintiffs.[557] Instead, citing a First Circuit court decision which held that irrespective of admissions by CRA executives of deficiencies in their ratings models, the Ohio District court would not hold them liable under securities laws for rating opinions, that although held honestly when

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[554] *See, Credit Alliance Corp. v Arthur Andersen & Co.,* 65 N.Y.2d 536, 551, 483 N.E.2d 110, 118 (N.Y. 1985). *Contrast* with ruling on actionable misrepresentation under New York law in *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.,* 910 F. Supp. 2d 543 - Dist. Court, SD New York 2012, Scheindlin, J. (ruling that "under New York law, [] a plaintiff [may] maintain a negligent misrepresentation claim against a defendant to whom no actionable misstatement can be attributed").

[555] *Ohio Police & Fire Pension Funds*, at 882 (citing *Kondrat v Morris*, 118 Ohio App.3d 198, 207, (Ohio Ct. App. 1997) ("[T]o be actionable, a misrepresentation generally must relate to an existing or pre-existing fact which is susceptible of knowledge".). See also *In re Ford Motor Co. Securities Litig.,* 381 F.3d 563, 572 (6th Cir. 2004) (Only "if the speaker does not believe the opinion and the opinion is not factually well-grounded" are statements of opinion deemed actionable) ; and *Mayer v. Mylod,* 988 F.2d 635, 639 (6th Cir. 1993) check brackets; *In re IBM Securities Litig.,* 163 F.3d at 107, 110–11 (2nd Cir 1998) (held "expressions of optimism" and "projections of future performance" allegedly made by a firm were not actionable under the 1933 or 1934 Acts. See e.g. Volkert S. Whitbeck & Manown Kisor Jr, *A New Tool in Investment Decision-Making*, 19 J. FIN. ANALYSTS (3) 55, 60 (1963), offering quantified "… projections of future performance …"), and *Fait v. Regions Fin. Corp., 712 F.Supp.2d 117, 120–25*(S.D.N.Y.,2010)(Kaplan J., ruling that projections and estimations were judgment and opinion, and not statements of fact).

[556] See e.g., *In re Nat'l Century Fin. Enterprises, Inc., Inv. Litig.,* 580 F.Supp.2d 630, 639-40 (S.D. Ohio 2008); *Doe v. SexSearch.com*, 502 F.Supp.2d 719, 731 (N.D. Ohio 2007); *Ziegler v. Findlay Indus.,* 464 F.Supp.2d 733, 738 (N.D. Ohio 2006) (all dealing with the need for a "special relationship").

[557] *Ohio Police & Fire Pension Funds*, 813 F.Supp.2d 871, 881, at 15 (2012).

formed, turned out to be inaccurate ex-post;[558] nor simply because the CRAs might possibly have formed better opinions, ex ante.[559] In dismissing the case, the Ohio District court accepted that CRA ratings were "predictive opinions"[560] and ruled that due to the plaintiffs' failure in bringing specific allegations of fraudulent intent or proving that they were owed a duty; ergo, the CRAs could not be held liable for negligence arising from their methodologies.[561]

The challenge that this ruling introduces for future lawsuits is of course that CRA ratings are by definition forward-looking[562] predictive statements that are derived from both factual and non-factual premises and are largely reliant on subjective interpretations of conjecture that are not always founded on either existing or pre-existing facts. In order to be able to find forward-looking statements liable, a plaintiff either needs to plead that they were knowingly false when made by the defendant, which in the absence of concrete

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[558] US-Gov-House-Hearing, *The Role of Investment Banks*, April 27, 2010 at 9 ("It's easy for a lay jury, deciding after a prediction has proven wrong, to conclude—using the fuzzy "reasonable person" standard—that the speaker should have reached a different conclusion") (written statement of Eugene Volokh, Gary T. Schwartz Professor of Law, UCLA School of Law to the US House Comm., on Fin. Servs., on May 15, 2009).

[559] *Ohio Police & Fire Pension Funds,* at 884 (2012).

[560] *See also, Compuware Corp.,* 499 F.3d 520, 522 (6th Cir.2007) (describing credit ratings as a "predictive opinion" of "future creditworthiness that is reached through a subjective weighing of [certain] factors.").

[561] *Ohio Police & Fire Pension Funds,* at 871. *Compare,* SEC, *2008 Summary Report*, July 2008, at 36 (OEA staff observed that CRAs applied fundamentally similar methodologies to rate RMBS with probability of default and loss severity models requiring "50 to 60 inputs" as with CDO models that required "only five inputs", or the reliance on historical corporate bond default probabilities for RMS and CDO modelling).

[562] *Ohio Police & Fire Pension Funds,* n.173 (citing Frank Partnoy's comments on the forward-looking nature of ratings).

evidence would itself be a subjective measure,[563] or that the objective basis on which the statement was made was unreasonable, even if subjectively it was believed to be true at the time. Essentially, this assumes that the facts now being questioned were reasonably knowable ex ante.[564]

In the absence of an objective or established standard[565] against which the CRA ratings decision-making process can be evaluated, an actionable misrepresentation claim would fail under the *Ohio Police & Fire Pension Funds* decision principle.[566] The evidence hereto suggests that it is reasonable to assume that other state courts would likely reach different rulings, and it is imperative that the court system develops a "standard" of

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[563] *See e.g.,* US-Gov-House-Hearing, *The Role of Investment Banks*, April 27, 2010, at 9 ("How to interpret the facts that A acquires…is a subjective matter. How to predict the future based on those facts is even more subjective. Even reasonable predictions will often prove mistaken.").

[564] William G. McGuiness, John W. Brewer, *Credit Rating Agencies Under the Microscope*, N. Y. L. J. (2009), *available at* http://www.newyorklawjournal.com/id=1202427131287?slreturn=20150225144202 (last accessed Mar. 25, 2015).

[565] *Ohio Police & Fire Pension Funds,* at 883. *See also*, comments by Cardozo J., on the absence of an objective standard by which to determine negligence claims in *Ultramares Corp.,* 255 N.Y. 170, (1931), at 188 ("Negligence, moreover, will have one standard when viewed in relation to the employer, and another, and at times a stricter standard, when viewed in relation to the public".); Dieter Kerwer, *Holding Global Regulators Accountable* 18 GOVERNANCE: INT'L J. POL'Y, ADMIN., & INST'S (3), 453, 469 (2005) (on the absence of a CRA equivalent to the G AAP standards / principles used by auditing firms.); Matthias Lampe, Matthias & Michelle Yeo-Mokhtar, , *'A Practioner's View of the Rating Process for Asset-Backed Securities'* (Conference on Credit Rating Agencies, Stockholm Univ., (check brackets no benchmarks are available as each [financial product] structure is unique). *See also,* CESR Report, May 2008, at 59-61 (CESR recommendation to EU Commission to form "…[] an international CRA standard setting and monitoring body…"). *See also,* Sisi Zhang, *Legal Liability of U.S. Credit Rating Agencies under Section 11 of the Securities Act,* *37 Note (Uni. of Toronto) (2010).

[566] *Contrast*, e.g., *Abu Dhabi Commercial Bank v. Morgan Stanley & Co*., Inc., 651 F.Supp.2d 155, 178 (S.D.N.Y. 2009); *In re Nat'l Century*, 580F.Supp.2d, 639, where courts held that CRA ratings were actionable misrepresentations.

sorts to improve ruling predictability.[567] In addition, similar to decisions already mentioned that relied on the actual malice standard, the Ohio District court also held that the complainant "…fail[ed] to allege [with particularity] that the rating agencies did not believe their ratings."

- *Abu Dhabi Comm. Bk. et al. v. Morgan Stanley & Co. et al.,*[568] *and King County, Wash. v. IKB Deutsche Industriebank AG (IKB)*[569]

The *Abu Dhabi Commercial Bank et al. v. Morgan Stanley & Co. et al.,*[570] lawsuit was litigated concurrent to the Kings County lawsuit in the Southern District of New York (S.D.N.Y.) court.[571] Similar to the ruling in *Ohio Police & Fire Pension Funds*, the 'aiding and abetting' claim[572] was dismissed in the *Abu Dhabi Commercial Bank* and *King County* lawsuits as well as in the lawsuit brought by CalPERS.[573] King County in Washington state invested $50 million into the Cheyne Finance structured investment vehicle (i.e. SIV)

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[567] John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis* 2009 COLUM. BUS. L. REV., (1) 109,193-196 (2009) (the "reasonable standard" delegates the setting of a standard to the court system).

[568] *Abu Dhabi Commercial Bank et al v. Morgan Stanley & Co et al*, U.S. District Court, Southern District of New York, No. 08-07508 (seeking $638 million in damages).

[569] *King County, Washington et al v. IKB Deutsche Industriebank AG et al* in the same court, No. 09-08387 (seeking $70 million in damages for SIV structured by IKB. A settlement was reached in 2012).

[570] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.,* 651 F.Supp.2d 155 Superior Court of California, Cty. of San Francisco, Case Number: CGC-09-490241 (2009).

[571] *King County v. IKB Deutsche Industriebank AG*, Case 1:09-cv-08387-SAS Document 262 (Filed 06/07/12).

[572] e.g., *Design Strategy, Inc., vs. Davis*, 469 F.3d 284, at 303 (2006) (plaintiff required to prove violation by the primary tort, as well as knowledge thereof by the aider and abettor as well as substantial assistance in the tort).

[573] *CalPERS Complaint* (Complaint alleges that the SIVs could only be sold to specific classes of buyers and were constituted of underlying assets that were known only to the SIVs, and the involved CRAs).

product alongside the $1.3 billion invested by CalPERS into Cheyne Finance and two other SIVs.[574] All three SIVs had been accorded the highest ratings[575] by the Big Three in 2006 before collapsing in 2007 and 2008.[576]

The plaintiffs claimed that ratings issued to the SIVs were "wildly inaccurate and unreasonably high" and that the rating methodology applied by CRAs was fundamentally flawed and incompetently applied. In its defense, Morgan Stanley contended that the SIV's losses were not the result of a drop in credit performance but rather the result of a fall in market prices.[577] Despite dismissing almost all of King County's claims, Judge Scheindlin in the September 2009 ruling, rejected the CRA's request to dismiss the case on the grounds of free speech. The court's rejection of the First Amendment defence was premised on its view that Cheyne Finance's ratings had not been widely disseminated as they had instead only been offered "to a select group of investors".[578] In addition, Judge

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[574] Stanfield Victoria Funding LLC and Sigma Finance Inc.

[575] AAA/ A-1 by S&P, Aaa/P-1 by Moody's for the Cheyne, Stanfield Victoria, and Sigma SIVs; and AAA by Fitch for the Sigma SIV.

[576] Karen Gullo, *Moody's, S&P Lose Bid to End Calpers Lawsuit Over Ratings of SIV Vehicles*, BLOOMBERG, Jan. 11, 2012, *available at* http://mobile.bloomberg.com/news/2012-01-12/moody-s-s-p-lose-bid-to-end-calpers-lawsuit-over-ratings-of-siv-vehicles (last accessed Apr. 2, 2015).

[577] *e.g.,* Gretchen Morgenson, *Court Papers Undercut Ratings Agencies' Defense*, N.Y. TIMES, July 2, 2012, at B1.

[578] *King County, Washington v. IKB Deutsche Industriebank AG (IKB),* 09-CV-8387 (although a Moody's spokesman disputed the allegation that the Cheyne ratings had only been offered to a select group of investors as they are published on the company's website, the webpage is only accessible to paid subscribers). *See also, In re National Century Financial Enterprise Inc. Invest. Litig.,* 580 F.Supp.2d 630, 639-40 (S.D. Ohio 2008) (held that ratings disseminated to a select group of (institutional) investors in connection with a private placement rather than to the general public did not merit First Amendment protection); and *Cal. Public Employees Ret. System, No. CGC-09-490241*, slip op. at 10 (Cal. Super. Ct. S.F. Cty. June 1, 2010) (same).

Scheindlin also ruled that the boilerplate disclaimers included by CRAs in the Information Memoranda were:

"… [U]navailing and insufficient to protect the rating agencies from liability for promulgating misleading ratings".[579]

The lawsuit was further narrowed on May 7, 2012 when Judge Scheindlin dismissed claims alleging aiding and abetting fraud, breach of fiduciary duty and negligence. The judge however refused to dismiss the negligent misrepresentation claims arising from Abu Dhabi Commercial Bank's and King County's "Cheyne" and "Rhinebridge" SIV investments, respectively. The court's decision was guided in part by the electronic correspondence[580] between S&P analysts wherein their acknowledgement of awareness of the unreliability of the ratings that they were issuing was stated; in part by the details presented confirming that the CRAs were in possession of non-public information that contradicted the high ratings awarded; and in part on the acceptance that the plaintiffs' reliance on the ratings was reasonable.[581] Confirming their intention to challenge the court's refusal to dismiss the negligent misrepresentation claim, S&P's spokesman John Piecuch and Moody's Daniel J. Noonan expressed their disagreement with the ruling, considering it to be "inconsistent with decisions of other courts and incorrect".[582]

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[579] Gretchen Morgenson, *Court Papers Undercut Ratings Agencies' Defense*, N.Y. TIMES, July 2, 2012, at B1.

[580] *See,* First Amended Complaint for Common Law Fraud, Negligent Misrepresentation, Negligence, Breach of Fiduciary Duty, Breach of Contract, Unjust Enrichment and Aiding and Abetting (Complaint) at 129, 130, *Abu Dhabi Comm. Bank v. Morgan Stanley & Co.,* No. 08 Civ. 07508 (SDNY March 31, 2009).

[581] Jonathan S. Sack & Kefira R. Wilderman, *Civil Liability of Rating Agencies: Past Success, Future Danger?* 243 N.Y. L.J. (53), at 1-2 (2010).

[582] *See e.g*., Jonathan Stempel & Noeleen Walder, *Rating agencies win dismissal of lawsuits*, REUTERS, May 11, 2011, *available at* http://uk.reuters.com/article/2011/05/11/ratingagencies-ruling-idUKN1120582120110511 (last accessed May 25, 2016).

To the earlier ruling that the boiler-plate disclaimer statements provided by CRAs were both "unavailing and insufficient to protect the rating agencies from liability for promulgating misleading ratings", the Scheindlin court on June 2, 2012 also refused the defendants' motion for the depositions and other related documentation to be sealed.

This ruling made e-mails and other electronic correspondence between CRAs and Morgan Stanley banking executives available for public scrutiny and as a result instances of Morgan Stanley bankers responding aggressively to indications from S&P's lead analyst on the Cheyne structured product that the some tranches would initially receive a "BBB" rating such that the rating was eventually changed to an "A" rating, or where the Morgan Stanley bankers conceded to actually having authored the new issue reports on behalf of Moody's, have been documented.[583] The *Abu Dhabi* lawsuit had potentially been considered by many scholars as a potentially landmark case for establishing the extent to which NRSROs in particular and CRAs in general, could be held liable. The reason for the high expectations was that as the lawsuit had snaked through the U.S. court system since it was filed in 2008, it had addressed many different aspects of the legal landscape for rating agencies. Subsequently, Judge Scheindlin's court had made rulings that appeared to lay the ground for a potentially favourable outcome for the plaintiffs, such as when it allowed their claim of negligent misrepresentation to proceed and when the court agreed to unseal the depositions made by the defendants.

4.3.2.2. Settlement agreements

On April 29th, 2013, barely a week before the Cheyne case was to go to trial on May 6th, 2013, a settlement agreement was reached between the parties and the court dismissed the $700 million negligent misrepresentation lawsuit concerning the Cheyne and

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[583] Gretchen Morgenson, *Court Papers Undercut Ratings Agencies' Defense*, N.Y. TIMES, July 2, 2012, at B1.

Rhinebridge structured investment vehicles.[584] The lawsuit brought against Moody's and S&P was "dismissed with prejudice", meaning that it cannot be filed and brought before the courts again.[585] The stock market responded favourably and immediately following the settlement announcement as Moody's share price jumped 9.2 percent while that of McGraw-Hill rose 5.5 percent.[586] Morgan Stanley, the bank cited as first defendant in the lawsuit for its active involvement in structuring the Rhinebridge SIV, as well as the marketing of both the Rhinebridge and Cheyne SIV, also negotiated a settlement.[587] Two earlier settlements related to the Rhinebridge SIV reached by Germany's IKB Deutsche Industriebank AG in 2012 and by France's Fimalac, the parent company of Fitch Ratings, proved to be the harbinger for the strategy adopted by the Big Two in dealing with the charges stemming from the Cheyne and Rhinebridge SIVs.

An unsettling takeaway for proponents of introducing acceptance of NRSRO liability would surely be that the settlement agreements were achieved at the expense of no admission of wrongdoing by the rating agencies.[588] Moreover, the near five year period since the lawsuit was filed in 2008 to the settlement announcement date, and the shortfall between the amount of damages initially claimed by defendants and the settlement

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[584] *Credit Rating Agencies Settle 2 Suits Brought by Investors*, REUTERS, April 27, 2013, *available at* http://www.nytimes.com/2013/04/28/business/credit-rating-agencies-settle-lawsuits-over-debt-vehicles.html?_r=0 (last accessed Mar. 25, 2015).

[585] *Id.,* REUTERS, April 27, 2013.

[586] Arash Massoudi, *Moody's outperforms as pair of outstanding lawsuits are settled*, FINANCIAL TIMES, April 30, 2013 at 26.

[587] Nate Raymond & Jonathan Stempel, *Moody's, S&P settle lawsuits over debt vehicle ratings*, REUTERS, April 26, 2013, *available at* http://www.reuters.com/article/2013/04/27/moodys-sp-settlement-idUSL2N0DE00Q20130427/ (last accessed May 5, 2016).

[588] *Id.,* Raymond & Stempel, "…[W]e've lost one of our last remaining chances to see the rating agencies answer to private investors").

amount[589] achieved of $475 million, also highlighted the limit to which investors are currently able to recoup in terms of compensation in lawsuits alleging flawed ratings.

Conversely, it can also be well argued that the settlement was itself a success: firstly, Moody's and S&P reached a settlement involving allegations that their ratings misled investors; and secondly, the settlement in this instance demonstrates a practical and readily available avenue for pursuing redress for investors in future lawsuits. Consequently, it would be reasonable to expect that these settlement agreements will motivate the rating agencies to take the steps necessary to reduce their liability exposure going forward, such as by issuing more conservative ratings or by adopting stricter operational governance standards.

The CalPERS case in particular introduces new and intriguing issues to the debate because initially Judge Kramer not only rejected a request by the rating companies to dismiss the case under California's anti-SLAPP law – a law which was designed to defend against lawsuits meant to stifle public debate[590] – but also ruled in 2010 that the ratings were indeed a protected form of speech. In order to fend off a dismissal of the case, the court required CalPERS to present sufficient evidence to show that the claim had a realistic probability of prevailing in the lawsuit. On January 12, 2012, Judge Kramer subsequently ruled that the pension funds had "produced sufficient evidence" illustrating that the CRAs made misrepresentations "without [holding] reasonable grounds" to believe they were telling the truth. This ruling goes significantly further than the First Circuit court's position that CRAs could not be held liable under the securities laws for ratings, that although issued honestly when formed, turned out to be inaccurate ex-post, or simply because CRAs could have formed "better" opinions, ex ante. What set this case apart was

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[589] $225 million

[590] *e.g.,* The Strategic Lawsuit against Public Participation (SLAPP) is a lawsuit that is intended to censor or hinder the impact of critics by burdening them with high legal defence costs until they abandon their criticism or opposition. The State of California enacted anti-SLAPP law to defend against SLAPP lawsuits.

that in this instance, the court actually accepted the evidence from plaintiffs that the CRAs had issued a rating that they knew at the time of issuing to be false.

Following the Dot.com crash of 2001, investigations revealed numerous instances where securities analysts had authored and published reports with "buy" or "hold" recommendations to the public, while simultaneously referring to the same stocks as "dogs" or "junk" in their internal communications. In addition, the ruling in *New York Times* established a requirement for plaintiffs to prove that there was doubt in the publisher's mind about the truthfulness of the statement at the time of publishing. However, the introduction of new corporate governance standards, regulations and more ethical practices for securities analysts ushered in by the Sarbanes-Oxley Act of 2002, would confidently suggest that in the absence of smoking gun scenarios,[591] the occurrence of which has been significantly curtailed, it would generally be difficult to prove intentional wrong-doing on the part of CRAs.[592] In 2001 Moody's pleaded to a single count of obstruction of justice and agreed to pay a $195,000 fine to the Justice Department for destroying potentially-related documents. Following the plea deal, Moody's subsequently required its employees to only discuss sensitive ratings related details in face-to-face meetings.[593] Admittedly, of greater concern for CRAs than the headline grabbing "structured by cows" comment, should be the precursor to that now infamous remark in the instant messaging exchange between the analysts quoted. One of the analysts

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[591] David Segal, *Debt Raters Avoid Overhaul After Crisis,* N.Y. TIMES, Dec. 8, 2009 ("It could be structured by cows, … and we'd rate it."). *See also*, SEC, *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, July 2008 at 12; and Levin & Coburn, Carl Levin & Tom Coburn, *Wall Street and the Financial Crisis,* April 13, 2011, at 272-76 (examples of questionable correspondences and interviews with CRA industry personnel).

[592] Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1077 (2009).

[593] See e.g., Jeannette Neumann, *Two firms, One Tail in Probes of Ratings*, WALL ST. J., Feb. 12, 2013, at 26.

acknowledges that although the inherent risk is perceivably very high, yet their model failed to capture even "half of the risk" in that structured product.[594]

As a consequence, it can now be reasonably inferred that such a development has greatly reduced the likelihood that plaintiffs would find evidence of similarly-themed and constructed communication that so clearly expose any dichotomy of views held by the analysts as that would present plaintiffs with a real opportunity to argue that the ratings issued were based on views that the CRAs knew to be false. And yet, because structured products are the result of a collaborative effort by CRAs and issuers, it appears less likely that a third party would be able to acquire sufficient damning proof of a CRA's contradictory views to a court, making it highly improbable that a successful lawsuit would result.

It is also worth noting that in 2005 the BIS Committee on the Global Financial System investigated concerns regarding the collaborative nature of the relationship between a CRA and issuers and reached the conclusion that because no fundamental differences in the rating process had [yet] been observed, structured products posed no greater involvement concerns for CRAs than for traditional bonds.[595] Their observation

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[594] See e.g., Sam Jones, *Rating Cows*, FINANCIAL TIMES (ALPHAVILLE), IM exchange between Moody's analysts: (Thursday, April 05, 2007 3:59:05 pm EDT SM: I know right…**model def does not capture half of the risk** // RDS (SF-NY): **we should not be rating it** // SM: we rate every deal / /SM: it could be structured by cows and we would rate it // RDS (SF-NY): but there's a lot of risk associated with it – I personally don't feel comfy signing off as a committee member),(emphasis added) *available at* http://ftalphaville.ft.com/blog/2008/10/23/17359/rating-cows/ [last accessed June 15, 2013]. *See also*, *Abu Dhabi Comm. Bank v Morgan Stanley,* USDNY Case 1:08-cv-07508-SAS-DCF Document 430 Filed July 2, 2012, at 8 (denial of summary judgement citing the Cheyne case where the S&P lead analyst e-mailed a colleague: "I had difficulties explaining 'HOW' we got to those numbers since there is no science behind it", *available at* http://s3.documentcloud.org/documents/394113/class-action-suit-against-ratings-agencies.pdf (last accessed Sept. 20, 2018).

[595] BIS, *The Role of Ratings in Structured Finance, (*CGFS Publications No. 23, Jan. 2005) *available at* http://www.bis.org/publ/cgfs23.htm (last accessed Sept. 20, 2018).

today stands in stark contrast to that of Eric Kolchinsky, Moody's former team Managing Director for US Derivatives, for the business line responsible for rating subprime backed CDOs. In his 2010 testimony to the FCIC, Kolchinsky commented that structured finance instruments were indeed unlike any other debt instruments rated by CRAs, most notably because they are characterized by structural flexibility and still had little history from which sound projections could be established. He concluded that ratings quality could only be improved by regulatory action to increase the minimum credit standards.[596]

4.3.3. Secondary actors' liability

The concept of secondary actors' liability considers the exposure to liability of CRAs with respect to parties other than those to which they have a contractual obligation. In order to successfully allege contractual breach, a plaintiff has to prove that investors that relied on ratings were the intended beneficiaries, albeit indirectly, of ratings issued subsequent to a ratings contract between a CRA and an issuer.[597]

Both the *Abu Dhabi Commercial Bank's* and the *CalPERS'* courts have ruled that the First Amendment right to public expression does not protect CRAs from liability for ratings conferred on SIVs which are not publicly circulated, but are instead shown only to a limited number of select investors.

- *Dun & Bradstreet, Inc. v. Greenmoss Builders*, (1985)

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[596] Eric Kolchinsky, *Credibility of Credit Ratings*, Credit Ratings, the Investment Decisions Made Based on those Ratings, and the Financial Crisis, (testimony of Eric Kolchinsky Before the Financial Crisis Inquiry Commission, June 2, 2010), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0602-Kolchinsky.pdf (last accessed Mar. 25, 2015).

[597] Sullivan, *94 Minnesota L. Rev.* 2136, 2147 (2010). See also, *Quinn v. McGraw-Hill Cos., Inc* 168 F.3d.331, 334-36 (7th Cir. 1999, applying Illinois law).

In *Dun & Bradstreet*[598] the Supreme Court held that an erroneous credit report distributed by Dun & Bradstreet, a credit reporting agency, to only five subscribers, did not constitute a "matter of public concern",[599] as they deemed it "speech solely in the individual interest of the speaker and its specific business audience".[600] Furthermore, in finding that First Amendment interests were less controlling in matters of a purely private concern than would qualify for matters that are deemed of public interest, the Court ruled that "permitting recovery of presumed and punitive damages in defamation cases absent a showing of 'actual malice', does not violate the First Amendment [when the defamatory statements do not involve matters of public concern]".[601]

In other words, because the defendant Greenmoss Builders was a private figure, Dun & Bradstreet had lesser rights to defame them. Subsequently, Dun & Bradstreet could therefore not require the proof of actual malice standard to be applied to Greenmoss as would otherwise have been necessary if the contentious statement had been made regarding a public figure.[602] This decision returns the debate to the question of whether it is the number of subscribers that received the communication (i.e. five, instead of five thousand or even five hundred thousand) which determines whether a statement made is regarded as public concern; or whether it is the nature (i.e. content) of the communication

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[598] *Dun & Bradstreet v. Greenmoss Builders*, 472 U.S. 749 (1985)(Cert., to S.Ct. Vermont) (5-4 decision) (i.e. The First Amendment protection does not extend to the statements of a non-media party, when its actions create slander and /or libel towards another private individual).

[599] *See Gertz v. Robert Welch* 418 U. S. 323 (1974) (i.e. Supreme Court held that the First Amendment restricted the damages that a private individual could obtain from a publisher for a libel that involved a matter of public concern, and also prohibited awards of presumed and punitive damages for false and defamatory statements unless the plaintiff shows "actual malice".)

[600] *Dun & Bradstreet v. Greenmoss Builders,* 472 U.S. 749, 762 (1985).

[601] *Id., Dun & Bradstreet,* at 755-76.

[602] *See e.g*., Ruth Walden & Derigan Silver, *Deciphering Dun & Bradstreet: Does the First Amendment Matter in Private Figure-Private Concern Defamation Cases?* COMM. LAW AND POLICY 14/ 1 (2009).

itself that controls[603]. The distinction between the *Dun & Bradstreet* and the *Abu Dhabi* rulings is at the core of the detailed review by Deats[604] which highlights the two courts' interpretations when deciding whether a CRA rating is a matter of public concern and is therefore to be afforded First Amendment protection.[605]

In *Abu Dhabi* Judge Scheindlin, construing *Dun & Bradstreet*, wrote that:

> "…[H]owever, where a rating agency has disseminated their ratings to a select group of investors rather than to the public at large, the rating agency is not afforded the same [i.e. customary First Amendment] protection."[606]

The Supreme Court in *Dun & Bradstreet* relied on both the 'private' nature of the communication (i.e. limited disclosure rating) as well as the non-public or private (i.e. by number of recipients) extent to which it was disseminated to deny Dun & Bradstreet the First Amendment protection provided for matters of public concern[607] of public

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[603] *See,* Caleb M. Deats, *'Talk that Isn't Cheap'*, 110 COLUM. L. REV., 1818, 1851-52 (2010) (argues that courts should analyse ratings as commercial speech because of its allowance of a standard for limited private liability while retaining First Amendment protections instead of considering the *Abu Dhabi* ruling which, although not a public concern, qualifies as commercial speech and calls for an assessment of whether the ratings were disseminated publicly or privately).

[604] *Id.,* Caleb M. Deats, *Talk that Isn't Cheap'*, 110 COLUM. L. REV., 1818, 1851-52 (2010).

[605] See, Figure 12: Dun & Bradstreet decision in contrast to the Abu Dhabi decision, below.

[606] *Abu Dhabi Commercial Bank v. Morgan Stanley & Co.,* 651 F.Supp.2d 155, 176 (2009) (Moody's Investors Service, Inc. and its affiliates, including wholly-owned and controlled subsidiary Moody's Investors Service Ltd., and the McGraw-Hill Companies, Inc., and its affiliates, including its wholly-owned and controlled business division. Standard & Poor's Rating Services were named as co-defendants in the lawsuit).

[607] *Dun & Bradstreet,* 472 U.S. 749, 763-64 (1985), Burger, C.J. (defamation in question not a matter of "public concern". Dissenting judges, 472 U.S. 774 (Brennan, joined by Marshall, Blackmun and Stevens, expressed the view that speech was still expression that was protected by the First Amendment, whether it was of a private or public concern).

importance.[608] However, in *Abu Dhabi,* the court's determination appears to only hinge on the private and limited extent to which the rating was distributed. The premise of this decision, a departure from the general rule on First Amendment protections, raises the question of how many primary recipients of a rating would suffice for a given distribution to be considered large enough to be deemed a public concern. A further question that arises is whether secondary recipients of the distribution would also have a third-party liability claim against the CRA. Fortunately, the US Supreme Court appears to have addressed the latter question in the Stonebridge case below.

4.3.3.1. Liability under Securities Law

- *Stoneridge Inv. Partners v. Scientific-Atlant*a, (2008)[609]

Arguably considered to be among the most important securities cases in the last decade,[610] this lawsuit was brought by Stoneridge Investment Partners on behalf of investors who had purchased Charter Communications, Inc., stock between November 8, 1999 and August 16, 2002; the petitioners claimed to have been victims of a "pervasive and continuous fraudulent scheme intended to artificially boost the Company's reported financial results".

The plaintiffs asserted that outside actors (namely, Scientific-Atlanta), had committed a Rule 10b-5 violation on a theory of "scheme liability[611]" and had aided and

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[608] *Dun & Bradstreet,* 472 U.S. 749, 774 (1985), White, J. (concurring, that defamation in question not a matter of "public importance").

[609] *Stoneridge Inv. Partners LLC, Petitioner v. Scientific-Atlanta, Inc.,* 552 U.S. 148 (Cert., to the United States Court of Appeals for the Eighth Circuit) (5-3 decision).

[610] Barbara Black, *What makes it the Most Important Securities Case in a Decade?* 1-17 (U. Cin. Public Law Research Paper No. 07-21, Oct. 9, 2007), *available at* http://ssrn.com/abstract=1020102.

[611] *Stoneridge Inv. Partners LLC, supra,* at 11. (Under "scheme liability" every secondary actor participating in actions promoting a "scheme" aimed at misleading investors can be held primarily liable to said investors. *See,* Peter D. Hawkes, *Aiding and Abetting Liability Under State Securities Statutes*, FOR THE DEFENCE, at

abetted Charter in committing fraud by participating in fraudulent actions designed to misrepresent a firm's financial statements despite not having made statements concerning the public transactions. For their part, the defendants relied on the decision in *Central Bank of Denver v First Interstate Bank of Denver* which found no statutory basis for "aiding and abetting" liability by secondary actors and hence precluded the plaintiff's claim of liability.

What sets this lawsuit apart from the majority of the aforementioned examples cited above – wherein the courts dealt with argumentation under tort law citing CRAs as primary actors and co-defendants – is that in this instance the lawsuit was filed under securities law (i.e. §10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission (SEC) Rule 10b–5.[612] In *Stoneridge* the Supreme Court addressed the scope of liability of secondary actors such as attorneys and securities analysts (i.e. other SEC recognized gatekeepers) for securities fraud.

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23 (2010). The scheme in question allegedly involved a "sham transaction" wherein Charter paid Scientific-Atlanta, its equipment vendor, inflated payments for equipment and Scientific-Atlantic paid back the extra payments as advertising fees enabling Charter to then book the returned payments as revenue).

[612] 17 C.F.R. 240.10b-5.

Figure 12: Dun & Bradstreet decision in contrast to the Abu Dhabi decision

Lawsuit	Claim	Nature of Communication	Distribution extent	Public Concern	Logic	Court Ruling
Dun & Bradsteet (Appellant)	False credit report distributed by credit reporting agency damaged defendant's reputation.	Private	Private (Only 5 recipients)	No	The private nature of the ratings and the limited distribution to a small group to which it was disclosed do not qualify the claim as a "public concern". (i.e. private-private)	**No** First Amendment protection for credit reporting agency. Appellant's claim is dismissed.
Abu Dhabi (Plaintiff)	Dismiss First Amendment protection claim and recover losses from mis-rated securities.	N/a	Private (Not to the public-at-large)	No	The limited distribution of the ratings do not qualify the claim as a "public concern". (i.e. n/a-private)	**No** First Amendment protection for CRA. Plaintiff's claim is upheld.

Section 10b of the Securities Exchange Act of 1934, known as the anti-fraud provision of the Act reads, in part:

"*It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange… [to use or employ] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors".*

Furthermore, Rule 10-b 5 was promulgated by the SEC under the Exchange Act and it creates liability by prohibiting any act or omission resulting in fraud or deceit in connection with the purchase or sale of a security.

4.3.3.2. §10(b) and SEC Rule 10b-5

Firstly, it is important to note that §10b requires a plaintiff to prove his reliance when making the decision to acquire or hold a security, upon a material misrepresentation or omission made to him by the defendant. Proof of intentional fraud or deceit by the defendant is a pre-requisite when invoking SEC Rule 10b-5. Secondly, private persons seeking to recover damages must demonstrate that the "requisite causal connection between a defendant's misrepresentation and a plaintiff's injury" exists as a predicate for liability.[613] And thirdly, construing the decision in *Central Bank*, Congress in §104 of the PSLRA 109 Stat. 757, [614] directed the prosecution of aiders and abettors, but only in actions brought by the SEC and not by private parties.[615]

Arguing that it would have made any aider and abettor liable under §10(b) if they committed a deceptive act in the process of providing assistance, the Supreme Court found the petitioner's liberal interpretation of §104 of the PSLRA to be "unsupportable".[616] Private investors can sue for fraudulent statements made to the general public that affect the whole market under the "fraud-on-the-market" theory[617] (an extension of the semi-

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[613] *Stoneridge Inv. Partners LLC*, (citing *Basic Inc. v. Levinson,* 485 U. S. 224, 243 (1988) and *Aff'd Ute Citizens of Utah v. United Sates,* 406 U.S. 128, 154 (1972).

[614] Private Securities Litigation Reform Act of 1995.

[615] See 15 U. S. C. §78t (e).

[616] *Stoneridge Inv. Partners LLC,* at 14.

[617] *Stoneridge Inv. Partners v. Scientific-Atlanta Inc.,* et al, Certio., to U.S. Court of Appeals, 8th Circuit., Eastern District of Missouri, Jan., 15, 2008, ("fraud-on-the-market reliance is presumed when the statements at issue become public") *available at* http://www.supremecourt.gov/opinions/07pdf/06-43.pdf, at 8; *Basic Inc. v. Levinson*, 485 U. S. 224, 243 (1988) (fraud-on-the-market provides for a presumption of reliance on defendant's misrepresentation causing damage to plaintiff); German law has not explicitly stated the fraud-on-the-market theory, although its securities laws presume causality from a prospectus document. *See also,* Oliver von Schweinitz, *Ratings Agencies* 181, Unlimited Publishing LLC, Bloomington, Indiana (2007).

strong form of the efficient capital markets hypothesis (i.e. ECMH))[618] as provided in the Supreme Court's ruling in *Basic Inc. v. Levinson*[619], which rests on the presumption of the plaintiff's reliance on a security that is traded on an established and efficient market.[620]

However, as structured products are most typically sold directly to investors through private placements[621] which are by definition significantly more opaque (and arguably less efficient) than publicly-traded exchanges, it is unclear to what extent it can successfully be posited that such platforms meet the standard of an established and efficient market. Moreover, in adopting a more literal interpretation of §10(b) and Rule

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[618] Eric L. Talley, *Panel Two: Sarbanes-Oxley Accounting Issues - Cataclysmic Liability Risk Among Big Four Auditors,* 106 COLUM. L. REV., (7) 1641, 1653, n.31 (2006).

[619] *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

[620] Douglas M. Branson, *Securities Litigation in State Courts - Something Old, Something New,... Something Borrowed*, 76 WASH. U. L. Q., 509,523 (1998) notes that some courts recognize the fraud- on-the-market principle in common-law fraud lawsuits irrespective of where the stock is traded (i.e. OTC as opposed to an established exchange), provided that the market is considered "efficient", and cites e*.g., Hurley v. FDIC*, 719 F. Supp. 27, 33-34 (D. Mass. 1989); *In re Boardwalk Marketplace Sec. Litig.,* 122 F.R.D. 4, 8 (D. Conn. 1988); and *In re United Energy Corp. Sec. Litig.,* 122 F.R.D. 251, 254-55, n.84 (C.D.Cal. 1988).

[621] *See e.g.,* , Richard Tomlinson & David Evans, *CDO Boom Masks Subprime Losses, Abetted by S&P, Moody's, Fitch*, BLOOMBERG, May 31, 2007 ("Almost all CDOs are sold in private placements, and their current values aren't posted anywhere"), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajs7BqG4_X8I (last accessed, Mar. 25, 2015); Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies,* 77 WASH. U. L.Q. REV. (3) 619, 680 n.301, 711 n.414 (1999) (referencing examples of private placements of issues); and John Crawford, *Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit rating Industry*, 42 CONN. L. REV. 13, 20, 23 (2009) (noting that the private placement buyers, typically funds, represent thousands of small scale investors, and suggesting that bond ratings issued to select investors cannot be kept confidential from determined parties), http://connecticutlawreview.org/files/2012/02/CrawfordFinal.pdf .

10b-5, neither of which mentions aiding and abetting,[622] in a 5-4 majority decision the Supreme Court[623] held that the private right of action under §10 did not extend to aiders and abettors. That is to say, aiders and abettors of fraud could not be held secondarily liable under the private right of action provided for by §10(b). They do however remain liable in instances where their own conduct satisfies each of the elements for §10(b) liability and where the plaintiffs can prove reliance on a material misrepresentation, for example. Secondary actors are therefore only deemed liable as primary violators if all the elements of fraud are met and a direct misrepresentation to the public is established for the claim of reliance on the part of the plaintiffs.

Although the Supreme Court did not make new law in the 5-4 ruling, this decision was a complete reversal from an established history of court decisions and enforcement actions by the SEC under which aiders and abettors, (typically banks, accountants, and attorneys)[624] had been found liable under Rule 10b-5.[625] Hence, while in this instance the

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[622] Peter D. Hawkes, *Aiding and Abetting Liability Under State Securities Statutes*, FOR THE DEFENCE, (2010) at 23.

[623] *Central Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.,* 511 U.S. 164, 166 (1994).

[624] *See e.g.* Jeffrey Farley Keller, LOYOLA L.A. L. REV., 1 June, 1189, 1191 (1989) ("…[G]enerally, Rule 10b-5 actions for aiding and abetting liability are brought against banks, for they tend to have "deep pockets,[] and attorneys and brokers because they generally carry liability insurance…").

