A "SARBANES-OXLEY" FOR CREDIT RATING AGENCIES?

A COMPARISON OF THE ROLES AUDITORS' AND CREDIT RATING AGENCIES' CONFLICTS OF INTERESTS PLAYED IN RECENT FINANCIAL CRISES

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INTRODUCTION

Both auditors and credit rating agencies have been linked to financial scandals in recent history. In the early 2000's, several of the "big five" accounting firms issued favorable audit opinions to public companies employing deceptive accounting practices. Some of these companies even committed outright fraud. Once the investing public caught wind of these accounting irregularities, it lost trust in the auditing industry, companies' financial statements, and the financial market as a whole.

Today, we face a new financial crisis and have found a new party to blame. When we discuss the current financial crisis, talk of the credit rating agencies is usually not far behind. These agencies issued notoriously favorable credit ratings to thousands of subprime residential mortgage-based securities and related financial instruments. However, once the housing bubble burst and interest rates rose, these financial instruments proved to be toxic investments. As the credit rating agencies downgraded the instruments, the public lost trust in the credit rating industry, credit ratings, and once again, the financial market as a whole.

At first glance, it appears that similar problems with auditors and credit rating agencies contributed to both financial crises. Foremost, both the auditing and the credit rating industries were premised on independence. However, over time the two industries faced external

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pressures that changed the way they did business. Today, both industries employ the client-pays model, where clients write checks directly to their auditors and credit rating agencies in exchange for evaluations. Additionally, both pre-Sarbanes-Oxley auditors and credit rating agencies market ancillary services to their audit and credit rating clients, respectively. These conditions create the potential for conflicts of interest.

In 2002, Congress passed the Sarbanes-Oxley Act to regulate the auditing industry and, in turn, prevent future accounting scandals and any financial crises which might arise. The Act increased oversight, prohibited auditors from providing most ancillary services to audit clients, and outlawed certain relationships between auditors and their audit clients. For the most part, Sarbanes-Oxley successfully eliminated the conflicts of interest that had plagued the auditing industry and played a large role in the financial crisis at the beginning of the century.

Unlike the auditing industry, the credit rating industry does not need formal governmental regulation to solve the problems it faces. While conflicts of interest were large contributors to the accounting scandals, the same conflicts do not pose large threats to the credit rating agencies. It is true that, at first glance, the credit rating industry might appear to face major conflicts of interest. However, the credit rating agencies have actually maintained their independence. The client-pays model does not tempt credit rating agencies to inflate ratings based on the improper influences of clients. Furthermore, ancillary services are a nonissue because they contribute to an insignificant fraction of the credit rating agencies' total revenue. Finally, credit rating agencies have firewalls and self-regulations in place to prevent any conflicts of interest from negatively impacting the integrity of their rating processes.

Due in large part to the reputational capital model, credit rating agencies have decided to self-regulate, which has proven effective. Consequently, the Securities and Exchange Commission's amendment of the Exchange Act of 1934 to increase formal governmental regulation over the credit rating agencies was unnecessary and possibly harmful. Instead of regulating credit rating agencies, the SEC would do better to more closely regulate the securities that the credit rating agencies rate.

Part II of this comment provides an overview of the current financial crisis. Part III discusses the financial crisis generated by Enron, Arthur Andersen, and other accounting scandals. Part IV of this comment examines how Sarbanes-Oxley changed the auditing industry by increasing oversight and eliminating opportunities for conflicts of interest. Part V compares and contrasts the conflicts of interest in the pre-Sarbanes-Oxley auditing and the credit rating industries. Part VI explains why formal governmental regulation, including the 2008 Amendments to Rule 17g of the Exchange Act, is not only unnecessary, but potentially harmful.

Finally, Part VII draws conclusions from the analysis presented below.

II. The Current Financial Crisis

In 2008, events unfolded which prevented the world from remaining blind to the problems that had been brewing for years. First, the Federal Reserve Bank of New York pulled Bear Stearns back from the brink of bankruptcy by assuming $30 billion in liabilities and arranging a sale to JPMorgan Chase.[1] Next, the Treasury Department took control of Fannie Mae and Freddie Mac after the stock prices of these two government-sponsored enterprises dramatically declined. Soon thereafter, Lehman Brothers declared bankruptcy, Merrill Lynch sold itself to Bank of America, and the federal government bailed out American International Group ("AIG") for $85 billion. At the same time, stock prices plummeted[2] and foreclosure rates soared.[3]

As the world watched the financial crisis unfold during the summer months of 2008, credit rating agencies[4] ("CRAs") became a hot topic of conversation in the media, academia, and politics. Many began to blame the economic downturn on the CRAs, arguing that the CRAs did a horrible job rating a novel financial instrument: subprime residential mortgage-backed securities.[5]

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1. *Credit Crisis – The Essentials*, N.Y. TIMES, Nov. 16, 2008, at C1.

2. *Id.*

3. "Real estate foreclosures in the U.S. were up 81 percent in 2008 and up 225 percent from 2006." *2008 Foreclosure Rates*, CBSNEWS (2008), http://www.cbsnews.com/elements/ 2008/02/12/business/map3823166.shtml.

4. A CRA is a for-profit company that evaluates financial instruments and obligations to determine the likelihood of default on repayment. To accomplish this task, a CRA issues a rating that represents the CRA's current opinion of the creditworthiness of the issuer or the actual financial instrument. These ratings are based on a letter scale. Moody's uses "Aaa" as its highest rating, followed by "Aa," "A," Baa," "Ba," "B," "Caa," and so on. JEROME S. FONS, UNDERSTANDING MOODY'S CORPORATE BOND RATINGS AND RATING PROCESS 7, (Moody's Investors Service, Inc.) (2002). Fitch uses an "AAA" rating for the highest credit quality, followed by "AA," "A," and "BBB," with "D" designating an instrument that has defaulted on its obligations. *Fitch Rating Definitions*, FITCHRATINGS ¶ 3(2009), http://www.fitchratings.com/corporate/fitchResources.cfm?detail=1. Standard & Poor's rating definitions resemble Fitch's definitions. *Insurer Financial Strength Rating Definitions*, STANDARD & POOR'S 1-2 (The McGraw Hill Companies) (2002). Each of the three CRAs then modifies their letter ratings with numbers or plus or minus signs. A CRA determines creditworthiness by considering the cash-flow risk of underlying assets and the creditworthiness of guarantors, insurers, and other forms of credit enhancement of the obligation. *Methodology: The Interaction of Bond Insurance and Credit Ratings*, CRITERIA ARTICLE 2 (Standard & Poor's) (2007), http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/4,5,5,1,1204833924205.html.

5. Securities, in general, are created by first pooling income-producing financial assets together. The cash flows from these pools are then divided into different classes, called

A. Subprime Residential Mortgage-Backed Securities and Their Role in the Current Financial Crisis

Subprime residential mortgage-based securities ("subprime RMBS") are a specific type of mortgaged-backed securities. While mortgage-backed securities and, more specifically, residential mortgage-backed securities ("RMBS"),[6] have been around for decades,[7] subprime RMBS are a recent invention. Subprime RMBS are unique because they are comprised of mortgages that demand very little money upfront, mortgages that require very small interest payments in the first few years, and mortgages that are issued by borrowers who likely would never qualify for home loans under traditional mortgage requirements. Until recently, these types of mortgages had never been issued in mass quantities nor had they been securitized. Consequently, subprime RMBS had been tested neither in a boom nor a bust economy.

In addition to the novelty of the subprime RMBS, the securities industry itself recently began changing. Today, securitization regularly occurs via private companies with "looser practices and little or no government regulation," unlike in the past when government-created companies subject to a high degree of governmental oversight created the securities.[8] Additionally, the securitization of mortgages became more prevalent than ever before. While in 1999 less than twenty percent of all U.S. mortgages were securitized, in 2005 and 2006 the private sector securitized almost two-thirds of all U.S. mortgages.[9] These features of

tranches or tiers. Losses from defaults on the underlying income-producing financial assets are allocated to each tranche strategically in order to create different risk exposure for each tranche. This process yields diverse investments with diverse risk profiles. Losses are first assigned to junior tranches, then mezzanine tranches, and finally to senior tranches as each respective tranche is exhausted. These investments are sold to different investors based on the expected return and risk. John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, The Insufficiency of Reform, and a Proposal for Improvement*, 1 COLUM. BUS. L. REV. 109, 117-18 (2009).

6. The main advantage of mortgage securitization is that the process allows lenders to sell their long-term accounts receivable, thereby increasing liquidity. Lenders can then use this increased liquidity to make more loans to homeowners and the general public.

7. The first residential mortgage-based securities were sold in 1970. *Statement of America's Community Bankers on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Hearing Before the H. Subcomms. on Housing and Community Opportunity and on Financial Institutions and Consumer Credit of the Comm. on Financial Services*, 108th Cong. 1 (2003) (statement of Cameron L. Cowan, Partner, Orrick, Herrington, and Sutcliffe).

8. *Do the SEC's New Rating Agency Rules Have Any Bite?* KNOWLEDGE@WHARTON, Dec. 10, 2008, at 2, *available at* http://knowledge.wharton.upenn.edu/article.cfm?articleid=2112.

9. David Goldstein & Kevin G. Hall, *Private Sector Loans, not Fannie or Freddie, Triggered Crisis*, MCCLATCHY WASHINGTON BUREAU, Oct. 12, 2008, *available at*

subprime RMBS and the securities industry made it difficult not only to predict how these securities would fair in a healthy market, but also to predict how they would react in an economic downturn.[10]

In addition to subprime RMBS's unpredictability, they are difficult to price due to the manner in which they are offered and sold. Subprime RMBS are a type of collateralized debt obligation ("CDO"), meaning that they may be offered and sold under Rule 144A of the Federal Securities Act of 1933.[11] Such instruments escape the strict marketing and sales restrictions of Section 5 of the Securities Act to which typical publicly offered securities are subject.[12] Consequently, the issuers in a Rule 144A offering need not make as much information available to investors or to the SEC. This leaves investors with only two options for valuing the offered CDOs: do their own research or rely on readily available information. Because doing one's own research is costly and time-consuming, it was logical for investors to pursue the latter option with regards to the subprime RMBS and thus rely heavily upon the CRAs' ratings of the subprime RMBS.

However, the CRAs were in a similar position as the investors - they had never seen anything like the subprime RMBS before. The issuers added to this problem by creating even more complex financial instruments out of the subprime RMBS by grouping, dividing, shifting around, and tranching the securities into multi-sector CDOs ("CDOs^2") and other opaque instruments. Nevertheless, seeing the fees they could earn by rating the instruments, the CRAs developed models and issued ratings anyway.

These ratings were generally very favorable, and the innovative financial instruments sold well.[13] Those who purchased the subprime RMBS excitedly held on to these new profit opportunities. Banks relished their newfound ability to move the mortgages off of their balance sheets and increase their liquidity. Bank equity holders marveled at high returns on equity. Homeowners enjoyed their new residences with low mortgage interest rates and the belief that they would realized huge gains upon

http://www.mcclatchydc.com/251/v-print/story/53802.html.

10. *Id.*

11. Hunt, *supra* note 5, at 117-19.

12. A 144A offering memoranda is first prepared without pricing terms. Then the COD's underwriter markets the offering and, once the issuing entity and the underwriter agree on a price, that price is inserted into a final offering memorandum. The underwriter subsequently buys the securities from the issuing entity at a price below that listed on the final offering memorandum. Finally, the underwriter immediately resells the securities at the offering price listed in the final offering memorandum. *Rule 144A Offerings – A Summary*, AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P. (1997), http://library.findlaw.com/1999/Jan/1/129383.pdf.

13. Investors required by law or policy to own only top-rated securities especially found these high ratings attractive. KNOWLEDGE@WHARTON, *supra* note 8, at 2.

subsequent resale. And, like everyone else, the CRAs profited from these marvelous new financial instruments as they pocketed the fees for their ratings.

B. The Housing Bubble and its Part in the Current Financial Crisis

For a while, everything seemed peachy. Everyone who was remotely involved with the subprime RMBS appeared to be striking gold. But these financial dealings did not exist in a vacuum. The subprime RMBS could only continue their success so long as the housing market remained strong, and by 2008, the housing bubble was set to burst.

The housing bubble began inflating in the beginning of this millennium. One factor that pumped up the bubble was the low interest rates that remained even after the dot-com crash of 2000 seemed like a distant memory.[14] These low interest rates contributed to high liquidity and increased borrowing. Also thanks to the dot-com crash, Americans began to view residential real estate as the wisest investment they could make.[15] Presidents George H.W. Bush[16] and Bill Clinton[17] enforced this belief by emphasizing the role which homeownership played in the "American Dream."

In addition to the low interest rates and the appeal of homeownership, a new form of borrowing—the subprime mortgage—fueled the increasing demand for houses.[18] This elevated demand for

14. After the dot-com crash and the 2001–2003 recession, the Federal Reserve lowered short-term interest rates from approximately 6.5% to 1%. Mortgage interest rates also dropped. Vasso P. Ioannidou et al., *The Impact of Short-Term Interest Rates on Risk-Taking: Hard Evidence*, VOX, Oct. 17, 2007, http://www.voxeu.org/index.php?q=node/641.

15. Buying into the housing market appeared to be a safer investment than buying into the stock market because average national home prices had not dropped between the end of the Great Depression and the recent housing bubble burst. Beth Belton, *Housing Bubble – or Bunk?*, BUSINESSWEEK, June 22, 2005, *available at* http://www.businessweek.com/bwdaily/dnflash/jun2005/nf20050622_9404_db008.htm. The image of real estate being a safe bet was magnified in 2000 when the dot-com bubble burst and the NASDAQ dropped dramatically.

16. President George H.W. Bush, Remarks on Arrival in Appleton, Wisconsin (July 27, 1992) ("Part of the American dream is owning your own home"), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=21270.

17. Bill Clinton commented that homeownership is "an essential part of the American dream we're working hard to restore." President William J. Clinton, (radio broadcast Feb. 27, 1993), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=46253.

18. A subprime mortgage is "a type of loan granted to individuals with poor credit histories (often below 600), who, as a result of their deficient credit ratings, would not be able to qualify for conventional mortgages." *What is a Subprime Mortgage?*, 2009, INVESTOPEDIA, http://www.investopedia.com/ask/answers/07/subprime-mortgage.asp. Subprime mortgages often involve "teaser rates," or low up-front interest rates that later

houses both truly and artificially, raised home prices; over fewer than ten years, the price of the average American home increased by more than 45 percent.[19] The supply chain reacted to the booming demand and big price tags by building more homes. And as the supply of houses increased, builders made homes grander, and subsequently more expensive, in order to differentiate their products. Thus, home prices continued to soar.

During the same period, the Federal Reserve began raising interest rates. After a dozen adjustments, the Fed stopped at 5.25% in August 2006.[20] The higher interest rate decreased the supply of money and made borrowing less attractive. The Fed was not the only one to raise interest rates; subprime mortgages with low teaser rates began to show their true colors by charging homeowners higher rates.

With the supply of houses, the cost of houses, the cost of borrowing, and the required payments on subprime mortgages all rising concurrently, the housing bubble was set to burst. It was not long before more and more homeowners found themselves in over their heads. Bankruptcy offered no help,[21] and the securitized subprime mortgages were almost impossible to renegotiate.[22] Consequently, homeowners who were unable to make their monthly payments began defaulting on their mortgages, driving up foreclosure rates across America.[23]

The spike in foreclosures had two direct effects. First, it increased the supply of houses on the market. Second, homeowners and investors lost confidence in the housing market. As a result, the demand for houses began to fall. This, in turn, caused prices to decline. The decline in prices snowballed because a home foreclosure lowers the value of the other houses in close proximity to a foreclosed property. Thus, between 2006 and 2007, the median value of a new home fell from $247,000 to $231,000.[24] By December 2008, the median value dropped to $175,400.[25]

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increase.