[625] (Neither §10(b) nor SEC Rule 10b-5 explicitly provide for a private right of action although the courts have inferred a civil cause of action. *See e.g., Superintendent of Ins. v. Bankers Life & Casualty Co.,* 404 U.S. 6, 13 n.9 (1971) (where-in Supreme Court first acknowledges a civil right of action for section 10(b) and Rule 10b-5). *See also, Herman & MacLean v. Huddleston,* 459 U.S. 375 (1983) (wherein Supreme Court confirms that "a private right of action under §10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years…", at 380, cited in Keller, J.F., Loyola of Los Angeles L. Rev., at n.2 (1989); *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 194-214(1976), (wherein Supreme Court stated that " …the existence of a private cause of action for violations of the statute and the Rule is now well established [and that] a private cause of action for damages will not lie under 10 (b) and Rule 10b-5 in the absence of any allegation of "scienter," i.e., intent to deceive, manipulate, or defraud on the defendant's part"); Jeanne P. Bolger, 49 FORDHAM L. REV. (5), 1 Jan., 817, 818 (1980) (noting that Federal Courts of

decision shielded gatekeepers and other secondary actors from privately initiated federal liability lawsuits, private lawsuits are still permitted under most state laws.[626] Still, as federal law, DFA's stipulation instructing the removal of regulatory requirement of credit ratings by financial regulators is silent on the reliance to be placed thereon by state insurance regulators[627], which can only further complicate the current state-versus-federal guidelines debate for market participants as well as for the state courts.

Hawkes cautions that rather than requiring the defendant to show that they already had a culpable mind – itself an onerous enough threshold of proof – some states have gone even further by requiring the secondary actor to show that they were not only unaware of the fraud, but would still have failed to discover the fraud despite the exercise of reasonable care.[628] Were this higher threshold to be applied to CRAs, it would require them to demonstrate that in spite of having followed demonstrably sound standards practice, good governance and/or reasonable care, any error in a credit rating against which fraud charges are later claimed, would have remained undetected.

Appeals recognize recklessness as sufficing as a form of scienter to support Rule 10b-5 liability claims); also contrasts recklessness and negligence while acknowledging that both concepts imply a breach of duty. *See, Ultramares Corp. v. Touche,* 255 N.Y. 170, 174 N.E. 441, n.45 (1931). *But see, Garfield v. NDC Health Corp*., 466 F.3d 1255, 1264 (11th Cir. 2006) (quoting *Bryant v. Avado Brands, Inc.,* 187 F.3d 1271, 1282-83 (11th Cir. 1999) – at 1078, n.277, 87 N. Carolina L. Rev (the "recklessness and severe recklessness" are the liability triggers (i.e. in order to establish scienter,) for audit firms are very high; exceeding "…merely simple and inexcusable negligence, but an extreme departure from the standards of ordinary care").

[626] Peter D. Hawkes, *Aiding and Abetting Liability Under State Securities Statutes*, FOR THE DEFENCE, (2010 at 22. ("… [M]ost *state* securities statutes *do* permit plaintiffs to sue for aiding and abetting securities fraud").

[627] John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis* 2009 COLUM. BUS. L. REV., (1) 109, 147 (2009).

[628] Peter D. Hawkes, *Aiding and Abetting Liability Under State Securities Statutes*, FOR THE DEFENCE, (2010) at 22-23.

4.3.4. Aiding and abetting

Figure 123 below provides a succinct overview of the key legal debate regarding the liability and accountability of CRAs, particularly with respect to their level of involvement in the process of constructing and rating structured products. The origin of the Big Three as publishing houses notwithstanding, it has become increasingly apparent that the First Amendment provisions no longer provide CRAs with a viable or effective legal defence in lawsuits. This shift in focus was recently illustrated by the decision by Floyd Abrahms, often recognized as one of the leading First Amendment defence lawyers in the US, who, after serving for the past 26 years as lead counsel in defence of S&P in lawsuits, elected to defer instead to renowned criminal trial lawyer, John Keker, to lead S&P's defence in the lawsuit brought against S&P by the U.S. Attorney General.[629] Towards the other end of the spectrum, there is evidence from recent decisions that State and District courts, as well as the US Supreme Court, have been reluctant to either equate CRAs to underwriters[630] or to prosecute them as aiders and abettors under existing securities laws.

Compromise between these two interpretations lies somewhere towards the middle range of the spectrum wherein CRAs are recognized by the courts, and in legislation, as gatekeepers. The evolution of their respective business models from the period when the Big Three predominantly produced unsolicited ratings and relied upon the issuer-pays model for their revenue, has been irrevocably altered mostly by the rise in prominence of structured products and the growing provision of ancillary services to their clients. In this

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[629] *See e.g.*, Karen Freifeld, S*&P hires top defense attorney for $5 billion lawsuit*, REUTERS, Feb. 6, 2013 *available at* http://www.reuters.com/article/2013/02/07/us-mcgrawhill-sandp-lawyer-idUSBRE91601C20130207; Andrew Harris, *Bet-The-Company Lawyer Steps In Between Government, S&P*, BLOOMBERG, Feb. 9, 2013, *available at* http://www.bloomberg.com/news/2013-02-08/s-p-lawyer-keker-brings-slashing-and-smashing-tactics.html (last accessed, Mar. 25, 2016).

[630] *Public Employees' Ret. Sys. v. Merill Lynch & Co.,* (Court found the Plaintiff's liberal view of what constitutes an underwriter was contradicted both by the interpretation adopted by both the SEC and the statutory definition).

realm, the need for courts and legislators to define and expand on the role and responsibilities of a gatekeeper to parties to which they are either contractually or non-contractually associated, becomes apparent. However, it is with the very idea of increased dependence and reliance on CRAs as gatekeepers[631]– a status which this dissertation critiques, and charges to be a mere legal fiction – [632] but a legal fiction, that now presents a real challenge in terms of seeking the most effective and efficient approach to steering CRAs towards accepting greater accountability for the accuracy of their ratings. This is particularly important since neither the financial market nor the legislators have yet identified a practical and/or efficient alternative.[633]

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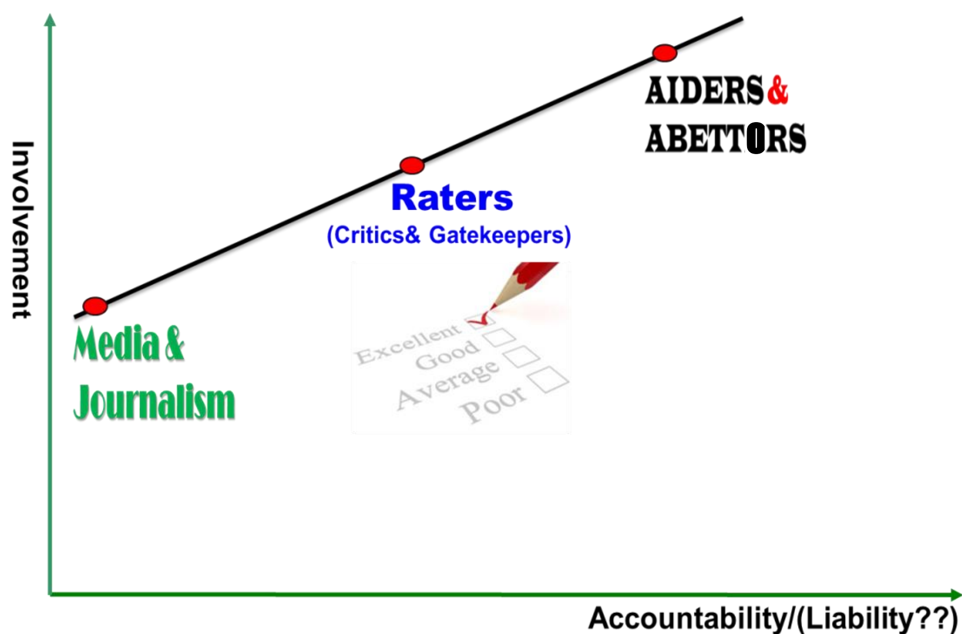
[631] Frank Partnoy, *Overdependence on Credit Ratings was a Primary Cause of the Crisis. Proceedings of the 2008 International Banking Conference: "The First Credit Market Turmoil of the 21st Century"* 9- 11 (World Scientific Publishers, San Diego Legal Studies Paper No. 09-015, July 9, 2009 (over-dependence on credit ratings and credit rating agencies allowed for the marketing of overly complex structured products), *available at* http://ssrn.com/abstract=1430653.

[632] Frank Partnoy in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 177 (2006) surmises two definitions of gatekeeper: a narrow (a reputational capital risking intermediary to assure investors of reliability) and broad definition (one empowered to open or close a gate).

[633] David Segal, *Debt Raters Avoid Overhaul After Crisis,* N.Y. TIMES, Dec. 8, 2009, (CRAs present "… capitalism's strangest hybrid – profit-making firms that perform what is essentially a regulatory role" and "but we don't want to kill the institutions because we have nothing to replace them with"), (comment by Representative Paul E. Kanjorski (D), Pennsylvania, the Chairman of the House Fin. Serv. subcommittee; Jesse Hamilton, *SEC Struggles to Gauge Risk Without Raters Post Dodd-Frank: One Year Later*, BLOOMBERG, "[O]ur staff has been given **an impossible challenge**: **finding an appropriate substitute for an objective evaluation of credit risk when it may not exist**,"(emphasis added), July 15, 2011, (comments by SEC Comm. member Luis Aguilar) *available at* http://www.bloomberg.com/news/2011-07-15/sec-struggles-to-gauge-risk-without-raters-post-dodd-frank-one-year-later.html.

See also, Francesco Guerrera, *Current Account: Here's How to Fix Those Credit Ratings,* WALL ST. J. ASIA, Aug. 16 2011, at 8, "Developing a suitable alternative to credit ratings would be impossible without creating undue regulatory burden." (comment by David K. Wilson, chief national bank examiner at the Office of the Comptroller of the Currency, on the feedback from canvassed financial groups). *See also*, [633] Dieter Kerwer, *Holding Global Regulators Accountable*, 18 GOV. INT'L J. POL'Y, ADMIN., & INST'S (3), 453, 469

Figure 12: Spectrum overview - Involvement vs Liability debate for CRAs



Since *In re Pan Am Corp.,*[634] where the court held that S&P was due the constitutional protections and privileges of a journalist and in *O'Neil v. Oakgrove Const., Inc.,*[635] where the court ruled that source information provided to a journalist could not be subpoenaed, there has been an undeniable shift in recent court decisions that have denied CRAs recognition as journalists meriting protection under constitutional media provisions. This has been particularly apparent in disputes involving structured products

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(2005)(posits that the removal of regulatory use of ratings would hurt regulators more than CRAs (i) finding a substitute or alternative to CRA ratings (ii) high market entry restrictions would still favour existing CRA over new entrants), White, Lawrence J., *The Credit Rating Industry: An Industrial Organization Analysis*, RATINGS, RATINGS AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 46 (Richard M. Levich, Giovanni Majnoni, Carmen M Reinhart, eds. Boston: Kluwer, 2002).

[634] *In re Pan Am Corp* 161 B.R. 577, 580-82 (S.D.N.Y.1993).

[635] *O'Neil v. Oakgrove Const., Inc.*71 N.Y.2d 521, 526-27, 528 N.Y.S.2d 1, 523 N.E.2d 277 (1988).

(e.g. SIVs)[636], where a rating was initially solicited and where the CRA collaborated with the construction process. The track record showing the persistent inability by plaintiffs to successfully plead their cases with particularity[637] before the courts possibly motivated CalPERS when it initially reached a settlement with Fitch in exchange for documentation and transcriptions from the *Abu Dhabi* lawsuit in order to challenge S&P and Moody's.

CRAs (by their own definition), only provide advice to issuers (or their advisors) with whom they have a contractual (service) agreement during the construction of structured products. It is thus not surprising that there have not yet been cases where the issuers have sued CRAs alleging fraud or negligent misrepresentation for flawed ratings. Of greater interest, however, are the instances involving secondary actors with whom the CRAs have no contractual relationship.[638] The US Supreme Court's 5-3 majority opinion in *Stoneridge* established that liability did not extend to aiders or abettors that participated in misstatements or omissions in connection with the sale of securities; the Supreme Court also reiterated that only the SEC – and not private investors – has been empowered by legislation (i.e. Congress) to prosecute aiding and abetting claims. Hence, despite the recorded concessions from both CRAs and issuers confirming the highly collaborative and iterative process that characterizes the construction and rating of structured products, the Supreme Court's decision appears to have effectively dissuaded future lawsuits by investors alleging aiding and abetting.[639]

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[636] *See e.g., California Public Employees' Ret. Syst. v. Moody's Corp.,* at n.8 and., *Abu Dhabi Comm. Bank, King Cty., Washington v. Morgan Stanley & Co.,* at n.237.

[637] *See,* section 4.3.1.2. above.

[638] *See e.g.,* Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1029 (2009) (no legal or financial relationship between [CRAs] and the beneficiaries of their screening roles).

[639] John C. Coffee Jr.: ("… [I]t is anomalous that one could be criminally liable of aiding and abetting by not being civilly liable for the same conduct in a private suit) (testimony of Professor John C. Coffee, Jr., Before the Subcommittee on Crime and Drugs of the United States Senate Committee on the Judiciary, (Crime & Drugs Testimony) on Sept. 19, 2009)

The merits of the aforementioned inference are disputed by Coffee who argues that permitting private lawsuits against aiders and abettors would offer "the most realistic means to prevent misconduct," and suggests instead that it would most effectively deter fraudulent misconduct.[640] Contrastingly, in citing *Central Bank of Denver (1994),* the majority of Supreme Court Justices remarked that allowing the claim for secondary liability for aiders and abettors to stand would not only make the civil remedies more expansive but would also "exac[t] costs that may disserve the goals of fair dealing and efficiency in the securities market".[641] Moreover, Judge Cardozo, in *Ultramares Corp., v. Touche (1932)* had also cautioned against the potential legal and economic disservice that would undoubtedly result if courts accepted a regime which exposed gatekeepers, accountants in that case, "to a liability in an indeterminate amount for an indeterminate time to an indeterminate class".[642] Cardozo ruled that while fraud "may also include the expression of an erroneous opinion …[,] liability for negligence ...[] is bounded by the contract, and is to be enforced between the parties by whom the contract has been made".[643] To sustain a successful claim, a plaintiff must show that they are an intended third party beneficiary from the active contract.

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[640] *Id.,* Coffee, Crime & Drugs Testimony, at 5-10.

[641] *Central Bank of Denver v. First Interstate Bank of Denver 114 S.Ct. 1439, 1454,* (1994), 511 U.S. 164 (1994), 128 L.Ed.2d 119. ("…Extending the 10b-5 cause of action to aiders and abettors no doubt makes the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served..."), *available at* http://bulk.resource.org/courts.gov/c/US/511/511.US.164.92-854.html.

[642] *Ultramares Corp., v. Touche* 255 N.Y. 170, 179, Court of Appeals of N.Y. (1931). *See also*, *Moch Co. v Rensselaer Water Co.,* 247 NY 160, 168 (1928) (Cardozo, J.,: "The assumption of one relation will mean the involuntary assumption of a series of new relations, inescapably hooked together.")

[643] *Ultramares Corp., v. Touche* 255 N.Y. 170, 185, (1931) Cardozo, J., citing *Courteen Seed Co.v Hong Kong & Shanghai Banking P. Corp.* (245 N. Y. 377) ("…[N]egligent words are **not actionable unless they are uttered directly**, with knowledge or notice that they will be acted on, **to one to whom the speaker is bound by some relation of duty, arising out of public calling, contract or otherwise**, to act with care if he acts at all".)(emphasis added).

Although Coffee takes his position in specific reference to effectively preventing misconduct, his argument indirectly lends itself to introducing the notion of efficiency to the debate. In particular, it raises the question of whether the contingent risk and cost of preventing fraudulent misconduct – in this instance, by potential aiders and abettors – is greater or lesser than the relative risk and actual cost of permitting lawsuits for, say, third-party liability for CRA ratings opinions in general.

In fact, in dismissing the plaintiff's third-party beneficiaries claim in *Abu Dhabi,* the S.D.N.Y. court construed the Seventh Circuit court's holding in *Quinn v McGraw-Hill Companies, Inc.,*[644] which held that the contract between an issuer and a CRA was for the issuer's direct benefit and any subsequent benefit accruing to an investor was purely deemed incidental thereby negating a third-party claim.[645] The S.D.N.Y. court's reliance on the holding in *Quinn* effectively limits the reach of the "near privity" line of pleading by enforcing the classic interpretation of the privity doctrine.[646]

The Fenrich v. Wawanesa Mutual Insurance Co., (2004)[647] is a case where the plaintiff, a named beneficiary of an insurance contract to which his father was party, brought a lawsuit against the insurer. The Court of the Queen's Bench in Alberta, Canada, held that even where a contract conferred benefits to third parties, only the parties to a

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[644] *See, Quinn v. McGraw-Hill Cos., Inc.,* 168 F.3d 331 (7th Cir.1999, applying Illinois law).

[645] *See, Quinn,*168 F.3d 331, 334-35 (7th Cir.1999) (applying Illinois state law) (ultimate consumer beneficiaries of contracts purposed for information generation are neither considered third-party beneficiaries of said contracts nor can they sue for breach).

[646] *See* section 3.6, 4.1 and 4.2.1 above for discussions of the privity doctrine. *Also see*, *Ultramares Corp. v. Touche*, 255 N.Y. 170,179 (1931); Claire A. Hill, 82. Wash. U. L. 43-95 (2004) (posits that greater judicial accountability could mean judicial or legislative intervention to overrule the Quinn decision, at 90, n.173).

[647] *Fenrich v. Wawanesa Mutual Insurance Company,* ABQB 310, (2004) See also *Fenrich v. Wawanesa Mutual Insurance Co.,* [2004] A.J. No. 458 (Q.B.); *Fenrich v. Wawanesa Mutual Insurance Co.*, [2005] A.J. No.788 (C.A.). (QB and CA both held that a plaintiff and third party beneficiary meeting the definition of "insured", could not bring a lawsuit in his own name as the contracting parties' intention had not been to permit third parties to sue; and hence, the principled exception to privity did not apply).

contract are empowered to sue for its enforcement. The *Fenrich* court construing *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.,* (1999)[648] affirmed that a "principled exception" where third parties intended by all named parties to the contract as beneficiaries could bring forward a lawsuit was not applicable in this instance because the Declaration clearly did not empower the named third party beneficiary a right to sue for enforcement.[649]

The ruling in *Fenrich*, if accepted as guiding and instructive by US courts, would clearly bolster the CRAs' defense. Absent a contractual relationship with a CRA,[650] investors would firstly need to be named beneficiaries to the contract between an issuer and a CRA in order to be able to later sue. Secondly, even when named as beneficiaries, this authority would only extend to their entitlement to the benefits of the contract, and not to the right to sue for the contract's enforcement.

The proposal put forward by Blaurock is that only investors who receive a rating due to their status as subscribers to a CRA should have grounds to pursue liability charges.[651] The likelihood of CRAs' acceptance of voluntarily naming and recognizing retail investors as contractual beneficiaries to a rating issue, appears highly improbable: And yet, it may represent a viable alternative to the current impasse. In addition, there is

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[648] *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.,* CanLII 654 (SCC), 1999, 3 S.C.R. 108 (Supreme Court of Canada's holding on "principled exception" of contract "incrementally" extended the privity doctrine for third party beneficiaries under two exceptions: whether the contracting parties sought to benefit the third party (claimant) and whether the claim is based on activities contemplated in general or particularly intended by the contracting parties). *See also, London Drugs Ltd. v. Kuehne & Nagel International Ltd.,* [1992] 3 S.C.R. 299 (privity doctrine protections should not hinder commercial reality and justice, 5-1).

[649] *Fenrich v. Wawanesa Mutual Insurance Company,* ABQB 310 (2004).

[650] Brooke Masters, *Court cases struggle*, FINANCIAL TIMES, Nov. 5, 2012 at 15 (absent a formal relationship with CRAs, securities buyers face a "difficult or impossible" task in demonstrating misrepresentation).

[651] Uwe Blaurock, *Control & Responsibility of Credit Rating Agencies*, 23, 11.3 EJCL Dec. 2007 (" [The] circle of parties entitled to bring a claim would be limited to the subscribers".)

scant evidence to suggest that non-institutional (i.e. retail investors) have either the appetite or the resources to afford the potentially higher ratings fees that can reasonably be expected to be introduced under a liability regime, particularly as CRAs would surely attempt to limit their own exposures and set aside provisional sums in the event of a blowout from subsequent litigation. To this end, Moody's Concept Release (File No. S7-25-09) reiterated that the rescission of Rule 436 (g) would motivate CRAs to assign fewer ratings, adopt stricter selection criteria of issuers to rate in order to mitigate ensuing engagement risk[652] and that the contraction in rating coverage generally would result in the complementary contraction in the availability of credit for the market.[653]

All in all, permitting contractual third-party beneficiaries would further complicate the litigation process. It has still not proved itself popular, but the adoption of a variant of the investor-pays model which is currently applied in less than five percent of NRSRO outstanding ratings would be significantly more practical.[654] Attempts at weaning a public that has grown accustomed to accessing credit ratings for free would require governmental support in order to be successful.[655] A conceivable model is one which would see both institutional and private investors being required to enter into purchase contracts with the

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[652] YASUYUKI FUCHITA & ROBERT E. LITAN (eds) in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? at 8, (exhibit unacceptably high engagement risk); and David Enrich, *Banks Warned Not to Leave Libor Panel*, WALL ST. J., Feb. 14, 2013, at 1,22 (attempts by several banks to limit their ongoing engagement risk exposure, a perceived potential liability, by withdrawing from the Libor setting panel were reportedly aggressively blocked by the FSA, albeit temporarily, to ensure market stability).

[653] Moody's Concept Release (File No. S7-25-09), Dec. 14. 2009, *available at* http://www.sec.gov/comments/s7-25-09/s72509-5.pdf (last accessed Apr. 15, 2015).

[654] *See e.g.,* Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1013(2009) (advocating that the investor-pays model creates "direct relationships and accountability" due to the repeat-player nature of their relationship, and this would ensure greater beneficiary scrutiny (i.e. due diligence) of CRAs), and Coffee cited in OECD, *Hearings*: *Competition and Credit Rating Agencies*, Oct. 5, 2010 at 18 ("…[I]t is possible that no level of regulation will truly work and that is why the focus should be on the subscriber or platform pays model.")

[655] OECD, *Hearings*: *Competition and Credit Rating Agencies*, Oct. 5, 2010 at 12.

issuing CRA in which the investors would declare their reliance on the rating in question as informing their investment decision and in exchange with the CRA agreeing to specific terms and conditions under which the investors may sue for performance. [656]

Admittedly the adoption of this approach appears tenuous at best, mainly because of the observed reluctance by private investors to pay for credit ratings in the current environment and yet if applied, it would not only simplify the principal-agent problem but it would also allow the CRAs and the investors – as end-users of their ratings – to freely negotiate the terms of such a contractual agreement in a putatively competitive market, which in turn would over time allow competitors to challenge the prevailing oligopolistic concerns.

4.4. Summing up

Firstly, it is generally recognized that the First Amendment defence no longer suffices for CRA defendants in court. Moreover, in the absence of an observable and reliable stand-alone standard, the inherent shortcomings of both the reasonable care standard for negligence liability and the reasonable basis standard for fraud means that the determination of an adequate standard in CRA lawsuits has by default been delegated to the various courts. [657] In particular, state court decisions reliant on state laws (e.g. Ohio, New York, California, and Delaware) have thus far delivered widely-ranging interpretations and outcomes for both plaintiffs and defendants.[658] For example, an outcome accredited to the lower threshold for proving scienter adopted by state courts[659] has resulted in the incoherency of outcomes that only a federal or even a global standard

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[656] *Compare, section 4.3.3.2* above for discussions on Rule 10b-5.

[657] Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1076-78 (2009).

[658] *Id.,* Manns, at 1082, n.292 (2009).

[659] Timothy M. Sullivan, 94 MINN. L. REV., 2136, 2148-49 (2010).

could hope to adequately address.[660] The EU Member States are poised to encounter the same challenges in their new regulation because although it accords EU Community-wide recognition for the ratings of approved and registered CRAs to be used for regulatory purposes,[661] it also recognizes each Member State as the "competent authority"[662] for enforcement as well as for any civil liability claims that may arise.[663] In the absence of an agreed common standard, disparate court outcomes can similarly be expected.

Secondly, in extending the Supreme Court's efficiency argument beyond the aiding and abetting consideration of that concerning the (increased) liability and accountability of CRAs, this dissertation proceeds to consider whether the new Dodd-Frank Act

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[660] *See e.g.,* Uwe Blaurock, *Control & Responsibility of Credit Rating Agencies*, 36-37 (11.3 EJCL Dec. 2007) (proposes capping liability, evidencing rules and well-defined and appropriate standards should be introduced); Timothy M. Sullivan, 94 MINN. L. REV., 2136, 2165 (2010) (a state law's pre-emption making state claims unavailable to private investors would allow for coherency at federal level and thus lead to more efficient judicious and economic outcomes; but was refused by Ohio court in *In re Nat'l Century* 580 F. Supp. 2d. 630, 651 (S.D. Ohio 2008) at 2165, n.182). *Compare*, Mark J. Roe, *The Inevitable Instability of American Corporate Governance* 8-11 (Harvard Law & Econ. Discussion Paper No. 493, Sept. 2004), (argues that the US' decentralized and porous regulatory system is one of two core instabilities for which no "one-and-for-all" solutions can be reached because while it offers flexibility and specialization, it's porosity – as a consequence of federalism - diminishes the ability of the regulators to be effective, *available at* http://ssrn.com/abstract=61556; Christian Leuz, *Was the Sarbanes-Oxley Act of 2002 really this costly? A Discussion of Evidence from Event Returns and Going Private Decisions*, 44 J. ACCT. & ECON., 146, 148 (2007) (it is easy to anticipate that inefficiencies are bound to be present in a situation where a one-size-fits-all federal legislation - like SOX - is adopted).

[661] *See also*, Partnoy, 'Not Like Other Gatekeepers', 94 (2006) (positing that registration of CRA instead of retaining NRSRO status would allow the SEC to actively inspect, examine, and enforce the regulations).

[662] EU Parliament, '*Regulations (EC) No.1060/2009*', OFFICIAL J. THE EUROPEAN UNION, (Sep. 16, 2009) *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF

[663] *Id.,* EU Parliament (2009).

provisions would also exact costs that may curtail the efficiency of the securities market in particular and the financial market in general. [664]

Thirdly, by construing the holding in *Quinn,* the S.D.N.Y. court appears to have curtailed reliance on Judge Cardozo's "near privity" holding. Similarly, an adoption of the ruling of the Court of the Queen's Bench in Alberta, Canada, in *Fenrich,* would face challenges from CRAs unenthused about contractually committing to investors as third-party beneficiaries of a rating issue contract with an issuer as well as requiring CRAs to embrace the investor-pays model of compensation. This approach is further confounded by the current resistance of investors to be weaned off the issuer-pays model and to transition towards the subscriber-pays model.

Fourthly, although the DFA was only enacted in June 2010, final versions of some of the rules regarding NRSROs as well as a study on the feasibility of establishing an alternative system for allocating credit rating assignments for structured finance products are still under consideration, in spite of initial projections that they would be published by the end of 2012.[665]

Finally, this dissertation recognizes and draws parallels between the DFA provisions and their (potential) impact on the CRA landscape subsequent to their elevation to newly recognized gatekeepers under the DFA. It also aims to compare and contrast these provisions with those emanating from the enactment of SOX in 2002 on two other

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[664] EU Parliament, *European Parliament legislative resolution of 16 January 2013 on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies (COM(2011)0747 – C7-0420/2011 – 2011/0361(COD)* (information asymmetries and efficiency advantages allow CRA ratings to drive investment choices of market participants), (Jan. 16, 2009) *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2013-0012&language=EN&ring=A7-2012-0221 (last accessed on Apr. 15, 2016).

[665] Moody's, Moody's.com; Events and Presentations (SEC is expected to adopt final rules relevant to NRSROs by year-end 2012) (2012)), at 19. *But see*, Hunt, *2009 Columbia Business L. Rev.,(1)*, 109, 150 (2009) ("overreliance on agency ratings, may be the least bad [of the] alternative[s]").

gatekeepers (i.e. auditors and securities analysts) for which substantial data is now available and on which numerous legal and economic studies investigating the legislation's effectiveness and efficiency, have been completed.

PART III: THE PRESENT – ECONOMICS of LEGAL LIABILITY

Chapter 5 The Dodd-Frank Act, gatekeeping and expert liability

5.1. Dodd-Frank's rescission of Rule 436 (g)

Numerous experts and legal scholars[666] have argued in favour of the rescission of the liability exemption from §7[667] and §11[668] of the Securities Act of 1933 that had been granted to NRSROs.[669] Nonetheless, the majority of the earlier literature favouring the

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[666] *See e.g.,* Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies,* CII (April 2009) at 5,14 (exemption from civil liability either under § 11 of the 1933 Act or under CRARA of 2006 holds for CRAs); Frank Partnoy, 'Not like Other Gatekeepers', at 83 (2006) (advocating for changes geared to increasing the threat of civil and criminal liability rating agencies);. Claire A. Hill, 82 Wash. U. L.Q. 43, 57 (2004) (exemption from liability under §11); Lisbeth Freeman, *Who's Guarding the Gate?* 55 VT. L. REV. 585, 589 (2009) (CRAs enjoyed "significant barriers to liability" in the past).

[667] Section 7: requires the filing of a written consent with the registration statement by **any** "**person whose profession gives authority to a statement made by him**, is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement" (often referenced as an "expert") (emphasis added).

[668] Section 11: ("**[E] very person who** signed the registration statement … every person who, with his consent, **is named in the registration statement …; every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him**, **who has with his consent been named as having prepared or certified any part of the registration statement**, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him **[has liability]**) (emphasis added).

[669] Non-NRSROs were not exempt from liability under either §7 or §11 of the Securities Act. See e.g., James C. Spindler, IPO Liability and Entrepreneurial Response 7–16 (Univ. of Chi. John M. Olin Law & Econ.,

rescission had, albeit reluctantly, accepted that the legislative challenge of raising the level of accountability of NRSROs[670] was decidedly too stoic an obstacle to surmount. This was in part because the political will to do so was lacking,[671] and in part because no credible alternative to relying on credit ratings has yet been presented. The liability exemption provided for by Rule 436(g)(1) reads as follows:

> **"[T]he security rating assigned to a class of debt securities**, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization, or with respect to registration statements … **shall not be considered a part of the registration statement prepared or certified by a person within the meaning of Sections 7 and 11 of the Act**" (emphasis added). [672]

In particular, Section 11(a) authorizes "any person" purchasing a security to sue on the premise of an untrue or misleading registration statement. Additionally, it eliminates the scienter requirement for liability and in so doing reduces it to a "strict liability source

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Working Paper No. 243, May 2005), (on file with the COLUM. L. REV.) (for general overview of Section 11 liability), *available at* http://ssrn.com/abstract=719768.

[670] NRSROs were deemed liable under § 10(b) of the Exchange Act, and the Investment Advisors Act. See e.g., Frank Partnoy, *Not Like Other Gatekeepers,* (2006) at 61, 81(due to economic rents made possible by the NRSRO status and the immunity from liability. See also Frank Partnoy, *Barbarians at the Gatekeepers?* 79 WASH. U. L. Q., 1, n.1 (2001) (citing investment banks, auditors and attorneys as gatekeepers); Lisbeth Freeman, *Who's Guarding the Gate?* 55 VT. L. REV. 585, 611-12 (2009) (Freeman does not consider Section 15 of SEC Act, 1933 because Rule 436 still exempted CRAs from liability on new issue ratings under Section 11; Jan Kleineman, Conference on Credit Rating Agencies, Stockholm Centre for Commercial Law, Stockholm Univ., 2012, (monopoly profits/rents are the price for enjoying a low cost and effective rating system).

[671] See e.g., Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 40-41 (Harvard Law and Economics Discussion Paper No. 525, Dec. 2005) (introduction of new corporate law lags following a "disaster – discoveries – outrage –reform clamour – adoption of emotion and perception driven reform legislation" cycle, as scientific policy-making may be inconvenient and slow resulting in reforms whose costs exceed its benefits) *available at* http://ssrn.com/abstract=808244.

[672] 17. C.F.R. §230.436(g)(1) (2008) (emphasis added).

of legal exposure for both issuers and accounting firms [and (presumably), CRAs too]".[673] Furthermore, section 11 specifically permits private rights of action, including actions against all certifying accountants.[674]

In 2004, Partnoy posited that the primary reason why NRSROs were still operating under a different judicial regime to other gatekeepers was because credit rating agency liability had yet to be intently scrutinized by an authoritative body.[675] The primary argument against a strict liability regime is that it appears to be premised on the rather seemingly optimistic assumption that the gatekeeper is able to fully mitigate either fraud or misconduct.[676] It has been demonstrated in the reviewed literature and evidenced in numerous recent court decisions, in particular the rulings made by District courts, [677] that reveal an evolution in the jurisprudence of a trend by US courts towards reducing – albeit

[673] Eric L. Talley, *Panel Two: Sarbanes-Oxley Accounting Issues - Cataclysmic Liability Risk Among Big Four Auditors,* 106 COLUM. L. REV., (7) 1641, 1658 (2006). *See also*, Section 3.4.1. (for discussions on strict liability). *See also* John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 349-53 (2004) (proposal to give attorneys limited liability for non-financial disclosures as opposed to a strict liability regime); Frank Partnoy, 79 WASH. U. L. Q., 2 (2001) (proposing a modified strict liability regime wherein gatekeepers would be liable for a portion, agreed *ex ante*, of any fraud damages accruing to an issuer); and Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1029, 1078 (2009) (on capping the potential liability of gatekeepers in order to preserve the process whilst addressing the potential to create deadweight losses arising from the over-deterrence of CRAs taking on the task of issuing rating in response to punitive regulations).

[674] Eric L. Talley, 106 COLUM. L. REV., (7) 1641, 1647 (2006).

[675] Frank Partnoy, *Not Like Other Gatekeepers*, 58, 89, (2006).

[676] John C., Coffee, Jr. '*Gatekeeper Failure and Reform'*, 84 BOSTON U. L. REV. 302, 381 (2004).

[677] See e.g., John Crawford, *Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry*, 42 CONN. L. REV. 13, 18 (2009) (calls for imposing discipline on CRAs by exposing them to liability for shoddy work).

slowly - the reach and impact of the exemption provisions that have for so long successfully shielded NRSROs from exposure to expert liability.[678]

In the aftermath of the 2007 crisis, the general recognition and acknowledgement of the pivotal role played by NRSROs in the inner machinations of the economic infrastructure resulted in heightened calls from investors and legislators alike[679] to finally expunge their exemption from liability in order to "force rating agencies to be more vigilant in guarding against negligent, reckless, and fraudulent practices".[680] Whether motivated by the need to change the dynamic and/or possibly persuaded either by the scholarship literature[681] or by some of the testimonies that were provided to authoritative bodies such as the Financial Crisis Inquiry Commission,[682] the Congress, through the Dodd-Frank Act, resolved the activities of NRSROs to be "matters of national public

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[678] See Chapter 4 above.

[679] FCIC, *Report on the Causes of the Financial Crisis* (2011) at 417.

[680] *See e.g.,* Aline Darbellay & Frank Partnoy*, Credit Rating Agencies and Regulatory Reform* (Research Handbook on the Economics of Corporate Law, San Diego Legal Studies Paper No. 12-082, 2012) at 16; and Caleb M. Deats, *'Talk that Isn't Cheap'*, 110 COLUM. L. REV., 1818, 1859 (2010) (arguing that liability incentivizes NRSROs to i) makes ratings more factual; and ii) increase the level of disclosure to investors ex ante).

[681] *E.g.,* Sisi Zhang, *Legal Liability of U.S. Credit Rating Agencies under Section 11 of the Securities Act: The Long and Winding Road toward Accountability* (2010) Note (Uni. of Toronto) at 17, 26 (increased disclosure will not enable the majority of investors to make better-informed decisions, but increased liability would compensate for the inherent deficiencies of the reputational model). *See also*, Marco Pagano & Paolo Volpin, Note, *Securitization, Transparency, and Liquidity* at 31-32 (Università di Napoli Federico II & London Business School, Dec. 3, 2008) (unlike naïve investors, only sophisticated investors are able to process and exploit additional information when it is complex) *available at*, http://www.fep.up.pt/investigacao/cempre/actividades/sem_fin/sem_fin_01_05/PAPERS_PDF/2009_02%20Paolo%20Volpin%20Paper.pdf (last accessed May 5, 2016).

[682]*See e.g.,* Eric Kolchinsky, *Credibility of Credit Ratings* (testimony of Eric Kolchinsky before the Financial Crisis Inquiry Commission, June 2, 2010) at 1 ("[T]he Nature of CRAs is quasi-regulatory and is very similar to auditing work performed by accounting firms").

interest" due to their perceived central role "in capital formation, investor confidence and the efficient performance of the United States economy".[683] Moreover, Congress also recognized an inherent conflict of interest due to the fundamentally commercial nature of their character[684] – particularly concerning structured financial products[685] – and emphasized the need to address rating inaccuracies by demanding higher CRA and NRSRO accountability.[686] As a consequence, the Dodd-Frank Act formally elevated the (legal) status of NRSROs to that of a "gatekeeper".[687]

The new and more stringent corporate governance measures ushered in by DFA include both re-cycled[688] and novel approaches[689], most notably including the requirement for all NRSROs to submit an annual report attested by their respective chief executive officers, to the SEC.[690] Other changes included granting the SEC authority to suspend or revoke an NRSRO's registration for a specified class or sub-class of securities; the directive for the SEC to introduce rules enforcing the separation of sales and marketing considerations or business units from those involved with the rating decisions of

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[683] H.R. 4173- 497, Subtitle C – Improvements to the Regulation of Credit Rating Agencies § 931 (1), available at https://www.sec.gov/divisions/marketreg/ratingagency/wallstreetreform-cpa-ix-c.pdf; in total the DFA comprises of 22 CRA related rules.

[684] H.R. 4173- 497, §931 (3).

[685] H.R. 4173- 497, §931 (4).

[686] H.R. 4173- 497, §931 (5).

[687] H.R. 4173- 497, §931 (2).

[688] H. R. 4173-507, §932 (t)(2).(Requiring NRSROs to provide at least ½ of the board seats (but not less than two) to be held by independent director, similar to SOX).

[689] H. R. 4173-509, §935, (amending §15E of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7)).

[690] H.R. 4173- 498, §932 (3)(B)(i-iii). Similarly, sub-section 404(b) of SOX requires an attestation report signed by the firm's independent auditor to be filed as part of the company's annual report of management's assessment of the company's internal controls.

NRSROs;[691] as well as the requirement for NRSROs to publicly disclose both their initial rating issues of securities[692] and the rating methodologies adopted.[693] Additionally, the Office of Credit Rating (hereafter OCR)[694] was specifically established by the DFA to enforce the new regulations. Another significant rescission in the DFA was the repeal of the Regulation Fair Disclosure (i.e. Regulation FD),[695] effective October 19, 2010, which thereto exempted NRSROs from the disclosure of insider information[696] provided that NRSROs proceeded to make ratings available to the public. This exemption was explicitly denied to securities analysts and other gatekeepers. [697]

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[691] H. R. 4173- 499, § 932 (3) (prohibiting NRSROs from providing consultations and advice on prospective or "potential" ratings creates conflicts of interest.). *See also*, Frank Partnoy, '*Not Like Other Gatekeepers,*' (2006), (prior to DFA, amongst gatekeepers only CRAs were permitted to develop ancillary business, i.e. consulting), at 68.

[692] H. R. 4173—503, §932 (q).

[693] H. R. 4173—503, §932 (r) and (s).

[694] H. R. 4173—502, §932 (p). The SEC named a Director for the OCR on June 5 2012 (as per Section 15E (p)(3)(c) of Securities Exchange Act of 1934), initially with team of 25 accountants, lawyers and examiners responsible for monitoring CRAs and tasked with conducting an annual examination of NRSROs and issuing the initial public report on 1st report on Sept. 30, 2011, available at www.sec.gov/news/press/2012/2012-113.htm (last accessed Mar. 25, 2015).

[695] 17 C.F.R. 243.100-243.103.

[696] *See e.g.,* Eric Baggesen, ("[W]e are almost required to look at those ratings simply because the credit rating agencies are allowed access to inside information that we do not have access to".) (comments of Eric Baggesen, Senior Investment Officer at CalPers, to the House Committee on Oversight and Government Reform: Hearing on 'Credit Rating Agencies and the Next Financial Crisis' at 136, Sept. 30, 2009), *available at* https://house.resource.org/111/gov.house.ogr.20090930.pdf (last accessed Mar. 25, 2015).

[697] See Dodd-Frank, Title IX, Subtitle C, § 939B.