19. After adjusting for inflation. DEAN BAKER, THE HOUSING BUBBLE FACT SHEET 1 (Center for Economic anc Policy Research) (2005), http://www.cepr.net/documents/publications/ housing_fact_2005_07.pdf. Contrast this with the price increase between 1950 and 1995, when home price growth was no greater than the growth for other goods or services. *Id.*

20. Krishna Guha and Jennifer Hughes, *Fed Holds Rates for First Time in Two Years*, FIN. TIMES, ¶ 1 (2006), http://infoweb.newsbank.com/iw-search/we/InfoWeb.

21. *See* 11 U.S.C. § 1322(b)(2)(2006) (disallowing the modification of the rights of the holders of claims secured only by a security interest in real property that is the debtor's principal residence); 11 U.S.C. § 1322(b)(3)(2006) (providing for the curing or waiving of any default).

22. Anna Gelpern and Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 SO. CAL. L. REV. 1075 (2009).

23. *See supra* note 4 and accompanying text.

24. MEDIAN AND AVERAGE PRICES OF NEW HOMES SOLD IN THE UNITED STATES 1-2, (U.S. Bureau of the Census), *available at* http://www.census.gov/const/uspriceann.pdf.

These low values created a vicious cycle of foreclosures because homeowners who owed more on their mortgages than their equity in their houses had little reason not to default and move on with their lives. As so many mortgages went unpaid, holders of RMBS began to wonder where the return on their investments had gone.

C. The Impacts of Defaults and the Popping of the Housing Bubble

Defaults and foreclosures on Main Street soon impacted Wall Street. The mortgage defaults equated to a lack of cash flow to the CDO[2]s and the lower tranches of CDOs. The CRAs responded to the lack of cash flow by downgrading thousands of subprime RMBS.[26] As the credit ratings fell, so too did investors' confidence in the financial instruments.[27] Investors began selling the subprime RMBS due to fear of market illiquidity,[28] leading to a modern day bank run. Banks were forced to sell off their assets at fire-sale prices in order to meet liquidity demands. This, in turn, caused the securities to look even uglier than they did before. Subprime RMBS were soon labeled "toxic waste"[29] that could not be sold quickly enough.

Subprime RMBS were not the only assets that investors were anxious to sell. Because his primary residence generally constitutes an individual's largest investment and source of wealth, that individual faces greatly reduced equity when the market value of his house drops below his purchase price or the value of his mortgage. Many individuals found themselves in this situation in 2007 and 2008, causing them to panic and sell whatever stocks they owned, even with stock prices already depressed.

Today, housing prices continue to decline and sales remain weak.[30]

25. Kelly Evans, *Home Prices, Sentiment Keep Sliding*, WALL ST. J., Jan. 28, 2009, at A3.

26. In just the first quarter of 2008, CRAs announced 4,485 downgrades of collateralized debt obligations. Dena Aubin, *CDO Deals Resurface But Down 90 Pct in Q1-Report*, REUTERS UK (2008), http://uk.reuters.com/article/marketsNewsUS.

27. As mentioned above, investors heavily relied on the ratings for these securities because they were not traded in a transparent market. TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, CONSULTATION REPORT: THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS *5 (International Organization of Securities Commissions) (2008), *available at* http://www.treasurers.org/node/3138.

28. *Id.*

29. William H. Gross, Investment Outlook: *Looking for Contagion in All the Wrong Places*, PIMCO (2007), http://www.pimco.com/LeftNav/Featured+Market+Commentary/IO/2007/ IO+July+2007.htm.

30. Jon Ward, *Obama Heralds Housing Market Improvements*, WASH. TIMES, Mar. 23, 2009, *available at* http://washingtontimes.com/news/2009/mar/23/obama-heralds-housing-market-improvements/ (explaining effect of Americans taking advantage of low interest rates).

Americans now face the "biggest crisis since the Great Depression."[31] Investment banks have fallen or reorganized, the federal government has seized control of the country's biggest insurance company and savings and loan association, and "[t]he channels of credit, the arteries of the global financial system, have been constricted, cutting off crucial funds to consumers and businesses . . . ."[32] During the shortest month in 2009, the Dow Jones Industrial Average dropped to a six-year low,[33] President Barack Obama signed into law a $787 billion stimulus plan[34] in the hopes of pulling America out of the current financial crisis, and Americans are left wondering who they can blame for this mess.

III. THE FINANCIAL CRISIS OF RECENT HISTORY AND THE ROLE OF AUDITORS

In recent history, America faced another financial crisis that similarly raised doubts about the health and integrity of our financial markets. In the first years of the new millennium, it was uncovered that several mammoth international corporations, such as Enron, Tyco, Adelphia, and WorldCom, employed irregular accounting practices, published deceptive financial statements, and committed outright fraud. After stock prices plummeted and some corporations declared bankruptcy, America experienced "a loss of hundreds and hundreds of billions, indeed trillions of dollars in market value."[35] The damage could be measured objectively in terms of ruined financial portfolios, lost jobs, and failed pensions. But the damage could also be measured more subjectively in terms of the public's lost confidence in financial statements, auditors, and America's financial markets.[36]

31. N.Y. TIMES, *supra* note 1.

32. *Id.*

33. Eric Martin & Cristina Alesci, "*Dow Theory" Says Worst Isn't Over for U.S. Stocks as YRC Falls Drop to 6-Year Law May Spur More Losses, Chart Analysts Say*, BLOOMBERG.COM, Feb. 21, 2009, http://www.bloomberg.com/apps/news?pid=20601110&sid=aMvcBJYDRy4k.

34. David Zalubowski, *Obama Signs Into Law Plan to Boost Economy*, WASHINGTON POST, Dec. 18, 2009, at C12.

35. Nance Lucas, *An Interview With United States Senator Paul S. Sarbanes*, 11 J. LEADERSHIP AND ORGANIZATIONAL STUD. 3, 4 (2004), *available at* http://findarticles.com/p/articles/mi_m0NXD/is_1_11/ai_n25101748/print?tag=artBody;coll

36. Interestingly, the CRAs were suspected of playing a role in this crisis as well as the current crisis because the CRAs rated Enron Corporation as a good credit risk up to four days before Enron declared bankruptcy. *Rating the Raters: Enron and the Credit Rating Agencies, Hearings Before the S. Comm on Government Affairs*, 107th Cong. 1-4 (2002) (statement of Senator Joe Lieberman, Chairman, S. Comm. on Government Affairs). The October 2002 staff report from the Senate Committee on Governmental Affairs concluded in part that the credit rating agencies failed to exercise sufficient diligence in rating Enron.

Many investors were angered that companies such as Enron were able to use such misleading accounting methods and issue fraudulent financial statements without earlier detection. Is it not true that these publicly held companies were audited by certified public accountants trained to detect accounting irregularities? And is it not true that professional auditors issued reviews each quarter and thorough opinions each fiscal year telling the public that the companies' financial statements contained no material misstatements? Sure. But it is also true that the pre-Sarbanes-Oxley accounting profession had morphed over time into an industry ripe for major conflicts of interest. While the profession began as one based on independence,[37] economic pressures contributed to what Senator Paul Sarbanes called one of the main triggers of the crisis: a lack of auditor independence.[38]

The journey from independence to conflicted interests started in the 1970s when the American Institute for Certified Public Accountants ("AICPA") began to fear antitrust action from the federal government.[39] To decrease this risk, the AICPA removed from its code of conduct[40] some of the prohibitions against competitive practices. Consequently, competitive bidding for audit projects increased among accounting firms. This drove down the price tag, and thus profitability, of audit services.

Accounting firms attempted to recapture lost profits by marketing ancillary services to their audit clients. Their efforts were successful: over the next few decades, non-audit services became as bigger moneymakers than audit services. For example, in 2000, more than half of the $52 million in fees that Enron paid Arthur Andersen was for non-audit work.[41] Not surprisingly, auditors came to depend on their cash-cow ancillary

37. It was easy for auditors to uphold the concept of independence when the profession first developed in Europe in the Nineteenth Century. An auditor's main duty was to oversee the absentee investments in existing and former colonies. Consequently, auditors did not feel like, nor were they seen as, advocates for the audited entities and investors. Additionally, British investors forbade auditors from investing in or working for the businesses they audited. This tradition of auditor independence continued as the profession flourished in the United States. For instance, during the New Deal, auditors' independence strengthened with the creation of the SEC, which furthered the concept of objectivity and neutrality. C. Richard Baker, *The Varying Concept of Auditor Independence: Shifting with the Prevailing Environment*, THE CPA J. ONLINE, Aug. 2005, http://www.nysscpa.org/cpajournal/2005/805/infocus/p22.htm.

38. Lucas, *supra* note 35, at 5.

39. *See* Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679 (1978) (finding that the society of engineers violated the Sherman Act by requiring that its members not engage in competitive bidding).

40. AICPA CODE OF PROFESSIONAL CONDUCT (Am. Inst. of Certified Pub. Accountants 2009).

41. STAFF TO THE S. COMM. ON GOVERNMENTAL AFFAIRS, 107th CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 30 (Comm. Print 2002).

services, even though such reliance opened them up to conflicts of interest. As a result, the accounting scandals were almost predictable. Federal laws required publicly held companies such as Enron to be audited by accountants who signed off on audit opinions. These accountants, however, were paid by their audit clients to write the audit opinions. Additionally, the auditors sold to these clients ancillary services which were often more profitable than the audit services themselves. Therefore, auditors had good reason to avoid digging too deep into or revealing bad news about their clients' financial statements because angry or bankrupt audit clients generally do not buy costly ancillary services from prying auditors. As a Senate Committee on Governmental Affairs staff member explained, "it is difficult to comprehend how such large consulting fees could not have created a serious conflict of interest for Andersen"[42] and other audit firms.

IV. FORMAL GOVERNMENTAL REGULATION AS THE SOLUTION TO THE AUDITORS' CONFLICTS OF INTEREST

Congress decided that the auditors' conflicts of interest were a major cause, if not the main cause, of the accounting scandals and the resulting financial crisis. Congress reacted to this conclusion by passing the Sarbanes-Oxley Act of 2002.[43]

Title II of the Sarbanes-Oxley Act establishes strict standards for auditor independence in both fact and appearance by focusing on two main goals. Sarbanes-Oxley's first main goal is to limit auditors' financial dependence on their audit clients, using three prohibitions. First, the Act prohibits auditors from providing most of the cash-cow ancillary services to their audit clients that they had offered in the past. The non-audit services that Sarbanes-Oxley bans include: book-keeping; designing financial information systems; providing actuarial services; performing internal audits; assuming management or human resources functions; and providing broker, investment, and legal services.[44] Second, the Act prohibits auditors from having any direct or material indirect business relationships with clients or the officers, directors, or significant

42. *Id.* at 22.

43. Pub. L. No. 107-204, 116 Stat. 745 (2002). President George W. Bush, who signed Sarbanes-Oxley into law, said it included, "'the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt.'" Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at C1.

44. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, § 201(a). The Act does, however, allow auditors to provide other non-audit services, such as tax services, with preapproval by the company's audit committee. *Id.* The audit committee's approval of these non-audit services to be performed by the auditor must be disclosed to investors in periodic reports. *Id.* § 202.

shareholders of clients.[45] Third, Sarbanes-Oxley prohibits specific financial relationships between auditors and their clients, including creditor/debtor, broker-dealer, futures commission merchant accounts, insurance products, and investment company interests.[46]

Sarbanes-Oxley's second main goal relating to auditor independence is to limit the possibility of collusion between auditors and their clients by prohibiting the audit committees of audit clients from approving contingent fee agreements or commissions for their audits.[47] Additionally, the Act requires lead and coordinating audit partners[48] and reviewing audit partners to rotate off clients at least every five years.[49] Finally, Sarbanes-Oxley seeks to close the "revolving door" between auditors and audit clients by limiting the ways a single individual may work for both an audit firm and an audit client of that audit firm. For example, the Act prohibits registered public accounting firms from performing any audit services for a client if the CEO, Controller, CFO, or any other high ranking employee of that client was employed by the accounting firm and was involved in any capacity in that client's audit for one year prior to the date of the beginning of the audit.[50]

V. CONFLICTS OF INTEREST AS THE SOURCES OF THE RECENT FINANCIAL CRISES

Today, as we once again find the financial market untrustworthy, we are reminded of the accounting scandals of the recent past and the resulting financial crisis. Just as the public lost confidence in auditors when the auditors issued favorable audit opinions for horribly misleading financial statements, so too has the public begun to question the trustworthiness of CRAs.[51]

Academics, financial experts, and politicians alike have blamed the

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45. OFFICE OF THE CHIEF ACCOUNTANT, U.S. SEC. & EXCH. COMM'N, AUDIT COMMITTEES AND AUDITOR INDEPENDENCE (2007), http://www.sec.gov/info/accountants/audit042707.htm.

46. *Id.*

47. *Id.*

48. Lead and coordinating audit partners are the partners who have primary responsibility for the audit.

49. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, § 203.

50. *Id.* § 206.1. *See also* OFFICE OF THE CHIEF ACCOUNTANT, U.S. SEC. & EXCH. COMM'N, APPLICATION OF THE COMMISSION'S RULES ON AUDITOR INDEPENDENCE: FREQUENTLY ASKED QUESTIONS (2007), http://www.sec.gov/info/accountants/ocafaqaudind080607.htm#prohibited (clarifying the prohibitions in Sarbanes-Oxley).

51. *See, e.g.*, Thomas Mann Fischer, "*Der Dollar fällt gewältig*," DIE ZEIT, Sept. 20, 2007, http://www.zeit.de/2007/39/Interview-Rogoff ("I could imagine that Moody's will become the Arthur Andersen of this decade.").

CRAs for the current financial crisis.[52] They question how the CRAs could have rated subprime RMBS so highly in good faith when the financial instruments proved to be such poor investments. One critic who blames the CRAs for the current financial crisis argued that the big three CRAs slapped "sterling grades on questionable securities."[53] Another said the CRAs "really messed up and led investors to slaughter by not recognizing (or perhaps willfully ignoring) risks in the products they rated."[54] And in a colorful edition of his monthly note, one financial manager wrote, "You were wooed[,] Mr. Moody's and Mr. Poor's[,] by the makeup, those six-inch hooker heels, and a 'tramp stamp.' Many of these good looking girls are *not* high-class assets worth 100 cents on the dollar."[55]

One of the main arguments for blaming the CRAs for the current financial crisis is based on the assumption that the CRAs had conflicted interests when they rated the subprime RMBS. There are arguably three sources of these conflicts of interest. All three of these sources mirror the sources of conflict the pre-Sarbanes-Oxley auditors faced when they issued favorable audit opinions on financial statements for companies like Enron. These sources include: (1) the industry's changing due to pressure from the federal government, (2) the client-pays model, and (3) the marketing of ancillary services.

Just as the auditing industry was experiencing a dramatic change in the 1970s,[56] the CRAs' role in the financial world morphed in reaction to governmental forces. Whereas the auditing industry adjusted due to the threat of federal antitrust action, the credit rating industry evolved due to new SEC requirements. Starting in the 1970s, the SEC began requiring institutions to receive credit ratings before selling bonds to the investing public. This policy shift created a captive audience for the CRAs' services. In effect, the SEC's rating requirement changed the role of the CRAs from providing protection for investors to advertising for bond sellers. Thus, just as it could be said that auditors switched their focus from investors to audit clients, it may appear that "what was once a responsibility to protect buyers

52. For example, Wharton finance professor Richard J. Herring says that erroneous mortgage securities ratings undermined the CRAs' credibility with other types of ratings, making the credit crisis even more problematic. *Do the SEC's New Rating Agency Rules Have Any Bite?*, *supra* note 8, at 2.