Equally noteworthy are the provisions and clauses of DFA that addressed NRSRO accountability and liability.[698] Concerning accountability, §933 (a) stipulated that CRAs would be held to the same enforcement and penalty provisions "in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws".[699] Furthermore, section 933 (2)(b)[700] uniquely modified the "state of mind" requirement standard and accordingly enabled private actions for monetary damages to be brought against CRAs. The notable exception however, is that post DFA, it now suffices for plaintiffs so pleading to show that the particularity of facts presented to a court "give[] rise to a strong inference that the credit rating agency knowingly or recklessly failed … [t]o conduct a reasonable investigation, … or [t]o obtain reasonable verification of such factual elements."[701] It is important to note, that pleading with particularity facts amounting to a "strong inference of fraud", remains a hard standard for plaintiffs to meet, particularly prior to discovery as plaintiffs are often limited by only having the facts available in the public domain to rely

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[698] E.g., Dustin Hall, *Dodd-Frank Wall Street Reform Bill Significantly Modifies the Regulation of Credit Rating Agencies*, (NRSRO's systematic importance and gatekeeper function warrants increased public oversight, as well as increased accountability and liability, July 2010), *available at* http://www.bankbryancave.com/2010/07/dodd-frank-wall-street-reform-bill-significantly-modifies-the-regulation-of-credit-rating-agencies/ (last accessed Mar. 25, 2015).

[699] H. R. 4173—508, §933 (a) (amending Section 15E (m) of the Securities Act of 1934 (15 U.S.C. 78o-7(m)). ("The enforcement and penalty provisions of this title shall **apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws**, and such statements shall not be deemed forward-looking statements for the purposes of section 21E.") (emphasis added).

[700] H. R. 4173—508, §933 (2)(B)

[701] H. R. 4173—50, §933 (2)(B) (i-ii).

on when pleading their case.[702] In addition, §934 (u) imposes a duty on NRSROs to report legal violations by issuers to law enforcement or regulatory authorities.[703] Save for one other clause,[704] Subtitle C of DFA appears to save the most explosive change for last, concluding with the §939G which simply reads:

> "Rule 436(g), promulgated by the Securities and Exchange Commission under the Securities Act of 1933, shall have no force or effect."[705]

Rule 436(g)(1) reads: "[N]otwithstanding the provisions of paragraphs (a) and (b) of this section, the security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization [NRSRO], … shall not be considered a part of the

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[702] *See e.g.,* Eric L. Talley, 106 COLUM. L. REV., (7) 1641, 1654 n.33 (2006) citing *Lovelace v. Software Spectrum, Inc*., 78 F.3d 1015, 1018, 1020 (5th Cir. 1996) ("… [A] failure to follow GAAP, without more, does not establish scienter") (2006).

[703] *Compare,* Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1074 nn.260-61 (2009) (requirement placed on auditors to file formal reports with a client's management and audit committee when aware that an illegal what? may have or did occur, in which case report to be filed with client's board of directors and the SEC. See 15 U.S.C. §§ 78j-1(b)(2) - (3); and duty of lawyers to report potential violations if credible evidence suggests material violations occurred. *See also,* 15 U.S.C. § 78-1(a)-(b)).

[704] H. R. 4173 – 515, § 939H confirms the mandate of Congress for the SEC to rely on § 15E(h)(2)(B) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–7(h)(2)(B)) to curtail the conflicts of interest arising from non-rating practices, e.g. providing advisory services.

[705] H. R. 4173 – 515, § 939G (nullification of Rule 436(G)). See also, Matthias Lampe & Michelle Yeo-Mokhtar, *'A Practioner's View of the Rating Process for Asset-Backed Securities'* (2012) (noting that the EU is considering civil liability of CRAs, establishing a two-ratings norm in the EU, additional disclosure requirements and removal of credit ratings references in the CRA3 proposals) (2012). *Compare,* Darbellay, Aline, and Frank Partnoy. "Credit Rating Agencies and Regulatory Reform." *Research Handbook on the Economics of Corporate Law*; San Diego Legal Studies Paper No. 12-082*, 18 April 2012 at 21 n.53 (who point out that DFA's removal of statutory ratings does not extend to references to ratings w.r.t. student loans (title 20), highways and infrastructure finance (title 23), or telephone media rules and loan guaranties (title 47)).

registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act." [706]

In other words, by repealing Rule 436(g) DFA permitted NRSROs to be qualified as experts under Section 11 of the Securities Act which exposed them to liability when their credit ratings were included or referenced into a Securities Act registration statement or prospectus. Ergo, not only does DFA nullify the liability exemption that had afforded NRSROs protection from litigation since 1982 by repealing Rule 436(g), but by also classifying NRSROs as gatekeepers[707] it places them on par with sell-side securities analysts, auditors and non-NRSRO rating agencies,[708] in terms of legal expectations of good governance.[709] In addition, DFA requires NRSROs to report violations to law

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[706] 17 C.F.R. § 230.436(g)(1).

[707] Commentators had been referring to NRSROs as "financial gatekeepers" or simply as "gatekeepers" long before DFA was enacted. *See e.g.,* Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1013 (2009) (CRAs as "gatekeepers of credit risk"); CII, letter to Senate Leaders, on May 12, 2010, *available at* http://www.cii.org/UserFiles/file/resource%20center/correspondence/2010/05-12-10%20Letter%20on%20Rule%20436(g)%20FINAL.pdf; Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA L. & BUS. REV. 10, 19 ("Gatekeepers, such as rating agencies, … "); James Surowiecki, *Ratings Downgrade*, NEW YORKER, Sept. 28, 2009 ("… [I]dispensable gatekeepers"), *available at* http://www.newyorker.com/talk/financial/2009/09/28/090928ta_talk_surowiecki; Gregory Husisian, *What Standard of Care Should Govern the World's Shortest Editorials* 75 CORNELL L. REV., 411 (1990); Frank Partnoy, '*Not Like Other Gatekeepers'*, (2006).

[708] *See,* Comments by Mary Keogh, MD Regulatory Affairs, DBRS on SEC Concept Release to rescind Rule 436(g), at 5 (positing that non-NRSROs tend to be less regulated and may have unmanaged conflicts of interest, opaque methodologies and undisclosed histories, *available at* http://dbrs.com/research/230933/dbrs-comments-on-sec-concept-release-to-rescind-rule-436-g.pdf (last accessed May 5,2016). *See also*, Cuomo Agreement requiring investment banks to provide due diligence data on loan pools to Big Three to review prior issuing ratings, *available at* http://www.ag.ny.gov/press-release/attorney-general-cuomo-announces-landmark-reform-agreements-nations-three-principal (last accessed Apr. 15, 2015).

[709] H.R. 4173- 497, §931 (3). Sub-section (3)(B)(i) however exempts "small" NRSROs from the separation requirement, although no definition of "small" is provided.

authorities and also directs them to carry out due diligence on information received from issuers and other third party sources, a function that hereto had been explicitly resisted en masse by NRSROs.[710] To put this policy reversal into clearer perspective, the SEC unequivocally discouraged the disclosure of ratings in registration statements prior to 1982.[711] The nullification of Rule 436 (g) meant that as of July 22, 2010,[712] NRSROs were required to file written consent forms permitting the disclosure of their rating and, in so doing, expose themselves to expert liability under §11 for material misstatements or omissions.[713] However, as the prospectus definition of Rule 405 only refers to §10(a) and not to "free writing prospectuses" as defined by §10 (b), expert liability exposure only applies to "registration statements" and "prospectuses".[714]

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[710] Editorial staff, *The Moody's Blues*, WALL ST. J., Feb. 15, 2008, at A14 (An S&P spokesperson confirmed that CRAs do not carry out due diligence on individual mortgages for example, stating: "We are not auditors; we are not accounting firms"), *available at* http://online.wsj.com/article/SB120303641478270219.html (last accessed Apr. 15, 2015). *Contrast,* Frank Partnoy, 'Not like Other Gatekeepers' (2006), at 59 CRAs, (although the least understood of the gatekeepers, play a "verification function … by designating alphabetical ratings to debt"); *Commercial Financial Services, Inc., v Arthur Andersen LLP, 94 P.3d 106,* 161 (Okla. Civ. App. 2004) (Civil Appellate court compared credit rating opinions solicited by an issuer to audit opinions produced by certified public accountants solicited by an issuer).

[711] SEC, Comments by Mary Keogh, MD Regulatory Affairs, DBRS on SEC Concept Release to rescind Rule 436(g), at 1, n2 (comments citing "Disclosure of Ratings in Registration Statements", Release No. 33-6336 (Aug. 6, 1981) [46 FR 42024]).

[712] As per §4 of DFA, §939G (the Rule 436(g) Rescission clause) was to take effect one day after the enactment date. President Obama signed the Act into law on July 21, 2010.

[713] *See e.g.,* Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective*, CII, April 2009 at 14 ("Rule 436 explicitly provides that NRSROs are exempt from liability as an expert under Section 11"). Issuers had a way around the Rule 436 (g) rescission through private placements possible through Rule 144A, the downside of which would involve the shrinking of the possible investor base.

[714] SEC, *'Compliance and Disclosure Interpretations'*, (SEC guidance to question of when a CRA's written consent is (see 233-04, 233.05) and is not not required (see 233.06) (2012), *available at*

5.2. Impact of the rule rescission

When arguing against the rescission of Rule 436(g) in Concept Release documents, Moody's had already indicated the real possibility of withholding their consent for their ratings to be referenced in registration documentation and withdrawing from certain markets in response to a nullification of the expert liability exemption. This was in response to a scenario which Moody's deemed likely to present "crushing" potential liability costs for their firm.[715] In keeping with their earlier indications, detailed in the Concept Release comments, to do so,[716] the NRSROs' general response to the rescission was as a clear and unequivocal: "No, thank you!"

The collective decision to withhold consent by the NRSROs coupled with their expressed concerns about whether compliance with either Regulation FD[717] or Regulation

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http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm#233.08 (last accessed Apr. 15, 2015). *See also,* Davis Polk, July 21, 2010 (legal guidance opinion on nullification of Rule 436(g)).

[715] *See e.g.,* Martha Coakley, *Rating Agency Consents and Regulation AB*, at 3, n8 (2011) citing comments of Moody's COO, Michel Madelain, at 3. *See also,* Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1024 (2009) (noting that gatekeeper liability could disproportionately impact CRAs).

[716] *See e.g.,* Martha Coakley, *Rating Agency Consents and Regulation AB* (2011) noting that of the eleven comment letters released by the SEC, five were against the rescission of 436(g), (i.e. Big Three and DBRS and their consultants); 2 were either a "no", and an "ambivalent" to the rescission of §11 liability, but both were in favour of increased CRA accountability (i.e. NYC Bar Comm., on Sec., Reg. and the Securities Industry and Fin., Markets Assoc.,); and four were in favour of rescission (Investment Company Institute, CalPERS, the Council of Institutional Investors and Demos, a think-tank) (2011).

[717] Regulation FD permitted issuers to share material non-public information with NRSROs without triggering broader disclosure requirements.

AB[718] would be legally possible, absent their consent had an immediate impact on the ABS market: The public ABS market ground to a whip-lashing halt.[719]

Several issuers that were preparing to issue new securities at that moment, most notably the Ford Motor Company[720] among them, were forced to consider shelving their pending ABS transactions.[721] It is worth observing that with the US economy already in a

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[718] Gilbert Liu, *The Repeal of Rule 436(g): Effects on the Asset-Backed Securities Market* 2 ("Regulation AB (i.e. Regulation on Asset Backed Securities) … includes a requirement to disclose whether an NRSRO credit rating is a condition of the issuance or sale of any class of securities and, if so, the identity of the NRSRO and the credit rating."); and Martha Coakley, *Rating Agency Consents and Regulation AB* (2011)("Regulation AB forms the centerpiece of the SEC's investor protection regime for the asset-backed securitization markets").

[719] *See e.g.,* Katharina Cavalli, "[T]his is a real and significant unintended outcome with real consequences to the general economy..." (citing comments by Richard Dorfman, MD and Head of SIFMA's Securities Industry and Financial Markets Association Securitization Group, of deep concern for the impact of the rescission on the ABS market), July 22, 2010, *available at* http://www.sifma.org/news/news.aspx?id=17732 (last accessed Mar., 15, 2015); Jesse Westbook, *U.S. Regulatory Bill May `Flash Freeze' Asset-Backed Market, Industry Says*, BLOOMBERG, July 21, 2010, *available at* http://www.bloomberg.com/news/2010-07-21/u-s-regulatory-bill-may-flash-freeze-asset-backed-market-industry-says.html; Anusha Shrivastava, *Bond Sale? Don't Quote Us, Request Credit Firms*, WALL ST. J., July 21, 2010, (on how the market 'effectively' seized up at the prospect of operating under a civil liability regime) *available at* *h*ttp://online.wsj.com/article/SB10001424052748704723604575379650414337676.html (last accessed Mar. 15, 2015); and Daniel Indiviglio, *Rating Agency Liability Wouldn't Have Prevented the Crisis*, ATLANTIC, Dec. 9, 2010 (ABS market freeze).

[720] Susan J. Thomas, request for a No Action Letter from Susan J. Thomas, Secretary and Associate General Counsel Ford Motor Credit Company LLC to the SEC, dated July 22, 2010 (noting Ford's inability to conduct an issue offering because of the failure "to comply with Rules 11 03(a)(9) and 1120 of Regulation AB under the Securities Act ("Regulation AB")" as a result of the NRSROs' refusal to give consent for their identities and ratings in issuing prospectus documentation, *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120-incoming.pdf. *See also* Martha Coakley, *Rating Agency Consents and Regulation AB* (2011) at 1.

[721] Thorsten Schröder, "Wir erleben einen Stillstand" (transl. 'We are experiencing a standstill'), according to an ABS lawyer quoted by the Financial Times Deutschland, *Panische Ratingagenturen verbieten*

deep recession and possibly teetering on the edge of a depression as it was in July 2009, the Ford Motor Company was hanging onto the noteworthy distinction of being the sole major US auto-maker that had up to that point not yet requested a government bailout to stave off the 2007 financial crisis.

Not surprisingly, the political will to assist Ford, a large employer in the U.S. automotive sector and indirectly, the general economy back on the path to recovery was substantial. Consequently, although faced with several arguably less intrusive alternatives for addressing the ensuing situation,[722] the SEC addressed the market's failure to resolve the resulting impasse with NRSROs in a timely manner through prompt intervention. In a demonstration of the "elasticity of law",[723] the SEC, through its Division of Corporation Finance on July 22, 2010, issued a no-action letter (i.e. NAL) that was valid for a transitional period, initially envisaged for six months. The NAL in question offered ABS issuers indemnification from punishment until January 21, 2011 if they omitted NRSRO ratings disclosures from a prospectus that was part of a registration statement

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Bewertungsnutzung, (transl. 'Panicked rating agencies prohibit use of ratings'), FINANCIAL TIMES DEUTSCHLAND, July 22, 2010, *available at* http://www.ftd.de/finanzen/maerkte/:nach-der-finanzreform-panische-ratingagenturen-verbieten-bewertungsnutzung/50147730.html (last accessed Apr. 15, 2015).

[722] Martha Coakley, *Rating Agency Consents and Regulation AB* (2011) (Coakley suggests three alternatives: i) leave it to the market to establish a price; ii) accredit more NRSROs prepared to accept the expert liability regime, or iii) use SEC statutory exemptive power to override Congress to exempt ABS issues from DFA disclosure requirements), at 5. Additionally, Stacey-Marie Ishmael, *What's the SEC to do about 436(g)? Call a time out*, FINANCIAL TIMES , (citing private placements via 144As as an alternative, while noting the likelihood of reduced transparency for both buyers and sellers, higher funding costs as well as generally lower origination volumes) (last accessed Apr. 15, 2015); USGov-House, *Credit Rating Agencies and the Next Financial Crisis: Hearing before the House Comm., on Oversight and Gov't Reform, 111th Congress, Sept.30*, 2009), (comments by Floyd Abrams on increased liability exposure will cause NRSROS to issue fewer ratings to the market), at 101, *available at* https://house.resource.org/111/gov.house.ogr.20090930.pdf (last accessed Apr. 15, 2015).

[723] *See e.g.*, Katherina Pistor, *Towards a Legal Theory of Finance* 7 (Columbia Public Law Research Paper No. 12-323, 2012) at 18-22.

prospectus.[724] The regulator's expectation was that the initial stance taken by NRSROs would be either be reconciled to the DFA requirement through negotiations or that market forces would pressure the NRSRO and their counterparties to overcome the impasse and find a workable solution to correct the market failure that had caused the freeze up of the ABS market.

However, in a subsequent replacement letter issued on November 23, 2010, the SEC cited the continued impasse with the NRSROs and the SEC's need for additional time to implement the DFA provisions in its decision to further extend the no-action waiver indefinitely "… pending further notice".[725] The most poignant criticism levelled against this indefinite waiver declaration has challenged the lack of legitimate legal force of NALs generally insofar as they affect the rights of private parties or governmental actors.[726] Subsequently the SEC decided to withdraw the NAL and instead permit market forces the freedom to determine the cost for issuing ratings.[727] The irony about the latter criticism is

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[724] As per Regulation AB, Item 1103(a)(9) and 1120.

[725] Katherine Hsu, Response of the Office of Chief Counsel Division of Corporation Finance at the SEC to the Ford Motor Company, Nov. 23, 2010, *available at*, http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm (last accessed Apr. 15, 2015).

[726] *See e.g*., Victoria McGrane & Jean Eaglesham, *With Election Over, Dodd-Frank Battle Changes*, WALL ST. J., Nov. 2, 2012, at 2 (Federal courts have struck down two rules incorporated in DFA, and more lawsuits against SEC and the Commodity Futures Trading Commission are pending. *See also,* Martha Coakley, *Rating Agency Consents and Regulation AB* (2011), at 7 (positing that SEC's NALs' contradict federal securities laws.). *Compare,* John C. Coffee, Jr., *The Political Economy of Dodd-Frank* 97 CORNELL L. REV., 1019, 1026 (2012) (arguing that the administrative implementation process, as demonstrated by the SEC's NALs, represent the organic process for correcting legislative mistakes or misjudgements form the original legislation).

[727] *See e.g*., Martha Coakley, *Rating Agency Consents and Regulation AB* (2011), at 10 (arguing that as experts at calculating risk of loss, CRAs should competently do this, and that the SEC should only intervene when the price set by CRAs intolerable market disruption unclear – and allows the courts to arbitrate the SEC's position. Coakley does not offer substantive suggestions on how the SEC would "forthrightly address" a high price outcome).

that the SEC only issued the NAL waiver because market forces had thereto failed to establish an effective mechanism to set prices for issuing ratings under a liability regime, hence the market freeze. It has been almost five years since DFA was enacted and the market has still not found or offered a practical solution to the problem and thus the indefinite waiver remains in place as the impasse continues unabated.

5.3. CRA comparables

Prior to DFA receiving acclaim for providing a "[s]weeping overhaul of the United States' financial regulatory system on a scale not seen since the [President F.D. Roosevelt] reforms that followed the Great Depression",[728] the task of restoring confidence to American business in the aftermath of a financial crisis had rested on the toughened new rules and provisions of the Sarbanes-Oxley Act (SOX) following its enactment on July 30th, 2002.[729] Likewise, SOX had also been hailed for ushering in the "most far-reaching reforms of American business practices [improving corporate governance and reporting] since Franklin Roosevelt was president".[730] Enacted in response to the litany of financial

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[728] Barack Obama, Remarks of the President on Regulatory Reform, June 17, 2009, *available at* http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform. *See also,* Viral V. Acharya, *The Dodd-Frank Act Leaves A Lot to Be Desired*, CENT. FIN. STUD., Qtr. 1, 12 (2011), ("The Dodd-Frank Act is the most ambitious and far-reaching overhaul of financial regulation since the 1930's").

[729] E.g., Haidan Li, Morton P.K. Pincus & Sonja O. Rego, *Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management*, 1 (SSRN, Sep. 24, 2006; updated from Dec. 5, 2003), ("SOX is the most important legislation affecting corporate financial reporting enacted in the United States since the 1930s"), *available at* http://ssrn.com/abstract=475163.

[730] Economist, *Sarbanes-Oxley: Five years under the thumb*, ECONOMIST, July 26, 2007, *available at* http://www.economist.com/node/9545905?story_id=9545905. See e.g., *Testimony Concerning the Implementation of the Sarbanes-Oxley Act of 2002: Hearing before Senate Comm., on Banking, Housing and Urban Affairs, 108th Cong*., *Sept. 9, 2003* (testimony of William H. Donaldson, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/090903tswhd.htm.

reporting fraud scandals,[731] the expedited[732] implementation of SOX had similarly earned both the support and rancour of legislators,[733] experts and scholars[734] in equal measure; its success, or lack thereof, continues to sustain an on-going vigorous debate on both sides of the argument. Critics[735] of SOX, among them Roberta Romano, Larry Ribstein and

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[731] Refer to Section 1.1. above.

[732] Comments of William H. Donaldson, SEC Chairman, *An Evening with the Chairman,* 23 CFA INST. CONF. PROC. Q. (1) 1-7 March 2006, at 7 ("[SOX] was pushed through in a hurry in response to the American public's horror at what was going on").

[733] *See, e.g.,* with Financial Takeover Repeal Act of 2011, March 31, 2011(Bill to repeal DFA, sponsored by Rep Mr DeMint et al., S.712, 112th US Congress). *See also,* H.R. 87: To repeal the Dodd-Frank Wall Street Reform and Consumer Protection Act (Sponsored by Sen. DeMint; H.R. 1539: Asset-Backed Market Stabilization Act of 2011; and S. 746: Dodd-Frank Repeal Act of 2011.

[734] *See e.g.,* John C. Coffee, Jr., *The Political Economy of Dodd-Frank* 97 CORNELL L. REV., 1019, 1025 (2012)(DFA attacked with same fervour as SOX, before it); Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV.1817, 1835 ("…[O]n average, managers consider SOX an intrusion and resent nearly all of it") (2007). *See also, Free Enterprise Fund v. Public Company Accounting Oversight Board.,* 130 S. Ct. 3138 (2010) (Supreme Court ruled in a split 5-4 decision which removed clauses on the PCAOB's appointment process but determined that the remainder of SOX was indeed constitutional; Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV., 1779, 1796 (2011)(DFA meets first four "bubble law" criteria, namely: i) enacted in response to crisis ; ii) crisis environment (but most political will and momentum to push through legislation); iii) populist backlash against firms and markets, iv) adopted on a federal as opposed to state level).

[735] *See e.g.,* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,* 114 YALE L. J., 1521, 1585-91 (2005) argues that SOX's corporate governance provisions were ill-conceived and resulted in an unnecessary law. Romano posits that the provisions should have ideally been left to the States, enabling a "race-to-the-top" instead of the federalist approach demanded by SOX; Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 88 (2003) ("… [T]he **consequent rush to the adoption of Sarbanes-Oxley, led to some questionable cures for corporate fraud**. … Similarly, the Act's new duties, liabilities, and penalties for corporate executives, including executive certification requirements, are unlikely to counteract the strong incentives for fraud operating in the bubble context…") (emphasis added); John J. Curran & Jesse Hamilton, *Schapiro SEC Seen Ineffectual Amid Dodd-Frank Funding Curbs*, BLOOMBERG, Mar. 31, 2011 (SOX was unnecessarily rushed), *available at*

Stephen Bainbridge, have extensively argued that the SOX legislation was not only premised on ill-conceived and unsubstantiated theories,[736] but also that it was both

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http://www.bloomberg.com/news/2011-03-31/schapiro-sec-seen-ineffectual-amid-dodd-frank-funding-curbs.html (last accessed Mar. 5, 2015). *See also,* Stephan Arping & Zacharias Sautner "Did SOX Section 404 Make Firms Less Opaque? Evidence from Cross-Listed Firms." 30 *CONTEMP. ACCOUNTING RES. 1133, 1150-53* (2013) (on the improvement in transparency (i.e. reduction in opaqueness) for US and EU cross-listed firms - particularly the latter – review the impact of SOX §404 and conclude that SOX had a positive effect on corporate disclosure quality); Lord & Benoit Report, *Do the Benefits of 404 Exceed the Cost?,* (study of 2,481 found that SOX-compliant firms experienced share price increases of 27% versus that of Russell 3000 index firms of 17% between March 31,2004 and March 31, 2006) at 3, *available at* http://www.section404.org/pdf/Lord%20&%20Benoit%20Report%20Do%20the%20Benefits%20of%20404%20Exceed%20the%20Cost.pdf; Larry E. Ribstein, *Sarbanes-Oxley after Three Years*, N.Z. L. REV., 365, 368 (2005) (for further arguments for the view that SOX was a misconceived and economically detrimental piece of legislation); HENRY BUTLER & LARRY E. RIBSTEIN, *THE SARBANES-OXLEY DEBACLE.: WHAT WE'VE LEARNED; HOW TO FIX IT,* AEI PRESS, Washington D.C., at 75-82, 100-102 (2006), (suggesting that SOX presented a litigation time-bomb and should therefore either be overhauled or repealed); Robert E. Freer Jr., & Raymond W. Burroughs, *Unintended Consequences: Sarbanes-Oxley and Its Progeny,* 7 S. C. J. INT'L L. & BUS., (1) Art. 3, 47, 49, 55-57 (2010)(SOX created more burdens than aid and §404 is the root of most of the Act's flaws as it creates a chilling effect between auditors and their clients); Foley & Lardner LLP, *Foley Study Reveals Continued High Cost of Being Public*, (study found that the total costs (i.e. including auditor fees, legal costs and board compensation) of being a U.S. public company increased significantly in the period 2001-2006), *available at* http://www.foley.com/foley-study-reveals-continued-high-cost-of-being-public-08-02-2007/ (last accessed Mar. 15, 2015); Ivy Zhang, Note, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, at 41-42, (Zhang finds no evidence that investors considered SOX to be beneficial. (Feb. 1, 2007), *available at* http://ssrn.com/abstract=961964); FEI, *FEI Releases Results of Seventh Sarbanes-Oxley Section 404 Cost-Benefit Survey* (reduction in total cost of §404 compliance and an increased sense of benefits, i.e. enhanced investor confidence in financial reporting, financial reporting reliability, and fraud prevention and detection), *available at* http://www.financialexecutives.org/KenticoCMS/FEI_Blogs/Financial-Reporting-Blog/April-2008/FEI-Releases-Results-of-Seventh-Sarbanes-Oxley-Sec.aspx (last accessed Mar. 15, 2015).

[736] *See e.g.,* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act* at 6, 9 (Harvard Law and Economics Discussion Paper No. 525, Dec. 2005) (argues against ideas adopted 'off-the-shelf', such as the separation of audit and non-audit services) without empirical proof of

hurriedly implemented and disastrously executed[737] to the economic detriment of corporations, as well as private and institutional investors. In particular, they cite the maligned preference for adopting inefficient securities laws on a federal level; the difference between the projected lower cost figures estimated by the SEC prior to the implementation of SOX (for example, §404 which proved to be understated by a factor of twenty)[738] and the actual compliance costs reported by firms;[739] the increase in the number

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usefulness); Roberta Romano, *'Quack Corporate Governance',* 114 YALE L. J., 1521, 1535-37 (2005) (did not find a negative association between providing audit and non-audit services in tandem, for 19 of 25 firms in the study). *Contrast*, Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV.1817,1824 (2007) (offering that the lack of correlation might only affirm that other conflicts, such as cognitive dissonance psychological biases could dominate the non-audit issue).

[737] *See e.g.,* Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV.1817, 1821 (2007) (citing "undue haste" in passing SOX); Robert E. Freer Jr., & Raymond W. Burroughs, *Unintended Consequences: Sarbanes-Oxley and Its Progeny,* 7 S. C. J. INT'L L. & BUS., (1) Art. 3, 47-48 (2010) (SOX was "a quick fix" attempt to rebuild consumer confidence); John C. Coffee, Jr., *The Political Economy of Dodd-Frank,* 97 CORNELL L. REV., 1019, 1020 (2012)(SOX possibly enacted with "… some haste").

[738] Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. (2), 703, 726 (2007) (SEC forecast understated cost by a factor of 20, i.e. $91,000 vs $1,820,000 on average per firm. *See also* Economist, *Five years under the thumb* (July 26, 2007). *Contrast*, Lord & Benoit Report, 'The Sarbanes-Oxley Investment' (costs of SOX §404 (a) and §404 (b) internal controls compliance at $78,000 (i.e.13% below original SEC estimate of $91,000 §404 (a) alone)), at 3 (2008), http://www.section404.org/pdf/Lord_Benoit_Report_The_Sarbanes_Oxley_Investment.pdf.

[739] Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act,* (Harvard Law and Economics Discussion Paper No. 525, Dec. 2005), at 28-31 (large initial outlay for firms, higher costs than forecasted by SEC and legislators, SOX's regressive costs hit smaller firms the hardest). *See also*, SEC, *Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers with Public Float Between $75 and $250 Million*, at 63 (2011); and William, J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private"* 2, 14 (Emory Law & Economics Research Paper No. 05-4, Feb. 2005) ("… [T]he burdens of complying with the Sarbanes-Oxley Act and its regulations exceed the benefits for many public companies, particularly the smaller ones.")

of firms either going dark or going private;[740] as well as event and other empirical studies whose findings suggest that SOX has had a net-negative impact on the economy.[741]

For their part, the proponents of SOX[742] acknowledge the limitations of the reactionary process that allows for the "bubble laws" phenomena;[743] the legislating of disproportionately correcting laws often enacted in a post-crisis environment. They also concede that – save for a crisis – legislators typically lack either the political support or willpower, and are thus hesitant to introduce tough and wide-reaching laws that could impose additional costs on corporations.

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[740] *Contrast,* Catherine Shakespeare, *Sarbanes-Oxley Act of 2002 Five Years On: What Have We Learned?* J. BUS. & TECH. L., 333,334-336 (2008) (increase in firms going private or going dark can also be explained by the increase in money flowing into private equity); and Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV.1817, 1851-52 (2007) (due to opportunistic managers retaining the private benefits of control that would otherwise be curtailed under SOX).

[741] Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. (2), 703, 726 (2007) (SOX damaged global competitiveness of US firms). *See also,* Donald C. Langevoort, 105 MICH. L. REV.1817, 1845(2007).

[742] *See e.g.,* Joseph D. Piotroski & Suraj Srinivasan, *Regulation and Bonding: Sarbanes-Oxley Act and the Flow of International Listings*, J. ACCT. RES., 28-30, 34 (2008) (found no change in listing preferences between US exchanges and LSE's Main Market for large firms in the period 1995-2006, but reported a decrease for listings of smaller firms on smaller US exchanges (NASDAQ) relative to its UK counterpart (i.e. LSE AIM). *Contrast,* Robert E. Freer Jr., & Raymond W. Burroughs, *Unintended Consequences: Sarbanes-Oxley and Its Progeny,* 7 S. C. J. INT'L L. & BUS., (1) Art. 3, 47, 65-66 (2010) (SOX compliance doubled the cost of a U.S. listing for foreign firms - citing Thomas Selling's article, '*Sarbanes-Oxley: Unintended Consequences'*, at 67 (2004) (90 percent of the 38 percent of firms that considered listing in the US but finally opted for an LSE listing, reportedly cited SOX as the deciding factor) *available at* http//:www.enewsbuilder.net/thunderbird/e_article000246430.cfm.

[743] Larry E. Ribstein, *Bubble Laws*, 40 HOU. L. REV., 77, 89 (2003) (on SOX being law enacted in response to the bursting of the stock market dotcom bubble).

Coffee[744] and Brown,[745] for example, agree that SOX was indeed rushed, but both still contend that it was procedurally correctly enacted. Brown posits that although corporate law is designed to facilitate a more efficient allocation of assets through private ordering, this will not automatically result in efficient bargains by either individual or collective actors.[746] Brown further argues that earlier studies to evaluate the cost of SOX have relied on typically anecdotal extrapolations from small samples that overstate costs, ignore once-off costs, and include costs that would have been incurred regardless of SOX.[747]

In spite of an extensive body of theoretical and empirical literature on SOX, the question of whether it has been a constructive or destructive piece of legislation is still starkly disputed.[748] The ongoing consternation notwithstanding, SOX remains a sound

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[744] *See e.g.,* John C. Coffee, '*The Political Economy of Dodd-Frank'*. 97 CORNELL L. REV., 9 January: 1019, 1020 ("[A] good crisis should never go to waste"]. *See also* Coffee, *Partnoy's Complaint: A Response*, 84 B.U. L. REV. 377, 382 (2004) ("[C]hange, if it comes at all, will come incrementally and in the form politically acceptable to powerful political interests"); and Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV., 1779, 1785 (2011) (Bainbridge's lament that corporate governance typically takes a backseat role to other pressing concerns in Washington, can be interpreted to mean Washington resolves to address far less controversial issues to deal with in ordinary times, than corporate governance).

[745] *See e.g.,* Robert J. Brown, *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance*, 90 MARQUETTE L. REV., 309-335 (2006) (revised March 21, 2012) (for a contrasting and positive evaluation of SOX), *available at* http://ssrn.com/abstract=959443.

[746] *Id.,* Brown, 90 MARQUETTE L. REV., at 311 (2006).

[747] *Id.,* Brown, 90 MARQUETTE L. REV., at 321 (2006).

[748] *See e.g.,* Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV.1817, 1818 (on-going disputed influence of SOX on economic behavior)(2007); Haidan Li et al., *Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management*, 1 (SSRN, Sep. 24, 2006 (whose studies relied on different event days and concluded that SOX was beneficial for firms (i.e. share price valuations)); and Zabihollah Rezaee & Pankaj K. Jain, *The Sarbanes-Oxley Act of 2002 and Capital-Market Behavior Early Evidence*, 23 CONTEMP. ACCT. RES. 629, 634-35, 651-52 (2006) (for the period Feb

reference source for assessing the DFA, particularly as it provided legislation whose rules and regulations were intended to reset the legal and economic landscape for two other groups of gatekeepers: auditors and sell-side securities analysts. Among the major features of SOX include the creation under Title I of an independent public-private oversight body,[749] of the Public Company Accounting Oversight Board (i.e. PCAOB);[750] the introduction of restrictions prohibiting auditing firms from offering audit and non-audit services to clients in tandem;[751] as well as other provisions to curb conflict of interests, such as independent audit committees and whistle-blowing guidelines[752] and §404[753]

2002-July 2002, find that firms deemed at the onset to be in compliance with SOX provisions experienced positive results).

[749] PCAOB's mandate to promote informative, accurate, and independent audit reports, *available at* http://pcaobus.org/About/Pages/default.aspx.

[750] Title I, ("All audit firms that wish to audit a public company must be registered with the PCAOB and are subject to its oversight." *See*, Pub. Co. Accounting Oversight Bd., Bylaws and Rules § 2.2100 (2007), *available at* http://pcaobus.org/Rules/PCAOBRules/Pages/Section_2.aspx.

[751] Recognition of efficiencies and synergies from audit firms also providing tax services possibly influenced the final decision not to include them on the list of prohibited (consulting) services. *See* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act, *6* (Harvard Law and Economics Discussion Paper No. 525, Dec. 2005). *See also*, Mark W. Nelson, *Ameliorating Conflicts of Interest in Auditing: Effects of Recent Reforms on Auditors and their Clients*, (SSRN, July 2005) ("little evidence that non-audit services diminish auditor independence": Nelson also cites studies by Kirney et al (2004) who that found that "providing tax services may actually improve audit quality"), at 12; Roberta Romano, *'Quack Corporate Governance',* 114 YALE L. J., 1521, 1536 (2005) (finding no dependence between the in-tandem provision by audit firms of non-audit services and audit quality); Jan-Pieter Krahnen, *In Rating Regulation, Sometimes Less is More*, CENT. FIN. STUD., (2), 2009, at 2 (EU Parliament and Council directive on rating agencies -16 Sept 2009 – prescribing the separation of rating and non-rating services).

[752] See SOX (i.e. Pub.L. 107–204), under Section 201.

[753] See SOX (i.e. Pub.L. 107–204), under Section 404—Management Assessment of Internal Controls; considered by some commentators as the "neutron bomb" within SOX. *See e.g.,* Ehud Kamar, Pinar Karaca-Mandic & Eric Talley, *Going Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, RAND, at 3 (2008); Klingsberg & Noble (2004) Klingsberg, Ethan, and Marie Noble*, SOX 404-*

which made more robust internal-control structures and procedures for financial reporting the responsibility of a firm's management team.

Although not exhaustive, some of the anecdotal parallels between the two pieces of legislation include that:

i) Both SOX and DFA were enacted in the aftermath of a financial crisis[754] and were targeted at addressing the perceived lapses of the gatekeepers (i.e. securities analysts and auditors under SOX, and credit rating analysts in DFA).[755]

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mania: Y2K Déjà vu, Myths, Risks and What it all means for M&A, *M&A Lawyer*, Sept. 2004, 1-7 (2004 Robert E. Freer Jr., & Raymond W. Burroughs, '*Unintended Consequences',* 7 S. C. J. INT'L L. & BUS., (1) Art. 3, 47, 49, (§404 is the most controversial provision of SOX) (2010); John C. Coffee, '*The Political Economy of Dodd-Frank*', *97 CORNELL L. REV.*,1019, 1037 (business expressly sought to soften §404) (2012). *But see*, Catherine Shakespeare, '*Sarbanes-Oxley Act of 2002 Five Years On'*, J. BUS. & TECH. L., 333,334-336 (2008), (arguing that §302 which required CEOs and CFOs to certify in the annual or quarterly financial reports had more impact than §404). *And Compare,* Freer Jr., &. Burroughs, 7 S. C. J. INT'L. L. & BUS., (1) Art. 3, 61 (DFA (i.e. Pub. L. No. 111-203, §989, 103 Stat. 440 (2010)) exempted firms with less than $75 million public float from the external audit requirement of internal control provision of SOX §404(b) (2010).

[754]Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV., 1779, 1796 (2011) (DFA is as inadequate as SOX, as both align with the eight attributes of quack corporate governance identified by Romano; castigates six sections of DFA as being either "meaningless symbolism" or possessing the serious potential to cause adverse consequences, at 1783. *Contrast,* Viral V. Acharya, *The Dodd-Frank Act Leaves A Lot to Be Desired*, CENT. FIN. STUD., Qtr. 1, 2011, at eight (argues for example that DFA's weakness is its lack of federal consolidation of its rules and regulations).

[755] H.R. 4173- 497, §931 (2). *See also,* Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA L. & BUS. REV. 10, 22 (2006) ("[T]he historical evolution of demand for the services of [CRAs] is identical to that of accounting firms"). YASUYUKI FUCHITA & ROBERT E. LITAN (eds) in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS?, 5 (2006) (based on the two-pronged criteria model suggested by the authors which considers the gatekeepers based on the influence on trading activities of their reports and their need for reporting uniformity; accounting requires the most oversight, then CRAs and lastly securities analysts); Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*,

ii) Both were crafted to address conflicts of interest inherent in the business models of the gatekeeper firms and in the incentive-drivers for their personnel.[756]

iii) Both sought to curtail the ability of the gatekeepers to provide ancillary products and services in tandem with their core businesses, either by prohibiting certain combinations of business services or by strengthening the legal and/or physical separation of the services.[757]

iv) Similar to the position of NRSROs, the auditing industry in particular is largely dominated by four large privately held international corporations.[758]

v) Both present practical difficulties in calculating and comparing the costs and benefits of implementing and complying with either SOX or DFA.[759]

The aforementioned traits notwithstanding, and aside from the common distinction of being recognized as "gatekeepers", the two groups still exhibit unique traits which limit the extent of their similarities.[760] For instance, similar to CRAs, the auditing industry is heavily characterised by the Big Four firms, but its function is to assess the reliability of

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Note, (2007) Figure 6.4, at 143, (any structural similarity between securities analysts, auditors, and CRAs does not infer similarity in economic functions between the three groups).

[756] H. R. 4173 - 515, §939(H).

[757] H. R. 4173 - 515, §939(H).

[758] See e.g., Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV.1817, 1838 (2007); Frank Partnoy, *'Barbarians at the Gatekeepers?* 79 WASH. U. L. Q. (2001) (proposing a modified strict liability regime wherein gatekeepers would be liable for a portion, agreed ex ante, of any fraud damages accruing to an issuer).

[759] John C. Coffee, '*The Political Economy of Dodd-Frank*', 97 CORNELL L. REV.,1019, 1027-29 (2012) (DFA is more narrowly focused than SOX, has no natural political allies and could be costlier for firms to comply with because its places greater interpretive power in the hands of its administrative implementers).