53. David McCann, *S&P's Parent Hires an Ex-E&Y Watchdog*, CFO.COM, Jan. 7, 2009, http://www.cfo.com/article.cfm/12896036/?f=rsspage.

54. Ryan E. Freund, *Abolish Credit Rating Agencies? Some Say Yes*, ISTOCKANALYST, Jan. 6, 2009, http://www.istockanalyst.com/ article/viewarticle/articleid/2929599.

55. Gross, *supra*, note 29.

56. The auditing industry underwent a dramatic change in the 1970s when the AICPA changed its code of conduct to allow competitive bidding for audit services. This decreased audit profitability and led auditors to market their non-audit services more heavily. Baker, *supra*, note 37 and accompanying text.

often became a responsibility to ensure the bond sellers a more profitable product."[57]

It may also appear that CRAs face a conflict of interest because, like auditors, they are paid by the entities they rate.[58] Before the 1970s, the CRAs sold their ratings directly to and were paid by investors.[59] However, technology advanced and with it came the use of, and easy access to, photocopiers. Once the CRAs realized that the unauthorized photocopying of their ratings manuals would destroy their profitability, they replaced the user-pays model with the issuer-pays model.[60]

It might be argued that the issuer-pays model creates a serious conflict of interest. It seems logical that the CRAs, like any other for-profit companies, should focus their efforts on pleasing and retaining their paying clients. Furthermore, if the customer is always right, it seems that the CRAs' efforts to please their customers might "conflict with providing rating with integrity."[61] The SEC expressed such a worry years before the current financial crisis and the popularity of pointing the finger of blame at the CRAs. The SEC stated that the issuer-pays model could tempt CRAs to "rate issuers more liberally, and temper their diligence in probing for negative information."[62] Other observers, such as the Financial Economics Roundtable,[63] believe that the issuer-pays model has resulted in issuers actively shopping for favorable ratings and refusing to pay for ratings they deem "too low."[64] This alleged ratings-shopping might explain why Moody's once changed its rating for a pool of Countrywide Financial securities the day after Countrywide complained that the CRA's rating was too tough, even though, allegedly, no new significant information had surfaced to cause Moody's to change its rating.[65]

Finally, it might also be argued that CRAs are plagued by conflicts

57. Jackie Speier, *Credit Rating Agencies Are No Longer First Rate*, SAN FRANCISCO CHRONICLE, Dec. 17, 2008, at B9, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2008/12/17/ED0L14P4OC.DTL

58. These ratings are then available to the public without charge. This is known as the "issuer pays" model.

59. Speier, *supra*, note 57; *Do the SEC's New Rating Agency Rules Have Any Bite?*, *supra* note 8, at 1.

60. *Do the SEC's New Rating Agency Rules Have Any Bite?*, *supra* note 8, at 2.

61. STAFF OF THE OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 23 (2008).

62. U.S. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF SECURITIES MARKETS: AS REQUIRED BY SECTION 702(B) OF THE SARBANES-OXLEY ACT OF 2002 41 (2003).

63. The Financial Economists Roundtable is a 15-year-old group of top economists from around the world.

64. *Do the SEC's New Rating Agency Rules Have Any Bite?, supra* note 8, at 3.

65. Gretchen Morgenson, *The Reckoning; Debt Watchdogs: Tamed or Caught Napping?* N.Y. TIMES, Dec. 7, 2008, at C1.

of interest because they market ancillary services to their clients. These services include rating hypothetical scenarios created by the issuers, providing risk management services, and providing consulting services.[66] It is easy to believe that the sale of these ancillary services puts the CRAs in the same boat as pre-Sarbanes-Oxley auditors. There is valid reason to worry that, just as Arthur Andersen was motivated to give Enron favorable audit opinions in order to ensure a continued stream of revenue from non-audit services, so too might the CRAs be motivated to give high ratings to issuers who purchase ancillary services.[67]

VI. SOLUTIONS TO THE CRAS' CONFLICTS OF INTEREST

A variety of options have been suggested to cure the CRAs' potential conflicts of interest. One approach to the alleged CRA problem is to eliminate the issuer-pays model. Two popular suggestions to achieve this goal are (1) returning to the traditional user-pays model, and (2) instituting of a new model where the general public pays for ratings.[68] There are, however, strong arguments against both of these suggestions.[69]

A different approach to the conflicts of interest involves eliminating dependence on CRAs altogether. Some argue that investors should use their own judgment because blind reliance on ratings is what led to America's current financial problems.[70] Perhaps, if investors did not have credit ratings on which to heedlessly rely, they might have second-guessed

66. U.S. SECURITIES AND EXCHANGE COMMISSION, *supra*, note 62, at 42.

67. *See, e.g.*, Letter from Sean J. Egan and W. Bruce Jones, Egan-Jones Rating Company, to Jonathan G. Katz, Secretary, SEC (November 10, 2002) ("[J]ust as accountants were compromised by their consulting assignments, rating firms have similar issues.").

68. *See, e.g.*, JEFFREY MANN, RATING RISK AFTER THE SUBPRIME MORTGAGE CRISIS: A USER FEE APPROACH FOR RATING AGENCY ACCOUNTABILITY, (2008) (forthcoming in North Carolina Law Review). Because they believe "the world is worse off for the existence of companies like Moody's and Standard & Poor's," columnists Michael Lewis and David Einhorn wrote, "there should be a rule against issuers paying for ratings. Either investors should pay for them privately or, if public ratings are deemed essential, they should be publicly provided." *How to Repair a Broken Financial World*, N.Y. TIMES, Jan. 3, 2009, at WK10.

69. *See* Josef Forster, *The Optimal Regulation of Credit Rating Agencies*, in DISCUSSION PAPERS IN ECONOMICS 2008, at note 23 (U. Munich, Dep't of Econ., Discussion Papers in Economics No. 5169, 2008) (reiterating that the investor-pays model cannot succeed due to technological advances); Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis* (NYU Ctr for Law and Business Research Paper No 01-001, February 2001) (discussing the efficiency gained from the issuer-pays model).

70. Financial blogger Paul Kedrosky recommends not using CRAs at all. Based on Kedrosky's point that there is no regulatory oversight for equities, professional investment adviser Ryan E. Freund asked, "why don't we just let the private investors rate these securities, like they do with equities?" Freund, *supra* note 54.

the supposed profitability of subprime RMBS. If there were no credit ratings, investors might have done their own research and laughed at the prospect of owning a piece of so many houses worth more than the homeowners could afford or loans that were supposed to be paid off by homeowners with minimal personal credit.

The discussions above indicate another option for curing the CRAs of their supposed conflicts of interest. Recall that issuers pay the CRAs for credit ratings just as audit clients pay auditors for audit opinions. Additionally, CRAs market ancillary services to their rating clients just as pre-Sarbanes-Oxley auditors sold ancillary services to their audit clients. Finally, the CRAs' high ratings seem to have contributed to the current economic crisis just as the auditors' favorable audit opinions contributed to the financial crisis just a few years ago. Because the problems with the CRAs appear so similar to the problems with auditors before Congress passed Sarbanes-Oxley, it seems reasonable to pursue a similar solution.[71] Like the passage of Sarbanes-Oxley, it seems logical for either Congress or the SEC to spend time and resources regulating the CRAs' conflicts of interest.

A. The SEC's Recent Steps to create a "Sarbanes-Oxley" for CRAs

On December 3, 2008 the SEC demonstrated its belief that regulation similar to Sarbanes-Oxley was necessary to cure CRAs' of their conflicts of interest and thereby improve the quality of credit ratings. After a ten-month examination of the three largest CRAs,[72] the SEC approved multiple regulations in the hope of increasing CRA accountability and transparency.[73] These regulations are discussed below.

The Final Amendments to Rule 17g-2(a)(8)[74] and Instructions to Exhibit 1 of Form NRSRO,[75] entitled "Record of Rating Actions," amends paragraph (d) of Rule 17g-2. They require each CRA recognized by the

71. One might argue that regulating CRAs is even more necessary than regulating auditors because, "in contrast to auditing . . . firms, CRAs so far cannot be made liable for consequences of inaccurate credit ratings. This is because credit ratings are regarded as an opinion, comparable to a report in a newspaper." Forster, *supra* note 69, at 16.

72. While there are many CRAs based in the United States and abroad, Moody's, Standard & Poor's ("S&P"), and Fitch are the three largest. The credit ratings of these three CRAs account for approximately ninety-eight percent of all outstanding ratings issued by CRAs recognized by the SEC. Hunt, *supra* note 6 at *1, *6. Such SEC-recognized CRAs are called Nationally Recognized Statistical Rating Organizations, or NRSROs.

73. SEC, *SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies*, SEC NEWS DIGEST, Dec. 3, 2008, http://www.sec. gov/news/digest/2008/dig120308.htm.

74. Rule 17g-2 under the Exchange Act. 17 C.F.R. § 240.17g-2 (2009).

75. A "NRSRO," or Nationally Recognized Statistical Rating Organization, is a CRA which issues credit ratings that the SEC allows other financial entities to use for certain regulatory purposes.

SEC (known as Nationally Recognized Statistical Rating Organization, or "NRSROs") to make publicly available a random sample of ten percent of the credit ratings they issue under the issuer-pays model.[76] Each NRSRO must also make publically available histories for each class of issuer-paid credit rating for which the NRSRO is registered and has issued 500 or more ratings. Each NRSRO must publish this information on its corporate website and disclose the information's location on Form NRSRO.[77] These requirements help the investing public see for which issuers the CRAs employ the issuer-pays model. Investors may then use their own judgment to determine whether these specific ratings might be tainted by conflicts of interest due to the issuer-pays model.

The Final Amendments to Rule 17g-2 create a record-keeping requirement triggered when a quantitative model is a substantial component of the rating process for a structured financial product. When this requirement is triggered, each NRSRO must keep a record of its rationale for any material differences between the credit rating implied by the model and the final rating issued by the CRA.[78] This requirement allows investors to determine when subjective reasons, such as conflicts of interest, might have played a role in a final credit rating.

The next amendments are certainly reminiscent of Sarbanes-Oxley in that they add prohibited conflicts to the list in Rule 17g-5(c). The first amendment limits the CRAs' ability to sell both rating and non-rating services to any given client. More specifically, the amendment prohibits an NRSRO from issuing a credit rating to an issuer or that issuer's securities when the NRSRO, or one of its affiliates, previously made recommendations to that issuer about the issuer's corporate or legal structure, assets, liabilities, or activities.

The second amendment to the list of prohibited conflicts under Rule 17g-5(c) bans a NRSRO from issuing a rating if the personnel responsible for determining the rating, or developing or approving procedures or methodologies used for determining the rating, previously participated in determining the fee which the NRSRO charges the related issuer.[79] This amendment creates a wall between the NRSRO employees who evaluate the financial instruments and issuers and the employees who collect money

76. Requiring public disclosure is a common method of regulation since, "publicity is justly commended as a remedy for industrial diseases [and] sunlight is said to be the best of disinfectants." LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 62 (1914).

77. SEC, FACT SHEET: OPEN MEETING OF THE U.S. SECURITIES AND EXCHANGE COMMISSION, (Dec. 3, 2008), http://www.sec.gov/news/press/2008/nrsrofactsheet-120308.htm.

78. *Id.*

79. An NRSRO that has too few employees to separate these functions may apply to the SEC for an exemption from this requirement.

from the issuers. Such division between functions should prevent CRAs from accepting additional compensation in exchange for inflated ratings.

The third amendment to Rule 17g-5(c) prohibits NRSROs from allowing an employee who participated in determining or monitoring the credit rating from receiving gifts from the obligator being rated or from the issuer, underwriter, or sponsor of the securities being rated. While this amendment lumps entertainment in the category of prohibited gifts, it allows items provided in the context of normal business activities that have an aggregate value of no more than twenty-five dollars.[80] This amendment serves to prevent CRAs from accepting gifts that may cloud their judgment when issuing ratings.

The next set of amendments, entitled "Re-Proposed Amendments to Rule 17g-5," prohibits an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer unless the information provided to the NRSRO to determine the rating is made available to other NRSROs.[81] These amendments will allow the NRSROs to monitor each other when the ratings are provided through the issue-pays model.

B. "Sarbanes-Oxley" for CRAs is unnecessary and potentially harmful

Some applaud the SEC's new regulations, believing they are necessary to reduce, and hopefully eliminate, any conflicts of interests the CRAs face. The Investment Company Institute is one such enthusiast. Paul Schott Stevens, the Investment Company Institute's President and CEO, explained that the organization "welcome[s] reforms that will make the rating process more transparent and objective and that will disclose potential conflicts that could play a role in a credit rating agency's determination of a rating."[82] Other advocates of CRA regulation[83] believe that the SEC has started well but would be wise to impose even more

80. FACT SHEET, *supra* note 77.

81. *Id.* *See, e.g.*, Forster, *supra* note 72, at 22 (explaining that, "while interaction between the issuer of a traditional debt security and the CRA are rather limited," interactions between issuers of structured finance transactions and CRAs are more involved. In rating structured finance transactions and products, CRAs not only offer rating services, but also additional consulting services).

82. Investment Company Institute, *ICI Commends SEC Approval of Credit-Rating Agency Rules: Investors will Benefit by Improved Disclosure, Transparency*, Dec. 3, 2008, http://www.ici.org/fcr/ 08_news_sec_cra2.html. The Investment Institute Company, or ICI, is a national trade association of mutual funds, exchange-traded funds, closed-end funds, and unit investment funds. The ICI is also an active participant in the legislative activity relating to CRAs.

83. One such fan of regulation is Jochen Sanio, the chairman of the German federal financial supervision authority (Ban), who called CRAs the largest uncontrolled power in the international financial system. Forster, *supra* note 69, at 32.

regulations on CRAs.[84]

Other parties, including this author, believe that these regulations will not play a part in any successful solution to the economic problems that the American financial markets currently face.

Numerous arguments support the notion that increased regulation of the CRAs will not solve the current financial crisis and likely would not have prevented the crisis if they had been implemented sooner.

First, regulation, in general, can be harmful. Opponents to formal governmental regulation claim that regulation puts the United States at a competitive disadvantage in the global economy. For example, one could argue that Sarbanes-Oxley weakened America's leadership in the financial service industry[85] because the restrictions the legislation imposed greatly increased the cost of performing audits. Rather than completely internalizing the increased costs, auditors have passed much of the costs onto the clients, which they audit. American companies requiring an audit under Sarbanes-Oxley are therefore forced to absorb these costs. Consequently, the companies must reduce other costs or charge customers more for their goods and services in order to pay for their larger audit expenses. No matter how the American companies choose to deal with their high audit costs, they are at a disadvantage when compared to their international competitors who do not face similarly high audit costs.

The same argument could be made regarding regulation of the credit rating agencies. If credit rating agencies face higher costs due to increased regulation, then they might charge issuers more for their ratings in order to pass on the costs. American issuers would then be disadvantaged compared to foreign issuers, and investment dollars would travel abroad.

In addition to hurting clients, regulations such as Sarbanes-Oxley might harm the regulated industries themselves in two significant ways. First, regulation reduces the areas in which the industry can profit. For instance, American auditors are at a competitive disadvantage to their international counterparts who are still permitted to perform both audit and ancillary services for audit clients. Second, regulations such as Sarbanes-Oxley can lead to moral bankruptcy. Regulations may cause regulated parties to only ask what is legal, rather than what is ethical. These regulated parties base their ethical decisions simply on what the regulations say is legal.[86] Clear-cut legal rules can also lead to manipulative behavior,

84. KNOWLEDGE@WHARTON, *supra* note 8, at 1.

85. A Mckinsey & Company study, commissioned by New York City Mayor Bloomberg and New York Senator Charles Schumer, cites this as one reason that America's financial sector is losing market share to other financial centers around the world. CITY OF NEW YORK & U.S. SENATE, SUSTAINING NEW YORK'S AND THE US'S GLOBAL FINANCIAL SERVICES LEADERSHIP 12 (2007).