[760] *See,* YASUYUKI FUCHITA & ROBERT E. LITAN (eds) in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? *passim* (2006) (for general discussion on similarities and differences between auditors, securities analysts and CRAs.)

past information whereas the main function of CRAs is to forecast future credit risk performance of debt issuers. The SEC's Office of International Affairs comment to the SEC Inspector General's 2009 report encapsulates the counter-arguments which highlight the limitations to the comparison[761] of auditors to CRAs:

> "While often linked together … as gatekeepers, the role of an independent auditor and a CRA is very different, and face correspondingly different conflicts of interest and transparency concerns. Auditors might be described as "backwards-focused", in that they use audit standards set by the [PCAOB] to opine on statements that an issuer makes regarding historic facts. By contrast, CRAs are "forwards-focused," using non-standardized and proprietary methodologies … to predict the likelihood of future events".[762]

Also, in the ruling in *Bathurst*, Jagot, J:

> "[T]he purpose of an audit of a company is one thing. The purpose of the assignment of a rating to a financial instrument is another. A rating is assigned to a financial instrument for the very purpose of communication to the class of potential investors for them to take into account, and rely upon, in deciding whether or not to invest. The same cannot be said of a financial audit of a company which is undertaken by an auditor for the company's own purposes and to comply with the company's statutory obligations."[763]

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[761] SEC, *The SEC's Role Regarding and Oversight of Nationally Recognized Statistical Rating Organizations (NRSROs)*, Aug. 2009, at 106 (other noted differences include unlike an auditor, a CRA analyst does not participate in fee discussions, his compensation is prohibited from being dependent on the fees collected from a covered issue as well as from participating in the selling (i.e. marketing) process or the setting of fees.), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2009/Report458.pdf.

[762] *See e.g.* Daniel Indiviglio, *Rating Agency Liability Wouldn't Have Prevented the Crisis*, ATLANTIC, Dec. 9, 2010 (the " …[K]ey difference between the agencies and these other parties [is that] the agencies must predict the future, and the others don't."). *See also*, Michel Madelaine, "…[R]atings are inherently and completely forward-looking, rather than backward-looking, in nature." (Comment letter of Michel Madelaine, Chief Operating Officer of Moody's Investors Service on Concept Release, Dec. 14, 2009).

[763] *See e.g*., *Bathurst Regional Council v Local Government Financial Services Pty Ltd.* (No 5) (2012),[763] (distinction between audit firms and CRAs), para 2758, at 1135-36.

It is also argued that the role of accountants also required them to be closer to the firms than CRAs[764] even as some commentators assert that unlike lawyers and auditors[765] who get purview into slices of the business at intermittent intervals, the role of CRAs is unique as a backstop of oversight for the other gatekeepers as a result of its ongoing access to public and non-public disclosures by issuers when assessing the latter's risk profile.[766]

As with the distinction between uncertainty and probability put forward by Pistor,[767] it can also be said that whereas accounting relies on calculus, rating opinions rely to a large extent on subjective judgments. The law governing securities analysts is considered

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[764] Lohman H.A. de Savornin & M.G. van't Westeinde, *Control and Liability of Credit Rating Agencies under Netherlands Law*, ECJ at *16 (2007)(prior to DFA, an accountant's role was closer to the company than a CRA because he was duty bound to report fraud, whereas CRAs have "no expert status, no duty to verify, no statement of fact" which potentially diminished their exposure to liability).

[765] Brigitte Haar, *Civil Liability of Credit Rating Agencies - Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence* 19 (University of Oslo Faculty of Law Legal Studies Research Paper Series No.2013-02, 2013 at *5 n.11 (for auditor liability see BGH Neue Juristische Wochenschrift 1956, 1595; for lawyer liability see BGH Neue Juristische Wochenschrift 1972, 678, 680).

[766] *Compare,* Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1073 (2009) (although CRAs have broader surveillance responsibilities over issuers, "they are likely not as privy to the internal goings on of issuers as are issuers' lawyers and accountants"). *See also*, Claire A. Hill, *Regulating the Rating Agencies*, 82 Wash. U. L.Q. 43, 75-79 (2004) on six differences between auditors and CRAs: i) Two-rating norm is credible deterrent to capture by issuers, ii) CRAs not being as focused on ancillary services as Auditors therefore less leverage by issuers possible: "The non-ratings work they (i.e. CRAs) have done has been less lucrative relative to rating work than non-auditing work has been relative to accounting work", at 93; iii) Reputational risks (e.g. Fitch ratings typically higher than Egan-Jones ratings which are more conservative); iv) Harder for CRAs to hide deliberate inaccuracies than for accountants since ratings inaccuracies can be measured and confirmed ex post, at 76; v) CRA compensation structures do not rely on ex ante 'rainmaking' or client retention therefore no push to favour own and client interests over those of the market?, at n.137: Vickie A. Tillman, "No percentage of analyst compensation is directly dependent on fees paid by issuer to Standard & Poor's"; vi) Possibility of another CRA issuing a widely disparate (lower) unsolicited rating, at 77.

[767] Katherina Pistor, *Towards a Legal Theory of Finance* (Columbia Public Law Research Paper No. 12-323, 2012), at *4.

by some commentators as being more apt and comparable to CRAs as both groups rely on information provided by issuers and/or clients as well as third parties in order for them to able to provide informed opinions on their expected future economic performance. This is unlike auditors, who generally opine on the clients' past performances. However, sell-side analysts are legally required to make public all private information that they receive from management executives while CRAs take private information into account when issuing ratings without the obligation to disclose it.[768]

This dissertation does not attempt to litigate the debate on the efficiency and effectiveness of SOX, or lack thereof, and while it is in agreement with the view that CRAs are unlike other gatekeepers,[769] it does however observe and draw on several distinctive and informative parallels observable between DFA and SOX. Despite being enacted in 2002, the implementation of some of the SOX provisions was still being delayed in 2007.[770] As a result, some of the studies published immediately after its enactment in 2002 have – with hindsight – since been shown to have overstated the

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[768] USGov-Hearing, *Credit Rating Agencies and The Next Financial Crisis, 2009, at 162 available at https://house.resource.org/111/gov.house.ogr.20090930.pdf* (private information that was denied to analysts and investors but made available to CRAs by issuers gives them an unfair advantage over other market participants and gatekeepers).

[769] *See,* Frank Partnoy, *'Not Like Other Gatekeepers'* (2006) (general discussion on distinctions with other gatekeepers).

[770] Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV.1817, 1819 (2007). Similarly, only thirty percent (123 of 398) of the DFA implementation deadlines had been met as of July 18, 2012. *See,* Davis-Polk, *Dodd-Frank Progress Report*, July 18, 2012, *available at* http://www.davispolk.com/files/Publication/15a76992-d82a-4d15-a2db-fcde9effc3d0/Presentation/PublicationAttachment/b82f9d23-0edc-49eb-af02-ff97ff34bd56/071812_Dodd.Frank.Progress.Report.pdf (last accessed Mar. 20, 2015)

compliance costs involved.[771] The 2007 Kaufman-RAND study[772] is one of several latter studies that found evidence suggesting that, subsequent to the initial outlay in year one,[773] financial reporting compliance costs for corporations actually dropped significantly from year two onwards.[774] This is because a) respondents in the early studies were possibly

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[771] *See e.g.*, Ivy Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, Note, 2007 at 20 (hypothesized an estimated net cost of SOX of $1.4 trillion, calculated as the total market value of NYSE, AMEX and NASDAQ as a result of major events on 14, 16 and 17 July), *available at* http://w4.stern.nyu.edu/accounting/docs/speaker_papers/spring2005/Zhang_Ivy_Economic_Consequences_of_S_O.pdf., (an updated version of the note does not refer to the same figure.); Begley & Gao, *supra* n.187, at 9 (SOX rules implemented over a two year period, and hence post-2004 data could be deemed more relevant and informative when measuring effects of SOX); Robert E. Freer Jr., & Raymond W. Burroughs, '*Unintended Consequences',* 7 S. C. J. INT'L L. & BUS., (1) Art. 3, 61-62 n88 (2010) (report findings from a Charles River Assoc., study of ninety Fortune 1000 firms which reported §404 compliance costs in 2004 of approximately $7.8 million, 0.1% of total firm revenue).

[772] Kaufmann-RAND, *Do the Benefits of Sarbanes-Oxley Justify the Costs?* RAND 1-3 (2007).

[773] Protiviti, *2011 SOX Compliance Survey* (A survey of over 400 executives and professional respondents from across industries, 62% of whom had revenues of $1 billion or higher, found that reported benefits of SOX compliance exceeded costs, post year one.), at 11.

[774] SEC, '*Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act',* 2011, at 85, 88-89 (Section 404(b) compliance costs have continued to decline, particularly post the accounting guidance provided in 2007); Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. (2), 703, 728 (2007) (drop in SOX costs in subsequent years due to software improvements, learning curve and staff experience). *Contrast,* Protiviti, *Building Value in Your Sox Compliance Program,* at 7-8 (2013 survey found that although reportedly manageable for most firms, SOX compliance costs and external audit fees were rising); William, J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private"* 1 (Emory Law & Economics Research Paper No. 05-4, Feb. 2005) ("…[R]egulation may have reached the point where the costs of regulation clearly exceed its benefits for many corporations"); Robert E. Freer Jr., & Raymond W. Burroughs, '*Unintended Consequences',* 7 S. C. J. INT'L L. & BUS., (1) Art. 3, 62 (2010) (SOX costs remain higher than anticipated, causing firms to remain private or to de-list: the authors cite a 2004 GAO study - quoted in a 2006 article – when similar studies typically over-estimated the compliance costs); and Anwer S. Ahmed, Mary Lea McAnally; Stephanie J. Rasmussen, & Connie D. Weaver, *How Costly is the Sarbanes Oxley Act? Evidence*

unclear about the impact of SOX and simply overstated their expectations[775] or b) the recognition of the improved status experienced by small companies that opted to stay in the market instead of going private or going dark was either understated or ignored.[776] A 2006 study found that firms that opted to go dark over going public tended to be smaller firms that demonstrated weaker stock market performance, higher leverage and had less growth opportunities "than the population of firms that could but chose not to go dark."

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on the Effects of the Act on Corporate Profitability 12 (SSRN, Sept. 2009) (firm profitability is lower for up to four years after the adoption of SOX), *available at* http://ssrn.com/abstract=1480394.

[775] Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV., 1779, 1781-82 (2011) (under-estimation of year one costs by a factor of 80 for large firms, and a factor of 16 for smaller firms).

[776] Kaufmann-RAND, *In the Name of Entrepreneurship: The Logic and Effects of Special Regulatory Treatment for Small Business*, at 159 (2007)(cites extensive studies that have identified the benefits of going private (e.g. lower agency costs, tax advantages, improved profitability and operating efficiency), as well as the cost of being public as key drivers in the decision to go private). *But see,* Christian Leuz, *Was the Sarbanes-Oxley Act of 2002 really this costly?* 44 J. ACCT. & ECON., 16 (2007)(agrees with the findings of Ivy Zhang (2005), Berger et al (2006) and Litvak (2006) that SOX imposed net costs on smaller firms, but finds little evidence of net costs to all US firms or the economy generally); and GAO, *Report to the Committee on Small Business and Entrepreneurship, U.S. Senate*, at 23 (study which found that SOX compliance costs were mentioned by firms 41% of the time as the reason for going private in 2003, and roughly 58% in 2004 and in 2005), although the number of firms going private had been steadily increasing, prior to SOX's implementation, at 22, 23. GAO, "Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies (April, 2006), Figure 2, at 22, and Figure 9, at 78 (increase in companies going dark pre-SOX). *See also,* Robert Prentice, *Sarbanes-Oxley* 29 CARDOZO L. REV. (2), 703 (2007) (SOX costs contributed to the going private or going dark decision. However, Prentice also suggests that the decision is driven by the selfish interests of opportunistic managers; see 742, n.247-248 for overview of literature on going dark or going private). See e.g., Daniel A. Cohen, Dey Aiyesha & Thomas Z. Lys, *Real and Accrual-Based Earnings Management in the Pre-and Post-Sarbanes Oxley Periods* 3, 24-27 (FARS Meeting Paper, June 2007) (on opportunistic behaviour of managers at firms - motivated by equity-based compensation – switched from accounting management to pursue harder- to-detect real earnings management).

[777] It is worth noting that the process of going private also requires more cash than going dark.[778]

Among the numerous robust explanations put forward to explain the discrepancies found in empirical studies evaluating the effect of SOX on the economy, three of the more convincing arguments include the observation that i) because several regulatory changes[779] were introduced at the same time as SOX, it is very difficult to disentangle its impact and establish its unique causality;[780] ii) the contrasting experience between large

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[777] Christian Leuz, Alexander J. Triantis & Tracy Yue Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* 3 (ECGI - Finance Working Paper No. 155/2007; AFA 2006 Boston Meetings Paper; Robert H. Smith School Research Paper No. RHS 06-045, Mar. 1, 2008), *available at* http://ssrn.com/abstract=592421

[778] Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, RAND, 10 (2008).

[779] *See e.g*., Robert Charles Clark, '*Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act'* 40-41(Harvard Law and Economics Discussion Paper No. 525,Dec. 2005), at 3 n.4 (posits that three other seismic policy changes were introduced together with SOX; namely, new listing requirements, new governance rating systems (e.g. Institutional Shareholder Services' "Corporate Governance Quotient" and tougher judicial opinions (particularly in Delaware)), contributed to the difficulty in disentangling the impact of SOX (2005); and Christian Leuz, '*Was the Sarbanes-Oxley Act of 2002 really this costly?'*, 44 J. ACCT. & ECON., 8 (2007) (criminal penalty provisions of SOX: Section 802(a), 18 U.S.C. § 1519 (fined, imprisoned up to 20 years, or both), and criminal penalty for retaliation against whistle-blowers by corporations, Section 1107, 18 U.S.C. §1513(e) (fine, imprisoned up to 10 years, or both). *See also,* Sarbanes-Oxley Act §906, 116 Stat., at 806.

[780] *See e.g.,* Ivy Zhang, Note, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, at 3 ("… [O]ne cannot decisively conclude that SOX is costly."); and Catherine Shakespeare *'Sarbanes-Oxley Act of 2002 Five Years On: What Have We Learned*? *J. BUS. & TECH. L.*, 333-355 (2008) (notion that SOX restored investor confidence to U.S. capital markets is "more[a] belief than an empirical fact" due to the difficulty in determining causality) at 355 (2008); *See also*, B. Hansen, G. Pownall & X. Wang, *The Robustness of the Sarbanes-Oxley Effect on the U.S. Capital Market* at *92 n.205 (2008)(causality still in question).

firms and small firms,[781] iii) the difference between the actual[782] and the opportunity cost estimates[783] projected for personnel committed to ensuring adequate compliance instead of focusing on the core business of running their firms.[784] A persuasive[785] view that has often been expressed in the literature argues that the benefits of SOX,[786] such as improved

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[781] SEC, 'Study and Recommendations on Section 404(b)', 2011, at 63 (study found smaller firms more likely to consider de-listing than larger firms Robert E. Freer Jr., & Raymond W. Burroughs, '*Unintended Consequences',* 7 S. C. J. INT'L L. & BUS., (1) Art. 3,58 (2010), (SOX compliance discouraged IPOs and forced de-listings by smaller firms); Robert Prentice, *Sarbanes-Oxley* 29 CARDOZO L. REV. (2), 703, 731 (2007) (inclusion of independent audit committees and other SOX implementation costs benefit large and mid-size firms over smaller firms).

[782] *See e.g.,* Robert J. Brown, *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance*, 90 MARQUETTE L. REV., 309, 321 (2006)(anecdotal extrapolations from small samples that overstate, ignore once-off costs and include costs that would have been incurred regardless of SOX).

[783] e.g., William, J. Carney, '*The Costs of Being Public After Sarbanes-Oxley'*1 *(*Emory Law & Economics Research Paper No. 05-4, Feb. 2005), at 8 (arguing that opportunity cost does not show up on the income statement of firms).

[784] *See e.g.,* Deborah Solomon & Cassell Bryan-Low, *Companies Complain About Costs Of Corporate-Governance Rules*, WALL ST. J, Feb. 10, 2004 (quoting Peter Bible, Chief Accounting Officer at General Motors Corp: ("[T]he real cost [of SOX] isn't the incremental dollars, [but rather,] it is the having people that should be focused on the business focused instead on complying with the details of the rules [of compliance]"); Freer & Burroughs, "Unintended Consequences: Sarbanes-Oxley and Its Progeny." *7 S. C. J. of International Law & Bus., (1)* 64 (2010)(positing that the detraction of workers from other functions due to SOX compliance requirements bears additional firm costs. The author makes no case for the benefits accruing from compliance).

[785] Robert J. Brown, *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance*, 90 MARQUETTE L. REV., 309 (2006); Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV.1817, 1822 (2007).

[786] *See e.g.,* GAO, *Report to the Committee on Small Business and Entrepreneurship, U.S. Senate* 26 (GAO, Apr. 13, 2006) firms citing positive impact on: i) audit committee involvement (60%); ii) company awareness of internal controls; iii) documentation of business processes (67%).

investor confidence,[787] improved audit quality,[788] and the positive cost of ensuring better corporate behaviour resulting in prevented fraud, for example, are difficult if not impossible to quantify,[789] and are therefore often ignored in cost-benefit calculations. Studies analysing actual costs, expected costs and even opportunity cost have been cited as evidence and confirmation of the negative economic impact of SOX.[790] While this line of argumentation has in part been challenged by subsequent studies that found that SOX compliance costs were not as high as initially anticipated and that the cost tapered off

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[787] *See e.g.,* Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 22 (Chicago Booth Research paper, Mar. 19, 2009) ("At this point, SOX has probably helped to restore confidence in the U.S. corporate governance system") *available at* http://research.chicagobooth.edu/economy/research/articles/185.pdf; GAO, *Report to the Committee on Small Business and Entrepreneurship, U.S. Senate,* 2006, *at* 52 (regulators, public companies, audit firms, and investors generally acknowledged that many SOX provisions have positively and significantly affected investor protection and confidence); David K. Min, *"The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic"*, March 30, 2011, at 2 (testimony of David K. Min, Assoc. Dir., for Financial Markets Policy, Center for American Progress Action Fund before Subcomm., on Oversight and Investigations of the House Fin. Servs. Comm., on benefits of regulation are financial stability, greater investor confidence and more efficient capital allocation which all contributed to high economic growth). *See also*, Protiviti, *2011 SOX Compliance Survey*, at 13 (SOX benefits recognized by respondents included increased effectiveness and efficiency of operations, and expansion of the scope and ability of internal audit to perform audits beyond traditional process business areas); and Robert J. Brown, *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance*, 90 MARQUETTE L. REV., 309, 329 (2006).

[788] *See e.g.,* Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*, Note, (2007), at 136.

[789] Robert Charles Clark, '*Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act'*, (Harvard Law and Economics Discussion Paper No. 525, Dec. 2005), at 27 ("SOX is "undeniably costly", … but [its] benefits are far harder to document"). *Id.,* Hence, calculating the impact of SOX accurately is nearly impossible to do, at 13.

[790] *See e.g.,* C William, J. Carney, '*The Costs of Being Public After Sarbanes-Oxley'*1 *(*Emory Law & Economics Research Paper No. 05-4, Feb. 2005), at 8. *See also*, John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis,* 2009 COLUM. BUS. L. REV., (1) 109, *passim*, (2009).

significantly after year one of implementation,[791] the plausibility of arguments offered by both proponents and critics of SOX is apparent. So, just how does one therefore proceed from the impasse? For starters, without comprehensive empirical studies, it is impossible to determine whether the benefits of preventing fraud and scandals as a result of SOX for example, [or DFA, for that matter] do in fact outweigh the negative effects.[792]

Arguing that the burden and therefore onus of providing empirical evidence proving that the SOX compliance costs outstrip its economic and social benefits lies on the objectors, is the position advanced by Clark;[793] and yet, however persuasive, the challenge of determining an acceptable model for accounting for the benefits of such legislation remains. In spite of the robust defence by its proponents, a stance that focuses predominantly on shareholder maximization for determining the impact and viability of legislation, cannot and should reasonably not be the sole standard for determining efficacy.[794] Merely looking at the initial and on-going compliance costs as a means of quantitatively measuring the economic (or social) contribution and impact of any legislation, just as would be the case with any financial investment,[795] falls short of a comprehensive and informative result, particularly if one does not also attempt to quantify the supposed benefits in order to net them off.[796]

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[791] *See e.g.,* Kaufmann-RAND, *Do the Benefits of Sarbanes-Oxley Justify the Costs?* 158 (2007).

[792] Robert Charles Clark, '*Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act'* (Harvard Law and Economics Discussion Paper No. 525 Dec. 2005), at 21.

[793] *Id.,* Clark, '*Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act'*, at 23.

[794] Donald C. Langevoort, 105 MICH. L. REV.1817, 1829 (2007).

[795] Financial capital budgeting includes net present value (NPV), internal rate of return (IRR), discounted cash flow (DCF) and payback period which all rely on the imputation of both cash inflows and outflows to enable calculation and subsequently comparison.

[796] *e.g.,* Donald C. Langevoort, 105 MICH. L. REV.1817, 1827 (2007. *See also*, Catherine Shakespeare, *Sarbanes-Oxley Act of 2002 Five Years On: What Have We Learned?* J. BUS. & TECH. L., 333,335 (2008) (the challenge of quantifying the benefits limit the effectiveness of cost-benefit studies as "much of the

At first blush, imputing an acceptable dollar valuation to benefits appears to be a fool's errand; more so because of the complexity in identifying an acceptable objective – or even for that matter – a subjective metric, to substantiate a claim. Postulating the limited benefits of repealing SOX, a commentator noted that while "[s]ome of the costs are reasonably easy to quantify, most of the benefits are not", because they are not "susceptible to empirical calculation".[797]

And yet, we cannot permit the search for perfection to be the enemy of the good; decisions must be made even in the absence of perfect legal and operational tools. The impact of the SEC's indefinite no-action letter waiver for CRAs cannot be understated as the fifth year anniversary of the enactment of DFA and the liability regime that it was intended to usher CRAs into has been passed, and the sixth is already in sight. In hindsight, the SEC's decision to enable an indefinite waiver through the issue of the NAL increasingly seems to have been a masterstroke, particularly as it appears as though the parties have not come any closer to resolving the status quo to bridge the economic impasse. The indefinite waiver has served to effectively suspend the law of the land in order to give the market participants a chance to resolve the matter and present a practical structure to enable the belated introduction of expert liability for NRSROs. Simply rescinding the NRSRO status would achieve this by demoting and thereby equating the current NRSROs to regular CRAs for which expert liability is the norm and to which §7 and § 11 of the Securities Act of 1933 apply. It would be simple to do, and may already have been done if the legal void left by rescinding the NRSRO designation could be seamlessly filled by a suitable alternative process and structure. But, until a practical alternative avails itself, the current dilemma will remain.

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improvements from SOX go unobserved"). *See also,* David K. Min, *"The Costs of Implementing the Dodd-Frank Act: Budgetary and Economic"*, March 30, 2011, at 2 (the costs of implementing DFA should instead be compared to costs of not implementing DFA).

[797] Robert Prentice, *Sarbanes-Oxley,* 29 CARDOZO L. REV. (2), 703, 759 (2007).

5.4. Summing up

The rescission of DFA had an immediate effect on the market: the ABS market froze.[798] It only recovered following the SEC's NAL intervention which served to temporarily plaster over the cracks resulting from the market failure. The limitations of comparing the impact of these two pieces of legislation separated by time and focus notwithstanding, SOX offers valuable lessons for anticipating the potential impact of DFA and the corrective amendments that the law might require going forward. SOX, when enacted, sought to address by redefining the role, responsibilities and functions of two gatekeepers; auditors and sell-side securities analysts. Furthermore, auditors operate in a similarly structured industry; one defined by high market concentration among its largest participants, while sell-side securities analysts provide independent economic and stock price forecasts of various firms. These similarities notwithstanding, Partnoy[799] and others have written extensively about the stark peculiarities that make CRAs in general and NRSROs in particular, significantly different from other gatekeepers. Almost five years since the SEC's intervention in July 2010, there still appears to be a dearth of practical solutions able to replace the NAL's indefinite waiver. It has been argued that NRSROs have been stonewalling merely out of brinkmanship, and because their continued resistance towards a liability regime enables them to continue earning economic rent. It is also possible that the laws could be changed to force NRSROs to either accept such a liability regime or to close shop and cede the market to other CRAs. However, an admittedly less dramatic but probably more likely reason for the sustained hold-up that has prevented NRSROs from reaching a compromise with their counterparts, is that there are economic realities that have hindered and continue to hinder the path towards a

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[798] See e.g., Jesse Westbrook & Alison Vekshin, *Regulators Would Oversee Credit Ratings in Senate Plan*, BLOOMBERG, May 13, 2010, "A number of transactions that had been planned for the upcoming weeks have been shelved indefinitely given this proposal" (Tom Deutsch, executive director of the American Securitization Forum).

[799] Frank Partnoy, '*Not Like Other Gatekeepers'*, *passim*, (2006).

compromise. If that is indeed the case, then it stands to reason that these economic realities need to be recognized and as far as possible, accommodated.

Chapter 6 Liability: Economic arguments

6.1. Rescinding Rule 436(g)

It seems reasonable that the initial ABS market freeze and the ensuing resistance by NRSROs to issue public ratings under an expert liability regime rests on the reasoned aversion of CRAs[800] to issuing ratings that could potentially expose them to legal and economic claims for "… an indeterminate amount for an indeterminate time to an indeterminate class [of plaintiffs]", as had been cautioned by Judge Cardozo.[801] In a written statement to the House of Congress, UCLA School of Law professor, Eugene Volokh, distinguished the liability that CRAs would be exposed to, from that under which auditors operate when he wrote: "[A]n accountant's ... is potentially liable only to one plaintiff; if a rating agency is held liable for unduly positive ratings, it could face lawsuits alleging "unreasonable" behavior by many thousands of investors".[802] At this juncture,

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[800] ("We have not consented to and will not consent to being named an 'expert' under any applicable securities laws"), submission by S&P in (No 5) [2012] FCA 1200 (Nov. 5 2012), para 2789, at 1147.

[801] *Ultramares Corp., v. Touche* 255 N.Y. 170, 179, Court of Appeals of N.Y. (Jan. 6, 1931). *See also*, Krupansky, J. dissenting in *Haddon View Inv. Co. v. Cooper & Lybrand* 70 Ohio St. 2d 154, 160 (Ohio 1982) (to the majority's rule that an accountant/auditor can be held liable for professional negligence to a limited third party class if reliance by the latter can be specifically foreseen. Krupanksy J.'s dissent noted that their abandonment of the privity doctrine extended auditor liability and exposed them to unlimited and indefinite third-party liability). *See also,* ("ripple effect") cited in *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (2012) (No 5) [2012] FCA 1200 (5 November, 2012), para. 2743, at 1130. *Contrast*, *Ohio Police & Fire v Standard & Poor's Financial*, 813 F.Supp.2d 871,880 (2011) (where the what? ruled that CRAs had no reason to foresee such reliance). *See also*, Haar, 21 ZBB (3) 177,182 n.87 (2009), (majority of scholars hold that third party liability fails under German law as the public dissemination to unlimited persons would expose the CRA to unlimited liability, and notes that this view is disputed by von Schweinitz).

[802] USGov-House-Hearing, "US House Financial Services Committee Hearings", http://archives.financialservices.house.gov/media/file/hearings/111/volokh.pdf, May 15, 2009 at 9 n.30 (written statement of Eugene Volokh).

the ongoing attempts to increase CRA accountability notwithstanding, it looks unlikely that CRAs will be required to accept an (unlimited) liability regime in the US in the near future. In that regard, the regulatory amendments that have been proposed by the EU Parliament which suggest a decidedly more assertive policy approach merit closer examination and will be reviewed in greater detail later in this section.

The Big Three have put forward the argument that rescission of §936 (g), in order to restore the liability exemption under Rule 436(g), would not only be in the interest of NRSROs but would also be in the interest of investors and issuers. For example, rescission would reduce the associated transaction costs,[803] avail their ratings to a broader market, and avoid the temptation of issuing rating opinions brimming with legalese more targeted at lawyers as opposed to straightforward opinions intended for use by ordinary investors.[804]

As was discussed in Chapter 4, although NRSROs have always been subject to anti-fraud laws, US courts have thus far relied extensively on tort law when adjudicating lawsuits involving CRAs because of the deficiencies of current securities legislation. The upside of Tort law has been that it not only compensates claimants against negligent injury, but it also deters negligent actions by actors. Still, a more economic and possibly 'truer' limitation of liability law is that even when the corporate veil is pierced to benefit plaintiffs, were the injured party to fail as a going concern and experience terminal failure, then claims against the CRA (as defendant) would "only" be limited to the latter's net worth, as opposed to being a measure of the actual damages experienced.[805]

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[803] *E.g.,* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 944 (1982), ("[A]part from minimizing transaction costs and possibly facilitating the operation of market forces that discipline management, corporation law has little role to play").

[804] Michel Madelaine (comment letter of Michel Madelaine, Chief Operating Officer of Moody's Investors Service on Concept Release, Dec. 14, 2009), at 1-2.

[805] Or in the case of an auditing firm, the value of the firm and that of its partners.

Conversely, it is possible that a large plaintiff facing terminal failure as a result of a provably flawed credit rating may possibly only subsequently receive a fraction of its market cap from a CRA; more so if there are numerous other claimants against the same CRA as would be the case in a class-action lawsuit.[806] Class-action lawsuits present the challenge of determining the criteria by which claimants would qualify; i.e. the causality question, as well as whether any payment to plaintiffs should be for restitutive and/or punitive purposes. In other words, the courts would have to first decide whether the payments to the plaintiffs would be set to serve as compensation or as a deterrent,[807] or arguably, both. And yet, removing limited liability altogether or adopting a strict liability is fraught with its own onerous limitations.[808]

In Japan, for example, Certified Public Accountants (i.e. CPAs) operate under an unlimited liability regime and can be banned from practicing by Japan's Financial Services Authority (i.e. JFSA). The Japanese Commercial Code from April 2006 onwards primarily allowed the punishment of individual accountants, and not necessarily of the firms themselves,[809] even though the JFSA reserves the right to also impose a fine on the firms.[810] Similarly, Swiss asset management firm Lombard Odier's eight Managing

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[806] YASUYUKI FUCHITA, FINANCIAL GATEKEEPERS IN JAPAN, IN FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 7 (Yasuyuki Fuchita and Robert E. Litan (eds), Washington D.C., Brookings Institution Press, 2006).

[807] This debate is addressed in greater detail under section 6.1.2. (e.g. First-come-first-served versus pro-rata?).

[808] *See e.g.,* John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis,* 2009 COLUM. BUS. L. REV., (1) 109, 207-08, (2009); John C., Coffee, Jr. *Gatekeeper Failure and Reform*, 84 BOSTON U. L. REV. 302, 306-307 (2004); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q., 491, *passim* (2001).

[809] *See*, YASUYUKI FUCHITA, FINANCIAL GATEKEEPERS IN JAPAN, IN FINANCIAL GATEKEEPERS, 26 (2006).

[810] Interview with Professor Teruhiko Harada of Kansai University at Goethe University, Frankfurt am Main, Germany on Monday April 2, 2012. *See also*, Yasuyuki Fuchita in *Financial Gatekeepers in Japan*, 2006, (for general discussion on gatekeepers in Japan).

Partners have unlimited liability, exposing them to the risk of significant personal losses, a feature that the Financial Times reports "tends to concentrate the [bankers'] mind[s]"[811] toward avoiding and managing risks.

A lawsuit brought against the US mortgage lender Countrywide (acquired by Bank of America in 2008), and its former executive Rebecca Mairone, who oversaw the business unit, were found liable for a single count of civil fraud. This whistle-blower initiated lawsuit brought by the US Department of Justice on behalf of Fannie Mae and Freddie Mac under the Financial Institutions Reform, Recovery and Enforcement Act of 1989[812], which provided for civil penalties for criminal violations ruled in favour of the plaintiff. The penalty was split into $1.3 billion penalty for Bank of America and $1.1 million for Mairone.[813] Judge Rakoff held that there had been ample evidence of the defendants' fraudulent scheme and fraudulent intent thereby setting it apart.[814] By finding a solitary executive civilly liable, the judgement suggests that a precedent may possibly be set, bringing lawsuits against CRA executives for ratings which are found to be fraudulently contrived.

In the EU, the European Parliament's resolution to amend the regulation on CRAs, (i.e. Regulation (EC) 1060/2009)[815] adopted on January 16, 2013, categorically reaffirms

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[811] Sophia Grene, *Lombard Odier pushes Risk Parity Approach to Investing*, FINANCIAL TIMES FUND MANAGEMENT (FTfm), Sept. 24, 2012, at 4.

[812] A.k.a., "FIRREA", 12 U.S.C. § 1833a.

[813] *See*, DoJ Statement, available at http://www.justice.gov/usao/nys/pressreleases/July14/BankofAmericaMortgageFraud.php (last accessed May 13, 2015). On August 30, 2014, Bank of America filed to have this ruling overturned, but were eventually unsuccessful on Feb. 3, 2015. *See*, U.S. ex rel O'Donnell v. Bank of America Corp et al, U.S. District Court, S.D.N.Y., No. 12-01422 (2014).

[814] Available at http://www.reuters.com/article/2015/02/03/bank-of-america-fraud-idUSL1N0VD28F20150203.

[815] European Parliament legislative resolution of 16 January 2013 on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies,

its interpretation that CRA ratings, unlike investment research generated by financial analysts, should not be considered as mere opinions concerning financial instrument valuations or financial obligation prices due to their regulatory value as perceived by regulated credit, insurance companies and other market participants.[816]

The amendment proposal also states that regardless of whether or not a contractual commitment between an investor and a CRA exists, an intentional infringement of the Regulation or an act of gross negligence resulting in the issue of flawed ratings may cause reputations of the rated entities to be impaired and their funding costs to be increased, thereby placing them at an economic disadvantage.[817] Consequently, the proposal empowers all investors and issuers who reasonably relied on the rating with a right to seek redress by claiming civil damages as per Article 36 (a) of Regulation (EC) 1060/2009 either for intentional or negligent infringements as provided under Annex III.[818]

6.2. Economic impact of a liability regime

In chapter 3 above, the concept of introducing expert liability for all CRAs as a means of enhancing CRA accountability was deliberated at length.[819] Dittrich surmises that "[t]he social costs of [a system that permits CRA liability]… are likely [to be] larger

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http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2013-0012&language=EN&ring=A7-2012-0221 (last accessed, May 5, 2016).

[816] *Id.,* European Parliament legislative resolution of 16 January 2013, at (*5).

[817] *See*, Point (24), *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2013-12#BKMD-7 (last accessed May 5, 2016).

[818] *See*, Title IIIa, Civil Liability of Credit Rating Agencies, Annex 35a (1- 40), (list of infringements recognized under the Regulation amendment proposal to Regulation (EC) 1060/2009), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2009R1060:20110721:EN:PDF (last accessed May 3, 2015).

[819] See section 3.4 above.

than [the] potential benefits",[820] and thus argues for strengthening the reputational mechanism, despite its shortcomings, as the more viable approach to attaining CRA liability. Among the more convincing arguments made in favour of allowing for expert liability is that it would permit less draconian ex ante supervision to be introduced as a direct consequence of the ability to then litigate ex post, and that the resulting competition from alternatives to using ratings would eventually spur CRAs towards improved rating quality.[821]

In laboring to introduce legislation that is practical and sustainable, legislators face the challenge that the legislation must not or be perceived to stifle or "chill" critical economic activity.[822] In other words, the incremental economic cost of any new regulation or regulatory amendments should not exceed its benefits activity, as was highlighted in the 2008 ESME Report on The Role of Credit rating Agencies where it expressed its preference for a self-regulatory model sustained through improved CRA analytics.[823] The report highlighted the need to recognize the limits of rating through-the-cycle, as well as improved governance; transparency; performance measurement; as well as culture and improved competition through substantive reduction in the barriers to entry for new CRAs.[824]

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[820] Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*, Note, (2007) at 145.

[821] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies,* CII, April 2009, at 16.

[822] *See e.g.,* Timothy M. Sullivan, *Federal Pre-emption and the Rating Agencies* 94 MINN. L. REV., 2136, 2158 (2010) (addressing concerns that liability would "chill" the participation of CRAs in the public rating process).

[823] ESME, *Report on Role of Credit Rating Agencies, European Commission*, at 22 (2008), ("Our view overall is that the incremental benefits of regulation would not exceed the costs and accordingly is not recommended") *available at* http://ec.europa.eu/internal_market/securities/esme/index_en.htm

[824] *Id.,* ESME Report (2008) at 18-21.

At its most contentious, the greater concern for any CRA is to be exposed to liability resulting from a rating error that is effectively so large as to put its own existence as a going concern at risk. A 2006 cost-benefit analysis of auditor liability confirmed terminal viability resulting from litigation in federal securities class action lawsuits to be a major concern among CRAs.[825] That study's review of the legal, theoretical, and empirical literature and arguments concluded that the long term viability of the auditing profession would be imperiled as a consequence of introducing a potentially cataclysmic liability regime to the industry.[826]

Whereas the enactment of SOX in 2002 ushered in auditor liability for audit firms in the US, legislators in the UK and EU instead worked deliberately toward introducing agreements to cap auditor liability.[827] In their attempts to curtail the ensuing liability exposure introduced by SOX, some of the US auditing firms responded by including "arbitration clauses, indemnity and hold-harmless provisions, and damages exclusions in their engagement letters".[828] The demise of the audit firm, Arthur Andersen, remains a testament to the capacity of engagement risk to terminally affect the economic viability of even very large, long established and internationally active firms. CRAs in the US today, like auditing firms before them, also face a host of potential causes of legal action at both the state and federal levels. [829] This is of particular concern because it appears that the

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[825] Eric L. Talley, *Panel Two: Sarbanes-Oxley Accounting Issues - Cataclysmic Liability Risk Among Big Four Auditors,* 106 COLUM. L. REV., (7) 1641-97 (2006).

[826] *Id.,* Eric L. Talley, at 1642.

[827] *Id.,* Eric L. Talley, at 1642 n.1.

[828] *Id.,* Eric L. Talley, at 1642.

[829] *Id.,* Eric L. Talley, at 1643-44.

contention that a significant number of cases are brought primarily for the purpose of extracting a nuisance settlement payment from large firms, is indeed valid.[830]

However, consistent with the findings of earlier studies on auditing firms and banking institutions,[831] it follows that CRAs would also actively seek to avoid the 'betting-the-firm' type of lawsuits at all costs, more-so where an unfavorable verdict could be terminal for the firm.[832] This view is however disputed by some commentators.[833] The repercussions of such action by CRAs would conceivably see them adapting their methodologies in order to minimize their engagement risk exposure such as by hoarding

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[830] *See e.g.,* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 500–01(1991) (concluding that settlement outcomes in class action securities claims were not significantly affected by merits). *But see, e.g.,* Eric L. Talley & Gudrun Johnsen, C*orporate Governance, Executive Compensation and Securities Litigation 4*, 25–26 (Univ. of S. Cal. Law Sch., Olin Research Paper No. 04-7, 2004) (2004), *available at* http://ssrn.com/abstract=536963 (on file with the Columbia Law Review) (arguing that PSLRA may discourage both meritorious and frivolous suits); Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 1647 n.19, (N.Y. Univ. Law & Econ., Paper No. 03-04, 2005, at 3-5, (2005)), *available at* http://ssrn.com/abstract=558285 (on file with the Columbia Law Review) (arguing that PSLRA deters meritorious suits that lack hard evidence before filing). *Contrast*, Marilyn F. Johnson, Karen K. Nelson, A.C., Pritchard, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J. L., ECON. & ORG (3) 627, 642 (finding evidence that the merits, post PSLRA, do matter more).

[831] *See e.g.,* John C. Coffee, Jr., '*Partnoy's Complaint: A Response*', 84 BOSTON U. L. REV. 377, 381 (2004) (audit firms raising audit fees are screening out perceived higher risk clients which Partnoy suggests are typically the smaller companies).

[832] Zoe-Vonna Palmrose, *Maintaining the Value and Viability of Auditors as gatekeepers under SOX: An Auditing Master Proposal*, 128 in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 128 (2006) ("Audit firms cannot take the risk of trying cases to verdict that "bet the entire audit firm" [i.e. terminal risk]").

[833] *See e.g.,* Caleb, M. Deats, *Talk that Isn't Cheap* 110 COLUM. L. REV., 1818, 1822 (2010) (Deats does not consider private liability to threaten the financial viability of the rating industry).

cash in expectation of potentially costly future payouts to claimants.[834] A more extreme response would result in CRAs chilling their active participation and involvement in the public ratings process,[835] which is exactly what was witnessed following the enactment of DFA on July 21st, 2010 when the ABS market froze due to NRSROs' response to DFA.