86. JOHN C. MAXWELL, THERE'S NO SUCH THING AS "BUSINESS" ETHICS: THERE'S ONLY ONE RULE FOR MAKING DECISIONS (2003).

where regulated parties follow the letter, but not the spirit, of the law.

While regulation may be viewed as a general problem, it is more specifically detrimental to the CRA industry and the U.S. economy today. In passing the Credit Rating Agency Reform Act of 2006,[87] Congress wished to promote competition in the credit rating industry. However, increased SEC regulation will increase the cost of doing business and reduce opportunities for high profit margins, just as Sarbanes-Oxley did for auditors. This will, in turn, discourage CRAs from applying for NRSRO status,[88] thereby thwarting a congressional goal for the industry.

Also, regulation creates additional cost. Auditors passed much of the costs created by Sarbanes-Oxley onto their clients. Given today's even weaker economy, it would come as little surprise if the CRAs passed the costs created by the new regulations onto their clients, the issuers. Such behavior would have two effects: first, it would discourage larger issuers from seeking multiple ratings, and for smaller issuers, from seeking a single credit rating.[89] This lack of ratings could further deteriorate the public's confidence in the American financial market. Second, the issuers who do purchase credit ratings will either internalize the cost or pass the cost on to investors. Neither issuers nor investors can withstand this extra cost in the current economy. Thus, this formal regulation will do more harm than good and is simply not what America needs at this time.

Even if one were to successfully argue that formal governmental regulation of the CRAs would not further weaken the already-bleeding economy, regulation is simply unnecessary at the current time. The CRAs do not need further Congressional or SEC regulation because the conflicts of interest the CRAs face are very minor, if not insignificant. While the CRAs initial high ratings and subsequent downgrading of subprime RMBS helped create our current economic crisis, the CRAs' conflicts of interest are not to blame. The conflicts simply are not great enough to have caused the CRAs to issue favorable ratings when the CRAs believed otherwise. Additionally, other mechanisms already exist to prevent these small conflicts of interest from having any significant effects on the credit rating process.

87. 15 U.S.C.A. §§ 780-87 (2006). The Credit Rating Agency Reform Act of 2006 requires the SEC to establish clear guidelines for determining which CRAs qualify as NRSROs. Furthermore, the Act gives the SEC the power to regulate NRSROs' processes for guarding against conflicts of interest.

88. Letter from Richard M. Whiting, Executive Director and General Counsel of The Financial Services Roundtable, to Nancy M. Morris, Sec'y of Securities and Exchange Commission (March 12, 2007), *available at* http://www.fsround.org/policy/regulatory/pdfs/CreditRatingAgency.pdf.

89. *Id.*

C. CRAs' Insignificant Conflicts of Interest

The American economy, financial market, and housing market currently face immense problems. Relatively, the CRAs' conflicts of interest are only minor predicaments. This can easily be seen when CRAs are more closely compared with auditors. Because the CRAs do not face substantial conflicts of interest, the SEC and Congress should use their time to solve more pressing economic problems.

Like auditors, CRAs are paid by the clients they evaluate. However, unlike the client-pays model's effect on audit opinions, the model's effect on the rating of subprime RMBS has been slight. This is true because, as the numbers indicate, no single issuer holds enough financial leverage over any CRA to make inflating a credit rating worthwhile for a CRA. Only a small number of CRAs are NRSROs.[90] Additionally, any given issuer can offer hundreds of different financial instruments. As a result, each NRSRO[91] rates thousands of different financial instruments and has thousands of different credit rating clients.[92] Although at the time of the accounting scandals there were only five "big" accounting firms,[93] there were thousands of Certified Public Accountants qualified to audit publically traded companies. Thus, while large public companies sought audit services from the big five accounting firms, the thousands of other companies in need of audit opinions turned to the often less expensive smaller audit firms and sole practitioners.

Thus, the audit client-to-auditor ratio was lower than the credit rating client-to-CRA ratio. These ratios indicate that before Sarbanes-Oxley an accounting firm could derive a large proportion of its total revenues from a single client. This was the case with the accounting firm Arthur Andersen and its client Enron. Andersen earned more than $50 million from Enron in 2000. One former Andersen partner even predicted that Enron fees could have reached $100 million-per-year.[94] The large sums of money

90. The number of NRSROs has fluctuated over the years. In 1975, the SEC recognized three – S&P, Moody's, and Fitch. Since 1975, the SEC staff has added six other CRAs. These include Dominion Bond Rating Service in 2003, A.M. Best in 2005, Japan Credit Rating Agency, Ltd., Ratings and Investment Information, Inc. in 2007, and Egan-Jones Rating Company.

91. Especially Moody's, Standard and Poor's, and Fitch, who received much criticism and are the main targets of the new SEC regulations.

92. For example, Moody's rates more than 135,000 finance securities, 65,000 public finance obligations, 10,000 corporate and financial institutional relationships, and 100 sovereign nations. LUBOMIR DUBECKY, A BRIEF INTRODUCTION TO MOODY'S RATING SERVICE 3 (2006).

93. These firms were Arthur Andersen, Deloitte and Touche, Ernst & Young, KPMG, and Price Waterhouse Coopers.

94. MAX H. BAZERMAN & MICHAEL WATKINS, PREDICTABLE SURPRISES: THE DISASTERS YOU SHOULD HAVE SEEN COMING, AND HOW TO PREVENT THEM 61 (Harvard

Andersen received from Enron made it extremely difficult for Andersen employees to view Enron objectively. They knew that if the firm lost Enron as a client, Andersen would lose a large portion of its total revenue. Andersen employees were therefore motivated to keep Enron afloat and happy. This was accomplished, until 2001, by Andersen's issuance of favorable audit opinions for Enron and their simultaneous negligent oversight (or purposeful ignorance) of accounting irregularities and fraud.

By contrast, the relationships between CRAs and their clients are much less involved. Fees from the average credit rating client constitute only a small fraction of each CRA's total revenue. In fact, no single rating client is likely to contribute more than two percent of any CRA's total revenue.[95] Consequently, it would be illogical for a CRA to inflate a rating for the sake of saving its business relationship with a single issuer. The financial payoff is not worth the potential harm to the CRA's reputation. The client-pays model therefore poses a less significant problem for the CRAs than it did for pre-Sarbanes-Oxley auditors.

Just as the issuer-pays model is not a significant problem for the CRAs, neither is the fact that the CRAs market ancillary services to their rating clients. Once again, the numbers differentiate the CRAs and the conflicted pre-Sarbanes-Oxley auditors. Prior to Sarbanes-Oxley, some audit clients paid their auditor more for non-audit services than for their annual audits and quarterly reviews.[96] Such an imbalance in favor of ancillary services does not occur with the CRAs. Services other than traditional credit ratings account for only a small part of each CRA's business. Because ancillary services account for a "very small portion of their [the CRAs'] total revenues," most experts find the conflict of interest created from these services to be "manageable."[97]

D. Self-Regulation Makes Government Regulation Unnecessary

In addition to the CRAs' conflicts of interest being minor, they are also already regulated by the CRAs themselves. Therefore, Congress need not step in and regulate.

The CRAs are proactive and self-regulate largely due to their business model. CRAs are only successful so long as their ratings are deemed reliable. If investors began to doubt the quality of a specific

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Business School Pub. Corp. 2004). *See also* Flynn McRoberts, *Ties to Enron Blinded Andersen*, CHICAGO TRIBUNE, Sept. 3, 2002, at A1.

95. U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 62, at 23. *See also id.* at 41 (explaining that no single issuer or issuer group represents more than two percent of S&P's annual revenue from its rating business).