Sullivan further argues that a liability regime would incentivize CRAs to deflate their ratings across the board.[836] While acknowledging the importance of both achieving market efficiency and ensuring investor protection as the two main aims of securities regulation,[837] wherein efficiency refers to attaining the most rational allocation of capital resources, in turn requiring (i) minimization of informational asymmetry, and (ii) minimization of transaction costs, of which there are costs on the Government level (administration infrastructure) and on the investor level (compliance costs), Rousseau clearly asserts that the investor protection mandate should carry less weight than the efficiency one.[838]

Rousseau's other argument, that retail investors should protect themselves by merely investing in funds managed by institutional investors who enjoy an informational

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[834] See e.g., Michel Madelaine, (comment Letter of Michel Madelaine, Chief Operating Officer of Moody's Investors Service on Concept Release, Dec. 14, 2009) at 11 (contraction in rating coverage would result in a complementary contraction in the availability of credit).

[835] Timothy M. Sullivan, *Federal Pre-emption and the Rating Agencies,* 94 MINN. L. REV., 2136, 2158 (2010) (allowing CRAs liability for causes other than fraud would "chill" their participation in the (" []… vital and vigorous participation in the ratings process… where the free flow of information and conflicting view ideally establish reliability", citing *In re Enron*, 2007 WL 1662658, at 4). *See also*, Brigitte Haar, *Civil Liability of Credit Rating Agencies* 19 (University of Oslo Faculty of Law Legal Studies Research Paper Series No.2013-02, 2013) at 18.

[836] Timothy M. Sullivan, 94 MINN. L. REV., 2136, 2159 (2010).

[837] Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L.J. 620, 620-624 (2006).

[838] Stephane Rousseau, 51 MCGILL L.J. at 645 (2006).

advantage due to the resources available to them and their ability to evaluate CRA ratings critically, is less convincing.[839] Such an approach would require retail investors to continue relying on third-party protections, a tact whose paltry success rate in lawsuits against CRAs hereto cannot be said to be beyond reproach.[840] Aside from the initial market freeze that was subsequently deferred by the issue of the NAL waiver,[841] the expected follow-on costs arising from introducing NRSRO expert liability would likely encourage those CRAs to not only reduce the number of ratings that they issue but also to charge higher fees for their ratings.[842] It seems more probable that once faced with a liability regime, CRAs would tend towards issuing increasingly more conservative ratings, and while this could be regarded as a safer and more desirable outcome, it would present negative knock-on effects for both investors and issuers.[843]

For instance, due to the higher fees and more conservative ratings, smaller potential issuers might no longer find benefit in issuing debt securities,[844] particularly if the securities receive low ratings which would require a higher yield payout on top of the increase in rating fees. A large majority of investors are unlikely to find lowly rated debt securities as attractive an investment option, especially when faced with significantly safer

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[839] Stephane Rousseau, 51 MCGILL L.J. at 645 (2006).

[840] See Chapter 4 for review of plaintiff low success rate in CRA lawsuits.

[841] Jesse Hamilton, *SEC Struggles to Gauge Risk Without Raters Post Dodd-Frank: One Year Later*, BLOOMBERG, JULY 15, 2011, available at http://www.bloomberg.com/news/2011-07-15/sec-struggles-to-gauge-risk-without-raters-post-dodd-frank-one-year-later.html.

[842] John C. Coffee, Jr., '*Partnoy's Complaint: A Response*', 84 BOSTON U. L. REV. 377, 380 (2004) (audit firms raising audit fees are screening out perceived higher risk clients which Partnoy suggests are typically the smaller companies).

[843] Timothy M. Sullivan, 94 MINN. L. REV., 2136, 2159 (2010).

[844] Interview of Prof. Teruhiko Harada of Kansai University at Goethe University, Frankfurt am Main, Germany on Monday April 2, 2012 (noting that Japan has about one million registered firms from which only approximately 3000 are able to issue debt securities).

alternatives such as sovereign bonds. On the other hand, the suggestion that CRA liability will give rise to such fee increases is not unchallenged. Hunt is unconvinced and argues that by either opting to disclose low quality ratings or by refraining from issuing (public) ratings altogether, CRAs can avoid the damage charges, which in turn would be constrained by the remedy's limited nature.[845] And yet, NRSROs' decision to refrain from issuing public ratings was the cause of the market freeze and as disclosure of low ratings is not really a concern for structured products, the problem remains.

Although rescinding NRSRO liability would also incur the costs that motivated the initial rescission of Rule 436 (g) as per §939(g)'s of DFA, this dissertation hypothesizes that these costs, although real, are but contingent, and are more likely to have a significantly limited immediate economic impact; in stark contrast to the real and immediate costs of a market freeze as was experienced post-DFA. The SEC's NRSRO ratings outstanding data further advocates that the issuer-pays model, as opposed to the investor-pays model, is the preferred, if not superior, model for retailizing CRA ratings.

The need to address the incentive drivers necessary to better align the interests of the CRA with those of the investors and to encourage more accurate ratings was recognized in the requirement under DFA for the GAO to carry out a study on the matter.[846] One such proposal would require CRAs to hold equity stakes in securities in proportion to their outstanding rating issues; much like earlier calls made for investment banks to similarly retain equity stakes in securities which they were underwriting as a means to better align their interests with those of investors.[847] In order to ensure that all stakeholders equitably bare the risk and cost of credit ratings, a transaction tax or fee on

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[845] John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis,* 2009 COLUM. BUS. L. REV., (1) 109, 194, n.270 (2009).

[846] Carl Levin & Tom Coburn, *Wall Street and the Financial Crisis,* SEN. COMM. HOMELAND & GOV. AFFAIRS April 13, 2011, at 316.

[847] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies,* CII, April 2009 at 12.

rated securities for example, could be levied to ensure the co-commitment of participating investors.[848] The credibility of the reputational capital defense continues to be challenged, more-so as its underlying rationale is now increasingly being questioned.[849] As a result, a model in which CRAs would be required to have more skin – read, capital – in the game, is likely to go a long way in assuaging these concerns.

Particularly in the aftermath of the 2001 crisis, it was generally acknowledged that more needed to be done to ensure that such equity, wherever held, is accurately reported; and that its risk is neither underestimated on the balance sheets, nor hived off the balance sheets into opaque SPV structures for reporting purposes such as via the Repo 105 type of transactions.[850] A reasonably foreseeable limitation to introducing an equity retention requirement is that it could restrict the number of ratings the CRA would otherwise have been prepared to issue, and this contraction would in all likelihood be to the greater detriment of smaller firms, start-ups and other institutions that typically have limited alternatives for raising capital.[851] In addition, once CRAs are compelled to hold equity

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[848] *See e.g.*, EU Commission, Council Directive Implementing Enhanced Cooperation in the area of Financial Transaction Tax, (although beyond the scope of this dissertation, the EU Council Directive proposal for implementing enhanced cooperation in the area of financial transaction tax, among 11 of the hereto participating member states, *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/com_2013_71_en.pdf. *See also*, Stephany Grifith-Jones & Avinash Persaud, Financial Transaction Taxes, passim, 2012, *available at* http://stephanygj.net/papers/FTT.pdf.

[849] *Id.,* Frank Partnoy, CII, April 2009, at 5-6.

[850] Agatha E. Jeffers, *How Lehman Brothers Used Repo 105 to Manipulate Their Financial Statements*, 8 J. LEADERSHIP, ACCOUNT. & ETHICS (5), 44, 47-49 (2011) (Jeffers referred to Lehman's use of Repo 105s as an "aggressive and deceitful accounting off-balance sheet device". Lehman's benevolent interpretation of Accounting Rule SFAS 140 allowed it to book such loans as actual sales. Lehman was able to reduce its reported liabilities by a reported $50 billion.).

[851] Stacey-Marie Ishmael, *What's the SEC to do about 436(g)? Call a time out*, FINANCIAL TIMES, July 22, 2010 available at (issuance volumes would, at least temporarily fall significantly as a consequence of repealing 436(G)).

stakes, it could erode their independence by further conflating the conflicts of interests, such as in instances where CRAs are later required to downgrade issues in which they themselves have exposure to.[852]

A further proposal includes requiring CRAs to either issue performance or surety bonds, wherein higher rated bonds would attract a higher penalty on default.[853] Bowden & Posch put forward that losses arising from a performance bond, together with the repercussions of diminished reputation resulting from ex post rating failure, would inequitably place greater risks on CRAs relative to the issuers. It seems a fair expectation that such disparity in risk attribution would lead CRAs to redress the perceived imbalance by seeking significantly higher rating fees upfront.[854]

Another proposal suggests issuing unsecured long-term senior and subordinated debt, at least once a year.[855] What remains unclear is how either a performance bond or a staggered fee payment structure would accommodate a re-rating, either upwards or downwards, of a security. Secondly, at what point would one draw the line, if there is one to be drawn, between say, a performance bond, and an offer for regular insurance?[856] It

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[852] *See e.g.*, Darbellay, Aline & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform* 12 (Research Handbook on the Economics of Corporate Law, San Diego Legal Studies Paper No. 12-082, 18 April 2012).

[853] *See e.g.*, Roger Bowden & Peter Posch, *Quality signalling and ratings credibility: regulatory reform for the ratings agency*, WHU NYC's 2011 conference paper, Campus for Finance, Koblenz, Germany (2011) at 17 (authors find that a performance bond would diminish the signalling content, and hence the informational value to investors, and conclude that such a registration arrangement would better reduce the economic deadweight cost).

[854] *Id.,* Roger Bowden & Peter Posch, *Quality signalling and ratings credibility* (2011) at 16.

[855] *See e.g.*, William Isaac & Cornelius Hurley, *At Last – how America can solve the 'too big to fail' problem*, FINANCIAL TIMES, Feb. 18, 2012 at 9 (applied in conjunction with a 20% cap on total equity and long-term debt to encourage disciplined risk-taking).

[856] *See e.g.*, JOHN C., COFFEE, JR. *GATEKEEPER FAILURE AND REFORM: THE CHALLENGE OF FASHIONING RELEVANT REFORMS, in* CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US 600, 648 (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, and Harald Baum

does not appear likely that CRAs would be prepared to provide a performance guarantee for most, if not all, of the rated issues. Moreover, assuming that they ever agreed to do so, one can again reasonably expect that it would be at a significant premium to current fee rates. The lack of definitive quantitative data as well as the subjective nature of the qualitative analysis and interpretation necessary to develop a credit rating, underscore why the notion of providing any form of guarantee is itself hotly refuted by CRAs.[857] While not disputing the well-documented argument which advocates making rating agencies more accountable,[858] this dissertation proposes an alternative model that seeks to enhance CRA accountability in a manner other than by merely enforcing NRSRO liability.[859]

6.2.1. Impact on fees

A commentator posited that investors faced three choices for fixing the current challenges concerning CRA ratings, namely: i) to continue relying on CRA ratings (ostensibly with tighter controls to ensure improved ratings performance), ii) to enlist third party assistance for due diligence, iii) or to carry out own analysis of securities.[860] The adoption of either or all of the aforementioned options would likely result in CRAs charging significantly higher fees to create a buffer against the risk,[861] or to finance the

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eds., 2005) (questioning the treatment of gatekeepers as the functional equivalent of insurers, whose certification is equated to an insurance policy).

[857] See discussion on rating quality under Section 3.4.2, above.

[858] See Chapter 3 above for discussions on increasing CRA accountability.

[859] See section 7.2 for discussion on proposed model.

[860] Francesco Guerrera, *Current Account: Here's How to Fix Those Credit Ratings,* WALL ST. J. ASIA, Aug. 16, 2011, at 8.

[861] *See e.g.,* Aline Darbellay & Frank Partnoy, Credit Rating Agencies and Regulatory Reform, 22 (San Diego Legal Studies Paper No. 12-082, 2012) (CRAs likely to insist on charging higher fees to cover any potential litigation costs); Coffee, 84 B.U. L. Rev. 307, 355 (2004) (as was the case with the separation of auditor and consultancy functions required by SOX, the separation of gatekeeper and advocate roles would

additional insurance, assuming that they are able to purchase such from the market.[862] For instance, the Financial Services Working Group headed by US House Representative, Stivers, argued that the rescission of Rule 436(g) would result in a ten-fold hike from an average of $100,000 to about $1 million per rating, an increase which would be prohibitive for a large number of potential issuers in the market.[863]

In addition, higher due diligence costs would also negatively impact the ability of investors to achieve efficient portfolio diversification.[864] Moody's for example, asserts that the safe harbor provision afforded by Rule 436(g) has in fact encouraged CRAs to publish credit ratings that are void of highly qualified legalese as would be written for lawyers instead of the more straightforward and simply worded opinions that are intended to be accessible to the average investor. And, whereas larger firms with alternatives to the debt market would also incur the higher fees, smaller and more vulnerable entities such as Small and Medium-sized Economies and Enterprises, as well as local governments and

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lead to increased transaction costs, e.g. as a result of duplication of work); Stacey-Marie Ishmael, *What's the SEC to do about 436(g)? Call a time out*, FINANCIAL TIMES, July 22, 2010 (expecting the rating agencies to charge higher fees to cover their liability).

[862] FUCHITA, YASUYUKI & LITAN, ROBERT E., in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 8 (2006).

[863] *See*, Adam Tempkin, *IFR-ABS: Bill reversing rating agency liability advances*, REUTERS, July 20, 2011, *available at* http://www.reuters.com/article/2011/07/20/abs-ratingagencies-idUSN1E76J17U20110720. However, Asset-Backed Market Stabilization Act of 2011 (H.R. 1539) proposed by Representative Stivers was never tabled, did not actually pass a vote in the full House of Representatives and was therefore never enacted. The Bill expired at the end of session for the Congress and would need to be re-introduced in future under a different number.

[864] *See e.g.*, Stacey-Marie Ishmael, *What's the SEC to do about 436(g)? Call a time out*, FINANCIAL TIMES, July 22, 2010 ("[I]nstead of seeing their funding costs rise, some issuers may reduce origination volumes …").

high yield issuers like start-ups, would very likely be frozen out of the debt market entirely.[865]

Comparable evidence of this was found in a study of auditing firms by Coffee,[866] which observed that the response by auditing firms to heightened auditor liability was an increase in audit fees and a corresponding systematic 'screening out' of perceived higher risk clients – which he suggests were typically the smaller companies.[867] The total fee earned by CRAs from a ratings issue generally constitutes two components: the pre-issue and the post-issues fees. The pre-issue fees arise from consultation services whereas the post-issue fees normally arise from the actual issue itself and the subsequent on-going monitoring associated with the security. Incidentally, the bulk of CRA income is earned in the pre-issue phase.[868]

The state of Ohio's O.R.C. § 1707.41(A) statute, for example, only allows plaintiffs to claim against fees earned post-issue. For its part, the 2008 Cuomo Agreement[869] requires issuers to pay for ratings upfront to allow CRAs to operate with greater independence, even though it also runs the risk of inadvertently promoting a moral hazard as CRAs may be less committed to investing in costly efforts to maintain the quality of their analysis once full payment has been received. Alternative solutions include a model

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[865] *See e.g.*, Michel Madelaine, (comment letter of Michel Madelaine, Chief Operating Officer of Moody's Investors Service on Concept Release, Dec. 14, 2009) at 11.

[866] John C. Coffee, Jr., *Partnoy's Complaint: A Response*, 84 BOSTON U. L. REV., 377-382 (2004).

[867] *See e.g.,* John C. Coffee, Jr., *Partnoy's Complaint: A Response*, 84 BOSTON U. L. REV., 381 (2004); Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. (2), 703, 735 (2007) ("small businesses benefit by having as many different ways to access capital as possible, []").

[868]*See e.g.,* Moody's Investors Services generated 58% of its 2011 revenue from transactions and 42% from recurring revenues earned over the life of the rated security.

[869] *See*, N.Y. State office of the Attorney General Press Release, *available at* http://www.ag.ny.gov/press-release/attorney-general-cuomo-announces-landmark-reform-agreements-nations-three-principal (last accessed May 5, 2016).

through which the fees would be earned-out,[870] or staggered,[871] in a fee-for-service format over the life of the issue where issuers could cease payment if rating quality under-performance exceeded the agreed thresholds in order to incentivize on-going rating accuracy. Arguing that the practice is well established in securities law, Haar proposes the adoption of disgorgement rules as a means of bringing adroit governance to the management of incentives, performance and fee retention.[872] Although disgorgement has at times proved operationally to be a strenuous undertaking, often taking years in the arbitration process effected by courts, it still remains a proven deterrent that certainly seems worth pursuing.

6.2.2. Impact on competition

A second foreseeable consequence of the introduction of a liability regime concerns its impact on competition among CRAs in general, and among NRSROs in particular. It has been argued that increased liability would not only result in diminished public access to fewer ratings, but would also discourage downgrades to limit liability exposure, produce less comprehensive rating analysis and increase concentration risk as greater

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[870] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies,* CII, April 2009, at 12-13 (on fee-for-service structure); Gregory W. Smith, *Approaches to Improving Credit Rating Agency Regulation*, May 19, 2009 *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg51592/html/CHRG-111hhrg51592.htm (last accessed May 5, 2015).

[871] Aline Darbellay & Frank Partnoy*, Credit Rating Agencies and Regulatory Reform,* 12 (San Diego Legal Studies Paper No. 12-082, 2012).

[872] *See e.g.,* Brigitte Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung?* 21 ZBB (3) 177, 185-86 (2009) (disgorgement of CRA profits to incentivize higher quality of ratings); Brigitte Haar, *Civil Liability of Credit Rating Agencies* 19 (University of Oslo Faculty of Law Legal Studies Research Paper Series No.2013-02, 2013) (disgorgement of profits as alternative to drawbacks of exposing CRAs to excessive liability).

homogeneity in methodology is encouraged between the different CRAs.[873] However, continued issuance of ratings by current NRSROs could result in the additional accreditation of new NRSROs by the SEC, or alternatively, the retraction of the NRSRO status altogether.

In the absence of a readily viable, effective and efficient alternative to the NRSRO status for regulatory purposes,[874] retraction of the NRSRO status in the near term does not seem likely. In addition, DFA only requires the elimination of reliance on NRSRO ratings for regulatory compliance in financial services and not in other sectors.[875] Nonetheless, both the exit from the NRSRO market by existing players and the reluctance to enter the market by prospective CRAs, would be contrary to the objectives of the Credit Rating Agency Reform Act of 2006, which had a mandate to increase competition amongst rating agencies.[876] It is reasonable to expect that smaller and less established CRAs would become less able to fiscally bear the risk attached to a strict liability regime as they would undoubtedly find it more challenging to negotiate and purchase indemnification policies on the market.

A 2013 proposal by the European Parliament would require CRAs to be mandatorily rotated in order to facilitate competition, although this requirement has been restricted to

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[873] USGov Hearing, *Credit Rating Agencies and the Next Financial Crisis,* at 101 (statement by Floyd Abrams), https://house.resource.org/111/gov.house.ogr.20090930.pdf (last accessed May 5, 2015).

[874] *See e.g.,* John Morley & Roberta Romano, *The Future of Financial Regulation* 37 (Yale Law & Economics Research Paper No.386, June 5, 2009) ("… people can't quite figure out what else to use, what another alternative is.").

[875] John Patrick Hunt, *Credit Ratings in Insurance Regulation: The Missing Piece of Financial Reform*, 68 WASH. & LEE L. REV., (4), Art. 3, 1667, 1667 (2008) (noting that DFA is silent on the regulatory requirements of ratings in the insurance industry).

[876] Refer to Section 3.2 above for review of CRA competition.

structured products for the time being.[877] Although a similar concept of mandatory periodic firm rotation had initially been floated as part of the audit industry reform discussions, it was eventually abandoned due to concerns of involuntarily stimulating a race to the bottom,[878] and instead one which required client executive-facing auditing firm employees to be rotated every five years, was adopted.[879] The upside of a mandatory rotation policy would of course be that the entrenchment of relationships between raters and issuers is avoided, thereby enabling greater transparency.[880]

Conversely, mandatory rotation on the proposed timetable would require a large automotive business like Volvo to change raters up to six times per year, for example.[881] An additional downside to rotation would be the lack of continuity between raters in the absence of generally accepted benchmarks and standards as this would hinder the ability of investors to compare ratings in the transition period. The introduction of benchmarks and standards, while improving comparability however, is faced with the hazard of

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[877] John O'Donnell, *EU agrees new controls for credit rating agencies*, REUTERS, Nov. 27, 2012, *available at* http://www.reuters.com/article/2012/11/27/us-eu-ratings-idUSBRE8AQ18L20121127 (last accessed May 5, 2015).

[878] Jonathan R. Macey, *The Politicization of American Corporate Governance*, 1 VA L. & BUS. REV. 10, 20 (2006).

[879] Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 40-41 (Harvard Law and Economics Discussion Paper No. 525, Dec. 2005).

[880] Protiviti, April 18, 2013 (comments from Bob Hirth, Snr MD, Protiviti recommending auditor rotation from the "2013 Business Challenges and How to Respond Effectively" seminar, April 18, 2013, Kuwait), *available at* http://www.ameinfo.com/protiviti-global-ia-leader-highlights-ten-338217 (last accessed May 5, 2013).

[881] *See also*, Eva Lindebäck Brandt & Fredrik Brunell, *Rating of enterprises*, (Stockholm Centre for Commercial Law, Stockholm Uni. June 12-14, 2012) (comments by Volvo Director Corporate Finance, Eva Lindebäck Brandt).

introducing concentration risk inherent in the adoption of universal methodologies, possibly curtailing the likelihood of detecting novel risk factors in the long-run.

6.3. Recent landmark court decisions

Even in the aftermath of the 2007 crisis it would seem as though the distinction between credit risk – the very essence upon which CRA ratings are built – and business risk, liquidity risk, fraud risk and other market-related risks, continues to be conflated. The distinction is oftentimes regarded as being merely informing rather than controlling. At times, the distinction, although pivotal, appears sidelined from the main debate and often approached as an academic exercise rather than the logical premise upon which to build legislative reforms for the industry. A notable outcome of the 2007 crisis was that it exposed CRAs to public and political demands that they be made both more liable and more accountable for issuing flawed ratings going forward.[882]

Yet, the concept of "flawed"[883] ratings itself remains somewhat contentious in that, excluding fraud, it implies there was an alternative methodology available to CRAs (or anyone else for that matter) for achieving perfect or "unflawed" ratings, *ex ante*. In an efficient market, a provider of "unflawed" ratings in the free-market-for-ideas sense would

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[882] See e.g., Brigitte Haar, *Civil Liability of Credit Rating Agencies* 12, (University of Oslo Faculty of Law Legal Studies Research Paper Series No.2013-0, 2013). See also, SANDRA. FISCHER, *HAFTUNGSFRAGEN DES RATINGS* 67 (Dr. Kovac 2007); K. Serfing & A. Pries, *Möglichkeiten und Grenzen des Rating*, DIE BANK 1990, 381; E. Vetter, *Rechtsprobleme des externen Ratings*, ZEITSCHRIFT FÜR WIRTSCHAFTS- UND BANKRECHT 2004, 1701, 1707, (2013).

[883] See e.g., *California Public Employees' Retirement System v. Moody's Corp., et al*, Filed July 9, 2009, (claim that rating methods used were "flawed in conception and incompetently applied"), *available at* http://online.wsj.com/public/resources/documents/calpers.pdf; *Ohio Police & Fire Pension Fund et al. v. Standard & Poor's Financial Services LLC et al*., case number 2:09-cv-1054, filed June 16, 2010 , U.S. District Court for the S. D. of Ohio; William Isaac & Cornelius Hurley, *At Last – how America can solve the 'too big to fail' problem*, FINANCIAL TIMES, Feb. 18, 2012, at 9 (proposing a "Subsidy Reserve Plan" to serve a reserve fund against losses from flawed ratings).

inevitably succeed and be rewarded with higher revenues and expanding market share. The anecdotal evidence on hand clearly suggests that producing unflawed ratings remains a fictional concept for all other experts who forecast performance. From investment and central bankers, to academic scholars and other experts, all equally erred in their pre-crisis forecasts which demonstrated that they were neither more or less reliable than CRAs.[884]

Rather, the expectation should instead be that when challenged, CRAs should rather be required to prove the logical and rational soundness that they applied when determining their ratings, and not necessarily their ability to achieve, or even approach, a fictional flawlessness in ratings quality. Where the rubber hits the road is, as is often the case, is on "how" this proof is to be attained. In this regard two recent court cases stand out. In the Bathurst Regional Council decision of the Federal Court of Australia, the court dealt with this very question, for it sought not to determine whether or not an alternative rating should have been awarded to the security but rather whether the CRA had a reasonable basis for the rating it did provide.

6.3.1. Bathurst Regional Council decision of the Federal Court of Australia

The 2012 Federal Court of Australia's (hereafter FCA) ruling in *Bathurst Regional Council v Local Gov't Fin. Servs Pty Ltd* [885] became a landmark case when it became the very first to find a rating agency, S&P in this case, liable to investors[886].

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[884] *See e.g.,* S&P's motion-to-dismiss complaint (S&P's memorandum for motion-to-dismiss at *6), available at, http://www.standardandpoors.com/spf/upload/Ratings_US/USvMcGraw-HillMemoranduminSupportofDefendantsnMotion.pdf.

[885] (No 5) [2012] FCA 1200 (5 November 2012) (ABN AMRO Bank NV (second respondent); McGraw-Hill Intl., (UK) Ltd (third respondent)) (2012), *available at* http://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/single/2012/2012fca1200/J121200.pdf.

[886] *See e.g.,* Rommel Harding-Farrenberg and Kieran Donovan, *Case Note Duty of Care, Rating Agencies and the 'Grotesquely Complicated' Rembrandt*, 14 BUS. LAW. INTL (2) 185-195 (2013)

The case involves the Rembrandt 2006-3 CPDO, a 'Constant Proportion Debt Obligations' financial product issued by the investment bank, ABN Amro. S&P rated the 10-year maturity structured product AAA, thereby indicating an "extremely strong" ability to repay the principal and interest.[887] However, the product collapsed within the first two years of issue. Twelve New South Wales local councils sued, claiming that S&P's ratings of the product which had influenced their investment decision were either false or negligently misrepresented. In particular, the plaintiffs stated that ABN Amro's "Surf" presentation to the councils had indicated a probability of default, that is, of not paying the principal or interest as required, of "not more than 0.728 [percent]",[888] which was in line with S&P's AAA cumulative default probability for a 10-year maturity.[889]

The "Surf" presentation, was made by ABN Amro to the Local Government Financial Services Pty Ltd (LGFS) to simplify understanding of the complex CPDO Term sheet[890]which highlighted the low probability of default as a cornerstone in its marketing effort of the product. It was deemed a "decisive consideration[]"[891] for both LGFS and the councils in their purchase and sale decisions.[892] This interpretation was accepted by the FCA as compelling.[893] In addition, the FCA accepted that causality had been satisfactorily established as it ruled that, but for S&P's AAA-rating and ABN Amro's "Surf" presentation, which was accepted by the court as a "condition precedent",[894] LGFS would

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[887] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) at 1051

[888] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) at 1245.

[889] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) at, 1262.

[890] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) para 1470, at 628.

[891] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) at 1290.

[892] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) at 1291.

[893] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) at 1292.

[894] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) para 2785, at 1145.

not have purchased the product, particularly as LGFS had thereto avoided investing in CDO (i.e. structured) products altogether.[895]

An e-mail from the S&P analyst who developed the rating model documented that it qualified to be rated "A-" which was significantly lower than the "AAA" rating that was eventually issued to the product by S&P.[896] The FCA ruled that a "reasonably competent"[897] CRA would not have awarded an AAA rating to the "grotesquely complicated" CPDO structured financial instruments,[898] and therefore the AAA rating was either false or negligently misrepresented. The FCA further ruled that both S&P and ABN Amro had breached the duty of care that they owed LGFS,[899] the firm that had advised the local councils on the investment. Additionally, LGFS was in turn found liable for breaching its duty of care towards the councils.

The defendants argued that the FCA's ruling that S&P had not acted in a reasonably competent manner when assigning the AAA rating to the Rembrandt CPDO suggested an interpretation of ratings performance which approximated that of a guarantee against

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[895] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) at 1293 (The Court dismissed ABN Amro's claim that LGFS would have made losses in other CDOs products had they not invested in the CPDO).

[896] (No 5) [2012] FCA 1200 (5 November 2012) (email correspondence between Mr Venus and Mr Ding) para 374 at 187-88. *See also*, David Fickling and Joe Schneider, *Australian Towns Awarded A$20 Million in S&P Ratings Case*, BLOOMBERG, Mar. 1, 2013 *available at* http://www.bloomberg.com/news/2013-03-01/australian-towns-awarded-21-million-in-s-p-ratings-case.html (last accessed May 5, 2016).

[897] *Id.,* No 5) [2012] FCA 1200 (5 November 2012) at 1080, ("[] … apparent that no reasonably competent ratings agency" rationally could have rated the Rembrandt 2006-3 CPDO AAA in these circumstances).

[898] (No 5) [2012] FCA 1200 (5 November 2012) (the Rembrandt 2006-3 was a "highly leveraged credit derivative, operating over a term of 10 years, within which the CPDO would make or lose money through national credit default swap contracts (CDSs) referencing two CDS indices known as the CDX and iTraxx indices (together, weighted 50% each, known as the Globoxx index, pt 3)). Available at, http://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/single/2012/2012fca1200/J121200.pdf

[899] S&P breached §1041E (making false and misleading statements) and ought to have reasonably known §1041H (engaging in misleading or deceptive conduct) of the Corporations Act 2001 (Cth) (Corporations Act) and §12DA of the Australian Securities and Investments Commission Act 2001(Cth) (ASIC Act).

default.[900] The emphasis of argumentation placed on the security's default occurring within the first two years post issuance would seem to lend support to this observation. While the Court accepted and acknowledged that S&P's AAA rating – its 0.728 probability of default notwithstanding – was neither a guarantee, a statement of fact nor advice about whether to invest in the product or not,[901] it still ruled that two additional requirements regarding pleas of negligent misstatement,[902] albeit challenged by S&P, had been met. The Court was also satisfied by the concession by S&P executives that they believed that ABN Amro structured product developers had succeeded, whether inadvertently or deliberately, in structuring the product to "optimize" or "game" S&P model's criteria[903] to the extent that it was able to deliver performance outcomes that were considered counter-intuitive.[904]

However, it seems logical to suppose that a reasonably competent developer of structured products could over time, either by trial and error or with specific insights, acquire the requisite expertise to optimize the rating criteria and methodology adopted by CRAs. Consequently, the involvement of two ABN Amro experts who had previously been employed by S&P in the marketing of the structured products cited by LGFS in protest as having potentially contributed substantial understanding of S&P's proprietary

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[900]"It turns S&P's predictions about the future into guarantees." (statement by S&P in response to Bathurst first instance ruling) Sue Lannin, *Standard & Poor's appeals landmark ruling in favour of NSW local councils* available at http://www.abc.net.au/news/2014-03-03/standard--poors-appeals-landmark-ruling-in-favour-of-councils/5293740 (last accessed, May 21, 2016).

[901] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2808, at 1154.

[902] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2804-09, at 1154-55, 1159 ("S&P had available to it all information it required to know that the average historical volatility of the relevant indices was 28%, not 15%.").

[903] (No 5) [2012] FCA 1200 (5 November, 2012), (testimony of Mr Ding, S&P executive, on ABN Amro's gaming of their model), at 103, 262-63, 1231-3.

[904] (No 5) [2012] FCA 1200 (5 November, 2012), at para. 897-98, at 403 (comments by Mr. Stephenson and Professor Schlögl).

rating methodology, is not convincing.[905] Moreover, the statement by LGFS that ABN Amro, after supposedly having gamed the S&P model, withheld from informing S&P of this development, appears to infer that ABN Amro owed S&P a duty to make such disclosure, lacks plausible merit. A duty requiring an issuer, such as ABN Amro, to inform a CRA that the bank is able to game the CRA's model, is clearly counterintuitive, particularly when one considers the conflict of interest faced by both counterparties.[906]

The Court also found merit in the plaintiff's claim of "indirect causation" resulting in third party reliance – a position contested by both ABN Amro and S&P in their prepositions[907] – ruling that ABN should have either known or at least reasonably foreseen that LGFS intended to sell the AAA-rated structured product to the councils.[908] Subsequently, the court ruled that, in instances where potential investors were vulnerable because of their inability to assess the creditworthiness of the relevant financial products or to challenge the CRA's premise for the rating, the CRA owed them a duty of care.[909]

While accepting that the 2007 crisis was not foreseeable, that S&P was not negligent for having failed to foresee it, and that the losses experienced by the Rembrandt CPDO were caused by the sustained widening in credit spreads which occurred in 2007 and 2008, the Court somewhat surprisingly held that the losses were in fact foreseeable because S&P had known from the onset that the main risk of a cash-out for the CPDO would be from a sustained widening of the spread. The Court achieved this ruling by construing *Sydney*

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[905] *Id.,* at 1085, 1099 (on the input of Messrs. Drexler and Martorell). *See also,* summary remark thirteen (13), available at http://www.austlii.edu.au/au/cases/cth/FCA/2012/1200.html (last accessed May 5, 2015).

[906] See sections 3.3.3 and 4.3.1 for discussions on duty of care.

[907] (No 5) [2012] FCA 1200 (5 November, 2012), at 2459.

[908] (No 5) [2012] FCA 1200 (5 November, 2012), at 1291. See also, *Haddon View Inv. Co. v. Cooper & Lybrand* 70 Ohio St. 2d 154, 160 (Ohio 1982) (majority ruling that an accountant/auditor can be held liable for professional negligence to a limited third party class **if reliance by the latter can be specifically foreseen**) (emphasis added).

[909] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2824, at 1162.

Water Corporation v Turano (2009)[910] which placed emphasis on a reasonably foreseeable class of harm as opposed to the "precise sequence of events"[911] resulting in the harm.

Although citing the 2007 crisis may be considered too general as an explanation for the cause of default of the Rembrandt CPDO, its overarching impact on credit spreads which caused them to unexpectedly widen from 25 bps to 200 bps and to continue to widen thereafter[912], should surely not have been so simply dismissed either.[913].

In their submission S&P claimed indeterminacy,[914] by which they plead that it was impossible for them to realistically calculate the loss and damage to the plaintiff immediately prior to the alleged breach of duty. The Court dismissed this claim, ruling that the "class of persons to whom S&P might owe a duty of care was [in this instance] ascertainable"[915] in that the amount of liability was limited in terms of both amount, location of issue, and minimum investment sum.[916] Noting that the notes were issued in two tranches of $40,000,000 and $5,000,000 respectively, with a minimum investment amount of $500,000, the Court held that S&P's liability was in fact determinable,

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[910] CLR 51; [2009] HCA42, at 46.

[911] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2824, at 1162.

[912] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2823, at 1161.

[913] James Weatherall, *It is not the maths that causes crises but the trust we put in it*, FINANCIAL TIMES, Feb. 15, 2013, at 9 (while Black-Scholes option pricing models are considered informative for periods of normal trading days till the expiration date [a GFC cannot be said to be normal]).

[914] See also, (No 5) [2012] FCA 1200 (5 November, 2012), para. 2750, ("[t]he principle of indeterminacy is designed to protect the defendant against indeterminate liability, not numerous plaintiffs.") (citing *Perre v Apand* [Pty Ltd (1999) 198 CLR 180; [1999] HCA 36] at [139], at 1132, and *Esanda Finance Corp., Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241; [1997] HCA 8.

[915] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2751, at 1133.

[916] (No 5) [2012] FCA 1200 (5 November, 2012), Para. 2786, at 1145, *Id.,* (on limited exposure controllable by S&P) at para 2751, at 1133.

irrespective of whether or not S&P knew the identity of the prospective or ultimate purchasers of the notes, [917], adding that it was always within the control of S&P "to define the class of persons to whom it might be liable [to]".[918]

The Court refuted that acknowledging a duty of care from CRAs towards investors would cast CRAs as insurers of projected investment performance, but rather that it would ensure that reasonable care is exercised when issuing ratings to products, holding that "… [b]reach of the proposed duty [of care] cannot be determined by reference to the performance of the product."[919]

Most critical in the FCA's ruling was its rejection of the claim put forward by S&P that because no contractual relationship existed between S&P and the investors, no duty of care could therefore be expected given that S&P had been engaged by ABN Amro for the purpose of communicating the AAA rating to an ascertainable class of investors. The matter of the contractual relationship was expanded upon by the FCA Full Court on appeal, and will be addressed below.

When first released, the one thousand four hundred and seventy-five page ruling initially appeared set to open the floodgates for a wave of similar lawsuits against rating agencies.[920] IMF Australia Ltd,[921] the Australian Stock Exchange-listed litigation firm which had funded the *Bathurst* lawsuit confirmed its intention to seek further "significant

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[917] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2754, at 1134. The maximum number of investors in the structured product was 80, and this was determinable, ex ante.

[918] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2754, at 1134.

[919] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2799, at 1150.

[920] Mary Watkins, Brooke Masters, Stephen Foley & Neil Hume, *Agencies threatened with new wave of attacks*, FINANCIAL TIMES, Nov. 6, 2012, at 15.

[921] IMF (Australia) Ltd, 2013, ("IMF is the largest litigation funder in Australia and the first to be listed on the Australian Securities Exchange"), available at http://www.imf.com.au/about.asp (last accessed May 5, 2015).

recoveries" in subsequent lawsuits that were planned to be filed in Europe[922], particularly as the six-year statute of limitation draws closer.

Immediately following the FCA ruling the share price of McGraw-Hill, S&P's parent company, fell 7.1 percent in New York, the most since August 2011. Moody's share price similarly fell 4.4 percent on the news.[923] Such steep falls in share price underline the argument that the market efficiencies ensure that investors will punish CRAs for poor ratings quality.[924] Similarly, when S&P voluntarily announced its discovery of "inconsistencies" in its CMBS market rating models, issuers initially withheld from engaging the firm to rate loan pool backed commercial property deals or cancelled planned deals.[925] Although these two examples successfully demonstrate the power of an efficient market to punish a CRA for misconduct, this author argues that a more structured and less ad hoc approach is preferable, particularly as efficient market mechanisms do not always apply to structured products.[926]

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[922] Mary Watkins et al., *Agencies threatened with new wave of attacks*, FINANCIAL TIMES, Nov. 6, 2012, at 15 (noting that of sixty lawsuits (including 12 in Germany and Italy) relating to Lehman bankruptcy, forty were either withdrawn or dismissed, although some are pending appeal, and the balance, (including six in Germany and Italy) are still being litigated). *See e.g*. Frankfurt Court of Appeals in Germany, Wochenüberblick, Betriebsberater (BB) 1482, (2010).

[923] David Fickling & Joe Schneider, *Australian Towns Awarded A$20 Million in S&P Ratings Case*, BLOOMBERG, Mar. 1, 2013.

[924] *See e.g.,* Nicole Bullock, *S&P to overhaul property bond ratings*, FINANCIAL TIMES, June 4, 2013, *available at* http://www.ft.com/intl/cms/s/0/a1eb1e3a-ae8d-11e1-94a7-00144feabdc0.html#ixzz2DofveoaP (last accessed May 5, 2015); Aline Darbellay, *Competition and CRAs*, Credit Rating Agency Conference, Stockholm Univ., Stockholm, Sweden, June 14, 2012.

[925] Nicole Bullock, *S&P to overhaul property bond ratings*, FINANCIAL TIMES, June 4, 2013,, ("… Goldman Sachs and Citigroup cancelled a planned $1.5bn securitisation of commercial mortgages" deal following S&P's announcement about inconsistencies).

[926] See, section 2.1.1 and section 4.3.3.2 above, on efficient market relevance for structured products.

In their appeal of the Court's first instance judgement, S&P accepted that the ratings had been flawed but challenged that it was reasonably foreseeable that its conduct could cause losses to the claimants as their investor classifications in the securities had not yet been determined at the point which the rating was issued.[927] The FCA Full Court upheld the ruling by Jagot J that the AAA rating assigned to the Rembrandt notes by S&P was misleading and deceptive.[928] The Full Court held the opinion represented by S&P that the Rembrandt notes' capacity to meet all its financial obligations was "extremely strong" was not only untrue, but that S&P knew that it was untrue at the time they made it. However, the Full Court overruled Jagot J by declaring that rather than being apportionable claims, ABN Amro, LGFS and S&P were consequently jointly and severally liable for the councils' losses.[929]

The absence of a contractual relationship between investors and CRAs has been a contentious issue ever since the majority of CRAs opted for the issuer-pays over the subscriber-pays model. S&P submitted that the absence of direct dealing between it and LGFS precluded a duty being owed by S&P to LGFS, a non-party. The Full Court, having ruled against the plea of determinacy, ruled that a duty could still be owed in the absence of a direct relationship.[930] It also expanded on Jagot J's description of the "true nature" of the transaction by asserting that by authorizing the distribution of the rating and publishing

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[927] *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65, at para. 1257 (Bathurst Appeal, 2014), available at http://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/full/2014/2014fcafc0065.