96. *See* Bazerman and Watkins, *supra* note 94.

97. U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 62, at 23.

CRA's ratings, they would either stop buying financial products rated by that CRA, or they would find a new way to evaluate the creditworthiness of the products. In either scenario, the CRA's clients would cease to be clients once they realized that the public no longer trusted the CRA's ratings. Unless legally required to get a rating, companies would have little impetus to pay for a rating that investors ignored. Thus, a CRA's survival is largely dependent on its reputation for issuing credible and reliable credit ratings.[98]

The same relationship between the perception of reliability and success holds true for auditors. Once an auditor loses the public's trust, his career is essentially ended. Audit opinions have value because they are believed to be honest evaluations of companies' financial statements from a trustworthy outsider. An audit opinion from a questionable auditor is therefore worthless. The downfall of Arthur Andersen proves this assertion. Andersen was not forced by a court or the SEC to close its doors. In fact, the Supreme Court pardoned the accounting firm on behalf of the Enron case. However, even though Andersen was permitted to continue auditing, it chose to cease operating as a firm because its reputation was damaged beyond repair. Because there had been so many questions about the integrity of Andersen's audit opinions, companies had no interest in paying for an Andersen stamp of approval to display to the investing public. The reaction of stock prices to Anderson's downfall also proves this assertion. Andersen audit clients faced larger negative stock returns than non-Andersen audit clients after the public learned about Enron and Andersen's shredding of documents.[99] Andersen audit opinions were not only worthless in attracting investor confidence, but perhaps even harmful to potential audit clients. Andersen's auditing career ended as soon as the public began to question the firm's trustworthiness.

The reputational capital model explains the strong link between the public's perception of a firm and the firm's success.[100] The reputational capital model, as it relates to the CRAs, explains that CRAs are extremely resistant to jeopardizing their reputations for fear of losing future business. Thus, despite the issuer-pays model, CRAs resist the temptation to bend to clients' wills and inflate ratings in order to satisfy customers. Doing so

98. *Id.* at 42.

99. *See, e.g.*, Jeffrey L. Callen & Mindy Morel, *The Enron-Andersen Debacle: Do Equity Markets React to Auditor Reputation*? (Joseph L. Rotman School of Management Research Paper Series, 2002) (comparing the daily stock returns of a sample of Andersen audit clients with those of a control sample of big five non-Andersen audit clients during the months of October 2001 through January 2002); Paul K. Chaney & Kirk L. Philipich, *The Shredded Reputation: The Cost of Audit Failure*, 40 J. OF ACCOUNTING RESEARCH 1221 (2002).

100. For an in-depth discussion of the reputational capital model as it relates to the CRAs, see, for example, Hunt, *supra* note 5.

would put the CRAs' reputations, and consequently, their whole future success, in great jeopardy.

In order to protect their reputations, CRAs regulate themselves and successfully limit their conflicts of interest. First, the CRAs have enacted detailed policies and procedures to ensure that the issuer-pays model does not affect their judgment as it affected Arthur Andersen's. First, the CRAs have strict rules regarding analyst compensation in order to prevent potential interference with the objectivity of the analysts' ratings.[101] These procedures have historically been successful, as seen when a Senate Committee staff report concluded that Moody's did not base the timing of its downgrade of Enron's credit rating on any improper influence, as many suspected.[102] The report found that Moody's adjusted its rating because new information caused the CRA to change its view of Enron's circumstances.[103]

Second, in order to limit the influence that ancillary services might have on credit ratings, the CRAs have created firewalls to separate the ratings business from non-rating services.[104] Thus, rating analysts are generally prevented from marketing ancillary services to credit rating clients.[105] In fact, the CRAs generally employ separate staffs to sell rating and non-rating services.[106] Non-rating analysts have no reason to concern themselves with a client's reaction to a low credit rating. Additionally, the performance of non-rating businesses does not directly impact rating analysts' compensation.[107]

Currently, the CRAs are implementing even more regulations to ensure they are not tempted by conflicts of interest. This is evidenced by the steps taken by one of the three largest American CRAs: S&P. S&P's parent corporation recently announced that "S&P is committed to helping restore confidence and transparency in the credit markets."[108] To do so, S&P has taken action to enhance its rating process. The CRA has implemented an analyst rotation program[109] reminiscent of the audit partner rotations required under Sarbanes-Oxley. Furthermore, S&P created a risk

101. U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 62, at 42.
102. *Id.*
103. *Id.*
104. "Fees from any single issuer typically comprise a very small percentage—less than 1%— of a rating agency's total revenue. U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 62, at 42. *See also* Letter from Richard M. Whiting, *supra* note 88, at 2 (arguing that certain proposed rules intended by the SEC to implement provisions of the Credit Rating Agency Reform Act of 2006 were "unnecessary").
105. U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 62, at 43.
106. *Id.*
107. *Id.*
108. McCann, *supra* note 53.
109. *Id.*

oversight committee and increased data requirements for certain issuers.[110] S&P has also taken a page from audit clients' books and created an internal monitoring position. S&P's parent company hired a former Ernst & Young executive[111] who will report directly to the S&P's parent company's chairman and CEO.[112]

All of S&P's safeguards demonstrate that although the CRAs already had sufficient safeguards in place to ensure they were not improperly influenced by the issuer-pays model or the sale of non-rating services, the CRAs are currently implementing additional measures to further limit any conflicts of interest, discover any problems, and increase investor confidence.

VII. CONCLUSION

Like pre-Sarbanes-Oxley auditors, the CRAs employ the client-pays model and sell ancillary services to the clients they evaluate. While formal governmental regulation of the auditing industry was necessary to restore public trust and eliminate large conflicts of interest, such regulation is not necessary to cure the CRAs' conflicts of interest. Not only are the CRAs' conflicts of interest insignificant, but the CRAs' effective self-regulation protects the integrity of their rating processes.

If conflicts of interests truly were a problem for the CRAs, there would have been indications in the past. The issuer-pays model has been an integral part of the credit rating industry for decades. CRAs have also sold ancillary services to their rating clients for many years. Thus, if conflicts of interest were, in fact, a problem for the CRAs, the dilemma "should have shown up in corporate and muni ratings at some point in the past 35 years – [however,] it simply hasn't, at least not in any statistically significant fashion."[113]

It is hard to ignore, however, the role the CRAs played in the current financial crisis. They initially rated the subprime RMBS highly, motivating investors to purchase these toxic assets. If the CRAs had correctly rated the securities initially, then perhaps investors would have seen the subprime RMBS for the junk instruments that they were. But these faulty ratings should be attributed to the CRAs' inexperience, not a lack of good faith. The CRAs were evaluating highly innovative asset sub-

110. *Id.*

111. Groves served as chairman and CEO of Ernst & Young for seventeen years. He later served as chairman of both Legg Mason Merchant Banking and Marsh Inc. *Id.*

112. *Id.*

113. Posting of "Bondboy" to *Blaming the Rating Agencies: Too Convenient*, http://seekingalpha.com/article/113687-blaming-the-ratings-agencies-too-convenient (Jan. 7, 2009, 19:33 EST). "Bondboy" writes that he worked in the bond business for approximately thirty years and is now retired.

classes that had never been through a down cycle.[114] Like the banks, investors, regulators, and the vast majority of economists, the CRAs honestly believed that the subprime RMBS were good investments. Like everyone else, the CRAs thought that mortgage defaults and home foreclosures would be captured in the most junior tranches of the securities, which were priced accordingly to reflect that risk. As a result, the CRAs cannot be blamed for failing to see the housing bubble for what is was, nor can they be blamed for failing to predict when the bubble would pop. The CRAs simply did their job in good faith using the little information available to them. As such, the CRAs differentiated themselves from pre-Sarbanes-Oxley auditors and do not need to be regulated in a similar fashion.

114. David Merkel, *Blaming the Rating Agencies: Too Convenient*, SEEKING ALPHA (Jan. 7, 2009), http://seekingalpha.com/article/113687-blaming-the-ratings-agencies-too-convenient.