[928] contravened §§1041H and 1041E of the Corporations Act 2001 and §12DA of the Australian Securities and Investments Commission Act 2001.

[929] [2014] FCAFC 65, at para. 16117 (Bathurst Appeal, 2014),

[930] E.g., *Caltex Oil (Australia) Pty Ltd v The Dredge "Willemstad"* (1976) 136 CLR 529 at 573-574; *Hedley Byrne; Henderson; Aiken v Stewart Wrightson Members Agency Limited* [1995] 1 WLR 1281; *Kestrel Holdings; Dartberg Pty Ltd v Wealthcare Financial Planning Pty Ltd* (2007) 164 FCR 450 and BT Australia.

the Pre-Sale Report and the Post-Sale Report, S&P had done so for the sole purpose of convincing the investors to act on this rating, and thus S&P cannot claim to the contrary.[931]

Admittedly, the FCA's ruling and the European Parliament's amendment proposal to Regulation (EC) 1060/2009 significantly weaken the argument that CRAs will simply opt to move offshore if a liability regime was adopted, particularly in the US. Taken together, the aforementioned reservations underscore this author's view which questions the likelihood of the FCA's ruling in *Bathurst* becoming a turning point for case law. Firstly, Justice Jagot's first instance ruling expressly limited the circumstances under which such a duty of care could be imputed on a CRA.[932] Secondly, in *Oddo Asset Management v Barclays bank*[933], the New York Supreme Court, in dismissing the plaintiff's suit in June 2012, recently affirmed that no fiduciary duty was owed to the investor, either by a CRA or an agency responsible for an investment product.

Summarily, on weighing up the aforementioned positions and arguments, this author is not convinced that the FCA's narrowly defined ruling in Bathurst will establish a precedent that will open the floodgates for similar rulings in neither the US nor the EU.[934] Subsequently, the more lasting contribution of the ruling in *Bathu*rst will likely be that other jurisdictions will more closely rely on the assessment of the CRA models and methodologies applied in generating the rating in order to impute liability. Finding

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[931] [2014] FCAFC 65, at para. 616 (Bathurst Appeal, 2014).

[932] ("Its duty was to exercise reasonable care in forming and expressing the relevant opinion about the credit risk of the Rembrandt notes. It was in that respect, and that respect alone, that S&P owed a duty of care…") FCA Full Court, para. 1266, *ABN AMRO Bank NV v Bathurst Regional Council* [2014] FCAFC 65. *See also,* Rommel Harding-Farrenberg and Kieran Donovan, *Case Note Duty of Care, Rating Agencies and the 'Grotesquely Complicated' Rembrandt*, 14 BUS. LAW. INTL (2) 185, 193 (2013).

[933] *Oddo Asset Mmgt v Barclays Bank*, N.Y. State Supreme Court, New York County (No 08-109547).

[934] Contrast, DLA Piper, Rating Agencies are no longer Bulletproof, Nov. 8, 2012, at 3, available at http://www.dlapiper.com/files/Publication/fc0e47be-2a76-4c18-8995-569b03317988/Presentation/PublicationAttachment/efcb13f7-2dec-485c-94ab-965baeb95bcf/ratings-agencies-no-longer-bullet-proof.PDF (last accessed May 5, 2015).

reasonable flaws in either the CRA models or the methodology, investors may finally have effective recourse when seeking redress for losses arising from flawed ratings.

6.3.2. US v. McGraw-Hill Cos., Inc.

US v. McGraw-Hill Companies Inc., (2013)[935] is a lawsuit brought by the U.S. Attorney General on behalf of investors, including several federally insured institutions, that were allegedly defrauded of billions of dollars as a consequence of "flawed" ratings issued by S&P.[936] The complaint alleges that S&P provided inflated ratings and in so doing communicated an understated measure of credit risk of Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations (CDOs) structured financial products to investors. The lawsuit further alleges misrepresentation by S&P when claiming that its ratings were independent, objective and were not influenced by S&P's existing relationships with investment banks.[937] In addition to three other lawsuits that had been brought against S&P in 2010 by the Attorneys General of Connecticut,

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[935] *U.S. v. McGraw-Hill Cos.,* 13-cv-00779, U.S. District Court, Central District of California (L.A.), Feb. 4, 2013, *available at* http://www.justice.gov/iso/opa/resources/849201325104924250796.PDF [U.S. AG Complaint].

[936] *See*, Federal Institutions Reform, Recovery and Enforcement Act (FIRREA), Mail fraud:12 U.S.C. § 1833a, 18 U.S.C. §1341; Wire fraud: 12 U.S.C. § 1833a, 18 U.S.C. §1343and Financial Institutions fraud: 12 U.S.C. § 1833a, 18 U.S.C. §1344(1) and §1344(2). For example, mail and wire fraud was allegedly committed when the institutions posted the ratings on the internet. FIRREA's ten year statute of limitations is twice as long as the traditional five year statute of limitations for fraud cases. See also, U.S. AG Complaint, at 109. *Compare*, Memorandum S&P's memorandum for motion-to-dismiss at *11-25, (disputing the wire, mail and financial institutions fraud charges), available at, http://www.standardandpoors.com/spf/upload/Ratings_US/USvMcGraw-HillMemoranduminSupportofDefendantsnMotion.pdf.

[937] *U.S. v. McGraw-Hill Cos.,* 13-cv-00779, U.S. District Court, C.D. of Calif. (L.A.), Feb. 4, 2013, [U.S. AG Complaint], http://www.justice.gov/iso/opa/resources/849201325104924250796.PDF at 28.

Illinois and Mississippi on behalf of their respective states,[938] fifteen other states and the District of Columbia had initially filed separate lawsuits against S&P.[939]

On Monday, April 22nd, 2013, S&P filed a request to dismiss the U.S Justice Department's lawsuit[940] on the basis that its ratings constituted "puffery",[941] citing a 2012 ruling upheld by the Second Circuit Court of Appeal as being an insufficient premise for basing a fraud claim under Section 10b-5[942]. Further, S&P claimed that the complainant also sought to find S&P liable for defrauding these federally insured financial

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[938] Jeannette Neumann, *States Could Add to S&P Tab*, WALL ST. J., Feb. 8-10, 2013, at 26.

[939] McGraw-Hill (S&P) facing a total of 20 lawsuits including from Arizona, Arkansas, Colorado, Connecticut, Delaware, Idaho, Illinois, Iowa, Maine, Missouri, North Carolina, Pennsylvania, South Carolina, Tennessee Washington, the District of Columbia as well as from the U.S. Justice Department. See, Steven Church, *McGraw-Hill to Consolidate S&P Lawsuits in Federal Court*, BLOOMBERG, Mar. 6, 2013, available at http://www.bloomberg.com/news/2013-03-06/mcgraw-hill-to-consolidate-s-p-lawsuits-in-federal-court.html; Michael Doyle, S&P settles lawsuit; feds, states take home nearly $1.4 billion (Eric Holder, US Att'y Gen: "In reality, the ratings were affected by significant conflicts of interest, and S&P was driven by its desire for increased profits and market share to favor the interests of issuers over investors"), available at http://www.mcclatchydc.com/2015/02/03/255352/sp-settles-lawsuit-feds-states.html#storylink=cpy.

[940] StandardandPoors, *Memorandum in Support of Defendant's Motion* in *United States of America v. McGraw-Hill Co. Inc., et al., Case 2:13-cv-00779-DOC-JCG* 16-1, filed April 22, 2013, *available at* http://www.standardandpoors.com/spf/upload/Ratings_US/USvMcGraw-HillMemoranduminSupportofDefendantsnMotion.pdf.

[941] *Boca Raton Firefighters & Police Pension Fund v. Bahash,* Case No. 12-cv 1776, 2nd Cir. (2012), (court accepting the definition of business puffery as "statements [that] are too general to cause a reasonable investor to rely upon them", in *Basic Inc. v. Levinson*, 485 U.S. 224, 206 (1988)).

[942] *Boca Raton Firefighters & Police Pension Fund v. Bahash, et al.,* case number 12-cv-1776, 2nd Cir. (2012), at 3, (dismissing the class action lawsuit) citing *In re JP Morgan Chase Sec. Litig.,* No. 02 Civ. 1282, 2007 U.S. Dist. LEXIS 22948, at *35-36 (S.D.N.Y. Mar. 28, 2007) (citations omitted), *aff'd* sub nom. ECA & Local 134 IBEW *Joint Pension Trust of Chicago v. JP Morgan Chase Co.,* 553 F.3d 187 (2d Cir. 2009). Aff'd 12-1776-cv, S.D.N.Y. (Sidney H. Stein, J.).

institutions,[943] including Citigroup and Bank of America, about the likely performance of the very products that the aforementioned banks had themselves created.[944] The plaintiffs' argument appeared to rest on their ability to determine what makes a good, or in other words, a flawless rating, by demonstrating how the rating in question had either been technically flawed or defective.[945]

Moreover, it seems judicious that the State must first establish that not only was it reasonably foreseeable that S&P should have been aware of the flaw or defect,[946] but also that S&P either had serious doubts about the truthfulness of the rating,[947] or had proceeded to issue the rating in spite of being aware of such flaw or defect.[948] The steps taken by S&P to consolidate the 19 state cases filed by the Attorneys General[949] and to bring them

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[943] A government review found executives at Western Financial Corporate Credit Union of California (WesCorp) and Eastern Financial Florida Credit Union (EFFCU) guilty of mismanagement.

[944] *See*, *United States of America v McGraw-Hill Co., Inc. et al*., US District Court, C.D. Cal.W. Div., Case No. CV13-779 DOC (JCGx) (2013) (S&P's memorandum for motion-to-dismiss citing that the rating agency did not "… create, issue, sell or receive any interest in any security at issue in the case", at 6)(challenging that the banks were victims) at 8, *available at* http://www.standardandpoors.com/spf/upload/Ratings_US/USvMcGraw-HillMemoranduminSupportofDefendantsnMotion.pdf. *See also,* Luciana Lopez & Aruna Viswanatha, *S&P asks federal judge to dismiss U.S. fraud lawsuit*, REUTERS, April 22, 2013, *available at* http://www.reuters.com/article/2013/04/22/us-sandp-fraud-lawsuit-idUSBRE93L12I20130422 (last accessed Mar. 5, 2015).

[945] Holman W. Jenkins, Jr., *S&P and the Lehmann Tsunami,* WALL ST. J., Feb. 11, 2013, at 15.

[946] (No 5) [2012] FCA 1200 (5 November, 2012), at 1291.

[947] See Section 4.2.1 on the actual malice standard's requirement for serious doubt as to the truthfulness of a rating.

[948] Jeannette Neumann, *Current Employees Star in S&P Lawsuit*, WALL ST. J., at 23, Feb. 26, 2013, (government lawsuit alleges that S&P assigned inflated ratings to products despite knowing that they incorrectly reflected the credit risk).

[949] Steven Church, McGraw-Hill to Consolidate S&P Lawsuits in Federal Court, BLOOMBERG, Mar. 6, 2013 (S&P faces at least 19 suits, including the U.S. Justice Department lawsuit).

to a federal court,[950] the settlements reached in the *Abu Dhabi* and *King County* cases, and the reportedly underwhelming evidence on which the State has based its case, has led some legal experts to opine that a settlement for a significantly lower sum than the $5 billion in damages sought by the government may in fact be the best-case scenario outcome that the State could realistically hope for in their suit.[951]

The lawsuits in New York and California appeared to offer the strongest prospects for high pay-outs for the plaintiffs. Under New York's "Blue Sky" Martin Act,[952] for instance, the New York Attorney General is not required to prove scienter. That is to say, they are not required to prove that the defendant even intended to defraud, in securities cases, where the public has been fraudulently exploited.[953] The powers granted under the

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[950] Luciana Lopez & Aruna Viswanatha, *S&P asks federal judge to dismiss U.S. fraud lawsuit*, REUTERS, April 22, 2013.

[951] Luciana Lopez, Peter Rudegeair & Matthew Goldstein, *Analysis: S&P paper trail may lead nowhere in government case*, REUTERS, Mar. 11. 2013 ("..[A] dozen securities lawyers interviewed by Reuters saw significant weaknesses in the [US government's] fraud claim"), *available at* http://www.reuters.com/article/2013/03/11/us-sp-lawsuit-ratings-idUSBRE92A02V20130311 (last accessed May 5, 2015); Paul M. Barrett, *S&P's Outrageous, Clever Fraud Defense*, BUSINESSWEEK, May 23, 2013, *available at* http://www.businessweek.com/articles/2013-04-23/s-and-ps-outrageous-clever-fraud-defense (last accessed May 5, 2015).

[952] The Martin Act is a New York General Business Law, Art. 23-A, §§352-353 1921. *See also*, Dechert LLP, *'New York State's Martin Act: A Primer' for general overview of the Act*, *available at* http://www.dechert.com/files/Publication/a4def5dd-77bf-48ae-bead-491bfcb9142c/Presentation/PublicationAttachment/dbeb2852-2e00-49d6-971f-4c2db9674658/FS_2004-04.pdf (last accessed May 5, 2015).

[953] *See, People v. Federated Radio Corporation*, 244 N.Y. 33, 38-39 (1926) "… **[A]ll acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others**, which do by their tendency to deceive or mislead the purchasing public **come within the purpose of the law**." (Emphasis added); *State v. Sonifer Realty Corp.,* 212 A.D.2d 366, 367 (1st Dept. 1995) ("… [that] reliance need not be shown in order to obtain relief"); and *People v. Barysh,* 408 N.Y.S.2d 190, 193 (Sup. Ct. N.Y. County 1978) ("no intent to defraud is required for a violation of the [Martin Act]).

Martin Act exceed those given to other regulators in all other U.S. states and pre-empt common law claims such as breach of fiduciary duty, gross negligence, unjust enrichment, and negligent misrepresentation that are all non-fraud. Nonetheless, several recent court decisions have however rejected this pre-emption.[954]

The Attorneys General of Arkansas and Colorado, for example, were seeking to recover through disgorgement, the revenue earned by S&P from the issue of the securities in question; and in *Bathurst*, S&P and the Royal Bank of Scotland (formerly ABN's Amro) were ordered to pay the various local government councils nearly $30 million to cover the $17 million lost in their investments (i.e. the amount the local councils paid for the Rembrandt 2006-3 CPDO notes less the amount they received on the cash-out of those notes),[955] plus legal fees and accrued interest. In contrast, California's fairly expansive investor-friendly state laws would permit a plaintiff to be awarded an amount up to three times the level of damages claimed. For instance, the lawsuit brought by California's Attorney General on behalf of CalPERS is claiming a loss of $1 billion, but is permitted to seek damages up to a multiple of three (3), thereby potentially inflating their total claim to over $4 billion.

Outside of the narrow parameters of the Bathurst ruling and in a jurisdiction where the duty of care to investors has not been recognized by US courts, the announcement of a $1,5 billion settlement reached between the US Department of Justice, the 19 States and the District of Columbia with S&P after two years of litigation and an examination of 290 million documents, did not surprise in the least.[956] In the settlement which was not subject

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[954] *See e.g., Assured Guaranty (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.,* No. 603755/08, 2010 N.Y. Slip Op. 8644 (N.Y. App. Div. First Dept. Nov. 23, 2010) (unanimous panel of New York's Supreme Court, Appellate Division, First Dept., determined that the Martin Act does not pre-empt private common-law claims of securities fraud).

[955] (No 5) [2012] FCA 1200 (5 November, 2012), at 3722.

[956] Timothy Raub, *McGraw Hill, S&P to Pay $1.5B to Settle Fraud Claims Over Credit Ratings*, LexisNexis Legal Room – Banking & Finance, Feb. 3, 2015 available at

to court approval, the Department of Justice and the 18 States and the District of Columbia together were awarded $685 million each. And an additional $135 million settled the claim brought by CalPERS.[957] Under the settlement S&P retracted its allegation of victimization by the DoJ and did not admit any violations of the law; it did however admit a delay by its executives in implementing new rating models that would have produced more conservative ratings of securities.[958]

6.4. Summing up

It would be facile to dismiss the decision by NRSROs to withhold their acquiescence for their ratings to be included in securities issue registration documents under a liability regime as a merely tactful exercise in brinkmanship designed to – at least temporarily – extend an arguably rent-seeking status quo.[959] However, such a view requires one to overlook the real and actual challenges faced by CRAs and all other market participants whose core functions involve the forecasting of future performance.[960] It is convincing that the market freeze following DFA's enactment was to a significant extent the result of an economically substantiated and hence logical aversion by NRSROs towards a strict

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http://www.lexisnexis.com/legalnewsroom/banking/b/banking-finance/archive/2015/02/03/mcgraw-hill-s-amp-p-to-pay-1-5b-to-settle-fraud-claims-over-credit-ratings.aspx (last accessed May 23, 2016).

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[958] Aruna Viswanatha & Karen Freifeld, *S&P reaches $1.5 billion deal with U.S., states over crisis-era ratings,* REUTERS, FEB. 3, 2015, available at http://www.reuters.com/article/2015/02/03/us-s-p-settlement-idUSKBN0L71C120150203 (last accessed May 23, 2015).

[959] Francesco Guerrera, *Rating Raters' Ratings*, WALL ST. J., Feb. 11, 2013, *available at* http://online.wsj.com/article/SB10001424127887323511804578297712623834952.html (last accessed May 5, 2015).

[960] *See* S&P's (i.e. McGraw-Hill) memorandum of motion-to-dismiss the U.S. Justice Dept., lawsuit, (refuting that S&P's lack of prescience in predicting the financial meltdown, as well as that of the "Federal Reserve, Treasury and other market participants", qualifies as fraud) at 6, *available at* http://www.standardandpoors.com/spf/upload/Ratings_US/USvMcGraw-HillMemoranduminSupportofDefendantsnMotion.pdf.

liability regime and as a consequence, exposure to potentially unlimited liability which could present an existential threat for their business.[961] In the ruling in *Bathurst*, the FCA noted S&P's submission of the traditional reluctance under common law to impose a duty of care on parties in order to avoid pure economic loss.[962] The literature concerning banks and auditing firms clearly shows that when liability was introduced or increased in both sectors, they responded by increasing their fees as well as by avoiding perceived higher engagement risk clients in order to curtail their exposure. S&P affirmed their motivation toward a similar stance in their submission to the FCA.[963] In addition, the goal of increasing competition in the CRA sector does not appear likely to be achievable in the near or medium-term. This is due to the dominance of the Big Three rating agencies which is currently so deeply entrenched to the extent that other NRSROs have only a sliver of the market share.[964] The FCA also ruled that S&P always had the control to define and thereby restrict the class of persons to whom it might be liable to,[965] particularly since a secondary market did not exist at the time the rating was issued. Although it may be possible for CRAs to exercise such "control" over some "bespoke" structured products,[966] such as the Rembrandt 2006-3 CPDO, it would present a distinct challenge for them to do so concerning structured products for which a viable secondary market exists when the rating is issued.[967]

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[961] Zoe-Vonna Palmrose, *Maintaining the Value and Viability of Auditors as gatekeepers under SOX: An Auditing Master Proposal*, 128 in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? (2006)8. In *Bathurst*, S&P submitted that the traditional reluctance of the common law to impose a duty of care to avoid pure economic loss was illustrated by the present case.

[962] (No 5) [2012] FCA 1200 (5 November, 2012), para 2742, at 1129.

[963] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2796, at 1149.

[964] See Section 3.2 for general review of competition in the industry.

[965] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2754, at 1134.

[966] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2743, at 1130.

[967] Or for corporate or sovereign ratings.

Regarding causation,[968] the FCA ruled that LGFS not only relied on the AAA rating to buy the Rembrandt 2006-3 CPDO notes, but also that it was reasonable for both LGFS and the local councils to rely on the rating from S&P without undertaking further inquiry regarding the rating from a financial advisor.[969] The Court also accepted that the ratings were meant to benefit potential investors and therefore ruled that a duty of care could reasonably be expected from investors, even in the absence of a contractual relationship with S&P. Justice Jagot concluded that a CRA "can always refuse to rate a product if it considers it inappropriate to do so for any reason":[970] It is fair to say the ABS market freeze that followed the enactment of DFA was a convincing demonstration by CRAs exercising their right to withhold ratings. And yet, save for the SEC NAL waiver, the significant negative repercussions for the global economy might have continued unabated, thereby hindering international economic efforts aimed at preventing the recession from evolving into a global depression.

A popular response to the aftermath of the 2007 global financial crisis was the determination that a key contributor to the questionable performance of NRSROs in the period leading up to and during the crisis was the legal indemnity that they thereto enjoyed. This dissertation has highlighted the potential economic impact of introducing a liability regime by providing comparable illustrations from the banking and auditing sectors regarding fees and competition. In testimony to the 'Credit Rating Agencies and the Next Financial Crisis' House Committee hearings, an expert argued that increased oversight would be a fairer, more efficient and more direct approach to improving CRA accountability than by introducing increased liability.[971] The expert advocated that increased liability would result in less comprehensive rating analysis, increased homogeneity among different agencies, public access to fewer ratings and would

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[968] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2425-2433, at 1015-20.

[969] (No 5) [2012] FCA 1200 (5 November, 2012), para. 2775, at 1141.

[970] (No 5) [2012] FCA 1200 (5 November, 2012), 2787, at 1146.

[971] USGOV Hearing: Testimony by Floyd Abrams (2010) at 102.

encourage downgrade avoidance by CRAs in an attempt to limit their own liability exposure.[972]

In the US, the market failure experienced in the ABS market freeze, which was only temporarily avoided by the SEC's intervening NAL waiver, remains in force to this day, almost five years later. Several credible scenarios are possible at this juncture, although the following three are not to be considered exhaustive. One scenario is where the waiver remains in place indefinitely, thereby keeping the exemption in place. A second scenario would involve revoking the waiver coupled with an amendment to the DFA to rescind §939 (g) and effectively re-install Rule 436; this would also allow NRSROs to retain the liability exemption. A third scenario would involve retracting the SEC's NAL waiver thereby introducing a liability regime as was initially intended by § 939(g) of the DFA. It is well possible that another ABS market freeze may materialize because the factors that caused the last market freeze in June 2012, namely, the NRSROs' continued objection to the imposition of a liability regime and the evolving body of jurisprudence based on common law and the securities statutes, are still in place.

Notwithstanding, in the US it remains unclear as to which parties, and for which infringements, and to what extent NRSROs would be held liable? In stark contrast, the European Parliament's amendment proposal to Regulation (EC) 1060/2009 on Credit Rating Agencies provides clarification on the aforementioned factors by defining to whom

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[972] USGOV Hearing: Testimony by Floyd Abrams, at 101.

CRAs will be liable, for which infringements,[973] and concerning which penalties are to be levied,[974] as well as the size of said penalties.[975]

The two recent landmark court decisions in Australia and in the US involving S&P have significantly shifted the landscape for NRSROs. The Federal Court of Australia's ruling in *Bathurst* which was upheld on appeal, finding S&P jointly liable with the bank, despite the strict limitations, has set a precedence for recourse for flawed ratings. In the *US v McGraw-Hill Cos., Inc.,* in the lawsuit brought by the US Attorney General, the plaintiff also faced steep challenges in its attempt to establish S&P's liability and subsequently the settlement was expected.

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[973]See Annex III, for list of recognized infringements: (1-54, Infringements related to conflicts of interest, organisational or operational requirements; 1-8, Infringements related to obstacles to supervisory activities; 1-11, Infringements related to disclosure provision), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2009R1060:20110721:EN:PDF.

[974] See Article 36a, for fines to be levied for infringements, at 48-49, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2009R1060:20110721:EN:PDF.

[975] EU-Parliament, *European Parliament legislative resolution of 16 January 2013 on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies (COM(2011)0747 – C7-0420/2011 – 2011/0361(COD)).*

PART IV: THE OUTLOOK

Chapter 7 Causation & (capped) liability

7.1. Causation: First and second instances

It seems logical to suggest that in order for a claim for damages against a CRA to be successful, a plaintiff would be required to prove in court that there was causation, or more specifically, that "loss causation" had occurred.[976] In other words, that the economic loss claimed by the plaintiff was instigated by a flawed rating issued by the CRA. The on-going debate surrounding the issue of causation has evidenced that two related but distinct interpretations of "causation" are frequently, and often inter-changeably, referenced to in the literature.

The first interpretation of, or alternatively, first-instance of causation occurs as an actual reliance trigger.[977] This is demonstrable by an influencing trigger upon which a plaintiff actively bases their investment decision process. Talley termed this first instance "transaction causation".[978] A major ongoing challenge for plaintiffs that persists when attempting to prove such reliance in court, particularly in the absence of a contractual commitment between a CRA and an investor, often lies in trying to meet the 'but-for' test standard. This standard requires the plaintiff to prove that, but-for the actions and

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[976] Eric L. Talley, *Panel Two: Sarbanes-Oxley Accounting Issues* 106 COLUM. L. REV., (7) 1641, 1652 (2006). *Id.,* at 1657 for analysis of the differences in applying loss causation under Rule 11 and under Rule 10b-5.

[977] *See,* Brigitte Haar, *Civil Liability of Credit Rating* 6 (University of Oslo Faculty of Law Legal Studies Research Paper Series No.2013-0, 2013).

[978] Eric L. Talley, 106 COLUM. L. REV., (7) 1652 (2006).

presentations made by the CRA, the plaintiff would have made a different investment decision and hence avoided incurring the damages now claimed. For the defendant in such cases, the challenge is rather to either eliminate or curtail the post-outcome claims that may be made by potentially opportunistic investors who may not, either initially or at all, have relied on the rating in question when reaching their investment decision.[979]

In the absence of a contractual commitment between investors and CRAs, establishing an actual reliance trigger based on a credit rating would require stronger third-party rights protections than are currently in place in order to protect and provide investors with the realistic chance of being successful in such lawsuits.[980] The Court in the *Bathurst* decision was satisfied that the local council plaintiffs had acted reasonably when placing reliance on S&P's AAA rated Rembrandt notes. To this end, and in dismissing S&P's claim of indeterminacy, it ruled that the structured product was, instead, a bespoke creation made specifically by the defendants for the plaintiff to purchase.[981] Moreover, the Court ruled that a duty of care was jointly owed to the plaintiffs by the defendants, S&P, ABN Amro and LGFS.

The second instance of causation occurs as a process argument in which a plaintiff alleges that the actionable damages suffered were a direct consequence of either gross negligence by the CRA when issuing the rating (i.e. methodology error), inadequate monitoring once the rating was issued (i.e. monitoring error), or fraud. If claiming methodology error, a plaintiff would not only need to show that the rating issued was in fact erroneous, but also what the error was, how a different and presumably accurate rating would have been arrived at but for the error or fraud, and that this would have avoided or

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[979] *See,* Brigitte Haar, *Civil Liability of Credit Rating* 4 (Research Paper Series No.2013-0, 2013).

[980] Refer to Chapter 4 above.

[981] (No 5) [2012] FCA 1200 (5 November, 2012), at 1130.

at least limited the economic loss claimed.[982] A further practical challenge for plaintiffs would rest in proving either that the error in question was reasonably foreseeable,[983] or that the alleged economic loss suffered by the plaintiff was the result of either gross negligence or of fraud, in addition to determining that the contribution of that error or fraud was the (main) cause of the damages suffered as opposed to a myriad of other potential factors that could have caused the loss, such as the consequence of unexpected liquidity risk or political risk.[984]

Taken together, these considerations undeniably present a high burden of proof for plaintiffs, more so when the plaintiffs are private investors as they are often faced with economic and other resource constraints when considering to bringing lawsuits against large financial services organisations such as NRSROs.

7.1.1. Causation under US law

The Second Circuit court in the ruling in *Merrill Lynch & Co. Inc., v Allegheny Energy Inc.,* (2007) held that in order to establish causation when alleging reliance, a plaintiff must show that: "… its reliance on the alleged misrepresentations was not so utterly unreasonable, foolish or knowingly blind as to compel the conclusion that whatever injury it suffered was its own responsibility".[985] The court in the *Abu Dhabi* lawsuit, in

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[982] *See e.g., South Australia Asset Management Corp., v York Montague Ltd*, [1996] UKHL 10, [1997] AC 191, 212.

[983] *E.g.,* as in, "proximate cause".

[984] As per DFA, CRAs liable to investors if they "knowingly or recklessly fail to conduct a reasonable investigation of a rated product". Refer, section 5.1 above.

[985] *Merrill Lynch & Co. Inc. v. Allegheny Energy, Inc.,* No. 055129cv, 2007,
U.S. App. LEXIS 20928 (2d Cir. Aug. 31, 2007), citing W. Page Keeton et al., Prosser & Keeton on the Law of Torts § 108, at 750 (5th ed.1984); *Abu Dhabi Comm., Bank v Morgan Stanley & Co.,* 651 F.Supp.2d 155 (2009) 651 F.Supp.2d 172), n.87.

construing *Gordon & Co. v. Ross,*(1996),[986] reaffirmed that "[t]he proper test of reliance in a fraud case is not 'reasonable' reliance, it is 'justifiable' reliance, a clearly less burdensome test." In addition, SEC Rule 9(b) stipulates that common law fraud claims must be "state[d] with particularity".[987] When overturning an earlier opinion issued by the Ninth Court, and thereby bringing it in line with decisions from the Second, Third, and Eleventh circuit courts on the element of loss causation,[988] the US Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo Inc.,* (2003)[989] ruled that a plaintiff "must be able to plead and demonstrate that the plaintiff later suffered an economic loss, presumably caused by a fall in market price once the news of the alleged fraud was disseminated".[990]

The holding in *Dura* also required plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind".[991] To these rulings, the downgrading of US sovereign debt by S&P from AAA (i.e. outstanding) to AA+ (i.e. excellent) in August 2011, offers a contemporary example of the high threshold faced by plaintiffs when making the 'process argument'. The process argument

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[986] Gordon & Co. v. Ross 84 F.3d 542, 546 (2d Cir. 1996).

[987] Fed. R. Civ. P. 9(b). See also, *Anschutz Corp. v. Merrill Lynch & Co.,* 690 F.3d 98, 108 (2d Cir. 2012) ("To satisfy this requirement the plaintiff must (1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent"), cited in *Boca Raton,* 2nd Cir.,(2012) (internal quotation marks omitted).

[988] *See e.g.,* Eric L. Talley, *Panel Two: Sarbanes-Oxley Accounting Issues* 106 COLUM. L. REV., (7) 1641, 1654-55 n.37 (2006)(citing divergent rulings of the aforementioned courts).

[989] See, *Dura Pharmaceuticals, Inc. v. Broudo Inc.,* 339 F.3d 933, 938 (9th Cir. 2003), *rev'd*, 544 U.S. 336; Eric L. Talley, 106 COLUM. L. REV., (7) 1641,1654 (2006).

[990] 339 F.3d 933, 938 (9th Cir. 2003), *rev'd*, 544 U.S. 336, 346.

[991] *Dura Pharms., Inc. v. Broudo,* 544 U.S. 336, 345 (2005) (quoting 15 U.S.C § 78u-4(b)(1), (2)), cited in *Boca Raton*, at *5, with a "a strong inference of fraudulent intent." *In re Carter-Wallace, Inc., Sec. Litig.,* 220 F.3d 36, 39 (2d Cir. 2000) (internal quotation marks omitted).

is based on the premise that the defendant erred when executing a required function. A recent example of this occurred when S&P's acknowledged making a $2 trillion process error in its calculation of the sovereign rating of the U.S. The very flawed calculation error was discovered by US Treasury officials who disputed the figures presented by S&P. Their concession of the error notwithstanding, S&P however still refused to revise its rating upwards to AAA citing instead its projections of continued political gridlock in the US Congress - a very subjective element in their calculation - as the pertinent overriding factor for maintaining the lower AA+ rating.

Given this scenario, it reasonably follows that private investors, who anecdotally lack the expertise and other resources necessary to verify such complex calculations, can be expected to face an even greater hurdle when pleading against flawed ratings issued by the same CRAs. Coffee likened the feasibility of expecting private investor to assess the credit risk of complex products like CDOs themselves to that of patient performing brain surgery on themselves.[992]

Moreover, as required in the U.S. under the heightened PSLRA standards, the process argument requires that as plaintiffs, investors must plead with particularity[993] by

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[992] John C. Coffee Jr., *Ratings Reform: The Good, The Bad, and the Ugly*, 5 (ECGI Working Paper Series in Law, Working Paper No.162, 2010).

[993] Pleading "particularity", see *Boca Raton* dismissal on failure by plaintiff to show "enough facts to state a claim for relief that is plausible on its face.", 2nd Cir. Court, construing *Bell Atl. Corp. v. Twombly,* 550 U.S. 544, 570 (2007), and the "failure to allege facts sufficient to support an inference of scienter". *See also, Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) ("To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face."); "To prevail on their claim that McGraw-Hill violated § 10(b) and Rule10b-5, the Fund must prove '(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation'", *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1317 (2011) (quotation marks omitted), at 5. *Boca Raton* appeal was premised on only the first two of these six requirements.

providing detailed evidence of the specific errors of omission or commission made by CRAs when issuing ratings. Hence, in order to prove causation, a plaintiff firstly has to convince the court that actual reliance was placed on the rating in question when making their investment decision; secondly, that their reliance on the rating was reasonable;[994] and thirdly, that the rating as issued was flawed in some manner, either in its methodological conception or in the execution of the methodology itself. The aforementioned decision flow considerations are simplified and summarised in Figure 13 below.

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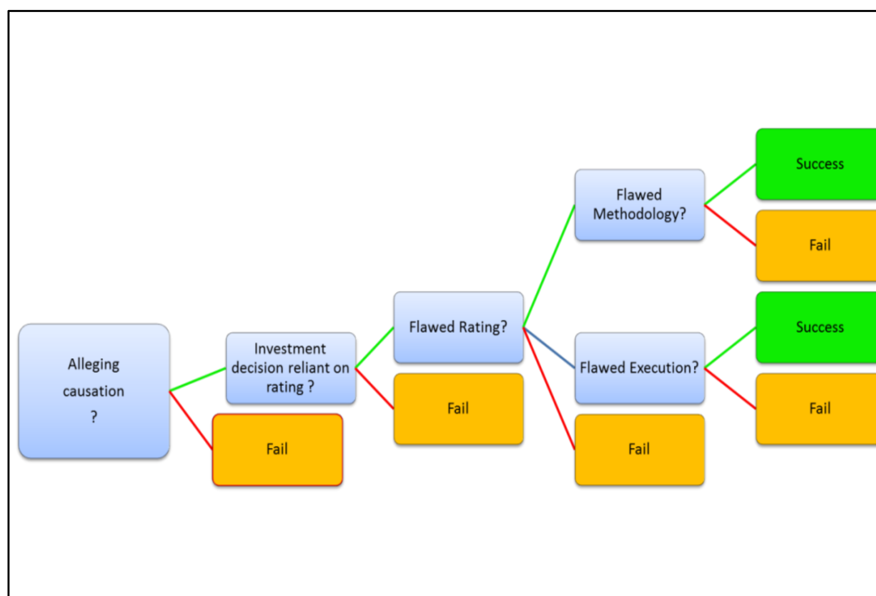
[994] *See*, (No 5) [2012] FCA 1200 (5 November 2012), (Jagot J: "A reasonable person is not required always to be right. A reasonable person is not required to second guess every belief they have. A reasonable person need not always obtain legal advice if there does not appear to be any need to do so."), para. 3630 at 1431.

Figure 13: Decision pathway for plaintiffs pleading "causation"



The pathway above in Figure 13 assumes starts with the premise that a lawsuit is brought by a plaintiff alleging causation of economic losses as a result of a rating issued by a CRA on which they relied. The first gate considers whether the plaintiff's investment decision was reliant on the rating. Here the plaintiff, as per the ruling in Abu Dhabi, would be required to demonstrate that it the decision was a) reliant on the rating and b) that such reliance was justified, as opposed to being necessarily reasonable. The second gate considers the premise for the alleged economic loss by establishing whether the rating itself was flawed. Here the jurisprudence appears to recognize for two options, both of which a plaintiff may pursue. One option for the plaintiff is to argue the rating methodology applied by the CRA was itself flawed, and the other is to argue that while the correctness of the ratings methodology is not contested, the execution of said methodology was erroneous. Either outcome would suffice to demonstrate the culpability of the CRA and thus establish liability. As has been mentioned throughout this research,[995]

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[995] See section 4 above.

the forward-looking nature of credit ratings, in particular their reliance on estimations and projections of future economic, financial, political, social and environmental states, makes it very difficult for plaintiffs that seek to prove the culpability of CRAs.

7.1.2. Causation under EU law

Absent a contract stipulating rights, terms and conditions between the CRA and an investor, the challenge facing plaintiffs in EU courts would appear to lie in determining the reliance claimed by plaintiffs who plead causation.

To the best of my knowledge, there are currently no specific legislative provisions for contracts between CRAs and investors in the EU and hence general contract law rules apply in the EU member states.[996] Contracts between CRAs and issuers have hereto been subject to contractual exclusions that are typically stipulated under the disclaimers accompanying CRAs' rating issues.[997] Whereas other EU member states have thus-far permitted contractual exclusions, only under the Loi de regulation bancaire et financière (a.k.a. the RBF Act) under French law, are contractual liability exclusionary clauses between CRAs and investors considered null and void.[998] In contrast, three Latin American countries, namely Chile, El Salvador and Peru, currently have comprehensive CRA regulations in place. Chile, for instance, allows for joint-and-several liability of the CRA and the individual rating agency employees involved.[999]

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[996] *See e.g.,* EU Parliament, '*Regulations (EC) No.1060/2009'*, OFFICIAL J. THE EUROPEAN UNION, (Sep. 16, 2009) *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF.

[997] *See e.g.,* Gretchen Morgenson, *Court Papers Undercut Ratings Agencies' Defense*, N.Y. TIMES, July 2, 2012, at B1.

[998] *See*, Brigitte Haar, *Civil Liability of Credit Rating Agencies* 3 (Research Paper Series No.2013-0, 2013).

[999] Uwe Blaurock, *Control & Responsibility of Credit Rating Agencies*, 25-26, 11.3 EJCL Dec. 2007.

Haar addresses the concept of "quasi-contractual liability"[1000] in the absence of CRA-investor contracting practice and in particular cites the pre-contractual liability clause in German law under § 311 para. 3 sent. 2 of the German Civil Code which explicitly recognizes a party's liability "if he or she inspires confidence, thus favourably influencing contract negotiations [between parties] or the conclusion of a contract".[1001] Haar notes that a narrow reading of the aforementioned clause would "suggest[] some immediate contact between the party held liable, [e.g. a CRA] and the claimant" is required.[1002] However, unlike in the relationship between CRAs and issuers which is predominantly characterised by the issuer-pays remuneration model, immediate contact is generally atypical to the CRA-investor relationship in the rating issuing process. Subsequently, only through a looser interpretation of the law would claimants likely prevail.

Under the current European Parliament's amendment proposal to Regulation (EC) No.1060/2009, a plaintiff claiming damages for a breach of the infringement, should present accurate and detailed information indicating that the CRA has committed such an infringement of this Regulation. By enabling issuers or third parties to sue CRAs for contractual breach on the one hand, and both issuers and investors to sue for infringements which affect the outcome of a rating, irrespective of a contractual obligation on the other,[1003] the 2013 Amendment Proposal, if adopted in its current formulation, would effectively permit contractual counterparties and non-contractual parties to sue CRAs for

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[1000] *See,* Brigitte Haar, *Civil Liability of Credit Rating Agencies*, 4 (Research Paper Series No.2013-0, 2013).

[1001] *Id.,* Brigitte Haar, citing German Civil Code §311 para.3 sent. 2, at 4.

[1002] *Id.,* Brigitte Haar, at 6.

[1003] EU-Parliament, European Parliament legislative resolution of 16 January 2013, point (24), (Jan. 16, 2013). See also, Amend. 35, Proposal for a regulation Recital 24; Amend. 37, Regulation (EC) No 1060/2009, available at http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2012-0221&language=EN.

damages on the premise of breaches of any of the recognized "infringements" listed under Annex III of the Regulation.[1004]

A CRA would thus be considered liable if its actions were deemed to breach the stipulated infringements in a manner that would "hav[e] an impact on a credit rating".[1005] However, the proposed text does not yet offer sufficient guidance regarding what is meant to be understood by the phrase 'having an impact', or how such impact is to be measured. The courts of the EU Member States are instructed to consult ESMA regarding any alleged infringements unless it is apparent that no such consultation is necessary.[1006] It does however exclude breaches of transparency obligations from infringements that would be deemed to impact the rating outcome[1007].

The use of imprecise wording currently adopted in the Amendment Proposal echoes that of similar wording used in the complaint brought by the US Attorney General in the *US v. McGraw-Hill Companies Inc.,(*2013) lawsuit which alleged that criminal violations by S&P had "affect[ed]" federally insured financial institutions.[1008] Here too, neither the meaning of, nor the means of measuring such an "affect", or the inferred effects, are explained in the Complaint.

[1004] *Id.,* 'European Parliament legislative resolution of 16 January 2013', at point (24).

[1005] EU-Parliament, 'European Parliament legislative resolution of 16 January 2013', TITLE III, Civil Liability of Credit Rating Agencies Article 35a, Civil liability, at point (20), sent. 1.

[1006] Amend. 2, Proposal for a regulation, Art. 1 – point (20), Regulation (EC) No 1060/2009, Article 35a, available at http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2012-0221&language=EN.

[1007] "Infringements which do not impact the rating outcome, such as breaches of transparency obligations, should not trigger civil liability claims.", Amend. 35, Proposal for a regulation Recital 24; Regulation (EC) No 1060/2009.

[1008] Case 2:13-cv-00779-DOC-JCG Document 16-1 Filed 04/22/13, at 6. *See also*, S&P's (close bracketMotion to Dismiss, *Memorandum in Support of Defendant's Motion* in *United States of America v. McGraw-Hill Co. Inc., et al., Case 2:13-cv-00779-DOC-JCG* 16-1, filed April 22, 2013.

One could argue that the Amendment Proposal intended to mean an infringement is deemed to have had an impact on a rating when either an intentional or grossly negligent action by a CRA results in the issuance of a rating that would be provably flawed ex ante, and where alleged causation between the infringement and the damages claimed is - or can be - established.[1009] Even so, the wording as it currently stands in the aforementioned instances in both the EU and the US remains too broadly defined to be meaningfully instructive.

The German Federal Court's decision in *IKB* which avoided the fraud-on-the-market reasoning applied by US courts,[1010] and the Dutch Supreme Court's decision in *World Online*[1011], have both recently further obscured the position regarding the requirement to prove reliance when pleading causation within the EU.[1012]

Whereas the 2011 version of the Draft Proposal of the Amendment at Art. 35a (4)[1013] required a CRA to either prove that it had not committed the alleged infringement or that

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[1009] EU Parliament, Art. 35a, para 1 of Draft Proposal of Amendment (Sep. 16, 2009), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF; Brigitte Haar, *Civil Liability of Credit Rating Agencies* (Studies Research Paper Series No.2013-0, 2013), at 11.

[1010] Brigitte Haar, *Civil Liability of Credit Rating Agencies,* at 6 n.14 (Studies Research Paper Series No.2013-0, 2013).

[1011] 14 *VEB v World Online*, Hoge Raad Nov. 27, 2009, (Netherlands Supreme Court, 2009), JOR 2010/43 (for a further analysis of this decision cf. B. de Jong, *Liability for Misrepresentation – European Lessons on Causation from the Netherlands*, 8 EUROPEAN CO. & FIN. L.REV. 364-366 (2011)); see, http://www.kernkamp.nl/case-law/2009/11/veb-versus-world-online-abn-amro-goldman-sachs/ (last accessed Mar. 26, 2015).

[1012] Brigitte Haar, *Civil Liability of Credit Rating Agencies*, 6 (Studies Research Paper Series No.2013-0, 2013).

[1013] EU Parliament, *Proposal for a Regulation of the European Parliament and of The Council amending Regulation (EC) No 1060/2009 on credit rating agencies*, Nov. 15, 2011 ("… it will be for the **credit rating agency to prove that it has not committed that infringement** or that that infringement did not have an impact on the issued credit rating") (emphasis added), available at http://eur-

the alleged infringement had not had an impact on the rating issued, the 2013 Amendment Proposal, in a significant reversal of the draft formulation text presented to the Commission, recognized the limitations facing third parties as a consequence of the absence of a contractual relationship between the credit rating agency and third parties, instead places the onus to prove occurrence of an infringement on third parties (i.e. investors and other plaintiffs).[1014]

The partial reversal of the burden of proof with regard to the existence of an infringement and the infringement's impact on the rating outcome proposed in the Amendment text would only place greater onus on the CRA once a plaintiff has reasonably established that an infringement occurred.

The Amendment text however makes a distinction between establishing the existence of an infringement and its impact on rating outcome on one hand, and establishing the existence of damage and the causality of the infringement for the damage on the other. The onus for establishing the latter is placed fully on the third party/ plaintiff.[1015] Conceivably, a plaintiff could be required to either prove that the rating methodology as provided by the CRA was flawed in its execution (lower level benchmark), or that the methodology as applied by the CRA was itself fundamentally

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lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52011PC0747:EN:NOT (last accessed May 5, 2015).

[1014] European Parliament legislative resolution of 16 January 2013,*(EC) No 1060/2009 on credit rating agencies (COM(2011)0747 – C7-0420/2011 – 2011/0361(COD)* Art.35a (4),("It shall be the responsibility of the investor or issuer to present accurate and detailed information [as assessed by a competent national court] **indicating that the credit rating agency has committed an infringement** of this Regulation, and that that infringement had an impact on the credit rating issued.") (Emphasis added), *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2013-0012&language=EN&ring=A7-2012-0221.

[1015] Amend. 37, Proposal for a regulation Recital 26, Report on the proposal (EC) No 1060/2009, available at http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2012-0221&language=EN.

flawed (upper level benchmark). Either benchmark level is likely to prove onerous to meet, even for retail investors.

The Amendment Proposal neither defines nor covers "causation" and "gross negligence", instead it defers that as a matter to be decided by the national courts of the member states.[1016] It does however take cognisance of the difficulties faced by investors in meeting the benchmark of proof necessary to successfully plead with particularity before the courts in that under point (26), where it directs the competent national courts in the respective member states to:

> "…tak[e] into consideration that the investor or issuer may not have access to information that is purely within the sphere of the credit rating agency."

This in itself would allow national competent courts significant leeway in defining at what point information is deemed exclusively within a CRA's sphere and beyond that of an investor. Structured products in particular, tend to be marketed to and purchased by investors who are often recognized as having above competent ability, if not being expert, in transacting in such securities either directly or with guidance from a financial advisor as was the case in the *Bathurst* lawsuit[1017]

7.1.3. Damages: Compensation and deterrence

Once CRA causation has been established by a claimant to the satisfaction of the competent court, the question regarding the amount of liability damages to be charged then needs to be addressed. Annex III of CRA Regulation (EC) 1060/2009 not only outlines the monetary fines to be levied for each infringement, but point (25) of the 2013 Amendment Proposal clearly states that an intentional or grossly negligent infringement

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[1016] EU-Parliament, European Parliament legislative resolution of 16 January 2013, *(EC) No 1060/2009 on credit rating agencies (COM (2011)0747 – C7-0420/2011 – 2011/0361(COD)*, at point (26)).

[1017] In *Bathurst,* citing LGFS marketing documentation touting its ability to provide clients with highly experienced financial market specialists, at 448, 598.

of the Regulation should result in exposure of CRAs to "potentially unlimited liability".[1018] Moreover, guidance on whether such awards for damages are be conceived as compensation for losses suffered by plaintiffs, or as deterrence to incentivise CRAs to act prudently, or both[1019], needs to be given in the legislation.

Firstly, when making a compensatory award in favour of a plaintiff for economic losses suffered, a competent court in the EU would need to show evidence that, but for the fraudulent or grossly negligent actions on the part of the CRA, an unflawed rating would have allowed the plaintiff to avoid or to minimize the aforementioned loss. To that end, it is reasonable to contend that a plaintiff would also be required to demonstrate that the losses not only stemmed - at least predominantly or decisively - from a flawed credit risk rating, as opposed to from other business and investment-related risks, and that it was also within the power and control of the CRA to generate and issue an accurate rating, ex ante. Failure to provide such a standard of proof could potentially open the door to lawsuits being brought by opportunistic investors seeking to shift the insolvency risk associated with most investments from themselves onto CRAs.[1020] In this regard, it is important to

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[1018] EU-Parliament, European Parliament legislative resolution of 16 January 2013, *(EC) No 1060/2009 on credit rating agencies (COM(2011)0747 – C7-0420/2011 – 2011/0361(COD)* point (25)).

[1019] Barbara Black, *What makes it the Most Important Securities Case in a Decade?* 1-17 (U. Cin. Public Law Research Paper No. 07-21, Oct. 9, 2007) at 15-16 notes that Coffee, in *Reforming the Securities Fraud Class Action: An Essay on Deterrence and its Implications*, 106 COLUM. L. REV. 1534 (2006) ("….argu[es] that justification for private securities fraud litigation must be deterrence and not compensation"). *See also*, Brigitte Haar, *Civil Liability of Credit Rating Agencies,* 17-19 (Legal Studies Research Paper Series No.2013-0, 2013).

[1020] Brigitte Haar, *Civil Liability of Credit Rating Agencies,* 4 (Studies Research Paper Series No.2013-0, 2013). *See,* RUDOLF LEMKE, HAFTUNGRECHTLICHE FRAGEN DES RATINGWESENS – EIN REGELUNGSPROBLEM? 82 Peter Lang, Frankfurt am Main, 2000, alternatively online, at http://www.gbv.de/dms/spk/sbb/recht/toc/306472805.pdf; Uwe Blaurock, 2007. "Control & Responsibility of Credit Rating Agencies." *11.3 Electronic Journal of Comparative Law,* 22 (on opportunistic risk shifting to CRAs by investors).

guard against defining quality ratings performance in a manner which would make it indistinguishable from a guarantee or an insurance policy through which all other investment risks, whether credit-risk-related or non-credit-risk-related, are then assumed to be borne by CRAs alone, as opposed to being shared with the investors. [1021]

Secondly, there are numerous models available on which calculation of damages to be paid by a CRA can objectively be based. The most convincing and possibly easiest to calculate and justify is one where the damages are based on fees paid to the CRA for the rating issue. These can either be based on the post-issue fees earned by the CRA only, or both the pre- and post-issue fees earned by the CRA. This model would allow the economic losses to be disgorged from the CRA on the basis of a specific rating issue. Moreover, the concept of disgorgement is an established practice with which US markets, from insider trading rules, and German markets, from anti-trust law, are both familiar and would thus be easier to introduce.[1022]

Alternatively, a disgorgement of all income or profit earned by a CRA from a particular ratings issue would permit the plaintiffs to recoup fees paid as well as an additional discretionary sum which can be interpreted to be the deterrent portion of the damages award. Less convincing, however, is the proposal that said damages be disgorged or otherwise recovered as assessed by a formula based on the percentage-of-revenue or profits earned by the CRA as happens to be the formulation currently drafted by the EU Parliament. In its amendment proposal, the EU Parliament directs ESMA to base its calculation of the fines to be imposed on the "… [t]he annual turnover in the preceding business year of the credit rating agency concerned".[1023] Article 35a, Amend. 2, point (3) directs competent EU national courts to seek ESMA's view when weighing up the

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[1021] Refer, section 6.3.1., above.

[1022] Brigitte Haar, *Civil Liability of Credit Rating Agencies,* 19 (Studies Research Paper Series No.2013-0, 2013).

[1023] EU–Parliament, *Regulation (EC) No 1060/2009 of The European Parliament and of The Council* (Regulation 2009R1060 - EN-21.07.2011-002.001-2), July 21, 2011.

infringement claim and shall be required to take formal ESMA decisions into its "consideration" when making its rulings.[1024]

Lower, middle and upper penalty limits prescribed by the EU Parliament have, [1025] for example, capped the upper limits for infringements at a maximum of EUR 750.000 for the largest CRAs whose turnover from the preceding year exceeds EUR 50 million.[1026] This translates to 1.5 percent of annual turnover at the EUR 50 million level of revenue, or 0.038 percent of Moody's 2013 revenue of $1,955 million.[1027] The UK law, under §90 of its Financial Services Act 2000 regarding prospectus listing misstatements,[1028] caps the damages to be awarded. For instance, under the provisions for promissory estoppel, it clearly states:

[1024] EU–Parliament, A7-0221/2012, Art.35a, Amend. 2, point (3), at 84, Aug. 23, 2012, *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A7-2012-0221+0+DOC+PDF+V0//EN.

[1025] EU – Parliament, *Regulation (EC) No 1060/2009 of The European Parliament and of The Council*, at 49 "The basic amount shall be at the lower end of the limit for credit rating agencies whose annual turnover is below EUR 10 million, the middle of the limit for the credit rating agencies whose annual turnover is between EUR 10 and 50 million and the higher end of the limit for the credit rating agencies whose annual turnover is higher than EUR 50 million".

[1026] EU-Parliament, *European Parliament legislative resolution of 16 January 2013*, *(COM(2011)0747 – C7-0420/2011 – 2011/0361(COD)*, Art. 36, point (26)a ("... for infringements referred to in points 1 to 5, 11 to 15, 19, 20, 23, 26a to 26d, 28, 30, 32, 33, 35, 41, 43, 50 and 51 of Section I of Annex III, the fines shall amount to at least EUR 500 000 and **shall not exceed EUR 750 000**") (emphasis added).

[1027] Alternatively, 0.038 percent, when based on Moody's Investor Services TTM revenue of $1,955 million as at March 31, 2013 at 5, *available at* http://files.shareholder.com/downloads/MOOD/2493356246x0x661870/DF0C2782-0A8F-4CDA-9F57-1A87DD154896/MCO_Investor_Presentation_1Q_2013_vFINAL.pdf

[1028] Restatement (Second) of Contracts, §90 Promise Reasonably Inducing Action or Forbearance. See e.g., http://www.lexinter.net/LOTWVers4/promissory_estoppel.htm.

> "Unless there is unjust enrichment of the promisor, damages should not put the promisee in a better position than performance of the promise would have put him."[1029]

Avoiding an injustice under promissory estoppel by awarding a plaintiff a sum equal to the value promised would be more contentious when dealing with CRAs in particular since any "value" communicated or associated with ratings can seldom be guaranteed, and is therefore debatable whether or not it can be deemed to actually ever be promised. Even attempts to compensate plaintiffs for losses suffered are themselves not beyond challenge as ratings downgrades, for example, do not always translate into actual economic losses.[1030] The merits of capping liability will be revisited later in this paper.

Thirdly, the question of who should qualify for such payments for damages would also need to be determined. As has already been mentioned, the EU Regulation 1060/2009 amendment proposal would permit plaintiffs to sue CRAs for infringements deemed to have negatively affected ratings.[1031] The competent national courts in the EU member states would be required to determine a mechanism for establishing whether, for example, either a pro-rata; first-come-first-served; class-action system; or some other formulation would be best suited for determining which parties should qualify to receive a payment for damages.[1032]

[1029] Restatement (Second) of Contracts, §90, Promise Reasonably Inducing Action or Forbearance (d) Partial enforcement. See §§344, 349.

[1030] FCIC, Financial Crisis Inquiry Commission. 2011. "Report on the Causes of the Financial Crisis." at 228 (FCIC report stating that most AAA rated MBS products had by 2010 avoided actual economic losses).

[1031] EU-Parliament, *European Parliament legislative resolution of 16 January 2013*, Point (24), (Jan. 16, 2013).

[1032] *See e.g.,* Section 90 of the Second Restatement of Contracts on the 'doctrine of estoppel' which states: "A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by the enforcement of the promise." (Restatement [Second] of Contracts § 90 [1981]).

The EU's decision to delegate the matter to the competent national courts of its member states closely mirrors the non-uniform approach already adopted in the U.S. across its federal court system and the resulting divergent court judgements they have thus far delivered.[1033] For example, the states of Arkansas and Colorado sought disgorgement from the revenues earned by S&P in their respective lawsuits.[1034] In comparison, in its decision in *Bathurst,* the FCA awarded the plaintiffs A$20 million. This sum constituted A$16 million that was originally invested by the local councils plus legal fees and interest that was to be paid in equal proportions by S&P, ABN Amro and LGFS.[1035] However, in marked contrast, the lawsuit brought by California's Attorney General on behalf of the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), claimed an economic loss of a staggering $1 billion. Under Californian state law CalPERS and CalSTRS were permitted to seek damages of up to a multiple of three times of the actual economic losses suffered. In other words, under Californian state law provisions, S&P could potentially have been required to pay damages of up to $4 billion.[1036] The potential economic threat posed by such high-value awards to plaintiffs of up to several multiples of the actual economic loss claimed can only serve to further entrench the position taken by NRSROs of refusing to provide ratings under a liability regime.[1037]

[1033] *Contrast, e.g.,* Uwe Blaurock, *Control & Responsibility of Credit Rating Agencies*, 36-37, 11.3 EJCL Dec. 2007 (arguing that incoherent and disparate national (and state) law are deficient, and positing that only a global approach makes sense).

[1034] Jeannette Neumann, *Current Employees Star in S&P Lawsuit*, WALL ST. J., at 26, Feb. 26, 2013.

[1035] *Compare, Credit Rating Agencies and the Next Financial Crisis*: *Testimony of Floyd Abrams*, at 94 (on the viability of requiring the CRAs to share information or to verify and be liable for errors made by other CRAs equated to joint liability).

[1036] Jeannette Neumann, *Current Employees Star in S&P Lawsuit*, WALL ST. J., at 26, Feb. 26, 2013.

[1037] Francesco Guerrara, Rating Raters' Ratings, WALL ST. J., Feb. 11, 2013, available at http://online.wsj.com/article/SB10001424127887323511804578297712623834952.html (last accessed

7.2. Proposed model

Aside from a few notable exemptions, such as the recent case brought against S&P by the US Attorneys General on behalf of government-backed financial institutions Fannie Mae and Freddie Mac, most of the lawsuits against CRAs claiming flawed or negligent ratings have been brought by institutional investors. This in itself is not surprising as private retail investors, unlike institutional investors, often lack the financial resources, co-ordination and expertise to pursue lawsuits against such well-financed financial services organisations. However, even lawsuits that have been brought forward by typically better resourced and organised institutional investors have thus far either been dismissed by the courts or have been settled.[1038] For this reason, the Federal Court of Australia's ruling in the decision in *Bathurst* is of landmark significance for the U.S., EU and other jurisdictions.

Due to the dominant prevalence of the issuer-pays remuneration model, particularly among NRSROs, the generally free access to credit ratings enjoyed has become entrenched. For instance, a study published in 2014 by the European Central Bank found that business models based either on investor-paid ratings, investor-produced ratings, or mandatory co-investments were observed to only have a limited potential to improve social welfare, if any. Subsequently, demand for these alternatives was expected to remain low among clients as long as issuer-paid CRAs were available on the market.[1039] The view

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May 5, 2015) (capping expert liability to "a set multiple of the fees" earned by the CRA firms on a given security). *See also,* JOHN C. COFFEE, JR. *GATEKEEPER FAILURE AND REFORM: THE CHALLENGE OF FASHIONING RELEVANT REFORMS, in* CORPORATE GOVERNANCE IN CONTEXT 600, 649 (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, and Harald Baum eds., 2005) (proposing a mandatory ratio between minimum liability and direct or indirect revenues earned from the client of 10:1).

[1038] *See e.g.,* Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. (1), 227-252, *passim* (1996) (Shareholder wealth increases for firms that adopt or settle and decreases for firms that resist).

[1039] Dion Bongaerts, *Alternatives for Issuer-paid Credit Rating Agencies*, 25-27 (European Central Bank Working Paper Series No. 1703, 2014).

that recent U.S. court decisions that have refused to recognise that a duty of care is owed to investors by CRAs have as a consequence weakened the ability of private investors to sue CRAs for flawed ratings is convincing.[1040]

In the absence of legal recognition for a duty of care being owed by CRAs towards investors who may place a significant level of reliance on credit ratings when making investment decisions, and in light of the fact that the status quo regarding either the remuneration mechanism or the recognition of a duty of care by CRAs towards investors seems unlikely to change in the near or medium term.

This dissertation proposes a model to this conundrum that would conceivably both strengthen investor protection and incentivize CRAs to be more accountable. By recognizing the existing bounds of liability[1041] and coupling them with capped liability, the proposal made in this dissertation aims to encourage and facilitate a more timely resolution of the current market failure in the US legal and financial system that resulted following the rescission of Rule 436(g).[1042]

To date, investors have generally sought to be recognized by courts either as indirect or as third-party beneficiaries meriting protection under statutory duty of care provisions.[1043] The model proposed adopts an investor and issuer "co-pay" approach, and would primarily be aimed at strengthening the ability of investors to hold CRAs in general, and NRSROs in particular, liable and accountable for issuing flawed credit ratings.

[1040] *See e.g*., *Commercial Fin. Servs.,* 94 P.3d, at 111; *Jefferson County School District. v. Moody's Investor Services,* 175 F.3d. 848, 850-51 (10th Cir. 1999), *Oddo Asset Mmgt v Barclays Bank*, N.Y. State Supreme Court, New York County (No 08-109547).

[1041] *See e.g*., *Ultramares Corp., v. Touche* 255 N.Y. 170, 179, Court of Appeals of N.Y. (Jan. 6, 1931).

[1042] *See e.g*., sections 5.1 and 6.1 above.

[1043] *See e.g*., *Bathurst,* ("The potential investor, on this analysis, is not a "free rider" on the contract between ABN Amro and S&P (in contrast to the beneficiary under the will in *Hill v Van Erp* (1997) 188 CLR 159 at 211, McHugh J.). The potential investor is the reason for the contract and thus the reason for S&P being able to earn money by providing the service."), para 2798, at 1150. See also, section 4.3.3., on secondary actors' liability.

Benefits of the co-pay model would include the apportionment of fees/costs between an issuer and any investor who purchases ratings from a CRA. The function of purchase is crucial as it most convincingly demonstrates the investor's reliance on the credit rating. This approach would enable bounded liability to be achieved and would make it more easily determinable. The co-pay requirement would also incentivise higher ratings accuracy[1044] and address the great reluctance thus far shown by investors to directly pay for credit ratings.[1045] However, the observed reluctance by investors to pay for ratings is unsurprising, particularly since the Big 3 and the majority of NRSROs ascribe to the issuer-pays model approach which grants investors access to ratings at no direct cost. Moreover, one of the main reasons that regulators are not enthusiastic about the subscriber-pays model is that it makes simultaneous disclosure of the credit rating reports to the market very difficult to implement and this is regarded by regulators as a hindrance to their generic mandate of ensuring market fairness.[1046]

From a strictly economic perspective, ensuring market fairness is a desirable objective for maximizing investors' utility, especially concerning credit ratings of retail securities that are sold to private investors. However, investors in structured products tend to be institutional investors whose business models are generally structured and accustomed to paying for market research. Subsequently, the co-pay model would have a higher likelihood of acceptance within the structured products space. A 2014 European Central Bank study argued that allowing investors to pay for ratings was at times the only way to improve welfare for complex products such as structured products where the

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[1044] Dion Bongaerts, *Alternatives for Issuer-paid Credit Rating Agencies*, 3 (European Central Bank Working Paper Series No. 1703, 2014).

[1045] Stephen Foley, *Issuer payment: model resistant to reform*, FINANCIAL TIMES, Jan. 14, 2013 ("The reality is that you wouldn't have a ratings industry if [investors were required to pay])" available at http://www.ft.com/cms/s/0/5a9d7522-5e3d-11e2-a771-00144feab49a.html#axzz3bAxzPtFs.

[1046] Stephen Foley, *Issuer payment: model resistant to reform*, FINANCIAL TIMES, Jan. 14, 2013.

incentive challenges were deemed severe.[1047] In contrast to the large pool of issuers, intermediaries and CRAs involved in the issuing of ratings for corporate and sovereign securities, the considerably much smaller constellation of participants that are active in the structured products space also suggests that adoption of co-pay in this smaller segment maybe be easier to implement.

Ultimately, the adoption of co-paying has the potential to significantly improve the ability of investors to successfully sue CRAs for flawed ratings quality as it would allow for more clearly-defined performance standards and benchmarks against which observed infringements could be identified and penalties ascribed in line with the negotiated terms in the purchase and performance contracts and agreements.[1048] This proposal, if adopted, would enhance the protections afforded to investors beyond those currently available under a typical CRA-issuer agreement, already has conceptual support among experts.[1049]

7.2.1. Product liability and co-paying

Product liability generally involves claims of *injuria* caused by manufactured goods. Credit ratings could be regarded as an information product as per the Restatement (Third) of Torts: Product Liability § 19(a) (1998), which states: "A product is tangible personal property distributed commercially for use of consumption". Under this premise, the motivation and practice for attempting to protect a potentially indeterminate public by fixing responsibility where it will most effectively [or efficiently] reduce hazards that are inherent in defective products that may be foreseeable to the producer or issuer, and not

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[1047] Dion Bongaerts, at 3-4 (European Central Bank Working Paper Series No. 1703, 2014).

[1048] *See e.g.,* Art.35 and 36 of EU Parliament Amendment Proposal to Regulation (EC) 1060/2009 on infringements and penalties.

[1049] David Fickling and Joe Schneider, *Australian Towns Awarded A$20 Million in S&P Ratings Case*, BLOOMBERG, Mar. 1, 2013 (suggesting that introducing a CRA liability regime could nudge the industry towards an investor-pays model and away from the issuer-pays model).

to the public, is now fairly established.[1050] The California Supreme Court, in its decision in *Greenman v. Yuba Power Products* (1963)[1051], became the first U.S. court to adopt strict tort liability for defective products. Without being required to prove the manufacturer's carelessness with specificity, that is to say, with particularity, the ruling placed the onus on the plaintiff to prove that the product had caused the harm claimed.

For instance, under German law there are requirements based on consumer goods and product performance testing wherein the question of liability is then only considered by the court once the requirements for neutrality, objectivity and expertise have been established.[1052] At the same time, evidence of causation has to be provided by plaintiffs in order to prove liability[1053] and negligent conduct only results in liability when absolute rights (e.g. rights regarding life, honour, real property), are violated. Protection of wealth or enforcing the respect of contractual relationships are precluded as acceptable claims.[1054] Capping liability damages, as has been proposed in the EU under the 2013 EU

[1050] John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit Crisis,* 2009 COLUM. BUS. L. REV., (1) 109, 197, nn. 279-280 (2009), Cf. *Escola v. Coca-Cola Bottling Co*., 24 Cal. 2d 453, 462 (1944) (Traynor, J., concurring, "Even if there is no negligence, however, public policy demands that responsibility be fixed where it will most effectively reduce the hazards to life and health inherent in defective products that reach the market"). *Id.,* at 207 (comparing the strict liability rule for defective products, where proper ex ante warnings are deemed a sufficient defense to either a disclose or disgorge policy).

[1051] *Greenman v. Yuba Power Products* 59 Cal. 2d 57, 377 P.2d 897(1963).

[1052] Uwe Blaurock, *Control & Responsibility of Credit Rating Agencies*, 19, 11.3 EJCL Dec. 2007 at 19 (German law relies on product testing case law).

[1053] For an overview of product liability under German law, see Brigitte Haar, *Nachhaltige Ratingqualität durch Gewinnabschöpfung? - Zur Regulierung und ihrerImplementierung im Ratingsektor,* 21 ZBB (3) 177-256 (2009).

[1054] OLIVER VON SCHWEINITZ, RATINGS AGENCIES: THEIR BUSINESS, REGULATION AND LIABILITY UNDER U.S., U.K. AND GERMAN LAW 171 (Unlimited Publishing LLC, Bloomington, Indiana, 2007).

Parliament's Amendment Proposal,[1055] and in the US by Partnoy[1056] and other commentators,[1057] would not only allow for a marked improvement in redressing the imbalance between compensation and deterrence, but would also likely facilitate the development of a potentially sustainable market-based pricing mechanism.[1058]

One notable advantage of capping liability is that CRAs would be able to calculate their potential economic exposure, ex ante, which would enable them to decide either to carry the liability on their own balance sheet or alternatively to purchase insurance from the market in order to contain the exposure instead.[1059]

A modified version of a strict liability regime would not only make gatekeepers liable for a portion of any fraud damages accruing to an issuer as contractually agreed ex ante, but it would also enable gatekeepers to reduce their expected liability costs by selectively screening buyers of the ratings purchase contracts.[1060] Alternatively, in the

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[1055] EU-Parliament, *'European Parliament legislative resolution of 16 January 2013'*, (Jan. 16, 2013).

[1056] JOHN C. COFFEE, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 187, (Partnoy advocates increasing gatekeeper quality by increasing liability and addresses the fear of insolvency for the big firms by calling for liability reform to cap liability).

[1057] *See e.g*., John Patrick Hunt, *Credit Rating Agencies and the Worldwide Credit*, 2009 COLUM. BUS. L. REV., (1) 109, 194, n.270 (the risk of over-deterrence absent a corresponding increase in benefits is the reason why damages should be "limited"; that is to say, capped); Uwe Blaurock, *Control & Responsibility of Credit Rating Agencies*, 36-37, 11.3 EJCL Dec. 2007.

[1058] *See e.g*., Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1079-80 (2009).

[1059] JOHN C. COFFEE, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? (2006) at 189 (Partnoy proposes introducing financial statement insurance for auditing firms, and suggests that this could also be applied to CRAs).

[1060] Frank Partnoy, '*Barbarians at the Gatekeepers?*' 79 WASH. U. L. Q., 42 (2001); Frank Partnoy, *'Not Like Other Gatekeepers'* at 96 n.117 (2006); Steven Harper, *Credit Rating Agencies Deserve Credit for the 2007-2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act*, 68 WASH. & LEE L. REV. 1925, 1929 (2011) (modified strict liability capping damages to multiple of annual revenues); and John C. Coffee Jr., '*Partnoy's Complaint',* 84 B.U.L. REV 365-366 (2004), and Steven Harper,' *Credit Rating Agencies Deserve Credit for the 2007-2008 Financial Crisis',* 68 Wash. & Lee L.

absence of such proactive engagement by the SEC and other regulators, CRAs may continue to ignore this concern and this would in all likelihood lead to a continuance of the current legal and economic impasse. Moreover, without comprehensive regulatory guidance, the CRAs may each ascribe to vastly different and inconsistent domestic and international standards thereby further complicating the process of providing supervision to their industry and perpetuating the unwelcome disparities currently observed in court judgements that only serve to invite regulatory arbitrage.

7.2.2. Model explained

Figure 14 below summarises the proposed model. Firstly, the model aims to avoids the classical dichotomy which requires a CRA to elect either an issuer-pays or an investor-pays model in that it embraces the characteristics of both in a hybrid co-pay structure. Aside from the benefits of the sharing of costs between issuers and investors – and in a sense, "effectively subsidizing" these costs for private investors[1061] – costs which this dissertation has argued can be expected to increase significantly under a liability regime, a further advantage of the co-pay option would be in improving the ability of investors to hold CRAs accountable for poor quality ratings. Instead of solely attempting to place reliance on duty of care protections owed to third parties which are enforced to varying degrees by the SEC and ESMA in the US and EU, respectively,[1062] the co-pay option

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Rev. 1925, 1969, (2011) (modified strict liability capping damages as a percentage of damages); as well as John C., Coffee, Jr. *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, in* CORPORATE GOVERNANCE IN CONTEXT 600, 649 (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, and Harald Baum eds., 2005) (proposing a mandatory ratio between minimum liability and direct or indirect revenues earned from the client of 10:1).

[1061] John C. Coffee Jr., *Ratings Reform: The Good, The Bad, and the Ugly*, 5 (ECGI Working Paper Series in Law, Working Paper No.162, 2010).

[1062] The Office of Credit Ratings (OCR) under the SEC in the US and ESMA in the EU have been empowered to enforce the new CRA regulations. See *supra* n. 29, and n.178. For example, in January 2012, the OCR banned Egan-Jones from rating bonds "issued by countries, U.S. states and local governments, or

would conceivably improve the ability of investors to bring lawsuits against CRAs on the basis of agreed terms and conditions of performance stipulated in the purchase contract for the ratings. As noted above, the US courts have not recognized a duty of care owed by CRAs to investors and third parties. The EU Amendment proposal, in contrast, recognizes that CRAs have an "important responsibility towards investors in ensuring …[] that their ratings are independent, objective and of adequate quality".[1063]

This model's premise rests on the expectation that, the challenges posed by a secondary market for such contracts notwithstanding, the purchase contracts would result would more accurately identify bona fide consumers of the ratings reports. The greater contribution of this approach, if adopted, is that it would significantly advance the debate for determining whether or not there was in fact reliance by an investor on an issued rating. Achieving this determination would in turn drastically reduce the likelihood of opportunistic claims of reliance by an investor arising.[1064] In addition, the ability to identify purchasers would also permit CRAs to proactively control their risk exposure. For example, economic exposure can be managed by exercising their right to limit the volume of ratings sold to investors, or where complex and sophisticated products are involved, controlling the class of investors permitted to participate in the purchase. The Federal Court of Australia in the *Bathurst* decision acknowledged the local councils' vulnerability due to their lack of expert investment knowledge of complex financial

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securities backed by assets such as mortgages, for at least the next 18 months.". *See* Jeannette Neumann, J. *SEC Reigns in Ratings Firm,* Wall St. J. online, available at http://online.wsj.com/news/articles/SB10001424127887324624404578257850769793788. See also, Cohan, W.D., *SEC Sues the One Rating Firm Not on Wall Street's Take*, BloombergView, available at http://www.bloombergview.com/articles/2012-09-30/sec-sues-the-one-rating-firm-not-on-wall-street-s-take (Cohan argues that Egan-Jones has been unjustly censured by the SEC as a consequence of its two downgrades of US Sovereign debt ratings).

[1063] Art.35, Recital 24 of EU Parliament Amendment Proposal to Regulation (EC) 1060/2009.

[1064] *See e.g.,* Brigitte Haar, *Civil Liability of Credit Rating Agencies,* 13 (Research Paper Series No.2013-0, 2013) (on opportunistic claimants).

instruments when dismissing the local councils' culpability. The co-pay option also recognizes that CRA ratings are true multi-task agents by nature as characterized by their single output with two dimensions.[1065]

Although the co-pay option would offer the aforementioned advantages, it would also entail several significant trade-offs. Firstly, the limitations inherent in both contracts and tort statutes to comprehensively foresee and provide for unforeseen and unexpected future outcomes, as exemplified by the 2007 global financial crisis, loom large over the proposal and would still require ex post judicial adjudication. To this end, the ability to either suspend the implementation of all, or sections of the enacted law or at least modify the contractual terms ex post, is worth considering.[1066] One such scenario could arise in instances where unforeseen developments materialise or where the realised economic performances differ significantly from those contractually agreed between the parties, occur.[1067] The German Civil Code (i.e. Bürgerliches Gesetzbuch, or BGB) for example, makes particular provision for this in instances where the "contractual or statutory distribution of risk, [as a result of which] one of the parties cannot reasonably be expected to uphold the contract without alteration".[1068] Such flexibility can however be concerning. Subsequently, the adoption of such a truly living and amenable approach would also warrant robust safeguards to mitigate against the expedited watering down of standing

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[1065] Gerrit De Geest, *Who Should Be Immune from Tort Liability?* 41 J. LEGAL STUD. (2) 316-17 (2012).

[1066] Katherina Pistor, *Towards a Legal Theory of Finance* 48 (Columbia Public Law Research Paper No. 12-323, 2012) (such as the German Supreme Court's (i.e. Reichsgericht) reliance on the bona fide doctrine to permit the modification of credit contracts during the high-inflationary environment in the 1920s).

[1067] *Id.,* Katherina Pistor, *Towards a Legal Theory of Finance,* 48 (2012).

[1068] *See* § 313 (1) – (3) BGB. Transl. German Civil Code §313 (1) - (3). English version, *available at* http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p1094 (last accessed Jan 12, 2013).

rules, regulations and statutes,[1069] as well as to ensure the preservation of the delicate balance between flexibility and predictability of legal outcomes through judicial application from which legal jurisdictions draw their force.[1070]

Secondly, it is doubtful whether private investors, more so when acting independently, would ever be in a position to negotiate proportionately fair terms with NRSROs when attempting to significantly improve their ability to successfully sue for non-performance, particularly when one considers the oligopolistic structure of the industry. Consequently, it is necessary for new regulations to be introduced by the SEC and other regulatory and legislative bodies to further enhance the rights of private investors by strengthening their ability to hold NRSROs liable, or at the very least, more accountable.[1071] Prescribing minimum terms and by introducing performance benchmarks and liability thresholds in the purchase contracts between CRAs and investors as has been proposed by Coffee[1072] are just two practical options available s for achieving this.

The potential economic loss to be suffered by CRAs would be substantial if – as can be reasonably expected – a secondary market for purchased ratings for structured product

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[1069] *See e.g.*, Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act*, 43 (Harvard Law and Economics Discussion Paper No. 525, Dec. 2005) (guarding against watering down of legislation in response to lobbying by special interest groups).

[1070] *Id.,* Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act*, 42, (suggesting that legislation be reviewed and re-assessed on an on-going basis by the relevant regulatory bodies to ensure suitability).

[1071] John C. Coffee Jr., *Ratings Reform: The Good, The Bad, and the Ugly*, 58 (ECGI Working Paper Series in Law, Working Paper No.162, 2010) (noting the need for 'regulatory intervention' to enable a general shift towards a subscriber-pays (purchaser-pays) model).

[1072] JOHN C. COFFEE, JR. *GATEKEEPER FAILURE AND REFORM: THE CHALLENGE OF FASHIONING RELEVANT REFORMS, in* CORPORATE GOVERNANCE IN CONTEXT 600, 653 (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, and Harald Baum eds., 2005) (requiring gatekeepers to perform "reasonable due diligence" on statements received from clients. Coffee proposes minimum liability limits, but not the investor-pays model suggested by this dissertation).

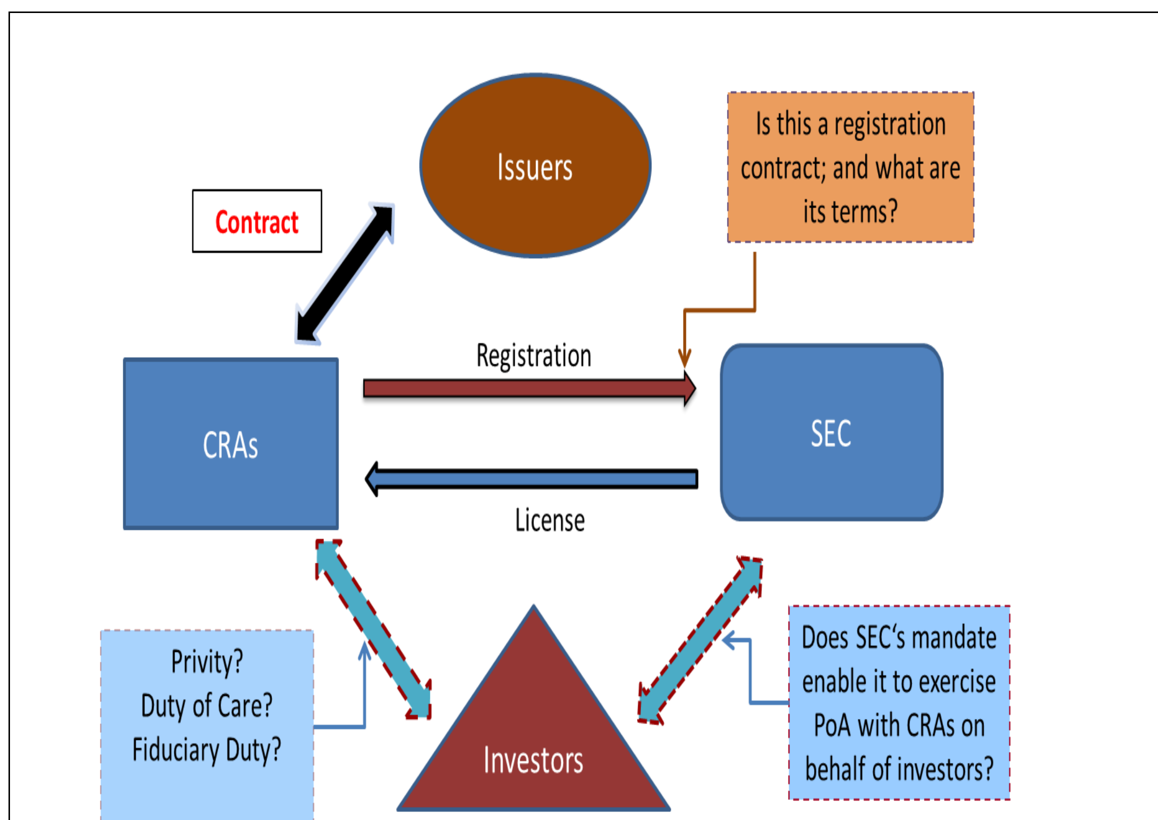
securities was to develop as CRAs would unlikely be compensated for the full value of the financial research information that they would have created.[1073] In particular, the availability to legal recourse for a secondary-market buyer of such a purchase contract in a claim against a CRA, is unclear. In addition, whether a secondary market buyer could convincingly contest for performance as per the original terms agreed between the original purchaser and the CRA is also unclear.

What the model proposed does offer is an approach aimed at bringing the likelihood to sue CRAs for flawed ratings closer than has thus far been possible under the prevailing status quo through; (i) the active participation of ratings reliant investors being brought into effect; and (ii) the agreement of contractual terms between CRAs and ratings reliant investors alongside standards and benchmarks set by the legislators/regulators to ensure enhanced protection of the rights of these investors. In the absence of such proactive engagement by the SEC and other regulators, CRAs may continue to ignore this concern which would result in a continuance of the current legal and economic impasse. And yet, without comprehensive regulatory guidance, CRAs may each ascribe to vastly different and ultimately inconsistent standards, thereby complicating the supervision of their industry and further promoting the unwelcome disparities observed across court judgements.[1074]

[1073] John C. Coffee Jr., *Ratings Reform: The Good, The Bad, and the Ugly*, 31 (ECGI Working Paper Series in Law, Working Paper No.162, 2010).

[1074] JOHN C. COFFEE, JR. *GATEKEEPER FAILURE AND REFORM: THE CHALLENGE OF FASHIONING RELEVANT REFORMS, in* CORPORATE GOVERNANCE IN CONTEXT 600, 657 (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, and Harald Baum eds., 2005).

Figure 14: Contract vs. Duty model



7.3. Summing up

In the literature, two interpretations of causation are observed. Often the two interpretations are used inter-changeably which further obscures discussions on the subject. The first instance of causation occurs as an actual reliance trigger,[1075] which is typically demonstrated by an influential trigger upon which a plaintiff bases their

[1075] *See e.g.,* Brigitte Haar, *Civil Liability of Credit Rating Agencies,*6 (Research Paper Series No.2013-0, 2013).

investment decision; termed "transaction causation" by Talley (2006).[1076] The second instance of causation occurs as a process causation trigger, wherein the plaintiff alleges that actionable damages suffered were a direct consequence of either gross negligence by a CRA when issuing the rating (i.e. methodology error), inadequate monitoring once the rating was issued (i.e. monitoring error), or due to fraud. Although broadly similar, the two instances present very distinct challenges of proof for plaintiffs; transaction causation requires plaintiffs to identify themselves and also to demonstrate their reliance on the credit rating for their investment decision; whereas the process causation trigger requires the plaintiff to demonstrate that the rating that he relied on was flawed in some reasonably provable manner. SEC Rule 9(b)'s requirement that common law fraud claims must be "state[d] with particularity"[1077], has thus far proved to be a difficult standard to meet for plaintiffs in lawsuits brought against CRAs. This has resulted in practically all of the cases either being dismissed or settled out of court. Furthermore, the Second Circuit court in *Merrill Lynch & Co. Inc. v Allegheny Energy Inc.,* (2007) held that in order to establish causation when alleging reliance, a plaintiff must show that: "…its reliance on the alleged misrepresentations was not so utterly unreasonable, foolish or knowingly blind as to compel the conclusion that whatever injury it suffered was its own responsibility".[1078]

[1076] Eric L. Talley, *Panel Two: Sarbanes-Oxley Accounting Issues,* 106 COLUM. L. REV., (7) 1641, 1652 (2006).

[1077] Fed. R. Civ. P. 9(b). See also, *Anschutz Corp. v. Merrill Lynch & Co.,* 690 F.3d 98, 108 (2d Cir. 2012) ("To satisfy this requirement the plaintiff must (1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent".)

[1078] *Merrill Lynch & Co. Inc. v. Allegheny Energy, Inc.,* No. 055129cv, 2007, U.S. App. LEXIS 20928 (2d Cir. Aug. 31, 2007), citing W. Page Keeton et al., Prosser & Keeton on the Law of Torts § 108, at 750 (5th ed.1984). *See also, Abu Dhabi Comm., Bank v Morgan Stanley & Co.,* 651 F.Supp.2d 155 (2009) 651 F.Supp.2d 172), n.87.

While it is reasonable to accept that CRAs, issuers and investors would all be best served with consistently reliable and accurate ratings, the economic advantages to be gained by either stakeholder from under or over-estimated ratings, as well as the economic cost of either too frequently adjusted ratings (e.g. resulting in churning of investment portfolios) or higher rating fees resulting in a lower volume of ratings issued as a direct consequence of introducing an expert liability regime for NRSROs make it an extremely challenging proposition to execute in practice. Although the proposed co-pay option can only address some of the aforementioned challenges, it does still suggest an approach that uniquely contractually advances the position of investors, in particular those of institutional investors, as they are more likely to have the requisite resources to best meet the standards for pleading with particularity demanded by the courts when suing CRAs for flawed rating or poor-quality ratings performance.

By capping the minimum terms of the purchase agreements on one hand, and capping the maximum penalties chargeable for liability infringements resulting from fraud or gross negligence on the other,[1079] the increased level of disclosure and improved accuracy (in certain respects) in terms of quantifying the potential economic exposure risk ought to suffice as trigger, if not as a mechanism, for pushing CRAs towards not only accepting, but potentially embracing, operating under an expert liability regime. It seems reasonable that the ability for CRAs to be in a position to quantify the engagement risk with some level of certainty about their economic exposure would encourage the issuing of substantiated and well-founded credit ratings. In addition, it would open up avenues for CRAs to purchase insurance to cover this risk exposure from insurers. In this regard, the infringements and penalties stipulated in Article 35a of the European Parliament's (EC)

[1079] *See e.g.,* Brigitte Haar, *Civil Liability of Credit Rating Agencies,* 17-19 (Research Paper Series No.2013-0, 2013). *See also,* Jeffrey D. Manns, 87 N.C.L. REV. 1011, 1076 (2009)(earnings based cap on liability); and Point (24), *available at* http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2013-12#BKMD-7 (last accessed May 5, 2016), on fraud and negligence.

Regulation Amendment Proposal provide a reasoned and workable model that merits further consideration in the US and other jurisdictions.[1080]

[1080] *See e.g.,* Art.35 and 36 of EU Parliament Amendment Proposal to Regulation (EC) 1060/2009 on infringements and penalties.

Chapter 8 Conclusions and policy implications

"There are things known and there are things unknown, and in between are the doors of perception." – Aldous Huxley

8.1. Conclusion

In the aftermath of the 2007 crisis, US and EU legislators acquiesced to public demands for greater accountability wherein the introduction of expert liability for NRSROs featured predominantly in discussions. The DFA's rescission of the Rule 436(g) expert liability exemption under which NRSROs had thereto enjoyed immunity from liability created a real and current economic problem for the market, the culmination of which was epitomised by the overnight freeze of the ABS market. 2015 was the fifth anniversary of the Non-Action Letter which was initially issued by the SEC as a stop-gap alternative meant to unfreeze the ABS market on June 22nd, 2010 until a solution could be reached. The temporary suspension of the rescission provision facilitated by §939 of the DFA, much like a détente between warring nations, should not continue to be regarded as a long-term solution to the problem, in particular when viable and testable alternatives are available.

Several options have been put forward thus far, including attempts to simply revoke the rescission of Rule 436(g). This option has been promoted in several draft versions of congressional bills (e.g. H.R. 87, the Financial Takeover Repeal Act of 2011 and H.R. 1539, Asset-Backed Market Stabilization Act of 2011) proposed by the US Congress. Likewise, similar efforts have been made to rescind the DFA, completely, or in part.[1081]

In the absence of viable legal and/or economic solutions - as evidenced by the continued reliance on the SEC Non-Action letter waiver - to circumnavigate the market

[1081] *See*, footnote 733 above, on examples of legislative attempts to repeal DFA.

failure, this dissertation posited a legal solution that attempts to also address the main economic concerns that have been raised. It achieves this by narrowing the legal and economic trepidations that currently exist between CRAs, issuers and private investors.

Whereas US courts, relying predominantly on tort law to decide lawsuits, have in recent court decisions generally ruled that while the role of CRAs will not be recognized as being on par with underwriters (i.e. as "aiders and abettors") on one hand, the courts have also increasingly denied CRAs the recourse to the First Amendment defence, on the other. This development has, as a result, left CRAs defined as lying somewhere in between the two extremes; a hybrid creation between independent market-participants and quasi-governmental system supervisors. This creation has now been encapsulated and defined by recognition under the term "gatekeeper".[1082] And yet, while this compromise may suffice for most of the ratings issued by CRAs, it particularly failed to address the unique challenges presented when rating structured products. The gatekeeper compromise has also left considerable ambiguity regarding the role and responsibilities of CRAs in general.[1083] This dissertation argues that the concept of CRAs as gatekeepers remains ambiguous and a direct consequence of this ambiguity is that it has served to perpetuate the legal fiction of gatekeepers. Furthermore, such acceptance has in turn hampered the ability of regulators, particularly in the US, to effectively provide investment protection to investors that are reliant on credit ratings through the introducing of a robust liability regime.

Despite being increasingly ubiquitous and highly profitable, structured products raise particular concerns. These concerns stem from the nature of the iteration process between CRAs and issuers through which credit ratings for structured products are developed and issued. Critics of this process have for a long time rather convincingly

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[1082] John C. Coffee, *Gatekeeper Failure and Reform,* 84 B.U. L. REV. 301, n.1 (2004) (crediting R. Gilson and R. Kraakman's article, *The Mechanisms of Market Efficiency,* 70 VA . L. REV 549, 612 (1984) for being the first to systematically ascribe the term "gatekeeper" when discussing the role of investment bankers).

[1083] Refer, discussion on the gatekeeper status in section 3.3.3., above.

argued that this iterative process adversely blurs the lines vis-à-vis the role and responsibilities of CRAs. Consequently, it raises both questions and concerns on the reliability and professed independence of CRAs.

The Dodd-Frank Act enacted in June 2010 formally recognized CRAs as gatekeepers in the US thereby elevating them to an exclusive peer group that includes auditors, sell-side securities analysts and lawyers. And yet, despite the common grouping, there is substantial evidence in the literature which compellingly affirms that CRAs are by their very nature and function so distinct from their "peers" that a direct comparison or common approach is neither effective nor reasonable.[1084]

Moreover, an acknowledged expectation gap remains between some counterparties and CRAs, regarding what the latter are either required or realistically capable of delivering, beyond a reasoned and substantiated opinion of the credit risk associated with a given security or institution. What is not in dispute, however, is a) the continued reliance by most market participants, regulators, intermediaries, issuers and private and institutional investors, on NRSRO ratings, and b) the absence of a viable alternative to NRSRO ratings to provide credit risk evaluations or to determine the creditworthiness of securities necessary for guiding the investment decisions of money market funds and other investors.

This dissertation has sought to answer two key research questions, namely: i) Is liability an appropriate tool to compliment the regulatory re-design of the CRA sector?; and ii) Can we optimize "liability" to improve the quality and credibility of CRA ratings? To this end, the dissertation shed light on the factors driving and sustaining the current impasse by highlighting the origins of the Big Three, the role and impact of the NRSRO status designation, and the criticisms levelled against the CRA industry such as the lack of competition as well as the conflict of interest inherent in the gatekeeping role itself. The 2007 global financial crisis provided ample evidence of the limitations of reputational risk

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[1084] *See e.g.,* Frank Partnoy,'*Not Like Other Gatekeepers',* (2006); and section 5.3 on CRA comparables.

as a latent but yet present safeguard mechanism for reigning in the actions and behaviour of CRAs. The ABS market freeze, pursuant to the enactment of DFA in June 2010, provided an undeniably unequivocal demonstration of the real and current economic ramifications of introducing a strict liability or an uncapped liability regime.

Earlier responses from the auditing and banking industries when faced with similar changes concerning a heightened liability regime, as was the case post-SOX, provide convincing anecdotal evidence of the potential drawbacks for proponents of such an approach. Driven mainly by their need to mitigate engagement risk exposure, such drawbacks would likely include an increase in rating fees[1085] which would in turn deny some issuers access to a last-resort source of capital for their enterprises. As CRAs seek to create limit engagement risk exposures they face several challenges. One of these challenges arises from the perceived depreciation in ratings quality that occurs as a consequence of an increase in significantly less risk-averse fly-by-night CRAs. Such CRAs may be more prepared to either liquidate when faced with an adverse judicial determination or to declare bankruptcy when facing a potentially expensive lawsuit. Another challenge may be due to the threat of a wholesale withdrawal from issuing public ratings by established CRAs, such as NRSROs, which may opt to provide ratings privately to a select clientele instead of providing them to the general public in response to their perceived engagement risk exposure.[1086]

The aforementioned challenges notwithstanding, this dissertation has sought to demonstrate that enforcing a liability regime would motivate much needed improvements to the status quo by forcing CRAs to adopt stricter due diligence standards and encouraging them to exercise and demonstrate greater discernment when either issuing or

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[1085] *Contrast,* JOHN C., COFFEE, JR. *GATEKEEPER FAILURE AND REFORM: THE CHALLENGE OF FASHIONING RELEVANT REFORMS, in* CORPORATE GOVERNANCE IN CONTEXT 600, 646 (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, and Harald Baum eds., 2005) (fraudulent issuers will be deterred from seeking a rating when the [rating] fees are very high).

[1086] *Id.,* JOHN C. COFFEE, JR. *GATEKEEPER FAILURE AND REFORM* 600, 647 (2004).

revising ratings. While such an approach may well lead to a drastic fall in the number of securities and entities that are rated AAA or even investment grade, a model that encourages the issuance of more conservative ratings and greater diligence regarding post-issue performance monitoring of securities will surely be a positive development. With the 2007 global financial crisis now in hindsight, it seems fair to say that, as far as AAA rated securities are concerned, more conservative ratings would be considered a more preferable development by a large majority of market participants.

The extensive body of judicial evidence and literature reviewed, analysed and presented in this work has clearly demonstrated that the demands of proving reliance and causality, more so with particularity, has proved spectacularly difficult for plaintiffs to meet. This has in turn resulted in nearly all of the lawsuits that have been brought against CRAs ending either in dismissals or settlements. Even the Federal Court of Australia's decision in *Bathurst*, although initially considered a major breach of the CRA's liability defence and a touchstone for future lawsuits, appears to this author to express an inimitable constitution of key factors that may prove difficult to replicate in other lawsuits and in jurisdictions as was discussed above, in section 6.3.1. above.

Having framed and addressed the "why" (i.e. infringements), and "to whom" (i.e. issuers, regulators, investors) questions, the "what", or more specifically, the "how much" aspect of the civil liability debate, was also addressed. This dissertation hypothesizes that the uncertainty surrounding exposure to costly lawsuits, particularly to class lawsuits in the US, is a key motivating factor in the decision taken by NRSROs thus far to resist the publication of their ratings under a liability regime. The European Parliament's deferment to the national courts of the respective EU member states as the competent authorities to address any civil lawsuits that may arise further, opens the door to divergent court rulings not dissimilar to the rather varied outcomes that have been witnessed in the US state court system. Similarly, the potential for such disparity across judgements has fuelled calls in the US by proponents who favour the introduction of a US federal law that would then coax state courts towards producing similar outcomes in lawsuits involving CRA ratings.

In the EU, the European Parliament's amendment proposal to Regulation (EC) No.1060/2009 provides such a workable framework in that, except for instances of gross negligence or fraud, CRAs can be found liable for a list of specific infringements under Article 35a[1087] because the penalty range for each infringement is not only provided ex ante, but is most importantly, capped. Such a heightened level of transparency should allow CRAs to calculate their potential engagement risk and, if conditions permit, purchase insurance on the market against such risk.

Ergo, the EU Parliament's proposed liability caps for stipulated infringements goes a long way towards mitigating engagement risk concerns as well as assuaging the CRA's fear of terminal risk exposure. Subsequently, once quantified, CRAs may decide to hold the resulting engagement risk on their own books, purchase insurance on the market, or even opt for some combination of the two.

Subsequent to the reversal of the initial draft requirement, a key area of concern in the current version of the European Parliament's proposal that is still to be addressed concerns the stipulation that the onus for proving the infringements lies with the plaintiffs as opposed to requiring the defendant to prove that his actions did not breach the infringement guidelines.[1088] As it currently stands, the role of establishing the existence of an infringement and its impact on rating outcome is shared between CRAs and investors but the onus of proving the existence of damage and the causality of the infringement for the damage in the current version of the regulation proposal, now rests solely on the investors.

To this end a co-pay model applied to the rating of structured products would not only bring greater clarity and simplicity to the claimant identification process, but it would also negate the need for plaintiffs to first prove reliance and "first-instance causation".

[1087] See, EU-Parliament, *'European Parliament legislative resolution of 16 January 2013'*, TITLE III, Civil Liability of Credit Rating Agencies Article 35a, Civil liability, Jan. 16, 2013.

[1088] *See,* European Parliament legislative resolution of 16 January 2013(EC) No 1060/2009 on credit rating agencies (COM(2011)0747 – C7-0420/2011 – 2011/0361(COD).

Moreover, the inclusion of minimum terms, standards and benchmarks stipulated by regulators as well as specific performance standards contracted for between investors and CRAs, would reinforce any "second-instance causation" claims in a lawsuit against the latter.[1089]

In conclusion, this dissertation finds convincing evidence to support proponents who favour a liability regime as an appropriate tool around which to establish CRA industry reforms. It also recognizes that in order to optimize the liability regime, it is necessary to introduce a collar approach in the solution wherein liability limits provide upper limit exposure caps on one end, while mandatory regulatory minimum terms and standards cap the disclosure and performance requirements placed on CRAs in particular at the other end. Only through the adoption of such a multi-faceted approach can the necessary balance between the conflicting incentive and constraint forces driving multi-task agents such as gatekeepers in general, but NRSROs in particular, be achieved.

8.2. Implications of the impasse

In recognizing the need to develop a model capable of i) attaining an appropriate balance between the immunity from liability provided under Rule 436(g)) and a strict legal liability doctrine ii) providing substantive incentives that adequately encourage CRAs to apply a higher level of discernment when both issuing and monitoring ratings, iii) while also avoiding chilling the participation of CRAs in the public ratings process, this dissertation proposes that a co-pay alternative should be implemented in tandem with the capping of liability for prescribed infringements. Although the argument favouring capping or providing a ceiling to CRA liability has been made previously by other commentators,[1090] this dissertation's proposal to couple such liability capping with a co-

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[1089] Refer, Chapter 7 above on Causation under US and EU law.

[1090] *See e.g.,* JOHN C. COFFEE, JR. *GATEKEEPER FAILURE AND REFORM: THE CHALLENGE OF FASHIONING RELEVANT REFORMS, in* CORPORATE GOVERNANCE IN CONTEXT 600, 661 (Klaus J. Hopt, Eddy Wymeersch,

pay system, breaks new ground towards enhancing investor protection by improving their ability to successfully bring lawsuits when CRA ratings fail to meet the agreed terms of quality performance, by rendering the issuer-pays vs. investor-pays debate mute.

While it is admittedly still too early to speculate on whether the capped liability limits proposed by the European Parliament – if and when adopted - will be sufficiently successful in incentivising the desired behavioural changes on the part of CRAs, a platform has now been laid upon which subsequent scientific evidence can be extracted and the liability limits adjusted accordingly as the evidence dictates. Recent judicial developments have significantly advanced the ability of investors to successfully sue CRAs. These developments can form the basis upon which a benchmark or proxy tool for measuring and contrasting the performance of the US approach towards enhancing CRA liability and accountability to that adopted by the EU member states and other jurisdictions, can be created. In particular, in the aftermath of the settlements reached in the high-profile *Abu Dhabi* and *King County* and the *US v McGraw-Hill Cos., Inc.*, lawsuits, the planned appeal to the *Bathurst* decision will be greatly indicative of the extent and the scenarios under which courts will be prepared to rule in recognition of a liability regime for CRAs going forward.[1091]

In spite of the challenges and limits that the co-pay model approach proposed in this dissertation can reasonably be expected to face, this author strongly believes that it still presents a decidedly more pragmatic legal and economic solution for addressing the market failure currently evident in the CRA industry than the alternatives. The proposed changes, if first adopted in the structured products space, can expedite the greater acceptance of a limited liability regime and this would in all likelihood incentivise the issuance of more conservative ratings by CRAs going forward. Alternatively, it could also motivate their refusal to provide ratings for securities, especially for those which the rating

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Hideki Kanda, and Harald Baum eds., 2005) (recommending adoption of strict liability, but with caps or ceilings on liability set at levels to deter gatekeeper misconduct).

[1091] *Credit Rating Agencies Settle 2 Suits Brought by Investors*, REUTERS, April 27, 2013.

analysts find too complex to rate. Either way, such an outcome can only be regarded as an improvement to the current legal and economic impasse that prevails in the US legal system, almost five years after the DFA was enacted on July 21, 2010.

APPENDIX

1. SEC's NRSRO designation assessment criteria

The staff also reviews the operational capability and reliability of each rating organization. Included within this assessment are:

(1) the organizational structure of the rating organization;

(2) the rating organization's financial resources to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates;

(3) the size and quality of the rating organization's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit);

(4) the rating organization's independence from the companies it rates;

(5) the rating organization's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and

(6) whether the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed. The staff also recommends that the agency become registered as an investment adviser.

2. SEC's 3 rule-making steps

Step 1: Concept Release describes the interest area and highlights the Commission's concerns and proposal of different approaches to addressing a problem. Typically provides questions to the public for their input which the Commission take into account. Step 2: Rule Proposal advances "specific objectives and methods for achieving them" between 30 and 60 days for review and comment. Step 3: Rule Adoption occurs by a vote of the full Commission and thus becomes an official rule for the securities industry.

3. Moody's, S&P and Fitch Ratings' definitions

Fitch's definition of a credit rating states that:

- Credit ratings provide an opinion on the relative ability of an entity to meet its financial commitments, such as interest, preferred dividends, and repayment of principal

- Credit ratings are used as indications of the likelihood of receiving the money back in accordance with the terms invested

- Credit ratings express risk in relative rank order, they are ordinal measures of credit risk and are not predictive of a specific frequency of default or loss

Fitch literature also categorically states that credit ratings do not do the following:

- Address any risk other than credit risk

- Forecast absolute probabilities of default

- Deal with the risk of a market value loss on a rated security due to changes in interest rates, liquidity and other considerations (correct tabbing)

Moody's credit rating definition:

Moody's definition reiterates that "the purpose of Moody's ratings is to provide investors with a simple system of gradation by which future relative creditworthiness of securities may be gauged".

Under the sub-heading "Limitations to Uses of Ratings*"[1092], Moody's include the following text excerpts:

"As ratings are designed exclusively for the purpose of grading obligations according to their credit quality, they should not be used alone as a basis for investment

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[1092] *Moody's Investors Services Inc. website, available at* http://www.moodys.com/Pages/atc001.aspx (last accessed Nov. 9, 2011).

operations. For example, they have no value in forecasting the direction of future trends of market price. Market price movements in bonds are influenced not only by the credit quality of individual issues but also by changes in money rates and general economic trends, as well as by the length of maturity, etc. During its life even the highest rated bond may have wide price movements, while its high rating status remains unchanged".

Regarding the forward-looking nature of credit ratings, Moody's also highlights the limitations of ensuring prognostic accuracy noting that:

"[S]ince ratings involve judgements about the future, on the one hand, and since they are used by investors as a means of protection, on the other, the effort is made when assigning ratings to look at "worst" possibilities in the "visible" future, rather than solely at the past record and the status of the present… Moody's ratings represent the opinion of Moody's Investors Service as to the relative creditworthiness of securities".

In reference to the above asterisk at footnote 1092, Moody's italicize the following text:

*As set forth more fully on the copyright, credit ratings are, and must be construed solely as, *statements of opinion and not statements of fact* or recommendations to purchase, sell or hold any securities. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor, and each provider of credit support for, each security that it may consider purchasing, selling or holding.

Standard & Poor's credit rating definition:

According to Standard & Poor's, the (four)[1093] key things you should know about credit ratings are that:"

▪ Credit ratings are opinions about relative credit risk.

▪ Credit ratings are not investment advice, or buy, hold, or sell recommendations. They are just one factor which investors may consider in making investment decisions.

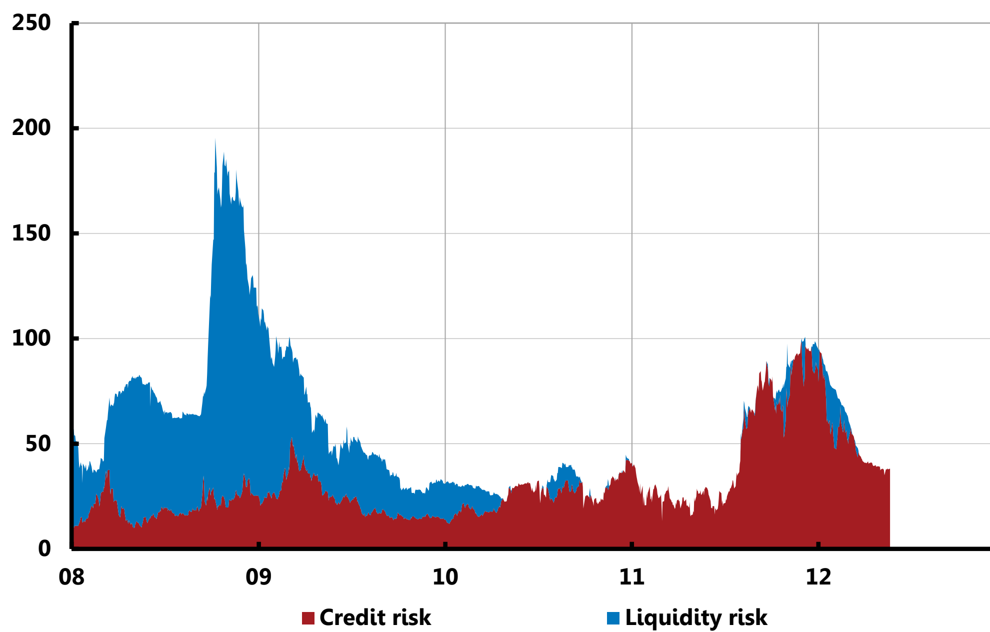
▪ Credit ratings are not indications of the market liquidity of a debt security or its price in the secondary market. See Figure 4, below.

▪ Credit ratings are not guarantees of credit quality or of future credit risk.

Ratings should not be viewed as assurances of credit quality or exact measures of the likelihood of default".

[1093] Visitors to the S&P homepage requiring more information about Credit Ratings are directed in S&P's Guide to Credit Rating Essentials – What Are Credit Ratings and How do They Work? Handbook not clear to visit two further websites, www.AboutCreditRatings.com and www.UnderstandingRatings.com

4. Indicative breakdown of the three-month risk premium in the euro area price



Source: Sveriges Riksbank, Financial Stability 2012 Report, Chart 2:16, slide 45,

available at *http://www.riksbank.se/en/Press-and-published/Reports/Financial-Stability-Report/*

(last accessed Nov. 12, 2015).

5. Share price development of Moody's, McGraw-Hill Group

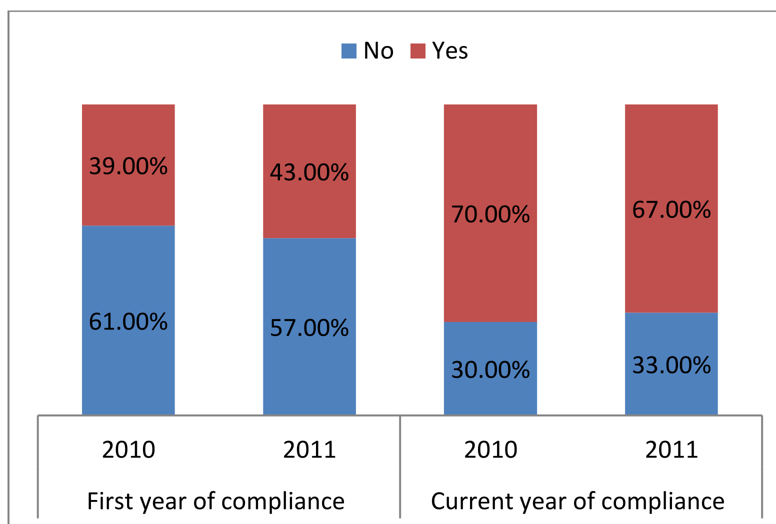
Source: Yahoo.Finance.com, showing McGraw-Hill Financial – MHFI (Sky blue (bold)); Moody's Corp. – MCO (Pink (bold)); JP Morgan, Inc. – JPM (Purple); Bank of America (Green); S&P 500 – (Brown (bold))

6. Registered NRSROs and their registration dates

- A.M. Best Company, Inc. (Sept. 24, 2007)
- DBRS Ltd. (Sept. 24, 2007)
- Fitch, Inc. (Sept.24, 2007)
- Japan Credit Rating Agency, Ltd. (Sept. 24, 2007)
- Moody's Investor Services, Inc. (Sept.24, 2007)
- Rating & Invest. Info., Inc. (Sept. 24, 2007; de-registered on Oct. 14, 2011); replaced by HR Ratings de México, S.A. de C.V. (Nov. 5, 2012)
- Standard & Poor's Rating Services (Sept. 24, 2007)
- Egan-Jones Rating Company (Dec. 21, 2007)
- LACE Financial Corp. (Feb. 11, 2008)
- Realpoint LLC (June 23, 2008)

Source: http://www.sec.gov/ocr

7. Do the benefits of SOX compliance outweigh the costs?



Source: Protiviti, 2011 Sarbanes-Oxley Compliance Survey, at 11.

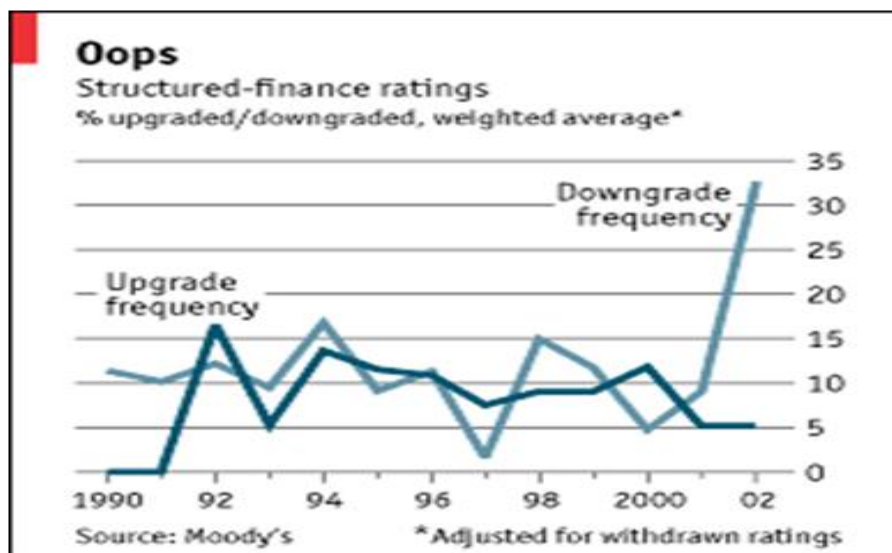
8. Stakeholder Ratings' Preferences

Player	Tenor on Ratings	Rating level	Timeliness	
			Upgrades	Downgrades
State	conservative	low	ambivalent	
Issuer	progressive	high	quick	slow
Investor – confined by regulatory restrictions	progressive	high	quick	slow
Investor – not subject to regulatory restrictions	conservative	low	quick	quick

Figure 6.5: Demands on ratings

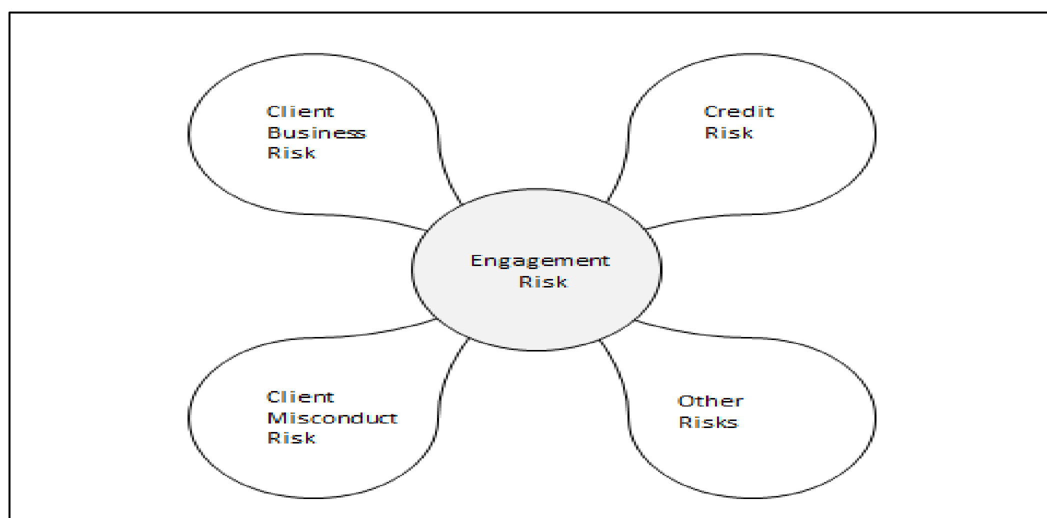
Source: Fabian Dittrich, *The Credit Rating Industry: Competition and Regulation*, Note (2007) at 147.

9. Structured Finance downgrades



Source:"Exclusion Zone: Regulators promise a Belated Review of Ratings Oligopoly", The Economist, at 65, Feb. 8, 2003 *available at* http://www.economist.com/node/1564776 (last visited Aug. 3, 2013).line up

10. Engagement Risk



Source: Adapted from Finney (Kinney, William R., Jr. 2000, Information Quality Assurance and Internal Control for Management Decision Making. Boston: Irwin McGraw-Hill): Audit Firm Business Risk and Engagement Risk, ("unknowingly certifying materially misstated financial reports / unknowingly issuing materially flawed ratings); Client Business Risk (future decline in client performance); Client Misconduct Risk (management fraud, illegal or unethical activities, and non-compliance)) from (Fuchita, Yasuyuki; Litan, Robert E., (eds) 2006), Financial Gatekeepers: Can They Protect Investors? at 111.

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Anschutz Corp. v. Merrill Lynch & Co., 690 F.3d 98, 108 (2d Cir. 2012)
Anschutz Corp. v. Merrill Lynch & Co., Inc., Case No. 1:2009cv09888 (S.D.N.Y. Dec. 2, 2009)
Anschutz Corp. v. Merrill Lynch and Co. 785 F.Supp.2d 799, 831 (N.D. Calif. 2011)
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Assured Guaranty (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc., No. 603755/08, 2010 N.Y. Slip Op. 8644 (N.Y. App. Div. First Dept. Nov. 23, 2010)
Baker v. Goldman Sachs & Co., 669 F.3d 105, 108, 112 (2d Cir., 2012)
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Basic Inc. v. Levinson, 485 U. S. 224, 243 (1988)
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Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570 (2007)
Bellios v. Victor Balata Belting Co., 724. F.Supp. 514, 519 (S.D. Ohio 1989)
Bigelow v. Virginia, 421 U.S. 809, 822-25 (1975)
Boca Raton Firefighters & Police Pension Fund v. Bahash , Case No. 12-cv 1776, 2nd Cir. (2012)
Boca Raton Firefighters & Police Pension Fund v. Bahash, et al., Case number 12-cv-1776, U.S. Court of Appeals 2nd Cir.(2012)
Branzburg v. Hayes, 408 U.S. 665, 691 (1972)
Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1282-83 (11th Cir. 1999)
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Am. J. Comp. L	American Journal of Comparative Law
B.U.L. Rev.	Boston University Law Review
Boston U. L. Rev.	Boston University Law Review repetition
Bus. L. Today	Business Law Today
Bus. Law	The Business Lawyer
Cardozo L. Rev.	Cardozo Law Review
Case W. Res. L. Rev	Case Western Reserve Law Review
CFA Inst. Conf. Proc. Q.	CFA Institute Conference Proceedings Quarterly
Colum. Bus. L. Rev	Columbia Business Law Review
Colum. L. Rev.	Columbia Law Review
Colum. Law Sch. Magazine	Columbia Law School Magazine
Comm. Law and Policy	Communication Law and Policy
Conn. L. Rev	Connecticut Law Review
Contemp. Acct. Res	Journal of Contemporary Accounting Research
Cornell L. Rev	Cornell Law Review
Crisis Response	Crisis Response
E.C.J.L.	Electronic Journal of Comparative Law
ECGI	European Corporate Governance Institute
Economica	Economica (Journal)
Entrepreneurial Bus. L.J.	Entrepreneurial Business Law Journal
European Co. & Fin. L. Rev.	European Company and Financial Law Review
Fed. Res. B.N.Y. Q. Rev	Federal Reserve Bank of New York Quarterly Review
Fin. Analysts J	Financial Analysts Journal
Fin. Markets, Institutions & Instruments	Financial Markets, Institutions & Instruments Journal
Fordham L. Rev	Fordham Law Review

Governance: Int’l J. Pol’y, Admin., & Inst’	Governance: An International Journal of Policy, Administration and Institutions
Hastings Bus. L. J	Hastings Business Law Journal
Hous. L. Rev.	Houston Law Review
Insurance J.	Insurance Journal
Internet Econ.	Journal of Internet Economics
Iowa L. Rev	Iowa Law Review
J. Acct. & Econ.	Journal of Accounting and Economics
J. Acct. Res.	Journal of Accounting Research
J. Bus. & Tech. L.	Journal of Business & Technology Law
J. Consumer Pol'y	Journal of Consumer Policy
J. Corp. Ownership & Control	Journal of Corporate Ownership and Control
J. Econ. Pers.	Journal of Economic Perspectives
J. Fin.	Journal of Finance
J. Fin. Econ.	Journal of Financial Economics
J. Fin., Am. Fin. Assoc.	Journal of Finance (The American Finance Association)
J. Inst. & Theoretical Econ.	The Journal of Institutional and Theoretical Economics
J. Int’l Banking Law and Reg.,	Journal of International Banking Law and Regulation
J. Law and Econ	Journal of Law and Economics
J. Law, Econ. & Org	Journal of Law, Economics, & Organization
J. Legal Stud	Journal of Legal Studies
J. Legis. & Pub. Policy	Journal of Legislation and Public Policy
J. Monetary Econ	Journal of Monetary Economics
J. Pol. Econ	Journal of Political Economy
J. Structured. Fin.	Journal of Structured Finance
Loyola L.A. L. Rev.	Loyola of Los Angeles Law Review
Marquette L. Rev.,	Marquette Law Review
McGill L. J	McGill Law Journal
Mich L. Rev.	Michigan Law Review

Minn. L. Rev	Minnesota Law Review
Mod. L. Rev.	Modern Law Review
N.C.L. Rev.	North Carolina Law Review
N.Y.L.J.	New York Law Journal
N.Y.U. L. Rev.	New York University Law Review
N.Z. L. Rev.	New Zealand Law Review
Nw. U. L. Rev.	Northwestern University Law Review
Q. J. Econ.	The Quarterly Journal of Economics
Rev. Austrian Econ.	Review of Austrian Economics
Rev. of Fin. Stud	Review of Financial Studies (Oxford Journals)
S. C. J. of International Law & Bus.	South Carolina Journal of International Law & Business
S.Cal. L.Rev.	Southern California Law Review
S.E. Euro. & Black Sea Stud.	Journal of Southeast European and Black Sea Studies
Sec. Reg. & L. Rep.	Securities Regulation and Law Reports
Seton Hall Legis. J	Seton Hall Legislative Journal
Stan. L. Rev	Stanford Law Review
Strategic Mgmt J.	Strategic Management Journal
U. Pa. L.Rev	University of Pennsylvania Law Review
Univ. of Penn. L. Rev.	University of Pennsylvania Law Review
Va. L. Rev.	Virginia Law Review
Va. L. & Bus. Rev	Virginia Law and Business Review
Vt. L. Rev	Vermont Law Review
Wash. & Lee L. Rev.	Washington & Lee Law Review
Wash.U.L.Q. Rev.	Washington University Law Quarterly Review
Yale J. on Reg.	Yale Law Journal on Regulation
Yale J. Reg.	Yale Journal on Regulation
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